LPL RESEARCH
BOND MARKET PERSPECTIVES

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YEARNING FOR YIELD

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KEY TAKEAWAYS

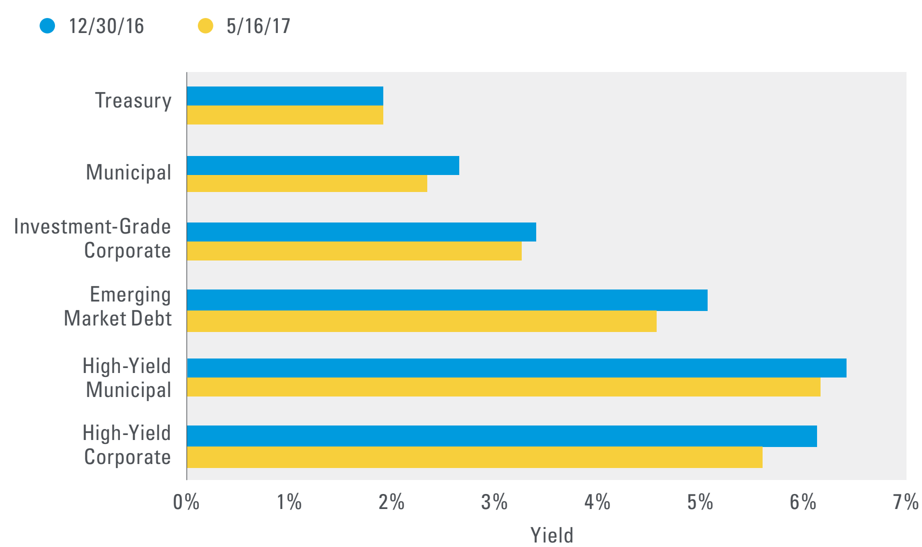
With Treasury yields still near record lows, income can be hard to come by, but opportunities in fixed income still exist for income-oriented clients.

Expensive valuations across many lower-quality fixed income sectors warrant caution when looking for income.

Lower-quality fixed income will generally not behave like high quality, especially in times of market stress; the economic sensitivity exposes investors to more equity sensitivity.

The post-election pickup in growth and inflation expectations brought high-quality bond yields along for the ride, weakening longer-duration bond prices but providing some relief for income-seeking investors. Some of that uptick in yields has unwound over the first five months of 2017 as economic activity slowed and exuberance about pro-growth policy waned [Figure 1].

1 YIELDS HAVE FALLEN FOLLOWING THE POST-ELECTION RUNUP



Source: LPL Research, Bloomberg 05/16/17

Indexes: Bloomberg Barclays U.S. Treasury Index, Bloomberg Barclays Municipal Bond Index, Bloomberg Barclays Capital U.S. Corporate Index, Bloomberg Barclays EM USD Aggregate, Bloomberg Barclays Capital High Yield Municipal Bond Index, Bloomberg Barclays U.S. Corporate High Yield

All Bloomberg Barclays indexes mentioned herein are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

LPL Research's *Search for Income* publication is a quarterly guide to our top ideas for income-producing securities and strategies. Due to the income focus of the document, the ideas may differ from our overall strategy as seen in the *Portfolio Compass* publication. The *Search for Income* offers active and passive income suggestions from our current mutual fund Recommended List, along with suggested exchange-traded products (ETPs). This piece will sample content from the latest *Search for Income*.

With high-quality bond yields still low, investors must go either out to longer maturities or down in quality to find meaningful yields. In general, we prefer to look domestically for income-generating investments given the more favorable economic backdrop, which should continue to support credit quality. Currently, our best ideas for potential income generation are:

- High-yield bonds (taxable and tax-free)
- Bank loans (floating rate funds)
- Preferred stocks
- Investment-grade corporate bonds (intermediate and long term)
- Emerging market debt (EMD)

ASSET CLASS IDEAS

Corporate High-Yield Bonds

The average yield of the high-yield bond market, based on the Bloomberg Barclays High Yield Index, has declined during 2017 to 5.6% as of May 16, 2017, down from 6.1% to end 2016 and well below the 20-year average of 9.1%. The yield fell to a multi-year low of 5.5% in early March, the index's lowest yield since September 2014.

Municipal High-Yield Bonds

Investors, regardless of tax bracket, may wish to consider municipal (tax-free) high-yield bonds. The average yield of tax-free, high-yield bonds is 6.2%, according to the Bloomberg Barclays High-Yield Municipal Index (as of May 16, 2017), which is higher than that of the taxable high-yield market. This translates to a compelling taxable equivalent yield of 10.2% (assuming a 39.6% tax rate). Because of the diversity of the municipal high-yield market, many securities may not yield this much. Though municipal defaults remain low and concentrated in certain problem areas, the sector carries elevated interest rate risk, evidenced by very weak performance in late 2016.

Floating Rate Bank Loans

The yield of bank loans rose to 6.3% as of March 31, 2017, based on the Credit Suisse Leveraged Loan Index. Although high yield has historically yielded more than bank loans, the opposite has been true since December 2016 with bank loans leading in yield. That yield disparity became larger during the first quarter of 2017, with bank loans ending the quarter yielding 0.4% more than high-yield bonds, up from 0.2% to end 2016. Based on this metric, this makes bank loans more attractive relative to high yield compared with the end of 2016. Bank loans have historically exhibited less volatility than high-yield bonds, and therefore, may be a better option for more conservative investors in search of yield within lower-quality fixed income.

Preferred Stocks

We still believe the sector can be used as a potential income generator in today's fixed income environment, but caution is warranted, due to the sector's high interest rate sensitivity and equity market sensitivity. Average yields declined from 4.9% to end 2016 to 4.7% as of May 16, 2017, based on the BofA Merrill Lynch Adjustable Rate Preferred Securities Index. The diverse nature of the preferred market means that yields may vary depending on the specific investment product utilized.

Investment-Grade Corporate Bonds

Investment-grade corporate bond yields remain historically low, but the asset class continues to be an option for income-oriented investors seeking higher-quality bonds. As of May 16, 2017, the average yield of investment-grade corporate bonds was 3.2%, below the 3.4% yield at the end of 2016. Such yield levels may not be exciting, but yields vary depending on the specific investment used. We believe investment-grade corporate bonds can still be used as an income-producing option in fixed income markets, considering historically low Treasury and mortgage-backed securities (MBS) yields.

Emerging Market Debt

The average EMD yield of 4.5% as of May 16, 2017 (based on the Bloomberg Barclays EM USD Aggregate Index), though below its 5-year average of 5.1%, stands out in a low-yield world. The challenging environment for bonds overall may provide headwinds, as might lingering concerns over the pace of global economic growth, commodity-related weakness, or removal of central bank accommodation. Protectionist trade policies are a new risk to the asset class that must continue to be monitored.

CONCLUSION

The decline in high-quality yields in the first five months of the year on the heels of a post-election runup has frustrated income-oriented investors, but pockets of opportunity for income remain. In general, investors must take on additional risk (above intermediate-term high-quality bonds) in the form of interest rate risk, credit (default) risk, or equity sensitivity to capture significant yield. Each of the asset class ideas discussed above is a unique income opportunity, but also comes with unique risks. The *Search for Income* dives deeper into the nuances involved with each segment listed. ■

INDEX DEFINITIONS

The Bloomberg 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 Bloomberg 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.

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

The Bloomberg 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 Bloomberg Barclays U.S. Corporate Investment Grade Index measures 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 Bloomberg Barclays Emerging Markets USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate US dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. Country eligibility and classification as Emerging Markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classifications. This index was previously called Barclays US EM Index, and history is available back to 1993.

BofA Merrill Lynch Adjustable Rate Preferred Securities Index tracks the performance of adjustable-rate US dollar denominated preferred securities issued in the US domestic market.

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+.

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