Bond Market Perspectives

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Light at the End of Tunnel

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Highlights

Municipal bond valuations remain near some of their most attractive levels of the past few years, and yields are at two-year highs.

Municipal bond prices have stabilized or improved over the past three trading sessions despite lingering supply pressures, a sign that investors find current valuations worth taking potential risks.

After above-average new issuance this week, issuance looks to taper off over coming weeks and may help restore a more favorable supply-demand balance in the municipal bond market.

Signs of stabilization have begun to emerge in the municipal bond market after a difficult two months. Fears of an earlier end to Federal Reserve (Fed) bond purchases drove widespread bond market weakness from the beginning of May through the first week of July. Less liquid and less frequently traded fixed income markets, such as municipal bonds, bore the brunt of weakness with municipal bonds suffering from the added challenge of a supply deluge. Rising interest rates and short-term supply pressures created a double whammy for the municipal bond market.

Over $16 billion in mutual fund redemptions in June, according to Investment Company Institute (ICI) data, led to forced liquidation and added to municipal bond weakness. Mutual fund redemptions led to a surge in bond selling and bloated secondary inventory [Figure 1]. The five-day moving average of bonds looking to be sold (known as "bid-wanteds") surged to the highest level since December 2012, the last time a short-term supply-demand balance pressured municipal bond prices lower. From June 1, 2013 through July 12, 2013, the dollar amount of bid-wanteds exceeded $1 billion on 12 days. The current stretch is second only to the Meredith Whitney inspired sell-off of late 2010/early 2011, when that total was exceeded on 14 days. The heavy selling pressure can force market participants to withdraw until selling subsides, which can exacerbate declines in the meantime.

1 A Supply Deluge in the Form of Fund Redemptions…

Source: Bloomberg, LPL Financial 07/15/13

2 … And Heavy New Issuance Exacerbated Recent Muni Bond Weakness

Source: Bond Buyer, LPL Financial 07/15/13

In conjunction with secondary market selling, new issuance in the primary market provided a double dose of supply pressure. June typically witnesses a seasonal increase in issuance due to the significant number of maturing bonds. Historically June and July are two of the biggest months of the year in terms of maturing bonds in the municipal bond market. Although many new issues were ultimately postponed, the dollar amount of new issuance slated to come to market remained above average for most of June 2013 [Figure 2]. As Figures 1 and 2 show, both secondary and primary market supply remain elevated, suggesting weakness may continue, or at a minimum, present a near-term headwind for municipal bonds.

However, the recent and rapid rise in yields and now cheaper valuations are attracting investors. Municipal-to-Treasury yield ratios, a common barometer of municipal bond valuations, remain very near some of their most attractive levels of the past few years [Figure 3]. As of Monday, July 15, 2013, the average 10-year AAA-rated municipal bond was yielding 111% of comparable maturities Treasuries. Such an elevated ratio is rare and historically provided investors with a good time to purchase municipal bonds. When the 10-year AAA municipal-to-Treasury yield ratio has exceeded 110% over the past four years, the broad municipal bond market, as measured by the Barclays Capital Municipal Bond Index, has returned an average of 3.9% over the subsequent six months. That return data includes the mid-2012 period when the 10-year Treasury yield bottomed at 1.39% during July 2012, and top-quality municipal yields were not far above record lows of their own. While future returns may not meet the average, the data show that high municipal-to-Treasury yield ratios have been favorable for municipal bonds.

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

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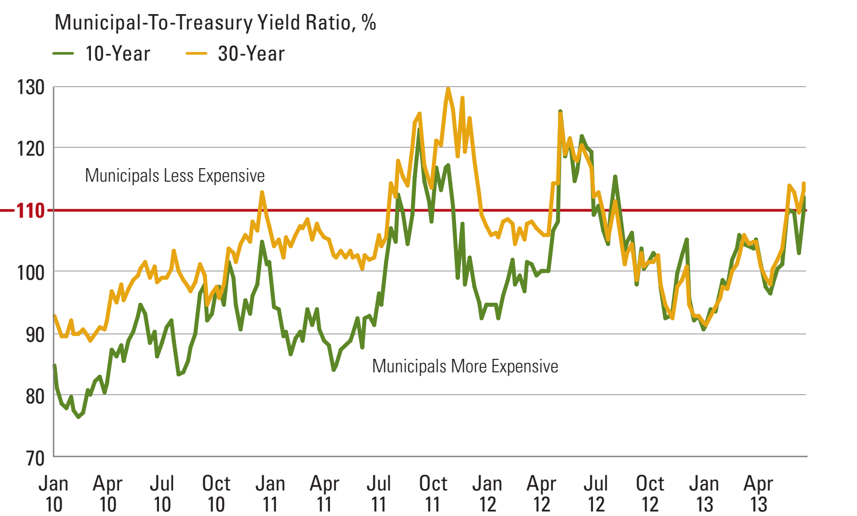
3 Municipal Valuations Remain Near Their Most Attractive Levels of the Past Few Years

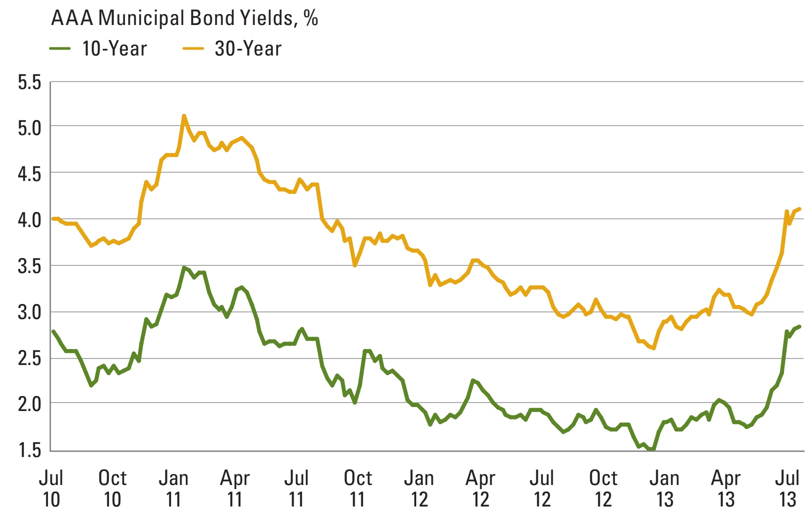


Source: MMA, LPL Financial 07/15/13

Yield Ratio depicts a comparison of the expected yield of one bond to the expected yield of another.

In addition to attractive valuations, higher yields also bolster the case for municipal bonds. Yields on intermediate- and long-term municipal bond yields are at their highest levels since the second quarter of 2011 [Figure 4]. In fact, yields are higher than during prior periods of attractive valuations such as late 2011 and mid-2012, denoted in Figure 3.

4 Yields Are at Their Highest Since 2011



Source: MMA, LPL Financial 07/15/13

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

The higher yields are translating to higher taxable-equivalent yields, which is starting to draw in more buyers. Municipal bond prices have either stabilized or improved over the past three trading sessions despite lingering supply pressures discussed earlier, a sign that investors find current valuations worth potential risks. According to Thomson Reuters' Municipal Market Data (MMD) the average 30-year A-rated municipal bond yields 4.8%, as of July 15, 2013. For a top 39.6% tax bracket investor, that yield translates to 7.95% taxable equivalent yield and is higher after taking into account the Affordable Care Act's 3.8% surcharge on investment income, which municipal bonds are exempt from, and an investors' home state tax rate if applicable. For higher AAA-rated 30-year municipal bonds, the average 4.0% yield-to-maturity results in a lower, but still compelling, 6.6% taxable equivalent yield.

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Within the municipal bond market, we find intermediate- and long-term maturity municipal bonds more attractive. In addition to higher yields, valuations are more attractive relative to short-term bonds, and both segments enable investors to take advantage of a steep yield curve. The yield differential between 2- and 30-year AAA municipal bonds increased by 1.0% since May 1, 2013 to 3.6% as of Monday, July 15, 2013, the greatest gap since mid-2011. Investors are therefore more rewarded for extending

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maturities compared to just two months ago. Intermediate-, long-term, and high-yield municipal bonds were among the hardest hit during the recent sell-off, and may stand to benefit most from any stabilization in the municipal bond market.

Finally, a favorable summer seasonal period, which has been delayed due to recent weakness, may provide an additional tailwind once supply pressures ease. The fact that June and July are historically among the biggest months in terms of maturing bonds also brings about reinvestment demand — the flip side of a seasonal increase in new issuance. As bonds come due, investors need to reinvest proceeds leading to buying demand. This year's broad bond market sell-off coupled with the postponement of some new issuance has delayed the start of one of the more reliable and favorable seasonal periods for municipal bonds. After above-average new issuance this week, new issuance looks to taper off over coming weeks and may help restore a more favorable supply-demand balance in the municipal bond market. Light is emerging at the end of the tunnel.

We caution that investors keep expectations in check despite the better valuations of the municipal bond market. As long as uncertainty regarding the Fed stays high, and the Fed remains focused on reducing the pace of bond purchases, price appreciation should be limited. Total returns will therefore likely be driven by interest income, meaning that investors may not experience a repeat of the strong performance witnessed in 2011 or 2012, even if a rebound materializes. Should Fed tapering fears prove misguided and broad interest rates resume falling, municipal bond prices may receive an added lift. In the meantime, signs of stabilization, attractive valuations, and higher yields provide a potential opportunity for bond investors. ■

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 referenced 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.

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.

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.

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

Treasuries are marketable, fixed-interest U.S. government debt securities. Treasury bonds make interest payments semi-annually, and the income that holders receive is only taxed at the federal level.

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.

This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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INDEX DESCRIPTIONS

The 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 Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

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