LPL RESEARCH

BOND MARKET PERSPECTIVES

KEY TAKEAWAYS

The *Bond Market Perspectives* "Search for Income" is a quarterly guide to our top ideas for income-producing strategies.

Yield opportunities improved during the first quarter amid broadly rising rates.

Lower-quality fixed income spreads remain tight, but stability may reign as domestic economic prospects continue to improve.

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SEARCH FOR INCOME
YIELD OPPORTUNITIES IMPROVE

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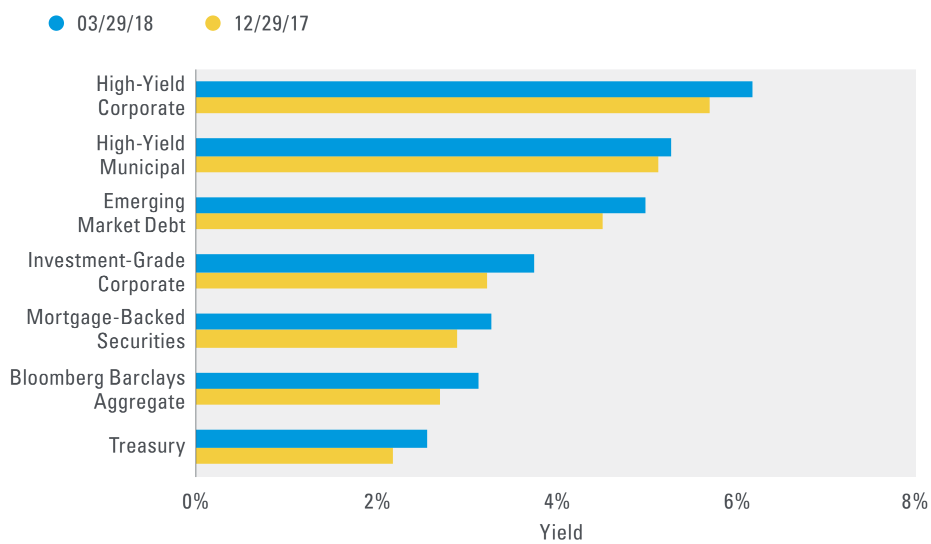
Rising rates led to a difficult first quarter for fixed income, but the silver lining is that income opportunities may have improved going forward [Figure 1]. Inflation expectations and real yields rose over the quarter amid continued economic growth, which pressed longer-term rates higher. Short-term rates were also pressured higher by increasing Federal Reserve (Fed) rate hike expectations and heavy Treasury supply. Lower-quality and shorter-duration fixed income tended to outperform higher-quality and longer-duration fixed income due to their lower sensitivity to the rise in rates over the quarter.

1 RATES ROSE IN ALL SEGMENTS OF FIXED INCOME DURING Q1



Source: LPL Research, Bloomberg 04/30/18

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

Indexes: Bloomberg Barclays U.S. High Yield Index, Bloomberg Barclays Muni High Yield Index, Bloomberg Barclays EM USD Aggregate Index, Bloomberg Barclays U.S. Corporate Index, Bloomberg Barclays U.S. MBS Index, Bloomberg Barclays U.S. Aggregate Index, Bloomberg Barclays U.S. Treasury Index.

All return figures are as of March 30, 2018, unless otherwise stated.

The economic forecasts set forth in the publication may not develop as predicted.

The yields referenced in this publication are based on these 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.

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 securities)
- Preferred stocks
- Investment-grade corporate bonds (short and intermediate term)
- Emerging market debt (EMD)

SECTOR SNAPSHOTS

HIGH-YIELD BONDS (TAXABLE): STABILITY MAY REIGN

High yield (Bloomberg Barclays U.S. High Yield Index) outperformed broad high-quality bonds (Bloomberg Barclays U.S. Aggregate Index) during the first quarter, but still fell 0.9% due to the rise in interest rates. Defaults actually increased during the first quarter (from 2.9% to 3.2%) due to elevated defaults in the retail sector amid pressure from online retailers. However, according to Moody's Investors Service, forward-looking (one-year) default forecasts for high yield remain very low (1.4%). Much of that optimism may already be priced in, leaving high yield near our fair value estimate. Given the continuing strength of the asset class since mid-February 2016, the sector may have little room for error. Also, the significant richening in valuations during 2016 and 2017 means future returns may be driven more by yield rather than continued price appreciation from spread tightening, which will likely be harder to come by.

Despite being a tailwind in the first quarter, the price of oil remains a key driver of the high-yield market, and future weakness below certain key levels may translate to pullbacks within high yield. Equity market drawdowns or volatility may also translate to headwinds.

Based on the Bloomberg Barclays High Yield Index, the average yield of the high-yield bond market ended the first quarter at 6.2%, up from 5.7% to end 2017, but still well below the 20-year average of 9.0%.

The average yield advantage of high-yield bonds to Treasuries rose to 3.5% as of March 30, 2017, up from 3.4% at the end of 2017. This yield advantage has decreased in the second quarter to 3.3% as of April 30, 2018.

For diversification purposes, we recommend suitable investors use a mutual fund or exchange-traded product (ETP) for exposure to this asset class.

MUNICIPAL (TAX-FREE) HIGH-YIELD BONDS: COMPELLING TAXABLE EQUIVALENT YIELDS

Investors, regardless of their tax bracket, may wish to consider municipal (tax-free) high-yield bonds. According to the Bloomberg Barclays High-Yield Municipal Index, the average yield of tax-free, high-yield bonds is 5.3% (as of March 30, 2017), which translates to a compelling taxable equivalent yield of 8.7% (assuming a 39.6% tax rate).

The average yield advantage of BBB-rated municipal bonds to AAA-rated, a proxy for the spread on municipal high-yield bonds, ended the first quarter at 1.1%, equal to the year-end 2017 level. The average yield spread remains near its lowest level in over 10 years.

The situation in Puerto Rico worsened due to devastating hurricanes last year, but spillover to other segments of the market has been very limited. However, the higher yield is not without greater risk. Municipal high-yield bonds have longer maturities than their taxable counterparts; therefore, they tend to be more interest rate sensitive—a risk worth noting should interest rates increase further.

After heavy overall municipal issuance in late 2017, issuance during the first quarter was muted, but technical headwinds remained. Lower corporate tax rates reduced the need for municipal bonds in some bank and insurance company portfolios, reducing demand. This, combined with the pressure of rising rates, led to the weakest first-quarter return in 15 years for broad municipal bonds. However, credit quality trends, like those of the taxable market, are largely supportive of the sector in our view. The number of municipal issuers that defaulted in the first quarter was restrained after a record low number in 2017. In general, municipal defaults remain isolated and have been concentrated in more speculative sectors like Puerto Rico.

FLOATING RATE BANK LOANS: MORE CONSERVATIVE APPROACH TO HIGH YIELD

Companies rated below investment-grade issue loans (debt) via banks for their short-term funding needs (hence the name "bank loans"). Most bank loans are senior-secured debt, as the companies generally pledge specific tangible assets for the loan, ranking them above traditional bonds and equities in a corporation's capital structure. This means that they are paid before unsecured bonds in the event of a default and recovery rates have historically been higher than unsecured bonds.

> Unlike traditional fixed-rate bonds (where rising interest rates hurt their prices), bank loans pay a higher rate when rates rise and therefore their prices do not necessarily fall.

These securities typically pay a higher yield than short-term securities, generally 1.0–4.0% above LIBOR (the London Interbank Offered Rate), and seek to provide protection against rising interest rates by adjusting interest payments at regular intervals to reflect changes in a short-term rate (usually three-month LIBOR). Unlike traditional fixed-rate bonds (where rising interest rates hurt their prices), bank loans pay a higher rate when rates rise and therefore their prices do not necessarily fall. Conversely, bank loans generally do not benefit from rising bond prices when interest rates fall. With an above-average yield, bank loans are an income alternative that helps balance the interest rate sensitivity of high-quality, income-oriented bond asset classes.

Three-month LIBOR rose from 1.69% at the end of 2017 to 2.31% at the end of the first quarter of 2018. The sharp rise was driven by increasing Fed rate hike expectations, as well as heavy Treasury issuance (to make up for fewer tax receipts following the recent tax cuts). The bank loan market is a "par market," meaning many issues may be called at par at any time. And with the majority of current issues already trading above par, call risk may become more pronounced as short-term rates continue to move higher.

Although high-yield bonds have historically yielded more than bank loans, bank loans have yielded more since the end of 2016. That yield disparity fell slightly during the first quarter, with bank loans (Credit Suisse Leveraged Loan Index) ending the quarter yielding 0.4% more than high-yield bonds (Bloomberg Barclays U.S. High Yield Index), down slightly from 0.6% to end 2017. Bank loans have historically exhibited less volatility than high-yield bonds (though still more than investment-grade issues), and therefore, may be a better option for more conservative investors. Like high-yield bonds, credit-quality metrics for bank loans are stable but not without risk, though default rates are lower and recovery rates are historically better.

PREFERRED STOCKS: POTENTIALLY ATTRACTIVE YIELDS

Preferred stocks are fixed income securities that suitable income-seeking investors may want to consider. The financial sector, which comprises roughly 80% of all preferred issuers, has benefited

Please be aware that the vast majority of tax-free, high-yield funds generate income that is subject to alternative minimum tax (AMT). We recommend that suitable investors use a fund to gain exposure. Please contact the fund or ETP companies directly to obtain a copy of the prospectus for the percentage of income subject to AMT.

from stable-to-improving bank credit quality metrics and industry deregulation efforts by the Trump administration.

We still believe that the sector can be used as a potential income generator in today's fixed income environment, but caution is warranted. Average yields rose over the first quarter to 5.1% from the 4.6% level seen at the end of 2017. The varied nature of the preferred market means that the yield advantage to comparable Treasuries may vary depending on the specific investment product.

Since preferred stocks have extremely long (30- to 50-year) maturities, they can be sensitive to interest rates. The sector exhibited resiliency during bouts of rising interest rates over the past three years, but price weakness in early 2018 serves as a reminder to investors that sharp increases in rates can weigh on returns. The yield advantage to Treasuries could help offset higher interest rate risk, as could the probability of early redemptions, but investors need to be aware of this risk.

INVESTMENT-GRADE CORPORATE BONDS: HISTORICALLY STABLE IN SLOW-GROWTH ENVIRONMENTS

Investment-grade corporate bond yields remain low historically, but are at their highest level in approximately eight years, increasing their attractiveness as an income-producing option for investors seeking higher-quality bonds. At the end of the first quarter, the average yield of investment-grade corporate bonds was 3.8%, higher than the 3.3% yield at the end 2017.

For some investors, such yield levels may not be exciting, but considering the low Treasury and mortgage-backed securities yields, they remain a viable high-quality option.

At the end of the first quarter, the average investment-grade corporate bond yield spread to Treasuries was 1.1%, below the 20-year average of 1.6%, but above the 0.9% level at the end of 2017. The spread was pushed higher partly by increased supply that had been on hold in late 2017 due to uncertainty surrounding the yet to be passed tax bill.

The ability of corporations to repay debt obligations in a timely manner (credit quality) has plateaued but remains stable. Nonfinancial debt-to-earnings ratios are increasing, but are still at manageable levels. Corporate credit quality metrics should support relatively stable yield spreads.

EMERGING MARKET DEBT: MAY BENEFIT FROM EMERGING MARKET GROWTH

Concerns about potential protectionist trade policies ramped up in the first quarter, with steel and aluminum tariffs by the United States opening the door to trade war worries. This was a headwind for EMD, leading to a difficult start to 2018. Over the first quarter, the average yield advantage of EMD above comparable Treasuries rose to 2.4%, from 2.3% at the end of 2017. Spreads remain tight historically, as a 4.0% yield spread has represented good value over the last five years and yield spreads have rarely stayed above that level.

The average EMD yield of 5.0%, just below its 5-year average of 5.1%, stands out in a low-yield world. The challenging environment for bonds overall (rising interest rates), commodity-related weakness, or the removal of central bank accommodation more quickly than anticipated may provide headwinds. The sector may also be vulnerable to potential protectionist trade policies.

We still expect most emerging market countries to exhibit higher growth rates than their developed country counterparts, which should help support credit quality over a longer horizon. Additionally, an average yield spread of 2.4% (as of March 30, 2018) may provide a buffer to potential risks. Local currency EMD, however, may be more volatile than dollar-denominated EMD, as has historically been the case, due to currency volatility. We believe that EMD can still be used for suitable income-seeking and total return-oriented investors.

SHORTER OPPORTUNITIES

A flattening yield curve is giving investors more yield with less interest rate risk at shorter maturities [Figure 2]. As of April 27, 2018, a 5-year Treasury yielded 2.80%, while a 10-year Treasury yielded 2.96%. Investors can essentially cut their interest rate sensitivity in half, while only sacrificing 0.16% in yield. Similar opportunities exist in other sectors. For instance, the Bloomberg Barclays Corporate 1–3 Year Index is yielding 3.08%, its highest yield since October 2009 and a meaningful yield with limited rate sensitivity.

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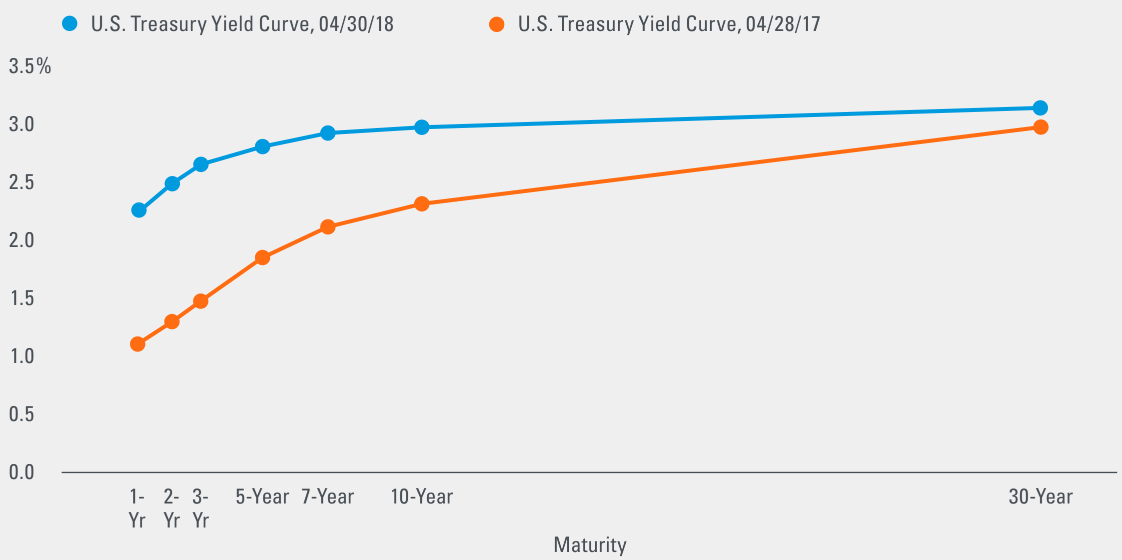
CONCLUSION

The first quarter of 2018 was difficult for fixed income investors, but the good news is that the outlook has improved for income investors moving forward. Yield levels have been a good indicator of future total returns, so increased yield levels may bode well longer term. Whether investing purely for income or within a balanced stock and bond portfolio, we believe that diversification remains a prudent principle to manage interest rate and credit/default risk. ■

2 FLATTENING TREASURY YIELD CURVE MAKES SHORT-TERM YIELDS MORE ENTICING



Source: LPL Research, Bloomberg 04/30/18

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. 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.

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. 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.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

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.

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. Floating rate 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.

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.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield. International debt securities involve 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.

Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield.

Investing in mutual funds involves risk, including possible loss of principal. The funds value will fluctuate with market conditions and may not achieve its investment objective. Upon redemption, the value of fund shares may be worth more or less than their original cost.

An investment in Exchange Traded Funds (ETF), structured as a mutual fund or unit investment trust, involves the risk of losing money and should be considered as part of an overall program, not a complete investment program.

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

DEFINITIONS

The 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 fixed on a daily basis by the British Bankers' Association. 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.

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.

INDEX DESCRIPTIONS

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 Municipal High Yield Bond Index is comprised of bonds with maturities greater than one year, having a par value of at least $3 million issued as part of a transaction size greater than $20 million, and rated no higher than 'BB+' or equivalent by any of the three principal rating agencies. (The long and the short are subindexes of the Municipal Bond Index, based on duration length.)

The Bloomberg Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

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.

The Bloomberg Barclays Corporate Bond Index is an unmanaged index of investment grade rated bonds issued by corporations and quasi-government agencies. Corporate bonds issued by foreign entities but denominated in U.S. dollars are also included in the index.

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 US MBS Index measures the performance of investment grade fixed-rate mortgage-backed pass-through securities of GNMA, FNMA, and FHLMC.

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