LPL RESEARCH

BOND MARKET PERSPECTIVES

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SECOND QUARTER RECAP

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KEY TAKEAWAYS

The second quarter of 2017 has carried over several themes from the first quarter: declining longer-term interest rates, flattening of the yield curve, and continued confidence in corporate bonds.

The unwind of reflationary "Trump trades" continued in the second quarter, with the winners in the first half of the year being those who were hit the hardest in late 2016, such as preferred securities, EMD, and municipal high yield.

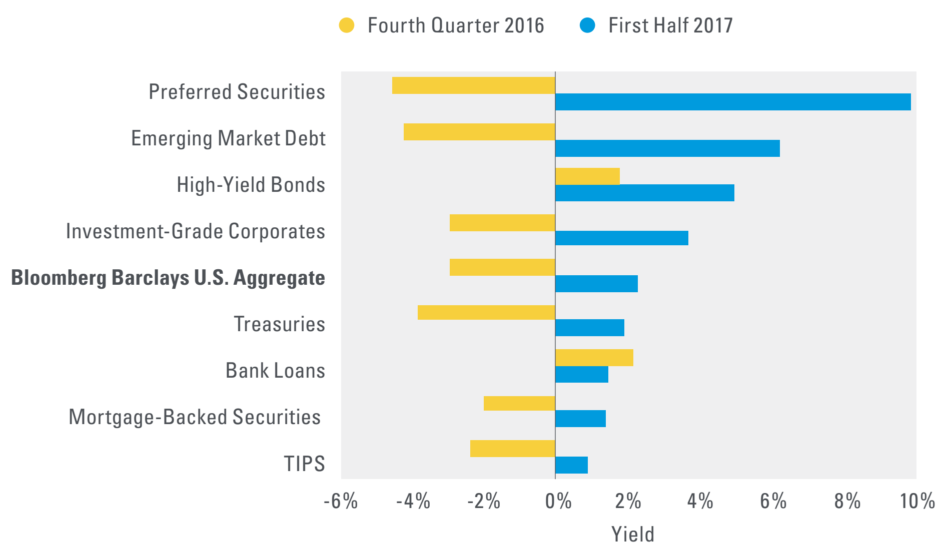
After sending conflicting messages during the first half of the year, bond and stock markets may be telling similar stories thus far in the third quarter.

The second quarter of 2017 carried over many of the same themes from the first quarter, with longer-term rates declining and the yield curve flattening. Duration (interest rate sensitivity) remained a tailwind and stability in credit markets powered lower-quality fixed income to outperform higher-quality. Additionally, many of the so-called "Trump trades" from the fourth quarter of 2016 continued the unwind begun in the first quarter of the year.

TRUMP TRADES CONTINUE TO UNWIND

Many segments of the market hardest hit during the fourth quarter of 2016 (with the ascendancy of reflationary "Trump Trades") have been beneficiaries of strength during the first half of the year. Preferred stocks, for instance, returned

1 FIRST HALF OF 2017 WAS A REVERSAL OF LATE 2016



Source: LPL Research, Bloomberg 07/10/17

Bond Market Asset Class Indexes: Preferred Securities – BofA Merrill Lynch Preferred Stock Hybrid Securities Index; Emerging Market Debt – JP Morgan Emerging Markets Bond Index; High-Yield Bonds – Bloomberg Barclays High Yield Bond Index; Investment-Grade Corporate – Bloomberg Barclays U.S. Corporate Bond Index; Treasuries – Bloomberg Barclays U.S. Treasury Index; Bank Loans – Credit Suisse Leveraged Loan index; Mortgage-Backed Securities – Bloomberg Barclays U.S. MBS Index; TIPS – Bloomberg Barclays Treasury Inflation-Protected Securities Index.

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

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-4.5% during the fourth quarter of 2016, as the elevated interest rate sensitivity of the asset class was a hindrance amid the rapid rise in rates. Emerging market debt (EMD) returned -4.2% during the fourth quarter of 2016 on concerns of protectionist trade policy by the incoming Trump administration. It is no coincidence that these two sectors are the strongest through the first half of this year, with preferreds leading the way, up 9.8%, and EMD up 6.2%. Preferreds benefited not only from the decline in longer-term interest rates in the first half of 2017, but by the recent rally in financials, which led all S&P 500 Index sectors in June with a 6.4% return and outperformed the broad market in the second quarter. EMD has rallied on concerns over protectionist policy largely fading from headlines.

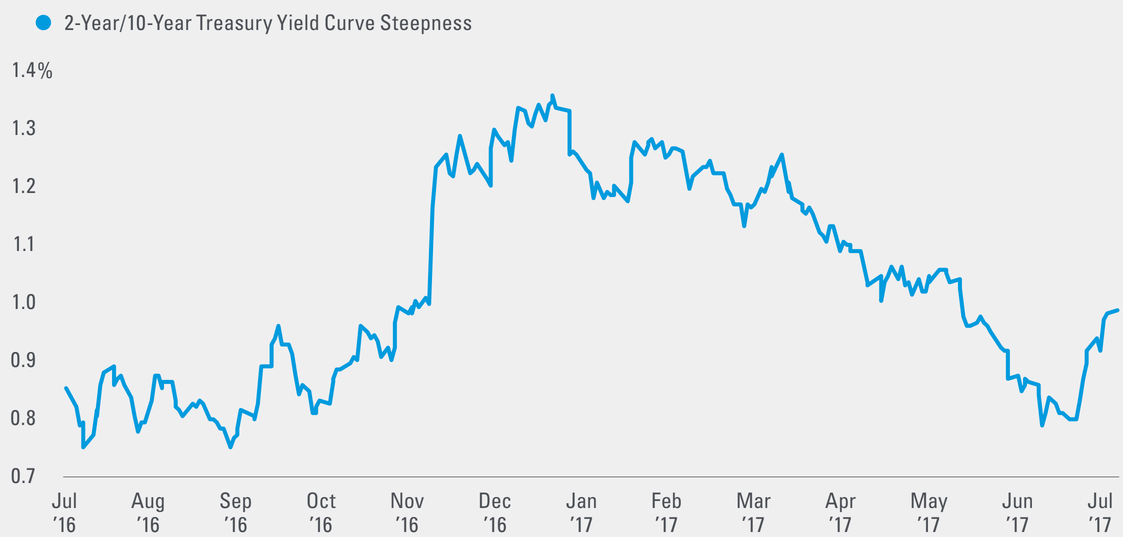
Aside from domestic lower-quality credit sectors like bank loans and high yield (which continued strength from the fourth quarter of 2016), the first half of 2017 has thus far been somewhat of a reversal of many trends seen late last year [Figure 1].

FLATTENING YIELD CURVE

Another rate hike during the Federal Reserve's (Fed) June 13–14 meeting pressured short-term rates higher, while softer than expected inflation readings helped pressure longer-term rates lower throughout the second quarter, evidenced by breakeven inflation rates declining materially. The result was that the yield curve, a proxy for future growth and inflation expectations, flattened considerably to the lowest level since before the U.S. election [Figure 2]. Fixed income markets seemed much less optimistic about domestic economic prospects than equity markets, which continued higher during the quarter.

The yield curve has steepened during the beginning of the third quarter, a healthy sign for the U.S. economy, and one step towards fixed income markets starting to tell a similar story to equity markets, after sending somewhat conflicting messages for the first half of 2017.

2 AFTER FLATTENING THROUGH FIRST HALF OF 2017, YIELD CURVE STEEPNESS RETURNS



Source: LPL Research, Bloomberg 07/10/17

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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 three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

CORPORATE CONFIDENCE (IN SPITE OF OIL)

Despite another quarterly decline in the price of oil (-5.8% in Q1 and -9.0% in Q2), corporate credit continued to strengthen, with valuations richening over the quarter [Figure 3].

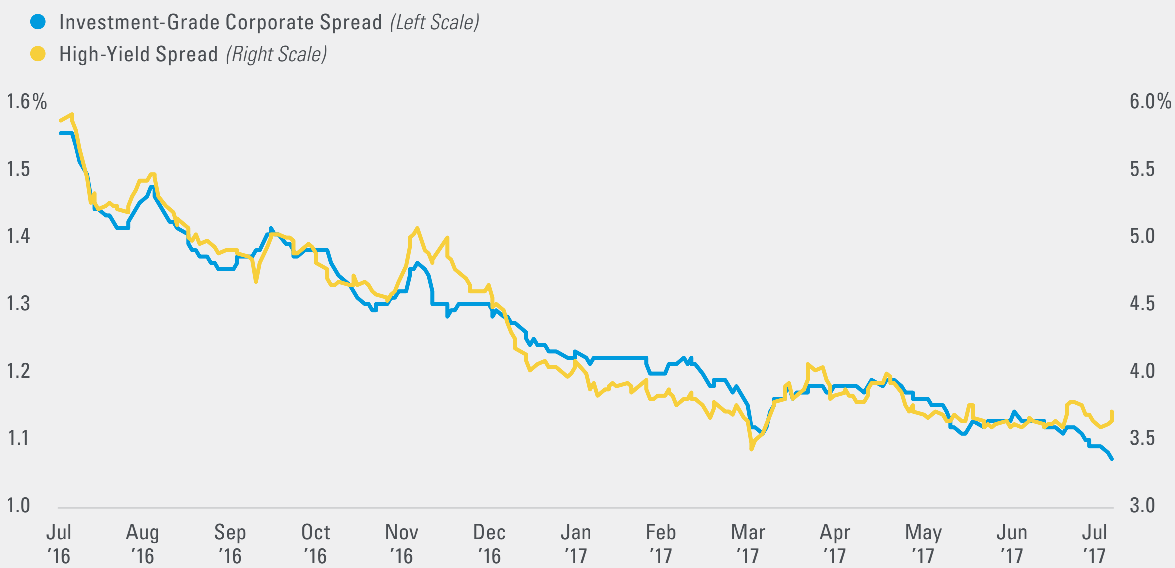
The weakness in oil did lead to spreads in energy sector corporate bonds widening, but the problem remained contained with limited spillover. Thus far in the third quarter of 2017, investment-grade corporate energy sector spreads have come back down from year-to-date highs and high-yield energy sector spreads have moderated, though they remain elevated relative to the end of the first quarter.

Forward-looking indicators reinforced a positive view of the credit cycle during the quarter. The Fed's Senior Loan Officer Survey (FSLO) has historically been a good leading indicator of default rates. The survey indicates whether banks are tightening or loosening lending standards for medium- and large-sized companies. This stands to reason: companies that can get a loan now will generally not default soon. As the modified adage goes, "a rolling loan gathers no loss." As of April 30, 2017 (the most recent reading), banks are now loosening lending standards (making it easier, all else equal, for companies to get a loan) on a net basis for the first time since July 31, 2015. This data point is solid confirmation of the default picture continuing to improve in 2017, and it helps to explain the continued richening of valuations in investment-grade and high-yield bonds.

WHICH THEMES PERSIST?

Despite two quarters of fairly consistent behavior from fixed income markets, we believe some of these themes may not persist. The flattening of

3 **CORPORATE SPREADS TIGHTENED THROUGH FIRST HALF OF 2017**



Source: LPL Research, Bloomberg 07/10/17

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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. Spread depicted is the yield differential between the average yield of comparable maturity Treasury bonds with the average yield of high-yield bonds and the average yield of investment-grade corporate bonds, respectively.

the yield curve may have run its course, partially evidenced by the steepening witnessed early in the third quarter. Long-term rates may have found a local bottom in mid- to late-June, and a pickup in growth and/or inflation could push rates modestly higher from here, as is our base case outlined in our *Midyear Outlook*. We believe confidence in corporate credit remains in play, as defaults are trending lower to near historically low levels and lending standards support that case. High-yield valuations remain expensive, however, and much of that good news has already been priced into the market.

Central bank influence could continue to have an impact on fixed income markets as well. The Fed has pointed to one additional rate hike this year, which has flattened the yield curve more often than not in the recent past. Additionally, however, the Fed plans on normalizing its balance sheet this year (maybe as soon as September), which could help pressure longer-term rates higher and steepen the yield curve.

CONCLUSION

The second quarter of 2017 was in many ways an extension of the first quarter, with rate markets implying a less optimistic economic outlook than equity markets. In previous analyses of the flattening of the yield curve, we submitted that the true state of the economy was likely somewhere between the pessimism of the bond market and the relative exuberance of equity markets. It seems that may be playing out thus far in the start of the third quarter, with the gap between stock and bond market signals closing. Since mid-June, the yield curve has been steepening with longer-term rates increasing and equities have been trading sideways. The third quarter may be the one in which markets sync up and start telling the same story once again. ■

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.

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.

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.

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.

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

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.

INDEX DESCRIPTIONS

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 Bloomberg 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 Bloomberg Barclays U.S. Corporate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

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).

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

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