LPL RESEARCH

BOND MARKET PERSPECTIVES

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IG CORPORATE BONDS—WHAT NOW?

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KEY TAKEAWAYS

Investment-grade (IG) corporate bonds are performing well year to date, beating most fixed-income asset classes with the exception of lower-rated and higher risk segments of fixed income.

The Bloomberg Barclays U.S. Aggregate Corporate bond spread relative to U.S. Treasuries is narrow relative to history, so excess returns from tighter spreads may be harder to come by than earlier in 2016.

Supply has been robust with five consecutive years of new issuance above $1 trillion per year, well above the average yearly supply from 1996 to 2011 of $650 billion, which could weigh on the secondary market.

Investment-grade (IG) corporate bonds were not spared from the selloff that occurred in fixed-income assets since the U.S. election on November 8, 2016. Year to date, however, they are outperforming the broader bond market as measured by the Barclays U.S. Aggregate Bond Index by 2.9%. Only the more risky, lower-quality segments of the bond market such as high yield, emerging market debt, and bank loans indices have been able to beat the 5.0% return of the Bloomberg Barclays U.S. Corporate Index year to date.

LOOKING FORWARD

The demand for bonds from international buyers seeking positive yields has been robust all year; as central banks in the Eurozone and Japan drove their yields lower with corporate bond buying programs, investors reached for the yield and relative safety of investment-grade U.S. corporate bonds. This demand, coupled with proposed corporate tax cuts discussed by the President-elect, has the potential to be beneficial to corporations and the sector moving forward. Additionally, rising interest rates may serve to reduce supply, as higher rates make it more costly to issue new bonds in the market. These factors are net positives for IG corporates, but it's important to realize the sector faces short-term headwinds. These include the sector's elevated interest rate sensitivity, the tight spreads (additional compensation investors receive for investing in bonds that are riskier than U.S. Treasuries) relative to U.S. Treasury bonds, and the record supply brought to market from 2010 through 2016 potentially weighing on the secondary market. As with any investment, risk cannot be eliminated entirely, but careful diversification that includes an allocation to IG corporate bonds may help suitable investors manage volatility.

DURATION PROFILE

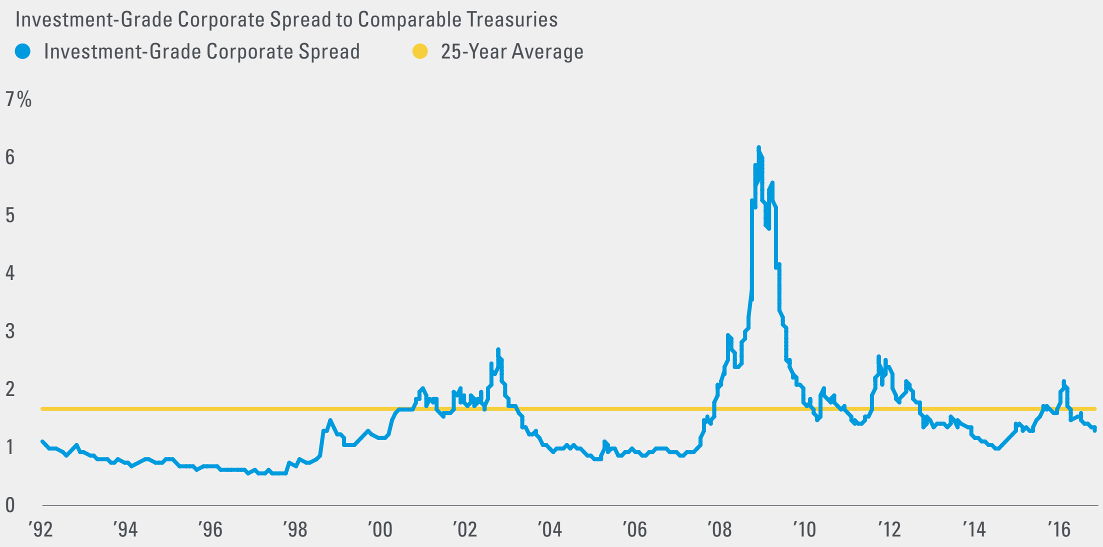
The IG corporate bond market is more interest rate sensitive than the broad bond market. The duration of the Barclays U.S. Corporate Bond Index, at 7.3 years, is longer than the Barclays U.S. Treasury Bond Index at 6.1 years and longer than the broad bond market, represented by the Barclays U.S. Aggregate Bond Index at 5.9 years. Duration is a measure of the price sensitivity of a bond to changes in interest rates. For example, in the case of the IG index with a duration of 7.3 years, for every increase in interest rates of 1%, the index would fall 7.3% in price. When dissecting the performance of individual bond sectors over the last four weeks, duration was the main driver of underperformance. The Bloomberg Barclays U.S. High Yield Index, with its duration of 4.2 years and lower average credit quality relative to the IG index, outperformed the high-quality IG index by 4.2% (-2.8% vs. 1.4%). Not only is high yield's duration shorter by three years, its yield per duration (yield of the index divided by its duration) is much higher at 1.25% versus the investment-grade index at 0.46%. Generally, the higher the number, the more investors are compensated with yield per unit of interest rate risk. This risk can be addressed by shortening the duration of IG corporate exposure until fixed-income markets stabilize.

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.

WHAT'S IN A SPREAD?

IG corporate bonds, like other high-quality bonds, depend on the creditworthiness of the issuing company. Bonds within the IG corporate bond universe are issued by a corporation and are investment grade, meaning they are rated by

1 IG CORPORATE BOND SPREADS TO COMPARABLE TREASURIES ARE BELOW LONG-TERM AVERAGE



Source: LPL Research, Bloomberg 12/12/16

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 credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market.

Performance is historical and no guarantee of future results.

rating agencies at Baa3/BBB-/BBB- or higher. Because of this, there is some degree of risk that the corporation may not be able to pay back the debt. Although IG defaults are low (less than 0.1% per year over the last 30 years) they do occur, and investors tend to buy corporate bonds with lower prices than comparable U.S. Treasury bonds to compensate for the additional risk. This compensation comes in the form of additional yield and is known in the market as a credit spread. During periods of high risk such as in 2007 and 2008, investors demanded more yield for the higher perceived risk of defaults. At the height of the financial crisis in December 2008, corporate bond spreads were 6.2% [Figure 1]. Since then, credit spreads have tightened substantially and investors have driven yields lower by buying corporate bonds at a record pace. The current spread for the index is 1.27%, well below the 1.63% 25-year average.

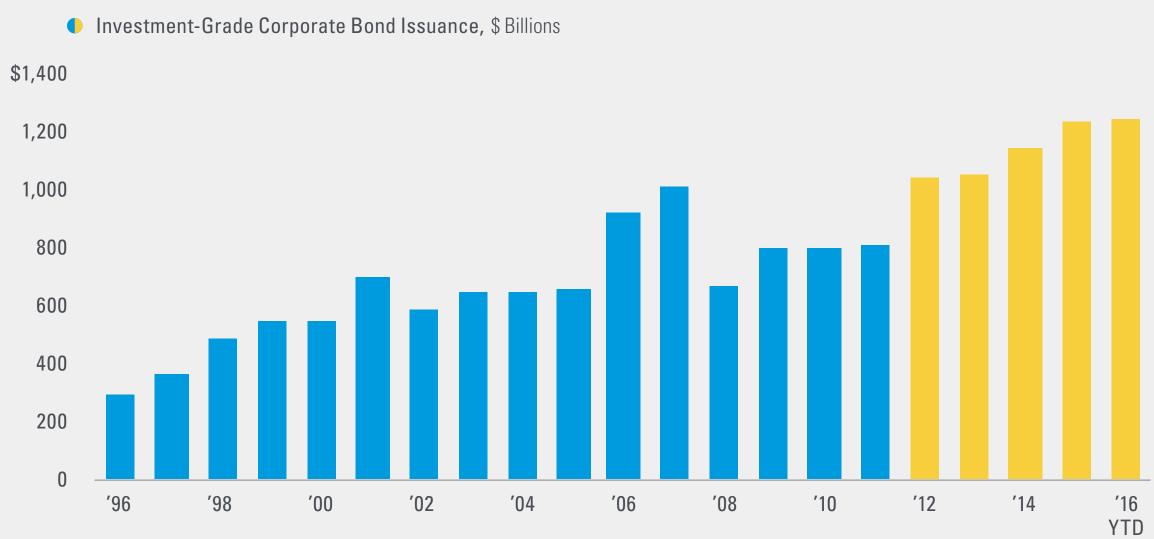
SUPPLY/DEMAND

According to data from the Securities Industry and Financial Markets Association (SIFMA), a widely recognized provider of issuance data, U.S. corporate bond issuance averaged $650 billion from 1996 through 2011. In 2012, investors were clamoring for yield and demand was high at wider than historical spreads (IG corporate spreads started 2012 at 2.33% and averaged 1.78% over the course of the year). Issuers answered the increased appetite for IG corporate bonds with five consecutive years of over $1 trillion in new supply. In addition, issuers extended their average maturity of their new debt from 13 years in 2011 to 17 years in 2016. Locking in lower rates for longer made financial sense and also freed up cash flows for operations, perhaps even allowing for stock buy-backs.

For now the supply is placed in investors' hands, but if interest rates spike substantially higher then

The credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

2 IG CORPORATE ISSUANCE OVER LAST FIVE YEARS IS ELEVATED RELATIVE TO HISTORY



Source: LPL Research, Securities Industry and Financial Markets Association (SIFMA). As of 12/12/16.

2016 – YTD reflects issuance through 11/30/16.

liquidity could become an issue as investors all attempt to sell simultaneously. This is not our base case scenario, as we are expecting more demand from foreign investors as the European Central Bank (ECB) agreed to continue its bond buying program. Central bank buying in Europe may crowd other investors out and push them to U.S. markets. Also, the President-elect's proposed corporate tax cuts could reduce new issue supply as corporations would have additional cash flow from lower taxes and may not want to tap the new issue market at higher interest rates.

CONCLUSION

In conclusion, suitable investors can address interest rate sensitivity by buying shorter-duration IG corporate bonds, which target an average duration of three to five years. Supply could be manageable, if proposed lower corporate tax rates reduce the need to issue bonds overseas. Additionally, this may also add to IG corporate credit quality as corporations would have additional capital available to invest in new products and services. Dual effects of reducing defaults and supply may be a long-term positive for the sector. Risks exist: a potential selloff in U.S. equities, which could drag down the high yield corporate bond sector and hurt longer duration IG corporates. Well diversified investors, however, with shorter than benchmark duration, may be able to manage this risk and potentially buy bonds at wider spreads. We remain generally constructive on IG corporates but will be following events especially related to the risks mentioned above. ■

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.

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.

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 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. These risks are often heightened for investments in emerging markets.

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. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

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.

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).

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. 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. 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.

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