Bond Market Perspectives

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Deliberating Defaults

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Highlights

A low default environment continues to support taxable and municipal high-yield bond investors.

A look at the types of defaults suggests that defaults are likely to remain low by historical measures in the taxable market through 2012.

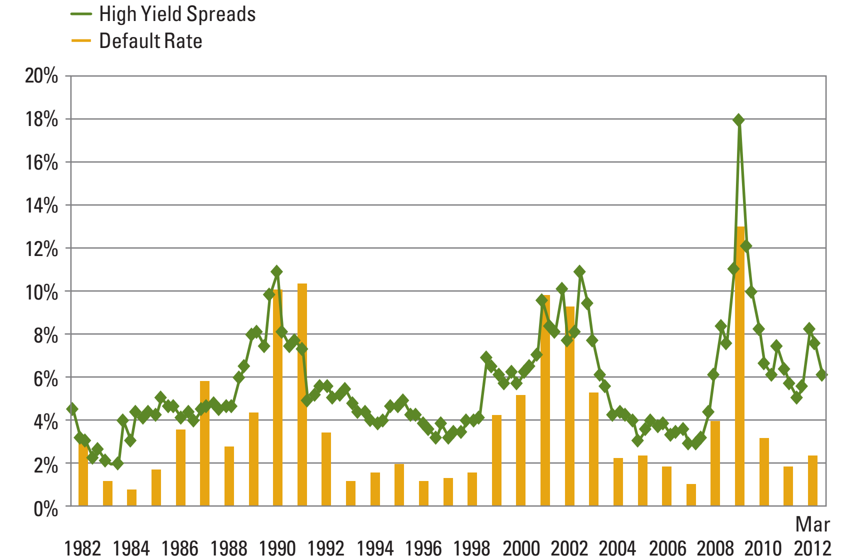
Municipal bond defaults remain concentrated among the most speculative issues and are on pace to decline for the fourth consecutive year.

We believe high-yield bond prices already reflect the prospect of higher defaults.

Bond investors, both taxable and municipal, pay close attention to bond defaults, which in turn can affect the prices of high-yield bonds. With a bond's maturity price capped at par (100), defaults open up bond investors to receive significantly less than par value and can more than wipe out the value of interest income received over the life of a bond.

As defaults increase, or are anticipated to increase, investors demand higher yield premiums relative to the safety and security of U.S. Treasuries. Conversely, yield premiums, or spreads, decline when defaults are anticipated to decline. In the taxable market, the correlation between defaults and yield spreads can be easily illustrated by comparing the yield spread with the 12-month trailing default rate compiled by Moody's [Chart 1].

1 High-Yield Bond Valuations, as Measured by Yield Spreads, Are Highly Correlated With Defaults



Source: Moody's, Barclays Capital, LPL Financial 3/30/12

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.

In 2011, yield spreads fluctuated wildly due to fear over a return to recession and the subsequent spike in defaults. European fears played a significant role in causing default expectations to soar. But throughout the noise, defaults steadily declined for most of 2011, before the number of defaults began to increase modestly late in 2011. Although higher, the default rate remains very low by historical standards—a testament to the financial strength of corporate bond issuers.

We caution investors that high-yield municipal bond performance is likely to slow after a strong first quarter...

The global speculative default rate increased to 2.3% at the end of March 2012, according to Moody's, up from a low of 1.8% in late 2011. Defaults have likely bottomed and are likely to move higher from here. Moody's forecast the default rate to increase to 3.0% at the end of 2012. Moody's default rate is based upon the number of issuers that default. Based upon the dollar amount of outstanding bonds, the default rate is a more benign 1.7% on a global basis and only 1.5% in the United States according to Moody's.

We believe high-yield bond prices already reflect the prospect of higher defaults. Even in the event that defaults exceed Moody's forecast to say 4%, for example, we believe current valuations, as measured by an average yield advantage of 6.5% to comparable Treasuries, adequately compensate investors for default risks.

Three Primary Bond Default Causes

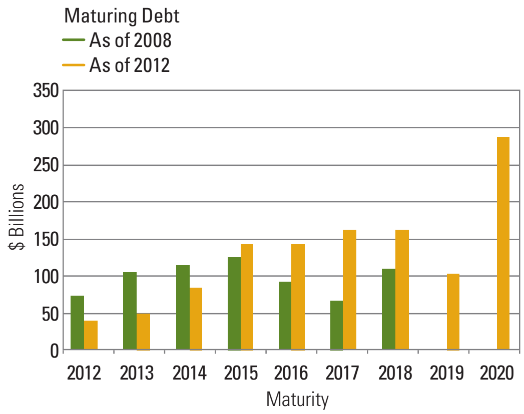
The primary causes of a bond default fall into three broad, but interrelated, categories:

1. **Insufficient revenue.** First, and most obvious, a default may occur when a bond issuer does not have enough revenue from the normal course of business operations to make scheduled interest or principal payments when due. Such defaults are often expected as regular financial reporting may reveal how long a bond issuer will be able to service debt obligations absent a change in economic or industry prospects.

...but manageable default risk still makes the sector an attractive consideration for bond investors.

2. **A lack of liquidity.** A bond issuer may default simply by being unable to attain funding, either from financial markets or business partners, at a critical point in time. For example, bond issuers often roll over maturing debt by issuing new bonds to help repay an upcoming maturing bond. Proceeds from the new bond issue are used to pay off the old bonds at maturity. During hostile market environments characterized by high risk-aversion, such as late summer 2011, demand for high-yield bonds may disappear. An issuer may not be able to sell new bonds in such an environment and may therefore be unable to access the bond markets for necessary funding, which may trigger a failure to repay debt obligations. In 2008, Lehman Brothers defaulted as counterparties failed to provide funding for day-to-day operations for fear of not being repaid.
3. **Strategic defaults.** Although rare, a bond issuer may default for strategic purposes. American Airlines is an example of this in the corporate world, as management viewed the company's cost structure as unsustainable in the long-run and viewed bankruptcy as its best option to restructure obligations with unions. Strategic defaults are possible in the municipal bond market and may become more frequent as issuers default and rely on insurers to make interest and principal payments to bondholders.

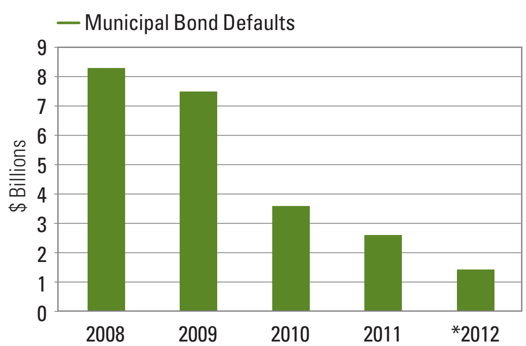
2 The Lack of Maturing Debt Through the End of 2013 Should Help Keep Defaults Low



Source: Bloomberg, LPL Financial 12/31/12

Strong credit quality and a lack of maturing debt should help keep defaults low and support high-yield bond valuations.

3 Municipal Bond Defaults Are on Pace to Decline for the Fourth Consecutive Year



Source: MMA, MSRB, LPL Financial 3/30/12

*First quarter pace annualized for full year 2012.

Strong Credit Quality and Lack of Maturing Debt Are Key Factors

Because of the strength in corporate earnings over recent quarters, defaults due to insufficient revenue, the first category described above, are likely to be few. S&P 500 earnings have more than doubled since early 2009. Corporate credit quality metrics finished 2011 on a strong note, and the modest 3% earnings growth expected for the first quarter of 2012 should support the strong debt service capability of U.S. high-yield bond issuers.

Due to the lack of maturing bonds over the coming two years, the risk of a surge in defaults from a lack of liquidity, the second type of defaults above, is also very low. High-yield bond issuers have done an excellent job of refinancing near-term debt maturities. Approximately $75 billion in high-yield bonds mature between now and the end of 2013 [Chart 2]. To put that into perspective, $75 billion is less than the approximately $100 billion in new high-yield bonds issued during the first quarter of 2012 alone. Taken together, strong credit quality and a lack of maturing debt should help keep defaults low and support high-yield bond valuations.

Municipal Defaults Remain Isolated

Through the end of the first quarter of 2012, municipal bond defaults continued to decline. According to Municipal Securities Rulemaking Board (MSRB) filings and Municipal Market Advisors (MMA) data, new municipal defaults totaled $363 million compared to $576 million over the same time period in 2011, a decline of 37%. Municipal bond defaults are on pace to decline for the fourth consecutive year [Chart 3]. Apocalyptic default fears from just over one year ago have failed to materialize. If the current pace of defaults were to continue, defaults would total $1.45 billion in 2012, or just 0.04% of the entire $3.7 trillion municipal bond market.

Not only are defaults low but municipal defaults continue to be concentrated among the most speculative issues. Non-rated issuers constitute the vast majority of defaults comprising roughly 80% of all defaults since mid-2009 according to MMA data.

One caveat to municipal default data is that since July 2009, $28 billion in municipal bonds have accessed reserve funds or some other measure of support. While most of these financially stressed issuers have not defaulted and continued to make regular interest payments, it still reflects ongoing stress in the municipal bond market. Still, the dollar amount is a small fraction of the outstanding municipal bond market. Finally, the fate of $3.2 billion in American Airlines-backed municipal debt is still in flux. While most of the American Airlines debt continues to make regular debt payments, a change could alter the default projections outlined above.

Defaults that have occurred in the municipal bond market have received a great deal of publicity, but these higher-profile defaults remain isolated cases. Special circumstances (Jefferson County, AL — corruption; Harrisburg, PA — an overleveraged waste incinerator project; Vallejo, CA — bloated union cost structure; and Stockton, CA — a strategic default to rely on municipal bond insurers to make interest payments) surround these defaults that we believe are not representative of the broader municipal bond market.

We believe defaults are not problematic for municipal bond investors. We caution investors that high-yield municipal bond performance is likely to slow going forward after a strong first quarter, but manageable default risk still makes the sector an attractive consideration for bond investors. ■

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Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

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 risk, and interest rate risk.

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.

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.

Default Risk is when companies or individuals will be unable to make the required payments on their debt obligations. Lenders and investors are exposed to default risk in virtually all forms of credit extensions. To mitigate the impact of default risk, lenders often charge rates of return that correspond the debtor's level of default risk. The higher the risk, the higher the required return, and vice versa.

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.

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

Non-rated bonds have not been issued a rating by bond rating agencies such as Standard & Poor's and Moody's. Bonds that have not been rated by an agency are usually considered to be junk bonds or fall below investment grade.

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Correlation is a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management.

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.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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