Bond Market Perspectives

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Fixed Income Mid-Year Outlook

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Highlights

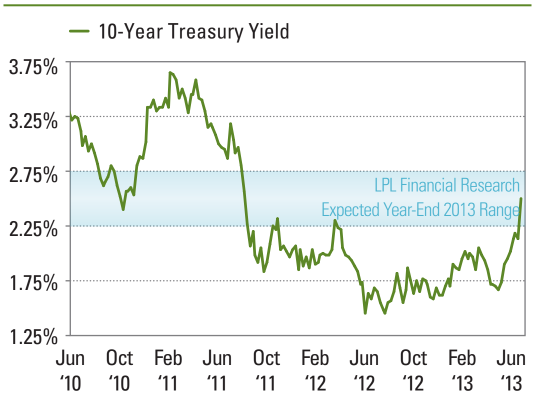
A tapering tantrum was the main driver of bond market weakness during the first half of 2013, producing the worst quarterly performance since 2004.

After rising notably over the first half of 2013, we expect bond yields to stabilize in a new, higher range.

Despite fears over Fed policy, several factors are likely to restrain an additional sharp and sustained rise in interest rates.

Given our expectation of stabilization in bond yields, we expect interest income to offset price declines and result in low single-digit returns for high-quality bonds over the second half of 2013.

1 Treasury Yields Likely To Finish 2013 in a New, Higher Range



Source: Bloomberg, LPL Financial 06/30/13

The bond market suffered through its worst quarterly performance since 2004 in response to the Federal Reserve (Fed) signaling it will reduce, or taper, the pace of bond purchases earlier in 2013 than anticipated. The economy also proved resilient to higher tax rates and government spending cuts. Both factors contributed to bond market weakness, but the "tapering tantrum" was the dominant driver during the second quarter of 2013, when the broad high-quality bond market, as measured by the Barclays Aggregate Bond Index, declined by 2.3% — the worst quarterly performance since the second quarter of 2004.

After rising notably over the first half of 2013, we expect bond yields to stabilize in a new, higher range as a result of an earlier start to the Fed removing stimulus and a greater reduction in bond valuations. We expect yields to finish the year in a new range, as defined by a 2.25–2.75% 10-year Treasury [Figure 1].

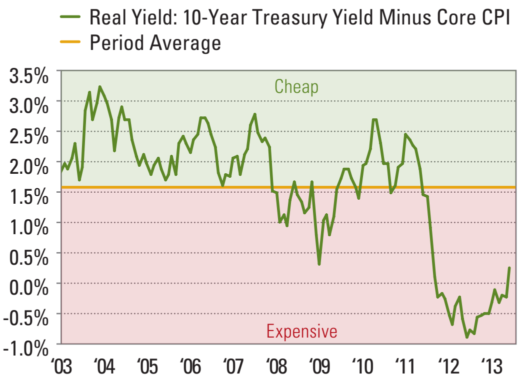
Despite fears over the potential change in Fed policy, several factors are likely to restrain an additional sharp and sustained rise in interest rates. These include:

- Sluggish economic growth of 2%;
- Low inflation; and
- The Fed remaining committed to keeping short-term interest rates near zero.

As a result, we expect recent bond market weakness to ease over the second half of 2013. Fears over an earlier-than-expected end to quantitative easing (QE) appear overdone, and a short-term opportunity in high-quality bonds may emerge, as yields may have shot too high given the factors outlined above. Should market concerns over a slower pace of Fed bond purchases subside, bond prices may rise and yields may decline. The last two times the Fed stopped QE, high-quality bond prices rose and yields declined.

Given our expectation of stabilization in bond yields, we expect interest income to offset price declines and result in low single-digit returns for high-quality bonds over the second half of 2013. Yields may rise higher in the event the Fed pursues a more aggressive reduction in QE and the economy continues to exhibit minimal harm from higher tax rates and reduced government spending. Although we place a lower probability on this outcome, the 10-year Treasury yield may rise to 2.75% or higher under that

2 Bond Valuations Remain Expensive by Historical Comparison



Source: Bloomberg, LPL Financial Research 06/28/13

3 Bond Weakness Was Broad Based During the Second Quarter

2013 Total Returns

Asset Class	Q2	YTD
Bank Loans	0.2	2.4
High-Yield	-1.4	1.4
Preferred Stocks	-2.2	0.4
Foreign Bonds (hedged)	-1.3	0.0
Mortgage-Backed Securities	-2.0	-2.0
Treasury	-1.9	-2.1
Municipal High-Yield	-4.1	-2.2
Barclays Aggregate	**-2.3**	**-2.4**
Municipal	-3.0	-2.7
Investment-Grade Corporate	-3.4	-3.6
Foreign Bonds (un-hedged)	-3.4	-7.1
TIPS	-7.1	-7.4
Emerging Market Debt	-6.1	-8.2

Source: Barclays Capital, JP Morgan, Citigroup, LPL Financial 06/30/12

Ranked by YTD Total Returns

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

All indexes are unmanaged. Past performance is no guarantee of future results. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment.

Asset Class Indexes: Bank Loans–Barclays US High-Yield Loan Index; High-Yield–Barclays US High Yield Corporate Index; Preferred Stocks–Merrill Lynch Preferred Stock Hybrid Index; Foreign Bonds (hedged)–Citigroup Non-US World Govt Bond Index Hedged for Currency; Mortgage-Backed Securities–Barclays US MBS Index; Treasury–Barclays US Treasury Index; Municipal High-Yield–Barclays Municipal High-Yield Index; Municipal–Barclays Municipal Bond Index; Invst-Grade Corporate–Barclays US Corporate Bond Index; Foreign Bonds (un-hedged)–Citigroup Non-US World Govt Bond Index (un-hedged); TIPS–Barclays Treasury Inflation Protected Securities Index; Emerging Market Debt–JP Morgan Emerging Markets Global Index.

scenario due to still higher-than-average bond valuations [Figure 2]. Such a result would likely translate to flat or negative total returns.

Questioning the Fed

A credibility issue between the bond market and the Fed developed during the second quarter, played a role in second quarter weakness, and may continue to pressure bond prices. The Fed appears singularly focused on labor market improvements while dismissing the other half of its dual mandate: price stability. Inflation decelerated over the first half of 2013 and would argue for continued bond purchases, but the Fed views the deceleration as a short-term aberration. The Fed also continues to dismiss sluggish economic growth, a classic driver of bond yields along with inflation. While the labor market improves, economic growth remains subpar with growth in the first quarter of 2013 recently revised lower to a 1.8% annualized rate and the second quarter on pace for a similarly lackluster growth rate.

Last Friday's stronger-than-expected June employment report continued the improving trend in the jobs market and produced a sharp single-day decline in the bond market, showing the market's continued sensitivity to Fed uncertainty. Much of the July 5, 2013 decline was reversed on Monday, July 8, 2013, but even though there is room for bond improvement, a return to first half 2013 highs in bond prices seems unlikely with the Fed focused on reducing bond purchases. How the Fed progresses toward an eventual exit will be a key focus for bond investors during the second half of 2013.

First Half Performance

Second quarter bond market weakness was broad based in response to Fed uncertainty [Figure 3]. Price declines were concentrated in May and June 2013, as the 10-year Treasury yield rose by 1% over a seven-week span, one of the sharpest rises in history for such a short period of time. Weakness was exacerbated in less liquid bond sectors such as municipal bonds, emerging market debt, preferred securities, and to a lesser degree, high-yield bonds. Municipal bonds suffered from the added forces of a supply deluge arising from significant new issuance and heavy secondary market selling. Emerging market debt also suffered from China and broader emerging market economic growth concerns.

Investing for the Second Half

For the second half of 2013, a focus on yield and intermediate-term bonds may help investors amid still-volatile interest rates. With relatively modest changes in prices ahead, yield will be a key driver of return in the second half of 2013. Strong corporate credit measures, such as interest coverage and debt-to-earnings ratios peaked in 2012, but witnessed only modest deterioration and remain strong relative to history. Flashes of why high-yield bonds are often referred to as "junk" were evident in some spurts of

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new bond issuance over the first half of 2013, but such activity was both minor and rare and nowhere near the degree witnessed just prior to the 2008 financial crisis. Valuations for both investment-grade corporate bonds and high-yield bonds cheapened over the past two months and offer an opportunity in a low-yield landscape.

More conservative investors may wish to consider bank loans, which weathered the storm of rising interest rates better than most sectors due to their short-term nature and lack of interest rate sensitivity. Although the yield disparity between bank loans and high-yield bonds has increased notably from a near-record narrow level, bank loans continue to offer an attractive yield without the interest rate sensitivity.

We remain focused on intermediate-term bonds, as we believe they continue to represent a solid combination of yield for a given level of interest rate risk.

Among high-quality bonds, municipal bonds were inordinately punished during the second quarter, and valuations have become much more attractive. However, lingering supply challenges suggest improvement may be slower to develop. A traditionally favorable summer seasonal period may take longer to shape up given lingering challenges, but demand has become more consistent recently due to higher taxable equivalent yields (over 7%).

We remain focused on intermediate-term bonds, as we believe they continue to represent a solid combination of yield for a given level of interest rate risk. Given our expectation of only a modest rise in interest rates, we believe short-term bonds come with too low of a yield to be attractive. Furthermore, should the economy falter or Fed bond-buying fears prove misguided, intermediate-term bond prices may increase more and provide better portfolio diversification benefits. Longer-term bonds offer only slightly higher yields in exchange for the potential of significantly larger losses if rates rise more than what we expect. ■

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free, but other state and local taxes may apply.

Treasuries are marketable, fixed-interest U.S. government debt securities. Treasury bonds make interest payments semi-annually, and the income that holders receive is only taxed at the federal level.

Debt-to-EBIDTA (earnings before interest, taxes, depreciation, and amortization) measures a company's ability to pay off its incurred debt.

Floating rate bank loans are loans issued by below investment grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

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.

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

Preferred stock investing involves risk, which may include loss of principal.

Inflation risk is the risk that unexpected changes in consumer prices will penalize an investor's real return from holding an investment. Because investments from gold to bonds and stock are priced to include expected inflation rates, it is the unexpected changes that produce this risk. Fixed income securities, such as bonds and preferred stock, subject investors to the greatest amount of purchasing power risk since their payments are set at the time of issue and remain unchanged regardless of the inflation rate.

This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

INDEX DESCRIPTIONS

The Barclays Capital Aggregate Bond Index is an unmanaged market capitalization-weighted index of most intermediate-term U.S. traded investment-grade, fixed rate, non-convertible and taxable bond market securities including government agency, corporate, mortgage-backed, and some foreign bonds.

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 US dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

The Barclays Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (Strips), or Treasury Inflation Protected Securities (TIPS).

The Barclays Corporate Index is an unmanaged index of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. The index includes both corporate and non-corporate sectors. The corporate sectors are industrial, utility, and finance, which include both U.S. and non-U.S. corporations. The non-corporate sectors are sovereign, supranational, foreign agency, and foreign local government. Bonds must have at least one year to final maturity, must be dollar-denominated and non-convertible, and must have at least $250 million par amount outstanding. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade.

The Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging markets debt. The index was created in 1986, with index history backfilled to January 1, 1983. The U.S. Corporate High Yield Index is part of the U.S. Universal and Global High Yield Indices.

The JPMorgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. It covers more of the eligible instruments than the EMBI+ by relaxing somewhat the strict EMBI+ limits on secondary market trading liquidityThe Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research. The index includes certain publicly issued, $25- and $100-par securities with at least one year to maturity.

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

The Barclays Capital High Yield Municipal Bond Index is an unmanaged index made up of bonds that are non-investment grade, unrated, or rated below Ba1 by Moody's Investors Service with a remaining maturity of at least one year.

The Citigroup Non-U.S World Government Bond Index (Un-hedged) is calculated on a market-weighted basis and includes all fixed-rate bonds with a remaining maturity of one year or longer and with amounts outstanding of at least the equivalent of U.S. $25 million. The Index excludes floating or variable rate bonds, securities aimed principally at non-institutional investors and private placement-type securities.

The Citigroup World Government Bond Index is a market-capitalization-weighted index consisting of the government bond markets. Country eligibility is determined based on market capitalization and investability criteria. All issues have a remaining maturity of at least one year.

The Barclays U.S. Treasury TIPS Index is a rules-based, market value-weighted index that tracks inflationprotected securities issued by the U.S. Treasury. The U.S. TIPS Index is a subset of the Global Inflation-Linked Index, with a 36.0% market value weight in the index (as of December 2007), but is not eligible for other nominal treasury or aggregate indices. In order to prevent the erosion of purchasing power, TIPS are indexed to the non-seasonally adjusted Consumer Price Index for All Urban Consumers, or the CPI-U (CPI).

The Barclays Mortgage-Backed Securities Index includes 15- and 30-year fixed-rate securities backed by mortgage pools of the Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), and Federal National Mortgage Association (FNMA).

The Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research. The Index includes certain publicly issued, $25- and $100-par securities with at least one year to maturity.

Core CPI is a subset of the total Consumer Price Index (CPI) that excludes the highly volatile food and energy prices. It is released by the Bureau of Labor Statistics around the middle of each month. Compare to Personal Consumption Expenditures (PCE); Core PPI; Producer Price Index (PPI).

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