LPL RESEARCH

BOND MARKET PERSPECTIVES

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INVESTMENT-GRADE CORPORATE BONDS: ONGOING STRENGTH

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

Investment-grade corporate bonds are performing well year to date, beating most fixed-income asset classes with the exception of high yield, emerging market debt, and preferred securities, which are typically lower-rated and higher risk.

Supply has been robust with five consecutive years of new issuance above $1 trillion per year, and is on pace for another record year in 2017, which could weigh on the secondary market.

The Bloomberg Barclays U.S. Aggregate Corporate Bond spread relative to U.S. Treasuries is narrow at 1.03%, well below the 25-year average spread of 1.62%, so excess returns from tighter spreads may be harder to come by than during the first half of 2017.

Investment-grade (IG) corporate bonds have been a strong performer in 2017, and our belief that corporates can add incremental value over Treasuries continues to be validated. Year to date (through July 28, 2017), they are outperforming the broader bond market as measured by the Bloomberg Barclays U.S. Aggregate Bond Index by 1.7%. Similar to 2016, only the more risky, lower-quality segments of the bond market such as high yield, emerging market debt, and preferred securities indexes have been able to beat the 4.5% return of the Bloomberg Barclays U.S. Corporate Index year to date.

DURATION REMAINS A RISK

The IG corporate bond market is more interest rate sensitive than the broad bond market. The duration of the Bloomberg Barclays U.S. Corporate Bond Index, at 7.5 years, is longer than the Bloomberg Barclays U.S. Treasury Bond Index at 6.2 years, and longer than the broad bond market, represented by the Bloomberg Barclays U.S. Aggregate Bond Index at 6.0 years. For IG corporates with a duration of 7.5 years, for every 1% increase in interest rates, the bonds would fall 7.5% in price. IG corporates' duration is nearly at record highs, although it briefly topped this level in mid-2016. The duration of the index oscillated near 6.0 years for much of the 1990s and 2000s, before steadily rising post-financial crisis to over 7.5 years today [Figure 1]. With interest rates at or near all-time lows, companies seek to lock in lower rates for longer periods of time. A prudent business decision, but one that increases interest rate risk for corporate bond investors. Although we believe corporates remain strong and a recession is not around the corner, the long duration profile of the asset class leaves it vulnerable to rises in longer-term interest rates.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest rate risk or reward for bond prices.

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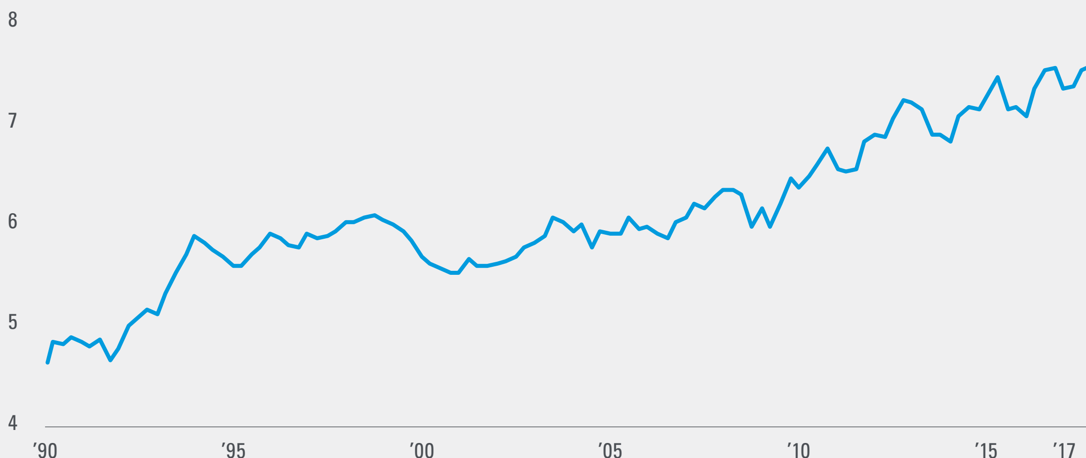
Aside from the sector's elevated interest rate sensitivity, risks include tight spreads (additional compensation investors receive for investing in bonds that are riskier than U.S. Treasuries) relative to U.S. Treasury bonds, and the record supply brought to market from 2012 through mid-2017 potentially weighing on the secondary market. As with any investment, risk cannot be eliminated entirely, but careful diversification that includes an allocation to IG corporate bonds can help investors manage volatility.

PUTTING SPREADS IN CONTEXT

The prices and yields of IG corporate bonds depend on the creditworthiness of the issuing company. Bonds within the IG corporate universe are issued by a corporation and are investment grade, meaning they are rated by rating agencies at Baa3/BBB-/BBB- or higher. Because of this, there is some degree of risk that the corporation may not be able to pay back the debt. Although IG defaults are low (less than 0.1% per year over the last 30 years) they do occur, and investors tend to buy corporate bonds with lower prices than comparable U.S. Treasury bonds to compensate for the additional risk. This compensation comes in the form of additional yield and is known in the market as a credit spread. During periods of high risk such as in 2007 and 2008, investors demanded more yield for the higher perceived risk of defaults. At the height of the financial crisis in December 2008, corporate bond spreads were 6.2% [Figure 2]. Since then, credit spreads have tightened substantially and investors have driven yields lower by buying corporate bonds at a record pace. Throughout 2017, corporate spreads have steadily declined and are now approaching 1%. The current spread for the index is 1.03%, a multi-year low and well below the 1.62% 25-year average and 1.35% 5-year average.

1 IG CORPORATE DURATION HAS BEEN STEADILY INCREASING, NOW NEAR RECORD HIGH



Source: LPL Research, Bloomberg 07/31/17

Data references the Bloomberg Barclays US Aggregate Corporate Index Modified Adjusted Duration.

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

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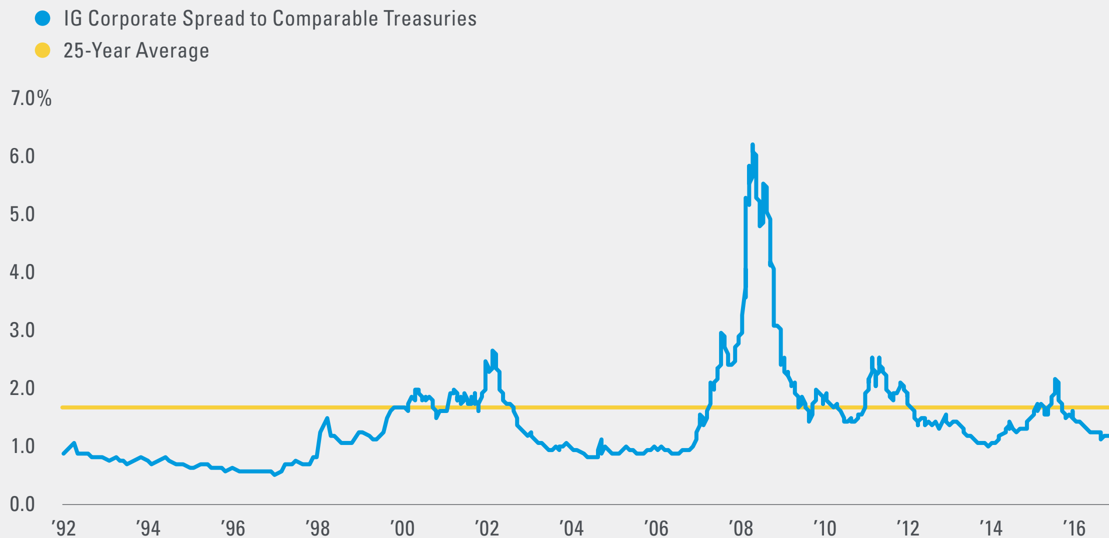
Although it is conceivable that spreads may tighten further given continued economic growth, tight spreads do limit returns for the asset class. Future returns will almost necessarily be driven more by coupon payments (interest) and less by capital appreciation (spread compression).

SUPPLY/DEMAND BACKDROP

According to data from the Securities Industry and Financial Markets Association (SIFMA), a widely recognized provider of issuance data, U.S. corporate bond issuance averaged $650 billion from 1996 through 2011. In 2012, investors were clamoring for yield and demand was high at wider than historical spreads (IG corporate spreads started 2012 at 2.33% and averaged 1.78% over the course of the year). Issuers answered the increased appetite for IG corporate bonds with five consecutive years of over $1 trillion in new supply. In addition, issuers extended their average maturity of their new debt from 13 years in 2011 to 17 years in 2016, explaining the one-year increase in duration of IG corporates over that same time period. Locking in lower rates for a longer period made financial sense and also freed up cash flows for operations, perhaps even allowing for stock buy-backs. Issuance through the first half of 2017 has been $868 billion, on pace for $1,736 billion in 2017 assuming the same pace is kept in the latter half of the year [Figure 3]. This would be another record, and could put pressure on the secondary market, all else equal.

For now the supply has been managed well by investor demand, but if interest rates spike substantially higher, liquidity could become an

2 IG CORPORATE BOND SPREADS TO COMPARABLE TREASURIES ARE WELL BELOW LONG-TERM AVERAGES



Source: LPL Research, Bloomberg 07/31/17

IG Corporate Bonds represented by the Bloomberg Barclays U.S. Corporate Bond Index. Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

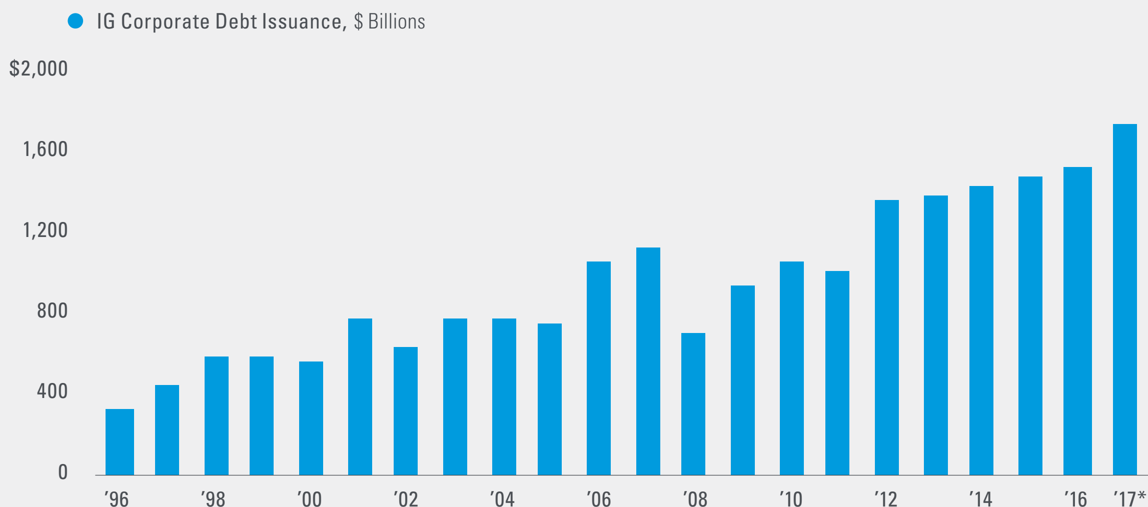
Spread illustrated is the yield on IG corporate bonds less the yield on comparable maturity Treasury debt.

issue as investors attempt to sell simultaneously. This is not our base case scenario, as we are expecting more demand from foreign investors as the European Central Bank agreed to continue its bond buying program. Central bank buying in Europe may crowd other investors out and push them to U.S. markets. Also, the President's proposed corporate tax cuts could reduce new issue supply as corporations should have additional cash flow from lower taxes and may not want to tap the new issue market, should interest rates move higher.

CONCLUSION

Domestic corporations appear to be on solid footing. A strong business environment for corporations and the potential for corporate tax cuts may be tailwinds for the asset class. Interest rate risk remains important, however, and is as high as it has ever been for IG corporate investors. Investors can reduce interest rate sensitivity by buying shorter-duration IG corporate bonds, which target an average duration of three to five years. A positive of increased supply is that IG corporate credit quality may be boosted as corporations will have additional capital available to invest in new products and services. Other risks exist as well, like a potential selloff in U.S. equities, which would likely drag down the high-yield corporate bond sector and hurt longer-duration IG corporates. Well-diversified investors, however, with shorter than benchmark duration, may be able to mitigate this risk and potentially buy bonds at wider spreads. We remain generally positive on IG corporates within high-quality fixed income, but remain cautious regarding interest rate risk as we see longer-term yields advancing higher in line with a pickup in growth and inflation. ■

3 IG CORPORATE ISSUANCE IS ON PACE FOR ANOTHER RECORD



Source: LPL Research, Securities Industry and Financial Markets Association (SIFMA) 07/31/217

*2017 – Annualized reflects issuance through 6/30/2017.

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IMPORTANT DISCLOSURES

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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.

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

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.

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.

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

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.

INDEX DEFINITIONS

The Bloomberg Barclays US 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 U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market. Bloomberg Barclay's U.S. Treasury Index includes public debt of the U.S. Treasury with a remaining maturity of one year or more.

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