LPL RESEARCH

BOND MARKET PERSPECTIVES

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HOT & COLD BONDS

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KEY TAKEAWAYS

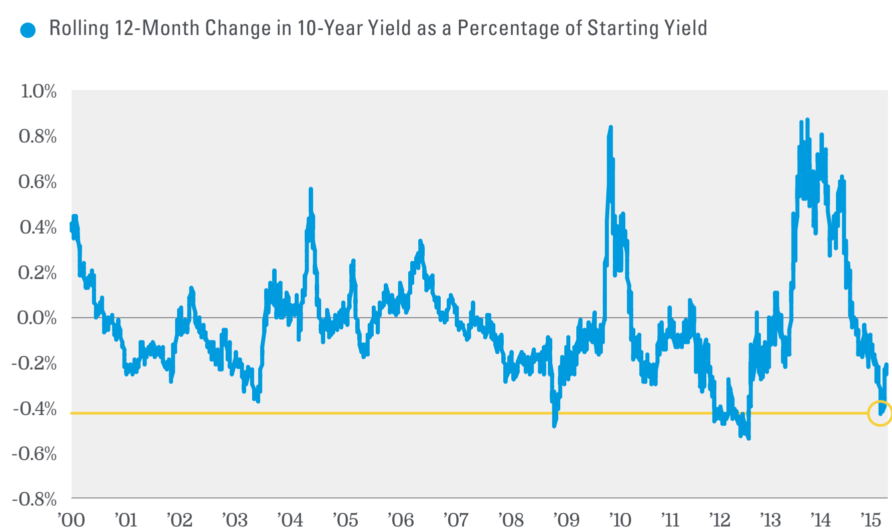
January 2015 was the best month for high-quality bonds since December 2008. In February 2015, high-quality bonds posted their worst monthly performance since June 2013 and the taper tantrum sell-off.

High-yield bonds experienced ups and downs thus far in 2015. After a muted January, high-yield bonds returned 2.4% in February, the largest single month gain since October 2013.

After a wild first two months, we expect more muted returns over the remainder of 2015.

The first two months of 2015 have been a case of Dr. Jekyll and Mr. Hyde for bond investors. January was the best month for high-quality bonds, as measured by the Barclays Aggregate Bond Index, since December 2008, with an impressive total return of 2.1%. On the other hand, February erased much of those gains, as high-quality bonds posted their worst monthly performance since the taper tantrum sell-off in June 2013, declining by 0.94%. As of the end of January 2015, the yield on the 10-year had fallen by over 40% over the prior 12 months [Figure 1]. Such an extreme is rare and has happened only two other times during the last 15 years: after the 2008 financial crisis and in 2012 in response the Eurozone crisis.

1 BONDS HAD REACHED AN EXTREME BY THE END OF JANUARY, SETTING UP FEBRUARY'S REVERSAL



Source: LPL Research, Bloomberg 02/27/15

All performance referenced is historical and is no guarantee of future results.

WILD RIDE

The wild ride of bonds is best illustrated by the 10-year Treasury yield [Figure 2]. When the dust settled, high-quality bonds finished up 1.14% on a year-to-date

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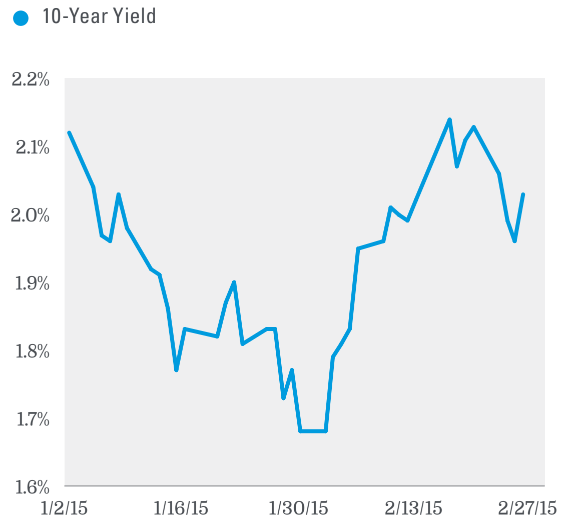
2 **THE WILD RIDE OF THE 10-YEAR TREASURY YIELD IN 2015**



Source: LPL Research, Bloomberg 03/02/15

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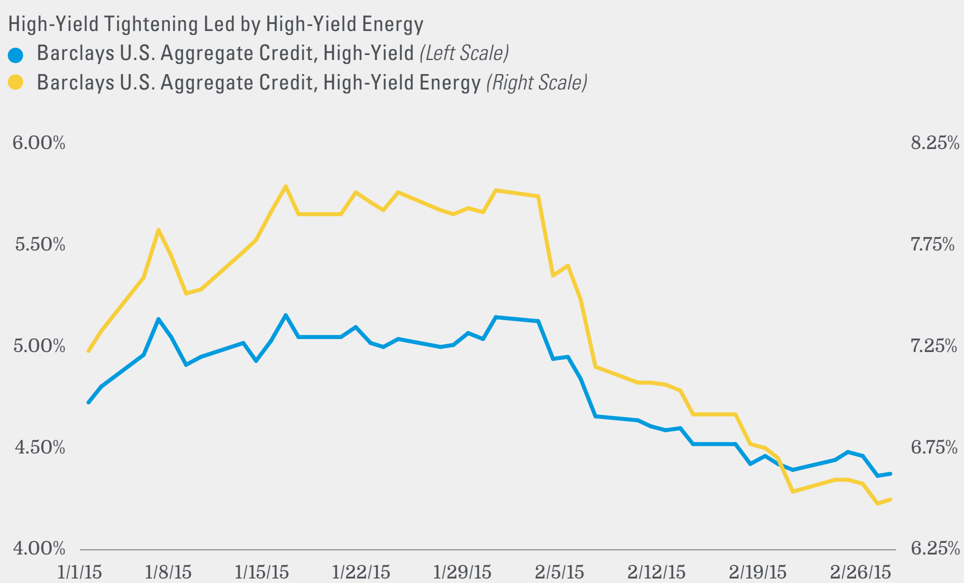
basis through the end of February, with prices still higher and yields lower for 2015.

NOT CONFINED TO HIGH-QUALITY BONDS

High-yield bonds experienced ups and downs as well thus far in 2015. After a muted January, high-yield bonds returned 2.4% in February, the largest single month gain since October 2013 (based on the Barclays U.S. High Yield Index). With oil prices stabilizing in 2015 after the dramatic decline in 2014, dire default predictions receded and yield spreads to comparable Treasuries contracted [Figure 3]. The strength of the energy sector and a relatively good earnings reporting season, which was all but completed by the end of February 2015, helped propel the overall high-yield bond sector higher after a soft start to 2015.

3 **AFTER WIDENING IN JANUARY, HIGH-YIELD SPREADS CONTRACTED QUICKLY IN FEBRUARY**



Source: LPL Research, Barclays Index data 03/02/15

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MORE TO COME?

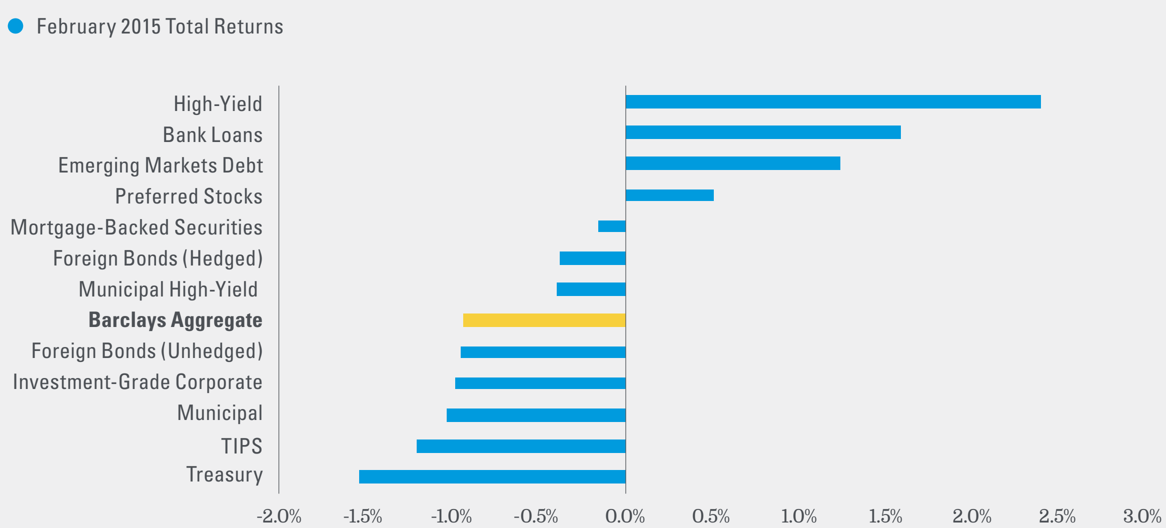
After two big swings, we believe the bond market is on more even footing. The sharp decline in Treasury yields in response to fears over a Greek exit from the Eurozone and overly pessimistic default fears from the high-yield energy sector has largely reversed. Although both of these factors will remain risks for investors in coming months, we believe pricing is more balanced. The risks, which are generally supportive of bond prices, are offset by the likely start of Federal Reserve (Fed) rate hikes later in 2015, and a resilient domestic economy that continues to expand at near 3%.

In the high-yield bond market, we find it unlikely that the sector returns to the highs of June 2014. The low in defaults may be in place, and the uncertainty over high-yield energy defaults could potentially restrain a full improvement back to June 2014 levels. While some modest, further price improvement is possible, interest income, not prices, will potentially be the main driver of return over the remainder of 2015.

SLOWDOWN

A slowdown in bond performance across the board may be the result of a hot and cold bond market [Figure 4]. Even after giving up some gains in February, high-quality bonds are still up a very respectable 1.14% year to date, which mathematically translates to a higher full-year return than we believe is likely. The pace of performance may possibly slow as interest rates gradually rise and prices soften in anticipation of Fed rate hikes and still firm economic growth. The same is true in the high-yield bond market where low yields may translate into mid-single-digit returns with little, if any, boost of additional price appreciation. After a wild first two months, we expect more muted returns over the remainder of 2015. ■

4 A STRONG JANUARY LED BONDS TO COOL OFF IN FEBRUARY



Source: LPL Research, Barclays Capital, JP Morgan, Citigroup 02/27/15

All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

Please see the disclosure page for index definitions and descriptions.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

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.

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.

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.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

INDEX DESCRIPTIONS

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

Barclays U.S. High-Yield Loan Index tracks the market for dollar-denominated floating-rate leveraged loans. Instead of individual securities, the U.S. High-Yield Loan Index is composed of loan tranches that may contain multiple contracts at the borrower level.

The Barclays U.S. Corporate High-Yield Index measures the market of USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

The Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC)

The Barclays U.S. Municipal Index covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

The Barclays Municipal High Yield Bond Index is comprised of bonds with maturities greater than one-year, having a par value of at least $3 million issued as part of a transaction size greater than $20 million, and rated no higher than 'BB+' or equivalent by any of the three principal rating agencies.

The Barclays U.S. Treasury TIPS Index is a rules-based, market value-weighted index that tracks inflation-protected securities issued by the U.S. Treasury.

The Barclays U.S. 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 BofA 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 Citi World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies, and has more than 25 years of history available. The WGBI provides a broad benchmark for the global sovereign fixed income market. Sub-indexes are available in any combination of currency, maturity, or rating.

The JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging markets countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

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