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MIDYEAR OUTLOOK 2016: BONDS STILL NOT A FRONT RUNNER

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KEY TAKEAWAYS

Investors face a challenging second half of 2016 after a strong start to the year.

Intermediate bonds, with an emphasis on mortgage-backed securities and investment-grade corporate bonds, provide the potential benefit of diversification and a favorable trade-off between yield and interest rate sensitivity.

This week's commentary features content from LPL Research's Midyear Outlook 2016: A Vote of Confidence, *published on July 12, 2016.*

Despite our revised forecast for low- to mid-single-digit returns (up from flat) in 2016, bond investors still face a low-return environment. The "good" news (for bonds) has been largely factored into current prices and absent signs of economic deterioration, further price gains, if any, may be limited. We expect the 10-year Treasury yield to finish the year roughly unchanged to 0.25% higher compared to a June 30, 2016 reading of 1.5%. An increase of 0.5% is certainly possible if the economy improves more than we expect over the second half of 2016, but tighter financial conditions due to Brexit may still mute the Fed's response. The 10-year Treasury yield is still likely on track to finish lower for all of 2016.

Given lingering questions about the global economy (especially post-Brexit) and the still large yield advantage of U.S. Treasuries compared to other high-quality government bonds overseas, high-quality bond demand is likely to stay elevated and limit potential weakness, if any. Our scenario analysis illustrates potential return outcomes over the final six months of 2016 and also shows that if stocks or the economy falter and yields decline further, high-quality bonds still play an important diversification role even at near-record low levels [Figure 1].

1 INVESTORS STILL FACE A LOW-RETURN ENVIRONMENT OVER THE SECOND HALF

Change in 10-Year Treasury Yield	-0.25%	0.00%	0.25%	0.50%
Total Return	3.00%	1.60%	0.20%	-1.20%

Source: LPL Research, Barclays Aggregate Bond Index 06/30/16

Scenario analysis is based on a return of 1.5% as of 06/30/16 for the 10-year Treasury yield, based upon a six-month time horizon, parallel shift in the yield curve, no change to yield spreads, and no reinvestment of interest income.

This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

Please see our *Midyear Outlook 2016: A Vote of Confidence* for in-depth insights on the economy, stock and bond markets, and investments for the second half of the year.

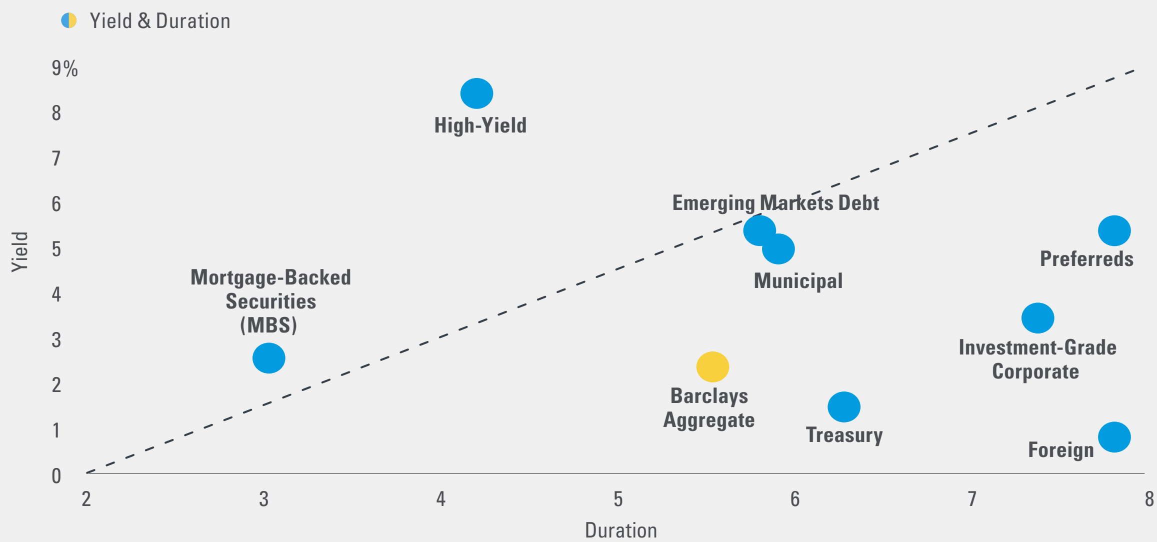
RISING TO THE CHALLENGE AMID LIMITED OPPORTUNITIES

In a world of limited opportunity, an emphasis on higher-quality bonds may be prudent until better value emerges. Specifically, mortgage-backed securities (MBS) may offer opportunity in a world of expensive alternatives. We find MBS valuations attractive after failing to match the pace of Treasury gains over the first half of 2016. The sector offers more yield per unit of interest rate risk (duration) than most other bond sectors [Figure 2].

In a low-yield world, the additional yield can help support returns while limited interest rate risk aids price stability. A backdrop of limited yield changes has historically been a tailwind for MBS and fits with the stable to slightly higher yield scenario we envision over the remainder of 2016. In 2015, a year with limited changes to Treasury yields, the Barclays U.S. Mortgage-Backed Securities Index outperformed the Barclays Treasury Index by 0.7%. A repeat may be unlikely, but the example is still valid in our view to illustrate the incremental difference MBS may potentially make given few attractive opportunities.

Combining MBS with investment-grade corporate bonds can help offset potential interest rate risk while still maximizing sources of income in today's market. With an average yield spread of 1.4% above comparable Treasuries, just above the 1.3% 20-year average, investment-grade corporate bond valuations are roughly fair to slightly more attractive than Treasury alternatives.

2 **MBS OFFER RELATIVE MORE POTENTIAL YIELD FOR A GIVEN LEVEL OF INTEREST RATE RISK**



Source: LPL Research, Barclays, BofA Merrill Lynch, JP Morgan, Citigroup 06/30/16

Asset class data shown are represented by the indexes listed in the Disclosure section.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

Past performance is not indicative of future results.

HIGH-YIELD STILL SLICK

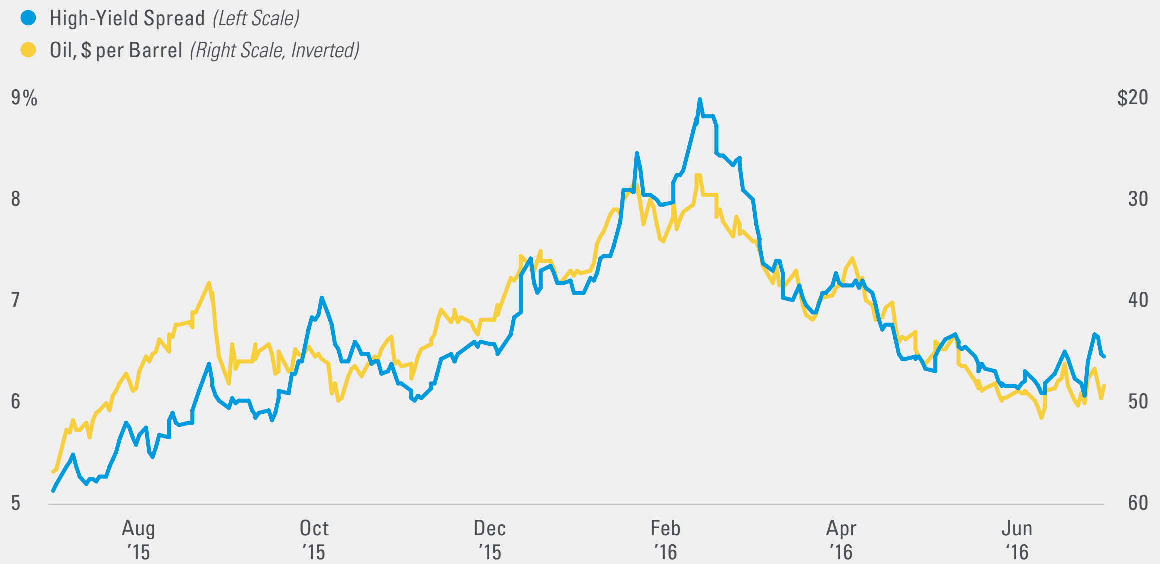
High-yield bond prices remain tightly linked to oil prices [Figure 3]. The average yield advantage, or spread, of high-yield bonds to comparable Treasury bonds has declined from over 9% in mid-February to under 6.5% as of June 30, 2016. (Note that bond yields and bond prices move in opposite directions.) The rise in oil prices since mid-February 2016 helped engineer the strongest four-month rally (mid-February to mid-June 2016) in high-yield bond prices since 2009 and the aftermath of the financial crisis. The rally pushed valuations into slightly expensive territory before Brexit-related weakness led to what we view as roughly fair valuations. Strength in oil prices has pushed high-yield bond prices higher than would be justified by fundamentals alone in our view. Defaults continue to rise, although the pace is decelerating. In today's low-yield world, a small allocation to high-yield bonds may be appropriate; but the sector's dependence on a single factor, oil, is a risk. ■

HOW TO INVEST: BONDS

Interest rate risk has diminished but a strong first half of 2016 and still higher valuations create a challenging investment environment. Amid historically low yields, intermediate bonds, with an emphasis on mortgage-backed securities and investment-grade corporate bonds, provide diversification benefits and a favorable trade-off between yield and interest rate risk. Municipal bond valuations have also richened in 2016, but the tax-exempt benefit of municipal bonds is still not fully accounted for in current prices and they remain attractive on a long-term basis compared to high-quality taxable alternatives.

Above-average yields and fair valuations on high-yield bonds can aid income generation and return. We avoid developed international bonds, which have benefited greatly from extraordinary central bank policy moves. Lower yields and higher valuations relative to U.S. counterparts, coupled with currency risk, offer limited value.

3 **HIGH-YIELD BONDS AND OIL PRICES REMAIN TIGHTLY LINKED**



Source: LPL Research, Bloomberg 06/30/16

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

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings and risk.

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.

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.

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Investing in foreign and emerging markets debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards.

Asset classes represented: Treasuries: Barclays U.S. Treasury Index; Mortgage-Backed Securities: Barclays U.S. MBS Index; Investment-Grade Corporate Bonds: Barclays U.S. Corporate Bond Index; High-Yield Bonds: Barclays U.S. Corporate High-Yield Bond Index; Municipals: Barclays Municipal Bond Index; Emerging Markets Debt: JP Morgan Emerging Markets Global Index; Foreign Bonds: Barclays Global Aggregate ex-USD Index; Preferreds: The BofA Merrill Lynch Preferred Stock Hybrid Securities Index.

INDEX DEFINITIONS

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).

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 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. 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. 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 rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging markets debt.

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 long and the short are subindexes of the Municipal Bond Index, based on duration length.)

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 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.

The Barclays Global Aggregate ex-USD Index is an unmanaged index considered representative of bonds of foreign countries.

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