

Bond Market Perspectives



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Stall Speed

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Highlights

Resurgent European debt fears and lower yields caused high-yield bond performance to stall recently.

Despite near-term challenges, we do not expect a repeat of last summer's weakness.

We continue to find high-yield bonds attractive for the full year, but investors should be aware of possible near-term turbulence.

First quarter earnings season, which has thus far seen S&P 500 companies produce a nearly 8% year-over-year earnings gain and increase revenues by 5%, illustrates that credit quality remains strong and helped support high-yield bond prices.

After a strong start to 2012, the high-yield bond market has stalled so far in May, as headwinds in the form of renewed European debt fears and near-record low yields on high-yield bonds have caused performance to slow. A good first quarter earnings season, which reinforced strong corporate credit quality trends, and steady mutual fund flows continue to provide lift (according to Lipper data), but high-yield bonds have been unable to increase altitude.

To its credit, the high-yield market has been resilient. The Barclays High-Yield Bond Index is up 0.3% month-to-date through May 14, 2012, compared to a 4.1% decline for the stock market as measured by the S&P 500 Index. First quarter earnings season, which has thus far seen S&P 500 companies produce a nearly 8% year-over-year earnings gain and increase revenues by 5%, illustrates that credit quality remains strong and helped support high-yield bond prices. Many high-yield companies have yet to report earnings, but the results so far indicate that corporate issuers' ability to service and repay debt remains very strong.

Insatiable Demand for Yield

The first four months of 2012 witnessed record inflows into high-yield mutual funds and Exchanged-Traded Funds (ETFs) according to Lipper data. While not a primary driver of performance, fund flows can have impact on the high-yield bond market. Bonds overall continue to see strong demand from individual investors (please see this week's *Weekly Market Commentary* for more details), and high-yield bonds have garnered their fair share of the inflows. In a low yield world, investors continue to seek high-yield bonds and that demand can provide a lift to the broader high-yield market.

European Turbulence

Over the past weekend, a coalition government failed to come together yet again in Greece, and German Chancellor Angela Merkel's Christian Democratic Union (CDU) party lost a regional election in Germany. Both events highlight growing anti-austerity sentiment in Europe. More importantly in Greece, the growing popularity of anti-bailout political parties increases the small risk of Greece exiting the Eurozone. While Greek government debt is priced to reflect such a scenario, it would be a first and the many unknowns could pressure high-yield bond prices lower.

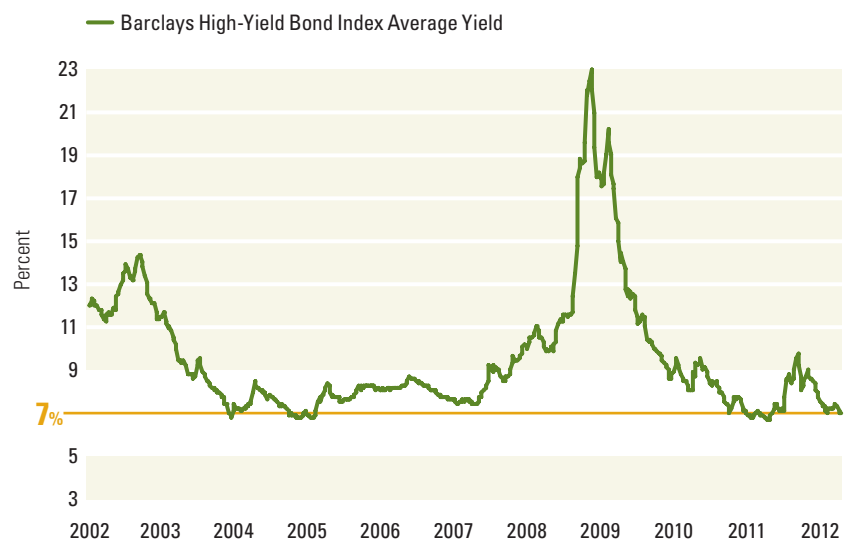


We believe U.S. banks are much stronger financially than their European counterparts, but a resurgence of bank fears could lead to illiquid trading conditions that could also pressure high-yield prices lower despite good fundamentals. In Spain, the government announced banks must put aside an additional €30 billion to offset losses from bad real estate loans and follows the government taking a 45% bailout-stake in Bankia, the country's third-largest bank by assets. The move is a modest positive but may not be enough, and a broader plan to recapitalize and shore up Spanish banks remains a work-in-process. Overall, the financial health of Spanish banks poses a manageable risk, in our view, but one that could still negatively affect global banks and adversely impact high-yield bond trading. A threat that may be compounded by looming downgrades from Moody's, which downgraded Italian banks, as expected, on Monday, May 14, 2012.

Yield Limbo

Aside from Europe, the average yield of high-yield bonds (as measured by the Barclays High-Yield Index) dipped below 7% in early May [Figure 1], a yield level that has historically led to waning demand for high-yield debt by most investors. The average yield has rarely dipped below 7% (as the figure illustrates) and perhaps is testament enough to how market participants are unwilling to push high-yield bond prices higher when the yield threshold is broken. In other words, high-yield bond prices have historically reached a ceiling when prices correspond to a sub-7% yield for the broad market. Part of this phenomenon is due to yield focused investors who simply shy away from buying high-yield bonds when the average yield fails to meet the 7% target bogey regardless of how good the underlying credit quality may be.

1 The Average **Yield** of High-Yield Bonds Fell Below 7% Briefly Last Week.



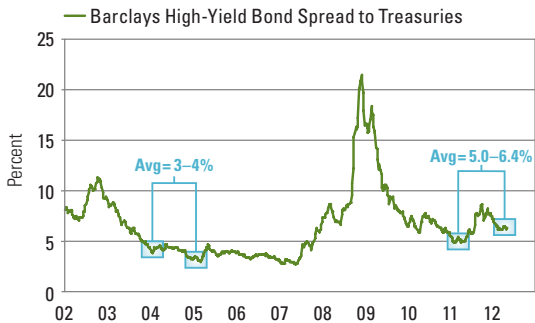
High-yield bond prices have historically reached a ceiling when prices correspond to a sub-7% yield for the broad market.

Source: Barclays, LPL Financial 05/11/12

The Barclays High-Yield Bond Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.



2 Current Valuations Are More Attractive Compared to Prior Yield Lows



Source: Barclays, LPL Financial 05/11/12

Spread is the difference between the bid and the ask price of a security or asset.

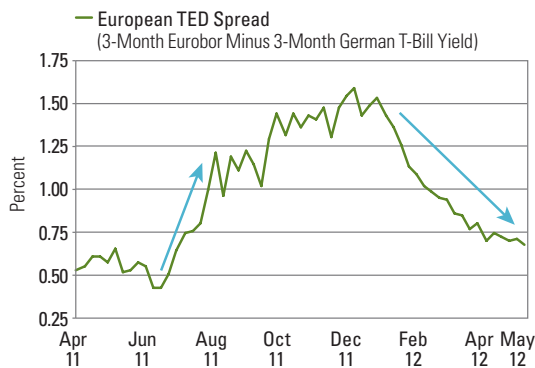
Of course, the big difference between the average yield now and prior sub-7% occurrences is valuations. High-yield bond valuations are more attractive now than prior episodes. In May of 2011, when the average yield on high-yield debt moved below 7%, the average yield advantage to Treasuries was 5.0% versus 6.4% as of May 14, 2012 [Figure 2]. In early 2004, late 2004, and early 2005—the last time the average yield was less than 7%—the average yield advantage to Treasuries varied between 3% and 4%, again much lower than today’s yield advantage or spread. The better valuations should provide a buffer if market conditions deteriorate.

No Expectation of a Summer Repeat

We do not expect a repeat of last summer’s weakness due to ample liquidity. The European Central Bank’s (ECB) three-year lending operations have infused cash into the banking system and helped keep bank funding risks in check. Despite the negative headlines from Europe, key measures of banking funding are showing no signs of strain, a sharp contrast to last summer. The yield differential between three-month Eurobor, a bank borrowing rate, and three-month German t-bill yields, a risk-free rate, remains near its narrowest level of the past year and continues to contract [Figure 3].

The high-yield bond market faces headwinds over the near-term. European debt issues along with lower yields may create near-term turbulence. More attractive valuations compared to prior periods when yields were at current levels. Ample liquidity should cushion any weakness and rule out a repeat of the summer 2011 sell-off. We still find high-yield bonds one of the more attractive fixed income options for the full-year but advise caution over the near-term. ■

3 Unlike Summer 2011, Bank Funding Strains Are Not Yet Evident



Source: Bloomberg, LPL Financial 05/14/12

The TED Spread measures the difference between 3-month LIBOR rate and the yield on 3-month Treasury bills. This is an effective measure of the liquidity available to banks. With bank capital adequacy near the center of the current crisis this is an important gauge of the stress in the banking system.



IMPORTANT DISCLOSURES

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

The Barclays Capital High Yield Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment-grade or high-yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds must also have at least one year to maturity, have at least \$150 million in par value outstanding, and must be U.S. dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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