LPL RESEARCH
BOND MARKET PERSPECTIVES

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Q1 RECAP: STRONG START

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KEY TAKEAWAYS

Almost all fixed income sectors posted positive returns in the first quarter of 2017 — a strong start to the year.

A flattening yield curve was a tailwind for longer-maturity fixed income, as a Fed rate hike pressured shorter-term yields higher.

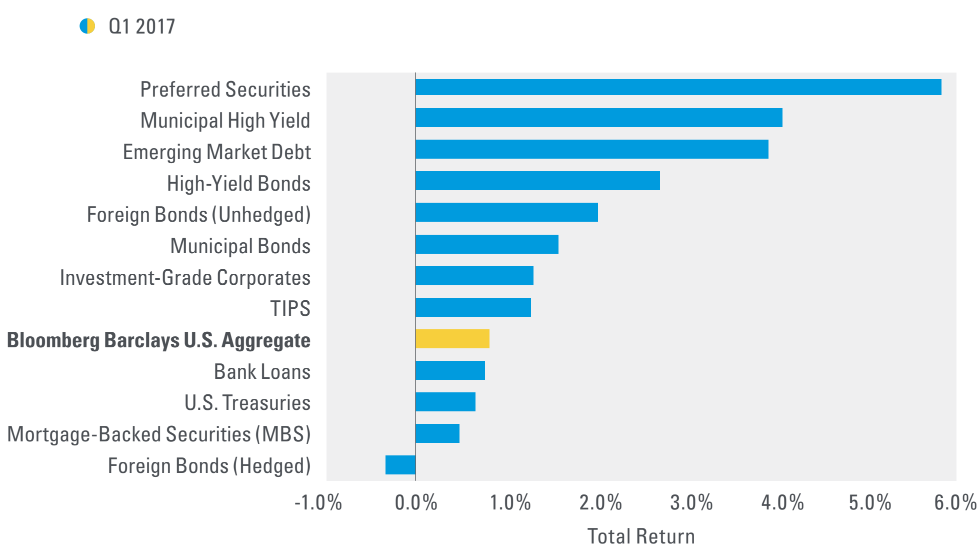
Economically sensitive, lower-quality fixed income had another strong quarter, but may have set an unsustainable pace for the year.

Fixed income is off to a good start in 2017, with almost all sectors in positive territory for the year at the end of the first quarter. It was in many ways a reversal of the fourth quarter of 2016, with some election-driven trades unwinding, as longer-duration fixed income benefitted from markets that may have overshot their landing in the fourth quarter of 2016 [Figure 1].

THE UNDERDOG WINS AGAIN: LONGER DURATION

Talk of rising rates has understandably led investors to remain underweight interest rate sensitivity (duration) relative to the Bloomberg Barclays Aggregate Bond Index, a broad fixed income benchmark, a prudent strategy given the improving economic backdrop and upward trending inflation. Despite that, longer-duration fixed income was actually a relative winner in the first quarter.

1 **LOWER-QUALITY AND LONGER-DURATION FIXED INCOME FARED BEST IN THE FIRST QUARTER**



Source: LPL Research, FactSet 03/31/17

Indexes referenced are: BofA Merrill Lynch Hybrid Preferred Securities Index, Bloomberg Barclays High Yield Municipal Bond Index, JPMorgan EMBI Global Index, Bloomberg Barclays US High Yield Index, Citigroup World Government Bond Index Unhedged, Bloomberg Barclays Municipal Bond Index, Bloomberg Barclays US Aggregate Credit Index, Bloomberg Barclays US Treasury Inflation Protected Notes Index, Bloomberg Barclays US Aggregate Bond Index, S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US Aggregate Government Treasury Index, Bloomberg Barclays US Aggregate Securitized MBS, Citigroup World Government Bond Index Hedged.

All indices are an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

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For example, the Bloomberg Barclays U.S. Treasury Index (duration of 6.1 years) returned 0.7% during the quarter, while the Bloomberg Barclays U.S. Long Treasury Index (duration of 17.2 years) returned 1.4% during the same period.

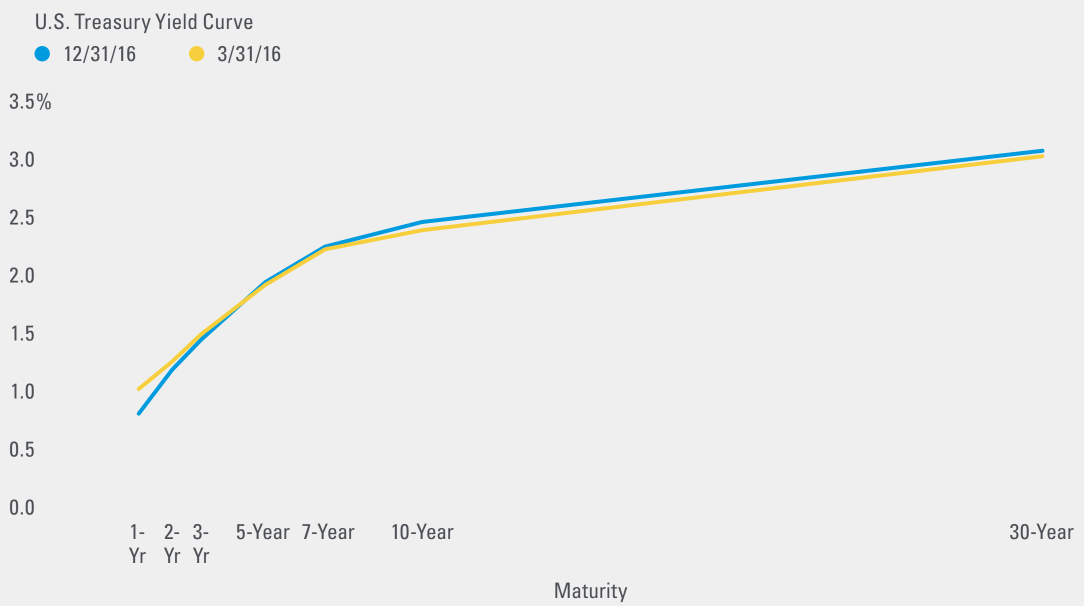
Longer-term interest rates were slightly lower during the quarter, despite the Federal Reserve (Fed) rate hike on March 15, 2017, which was mainly expressed via higher short-term interest rates. This led to a modest flattening of the Treasury yield curve over the quarter [Figure 2].

While longer duration benefitted fixed income investors in the first quarter of 2017, we maintain that moving far out in the yield curve is generally not worth the interest rate risk that investors must assume. In our March 14, 2017 *Bond Market Perspectives*, "Finally, Higher Yields in Shorter Maturities," we discussed the potential for investors to stay in the intermediate section of the yield curve without sacrificing much yield relative to longer maturities and without taking on substantially more interest rate risk in the process.

TRUMP TRADES RECOVER

It is no coincidence that two of the hardest hit fixed income sectors post-election, preferreds and municipal high yield, were the two best performing sectors in the first quarter of 2017. Preferred shares were hurt late last year as longer-term rates skyrocketed post-election, leading to a continuation of downward pressure on preferreds that had begun in mid-2016. In the first quarter of 2017, preferreds benefitted from stabilization in longer-term interest rates and from a positive outlook on the financial sector due to anticipated deregulatory policies from the Trump administration. Despite financials' underperformance relative to the broad equity market post-Fed rate hike (March 15–March 31, 2017), preferreds continued their recovery and are currently trading approximately where they peaked in mid-2016.

2 FED RATE HIKE AND MODERATING GROWTH EXPECTATIONS LED TO A FLATTER YIELD CURVE



Source: LPL Research, Bloomberg 04/03/17

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt.

MUNICIPAL MOMENTUM

With a return of 4.1% over the first quarter, high-yield municipals have recovered partially from their election-driven sell-off in the fourth quarter of 2016 (-5.8%), benefiting from a compelling yield of 6.25% (a 10.34% taxable-equivalent yield assuming a 35% tax rate). Much of the yield advantage is derived from a longer duration profile, which worked well during the first quarter due to flattening of the yield curve. In addition to compelling yields, default risk, a key variable in determining price volatility, remains subdued and appears unlikely to pose a notable risk in 2017. A well-diversified portfolio with exposure to shorter-term high yield may help manage volatility risk moving forward. Outside of high yield, reduced supply and compelling taxable-equivalent yields drove high-quality municipal outperformance relative to Treasuries during the quarter.

FOREIGN BONDS: A DOLLAR AND DIFFERENTIAL STORY

Foreign yields pressed higher during the first quarter of 2017, leading to a -0.4% return for currency-hedged foreign bonds. Unhedged foreign bonds, however, benefitted from the dollar's 1.8% decline during the quarter and returned 2.0%. The yield differential between the 10-year U.S. Treasury and the 10-Year German bund hit its all-time high of 2.36% on December 27, 2016. That elevated differential could only stand for so long as investors migrated out of foreign bonds and into Treasuries to capitalize on the higher domestic yields. That differential fell to end the first quarter at 2.06% [Figure 3].

LOWER-QUALITY FIXED INCOME CONTINUES TO CLIMB

Gradually higher-trending equity markets in the first quarter continued to be a tailwind for lower-quality,

3 TREASURIES' YIELD ADVANTAGE TO BUNDS FELL DURING Q1 AFTER HITTING ALL-TIME HIGH

Source: LPL Research, Bloomberg 04/03/17

Performance is historical and no guarantee of future results.

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more economically sensitive segments of fixed income. High yield and emerging markets debt (EMD) benefitted from ongoing spread tightening throughout the quarter. Equity market hesitation in the first two weeks of March 2017 proved to be a greater headwind for high yield than EMD. High yield valuations hit their richest level since mid-2014 in early March, falling to a spread of 3.4%, before widening out above 4%, then moderating to end the quarter at 3.8%. Based on the low default forecasts for this year, we still believe high yield investors could potentially enjoy a mid-single-digit return for the year, but valuations remain elevated and the price of oil and equity market volatility remain important drivers of the asset class.*

Bank loans underperformed high yield during the quarter, with the Bloomberg Barclays High Yield Loan Index returning 0.8%, in line with the Bloomberg Barclays Aggregate. It should be noted that there are differences within bank loans indexes, and the Credit Suisse Leveraged Loan Total Return Index returned 1.2%, outperforming the Aggregate on the quarter. Libor (the London Interbank Offered Rate) continued to grind higher throughout the quarter, benefitting bank loans whose floating rates are tied to the global reference rate. The par nature of the market, where loans can be called at par at any time, created a headwind for the sector as continued demand caused a fair amount of repricing during the quarter.

LIBOR

London Interbank Offered Rate (Libor) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market.

The Libor is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

CONCLUSION

Fixed income has started off 2017 on solid footing, with almost every sector of the market posting a positive total return during the first quarter. A flattening yield curve led to longer duration outperforming short. Lower-quality, economically sensitive segments of the market posted another strong quarter of returns. These are not necessarily the trends that we think will continue through the remainder of the year, however. With long-term rates near the bottom of their respective ranges, long-duration fixed income could come under pressure throughout the year as growth and inflation build. We expect economically sensitive fixed income like high yield to remain stable as the economic expansion continues, but believe they will be hard pressed to continue the spread tightening that has powered returns since February 2016, as valuations are already on the expensive side of fair value. ■

*As noted in our *Outlook 2017: Gauging Market Milestones*, we believe interest payments will drive the majority of high-yield's return, similar to high-quality fixed income. Given that, we anticipate mid-single-digit returns driven by interest income for high-yield bonds.

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.

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

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 rates rise. Interest income may be subject to the alternative minimum tax. Federally tax free but other state and local taxes may apply.

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.

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

INDEX DESCRIPTIONS

The Barclays High Yield Bond 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, and 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 nonconvertible. Bonds issued by countries designated as emerging markets are excluded.

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

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 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 Bloomberg Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

The Bloomberg Barclays High Yield Municipal Bond Index measures the performance of the high yield municipal bond market. To be included in the index, bonds must be rated non-investment-grade (Ba1/BB- or lower) 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 non-investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark. On August 24, 2016, Bloomberg acquired the Barclays fixed income benchmark indices from Barclays. Barclays and Bloomberg have agreed to co-brand the indices as the Bloomberg Barclays Indices for an initial term of five years.

The Credit Suisse Leveraged Loan index tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

The 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-indices are available in any combination of currency, maturity, or rating.

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