LPL RESEARCH

BOND MARKET PERSPECTIVES

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THE LOST YEAR

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KEY TAKEAWAYS

The broad high-quality bond universe has produced a slightly negative return over the last year due to a pickup in rates from the depressed levels of last summer.

Even with the headwinds, there have been pockets of success over the last year and opportunities remain.

Despite the potential for ongoing pressure in high-quality fixed income, it remains a critical tool in diversified, balanced portfolios.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

Over the last year, the broad, high-quality Bloomberg Barclays U.S. Aggregate Bond Index has given investors a total return of -0.2% (as of August 4, 2017). This may leave some investors frustrated, scratching their heads, and questioning their high-quality fixed income allocations. Despite the tough previous year, there were pockets of outperformance, even within high-quality fixed income, and opportunities remain. Additionally, we maintain our belief that high-quality fixed income plays a vital diversification role within balanced portfolios.

HOW DID THIS HAPPEN?

Rates became very depressed in summer 2016 on concerns over weak growth, evidenced by soft GDP figures in the first two quarters of 2016, and weak inflation, with year-over-year CPI falling to 0.8% on July 31, 2016. Yields abroad also pressured domestic rates lower, as the German 10-year government bond bottomed at -0.19% on July 8, 2016. A pickup in domestic growth and inflation

1 YEAR-OVER-YEAR RISE IN YIELDS HAS PRESSURED HIGH-QUALITY FIXED INCOME

Source: LPL Research, Bloomberg 08/07/17

Past performance is no guarantee of future results.

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expectations, and global yields, has helped push the 10-year U.S. Treasury yield significantly higher since a year ago, up 76 basis points (0.76%) from August 4, 2016 to August 4, 2017 [Figure 1]. This rise has put pressure on high-quality, longer-duration fixed income, contributing to the slightly negative total return for the broad high-quality bond market over the last year.

POCKETS OF OPPORTUNITY

There have been pockets of relative success over the last year, however. The three largest segments of the Bloomberg Barclays Aggregate are Treasuries, investment-grade corporates, and mortgage-backed securities (MBS). These three groups combined to represent approximately 91% of the index as of August 4, 2017, and over the last year showed significant dispersion. Treasuries, with above-benchmark duration and low yields, fared the worst returning -2.1%. Our two preferred segments (both a year ago and today)* within high-quality fixed income, investment-grade corporates, and MBS performed better than the Aggregate. MBS returned 0.3% over the last year (Bloomberg Barclays U.S. MBS Index), with below-benchmark duration being a major tailwind for the segment in a period of rising interest rates. Investment-grade corporates, despite the highest duration among these three segments, performed the best returning 1.8% (Bloomberg Barclays U.S. Corporate Index). A significant tightening in spreads over that period boosted performance, as did investment-grade corporates' relatively high yield compared with Treasuries and MBS. (For more information about the makeup of the Bloomberg Barclays U.S. Aggregate Bond Index, please see our previous *Bond Market Perspectives: Understanding Bond Benchmarks.*)

Lower-quality fixed income performed well also, in line with the sharp moves higher in equity markets over the last year. High yield and bank loans, which have been our favorite two low-quality segments over the last year, are the top two performing asset classes within fixed income overall. High yield boasts a 10.9% total return on a one-year basis (Bloomberg Barclays High Yield Bond Index), and bank loans 5.9% (S&P/LSTA U.S. Leveraged Loan 100 Index). Our preference for bank loans became pronounced in late 2016, as high-yield valuations became quite expensive, in our view, and loans were more conducive to our forecast of gradually rising short- and long-term interest rates.

THERE MAY BE MORE PRESSURE...

LPL Research's view of the direction of longer-term interest rates throughout the year has been marginally higher, with rates gradually increasing amid a pickup in growth and inflation. We continue to expect the 10-year Treasury to end 2017 in its current 2.25–2.75% range. Given that we are

2 POTENTIAL PRESSURE FOR HIGH-QUALITY FIXED INCOME OVER REMAINDER OF YEAR

Interest Rate Shift	-0.50%	-0.25%	0.00%	0.25%	0.50%
4-Month Bloomberg Barclays Aggregate Total Return	4.04%	2.53%	1.02%	-0.49%	-2.00%

Sources: LPL Research, Bloomberg 08/03/17

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Analysis assumes a 4-month time horizon.

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.

*We continue to find relative value in investment-grade corporate bonds given continued strength in credit markets and the yield premium over Treasuries. Among high-quality bonds, MBS continue to offer an attractive trade-off between yield and interest rate risk.

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now trading at the bottom of that range, our bias would be for rates to end the year marginally higher than where they are now. This could put more pressure on high-quality fixed income throughout the remainder of the year [Figure 2]. In fact, over the remaining four months of the year, an increase in Treasury yields of just 17 basis points (0.17%) would result in a flat return for the Bloomberg Barclays Aggregate (assuming no change in spreads across high-quality sectors like investment-grade corporates and MBS). Importantly, if yields advance due to increasing levels of growth and inflation, spreads across investment grade and MBS could decline further, offsetting the impact of increasing interest rates.

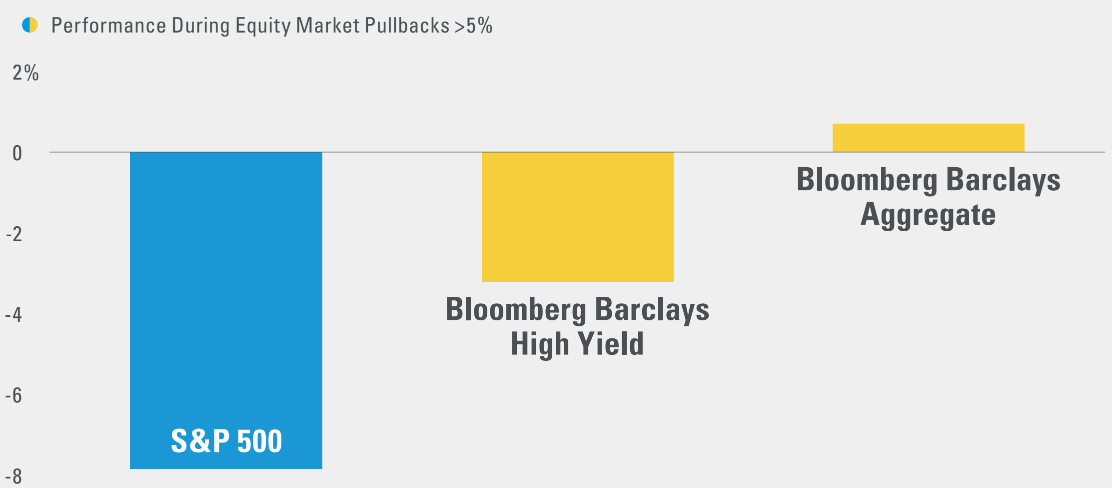
…BUT DON'T GIVE UP ON HIGH-QUALITY

Despite the pressure that high-quality fixed income has been under over the last year, it remains a vital part of well-balanced, diversified portfolios and investors should resist the temptation to move down the quality spectrum amid expensive valuations in asset classes like high yield. Despite low-quality fixed income's outperformance over the last year, one needn't look further than recent pullbacks in equity markets to solidify the belief that high quality is a valuable risk mitigation tool in balanced portfolios [Figure 3]. Although lower-quality fixed income choices like high yield and bank loans can add yield and upside potential to fixed income allocations during times of economic and equity market strength, they do not provide the same protection as high-quality fixed income in down markets.

CONCLUSION

The relatively flat year for broad high-quality fixed income has been challenging for diversified investors, and may logically have some questioning their allocations. Contributing forces included a start from very depressed rates a year ago and a large pickup in growth and inflation expectations due to the Trump administration's pro-business policy stance. Notably, there have still been

3 **HIGH-QUALITY FIXED INCOME SHINES DURING EQUITY MARKET WEAKNESS**



Source: LPL Research, Bloomberg 08/03/17

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Analysis averages returns during 5% or greater pullbacks in the S&P 500 over the previous five years (8/2/2016–8/2/2017). This includes eight pullbacks in the time frame.

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bright spots over the year, like investment-grade corporates, MBS, and lower-quality fixed income. We believe investors should maintain high-quality fixed income allocations for diversification purposes and resist the temptation to rotate to lower-quality assets for higher yields amid stretched valuations in asset classes like high yield. High-quality fixed income shines during periods of equity market weakness and has protected investors in ways that lower-quality fixed income has not historically. Despite the recent headwinds (and potential for more in the near term), we maintain that high-quality fixed income is critical to well-diversified, balanced portfolios.

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.

Because of their 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."

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.

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.

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

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.

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.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

Consumer Price Inflations is the retail price increase as measured by a consumer price index (CPI).

INDEX DEFINITIONS

The Bloomberg 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).

Bloomberg Barclays High Yield Bond Index is an unmanaged index of corporate bonds rated below investment grade by Moody's, S&P or Fitch Investor Service. The index also includes bonds not rated by the ratings agencies.

The Bloomberg 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 Bloomberg 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 S&P/LSTA U.S. Leveraged Loan 100 Index is designed to reflect the performance of the largest facilities in the leveraged loan market.

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