

Bond Market Perspectives



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Highlights

The U.S. bond market posted robust performance over the first half of 2010 as the Barclays Aggregate Bond Index returned 5.3%.

More economically sensitive bond sectors, such as High-Yield Bonds and Emerging Market Debt (EMD), underperformed during the second quarter but still finished with solidly positive performance for the first half of the year.

Safe-haven buying propelled Treasuries to lead bond market performance, but the current pace of performance is unsustainable in our view.

While we expect government bonds to hold much of their gains over the near-term, we would caution against a repeat performance. We believe growth, and not recession, will become evident over the second half of 2010 allowing more economically sensitive bonds to benefit.

We believe the steady rise in high-quality bond prices is unsustainable over the remainder of 2010 and believe higher-yielding segments of the bond market will outperform over the second half of 2010.

July 6, 2010

Bondholder Pride

The celebration of Independence Day, the Fourth of July, evokes a sense of national pride from Americans across the country. Bond Investors were similarly proud after a good first half of 2010 as the broad Barclays Aggregate Bond Index returned 5.3%. The robust performance was greater than many, us included, expected over the first half of this year. The second quarter witnessed high-quality bond prices rise almost steadily to drive the bulk of first half 2010 performance. High-Yield bonds disappointed over the second quarter with flat total returns, but still managed solidly positive total returns for the first half. We believe the steady rise in high-quality bond prices is unsustainable over the remainder of 2010 and believe higher-yielding segments of the bond market will outperform over the second half of 2010.

It Was a Good First Half of 2010 for Bondholders

Sector:	First Half of 2010	Q2
Municipal High-Yield	7.29	3.10
Treasury	5.86	4.68
Investment-Grade Corporate	5.79	3.42
Emerging Market Debt	5.37	1.16
Aggregate (composite)	5.33	3.49
Preferred Stocks	5.14	-0.11
High-Yield	4.51	-0.11
TIPs	4.41	3.82
Municipal	3.31	2.03
Mortgaged-Backed Securities	2.87	4.46
Foreign Bonds (hedged)	2.69	1.56

Source: Barclays Capital, JP Morgan, Citigroup, LPL Financial 6/30/10

Sector performance ranked by first half 2010 performance.

Aggregate (composite) refers to total return of overall high-quality U.S. bond market as measured by the Barclays Aggregate Bond Index.

Treasury Fireworks

U.S. Treasuries were the best performing taxable bond sector and the primary driver of first half high-quality bond market performance as measured by the Barclays Aggregate Bond Index. After briefly touching the 4% level, the 10-year Treasury yield closed the first quarter below 3% and has declined by an impressive 0.91% since the end of 2009. Like a rising tide that lifts all boats, the decline in Treasury yields provided benefits across the bond market. Investment-grade corporate bond and mortgage-backed security prices benefited from the decline in yields even though both sectors lagged Treasuries. We would not be surprised to see Treasury yields decline



further over the near-term, but over the second half we do not expect a similar magnitude yield decline, which, if it occurred, would take the 10-year yield to the lows witnessed during the height of the financial crisis. Both the economy and financial markets are in much better health now and we do not believe such a yield decline is warranted. Therefore, we expect lower performance from high-quality bonds during the second half of 2010.

The 5.8% gain posted by the Treasury sector is the best first half start since 1995 when Treasuries benefited from expectations of Fed rate cuts and slower economic growth. Both would ultimately materialize. While we expect the pace of economic growth to slow, similar to 1995, we do not expect a double-dip recession and with the Fed Funds rate at a rock bottom level, Federal Reserve rate cuts are not a potential catalyst for Treasuries now.

Global Duds

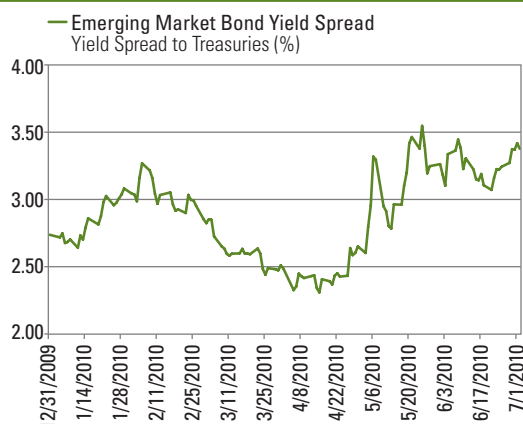
Aside from Independence Day being a U.S. holiday, there was little cause for celebration for holders of developed foreign bonds. Since European government bonds comprise the bulk of developed foreign (as opposed to emerging market) bond markets, price declines among government bonds issued by fiscally troubled nations weighed on performance. European economic growth will likely be crimped as a result of enhanced fiscal belt-tightening measures and progress on budget deficits will be slow to develop. This one-two combination will likely continue to weigh on foreign bond performance. Yields on more fiscally prudent European government issuers remain at or near historic lows and we continue to avoid European bond exposure.

What's Next

Over the near-term, we expect high-quality bonds, including Treasuries, to hold recent gains, as risk aversion remains high. Furthermore, with many central banks on hold, inflation low, and U.S. economic data showing signs of a soft spot, there is little near-term interest rate risk for intermediate and long-term bondholders. A new, lower yield range may develop as investors wait for earnings season and/or European bank stress tests to provide additional clarity on economic growth and health of European banks, who are important participants in global financial markets. We continue to believe that recent economic data reflects a soft spot and not the onset of a double-dip recession. While parameters of the upcoming European bank stress tests are unknown, we believe the end result will be an extra level of transparency that should allay fears of contagion from Europe to the United States. Lending facilities so far instituted by the European Central Bank (ECB) have supported short-term markets liquidity and will likely continue to do so.

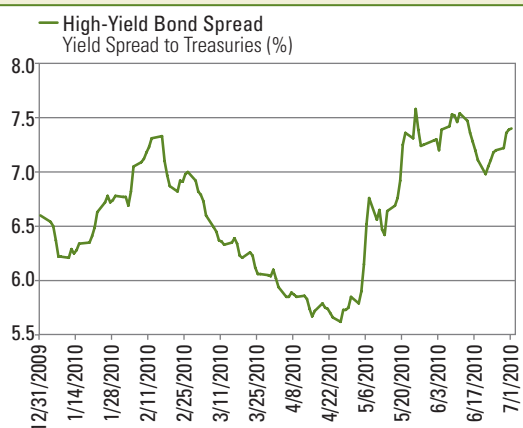
As economic data continues to reflect modest growth, rather than recession, we believe investors will gradually migrate into economically sensitive bonds such as High-Yield and Emerging Market Debt. Both sectors may not rally immediately while investor risk aversion remains high. Interestingly, yield spreads for both High-Yield Bonds and EMD have not broken above the late May/early June peaks, a positive signal that suggests investors are finding value at current levels despite the negative sentiment. Nonetheless, the now extra yield relative to Treasuries [Charts 1 & 2] indicates that investors are paid

1 Higher Emerging Markets...



Source: JPM Morgan, LPL Financial 7/2/10

2 ...And High-Yield Bond Spreads Mean Investors Are Paid to Wait for Improvement to Arrive



Source: Bloomberg, LPL Financial 7/2/10



to wait. With high-quality bond yields near historic lows, including the Barclays Treasury Index yielding 1.8%, and priced to reflect a very slow growth scenario, we favor higher yielding sectors over the second half of 2010.

IMPORTANT DISCLOSURES

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.

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

The Barclays Treasury Index consists of public debt obligations of the U.S. Treasury with a remaining maturity of one or more years. The index does not include Treasury bills, Treasury STRIPS, or Treasury Inflation-Protected Securities (TIPS).

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 funds shares is not guaranteed and will fluctuate.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

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 taxed may apply.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index - while providing a real rate of return guaranteed by the U.S. Government.

Preferred stock investing involves risk including loss of principal.

Mortgage-Backed Securities are subject to credit, default risk, 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, and interest rate risk.

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