Weekly Market Commentary

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The One Big Risk

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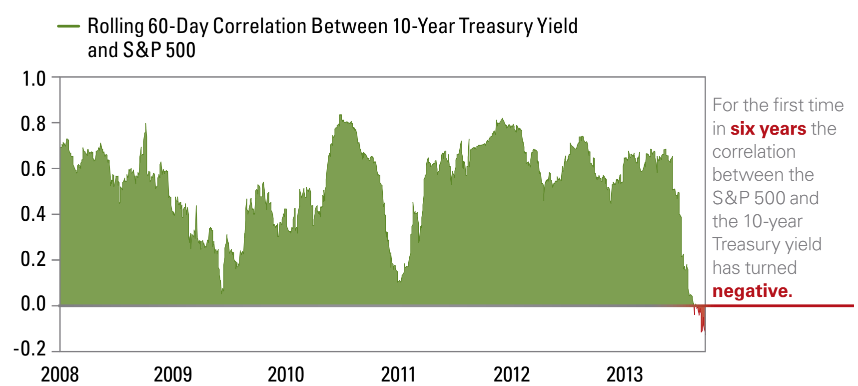
Highlights

As Lehman Brothers filed for bankruptcy on September 15, 2008, there was one big risk everyone was worried about across their portfolios: credit risk. Five years later, another single big risk has emerged in the minds of investors: interest rate risk. High-yield bonds and low-yield stocks may provide some insulation from rising rates in your portfolio.

When Lehman Brothers filed for bankruptcy on September 15, 2008, defining the seminal event of the financial crisis, there was one big risk investors were worried about across their portfolios: credit risk — the potential losses arising from the inability of mortgage borrowers, financial institutions, and government enterprises to pay back their debts. As we reach the five-year anniversary of that event this coming weekend, another single big risk has emerged in the minds of investors: interest rate risk — the potential losses from rising interest rates on financial assets. While not worthy of anywhere near the same degree of concern as five years ago for most investors, all market participants have been focusing on this traditionally bond-market-centric risk.

Of course, for bond investors, rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. In general, the prices of longer-term and lower-yielding bonds have the greatest interest-rate sensitivity. Over the past four months, the sharp rise in the yield on the 10-year Treasury from 1.6% on May 2 to 3.0% on Friday of last week has resulted in losses for many high-quality bonds. But it has been no picnic for other asset classes either. For much of the past five years, high-yield bonds have acted a lot more like stocks than bonds, measured by statistical correlation. However, the rise in rates this year has reminded high yield bondholders that they are still bonds, as they have tracked the losses in bonds since May 2 rather than the gains in stocks.

1 Relationship Between Stock Prices and Bond Yields Turns Negative



Source: Bloomber, LPL Financial 09/06/13

The S&P 500 is an unmanaged index, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. Index performance is not indicative of any particular investment. Past performance is no guarantee of future results.

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

Normally, rising rates are not a problem for stocks until the yield on the 10-year Treasury gets above 5%, when increasing inflation typically starts to become a problem. But the pace at which yields head higher matters at any level. The sharp rise in rates in August prompted a pullback in stocks. For the first time in six years, the correlation between the S&P 500 and the yield on the 10-year Treasury has turned negative [Figure 1].

So it seems just about everything in portfolios suddenly got very averse to rising interest rates. There is no way to completely insulate a portfolio from rising rates using traditional investments. Even holding only cash will eventually lose ground to inflation as rates rise (and current money market yields are well below the pace of inflation). So how do you provide some insulation from rising rates in your portfolio? In general, within portfolios, consider:

- Stocks over bonds,
- High-yield bonds,
- Low-yield stocks.

While it may be impractical or undesirable to eliminate all bond exposure from your portfolio, favoring stocks over bonds can help to mitigate interest rate risk. While stocks can suffer as rates spike, high-quality bonds may fare worse. For example, high-quality bonds, as measured by the Barclays Capital U.S. Aggregate Bond Index, are down 4.6% since May 2 while stocks are actually up 4.5%, as measured by the S&P 500 Index.

Within the bond market, high-yield bonds offer some insulation from rising interest rates relative to low-yielding bonds. However, that is not the case for stocks, where stocks with the highest dividend yields have been the worst performers. The high-yielding utilities and telecommunications sectors have fallen about 10% since yields began to rise on May 2, 2013 [Figure 2]. Lower-yielding, higher-growth sectors, such as consumer discretionary and industrials, have fared the best.

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2 High-Yielding Stock Sectors Have Fared the Worst

Price Performance of S&P 500 Sectors

Sector	Since August 2	Since May 2
Industrials	-2.4%	8.4%
Discretionary	-3.1%	7.3%
Financial	-4.6%	6.4%
Health Care	-2.0%	6.1%
Materials	0.3%	5.4%
Energy	-0.7%	5.2%
Tech	-0.7%	4.9%
Staples	-4.7%	-3.2%
Utilities	-6.7%	-9.9%
Telecom	-6.7%	-10.8%

Source: Bloomberg, LPL Financial 09/06/13

Sector Indexes: Industrials – S&P 500 Industrials Index; Discretionary – S&P 500 Consumer Discretionary Index; Financial – S&P 500 Financials Index; Health Care – S&P 500 Health Care Index; Materials – S&P 500 Materials Index; Energy – S&P 500 Energy Index; Tech – S&P 500 Information Technology Index; Staples – S&P 500 Consumer Staples Index; Utilities – S&P 500 Utilities Index; Telecom – S&P 500 Telecommunications Index.

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Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

The financials sector has been among the best performers since May 2, but it has suffered over the past month as the rise in rates accelerated towards 3%. Rising rates help improve bank's profitability as loan rates go up, but too sudden an increase in rates may hurt their assets. The impact on profitability takes place relatively slowly, as new loans are made and old loans reprice at new interest rates over time. However, as rates rise, banks immediately suffer the risk of potential losses to the market value of the bonds and other assets they hold, just like any investor.

For the overall stock market, just like for financials, a slow and steady increase in rates is generally a plus, and a sharp jump acts as a negative. Fortunately, the sharp rise in rates may be due for a pause. Historically, the yield on the 10-year Treasury tracks nominal gross domestic product (GDP) growth, or real GDP growth plus the pace of inflation (please see our June 19, 2013 *Bond Market Perspectives* for more on this relationship). Third-quarter real GDP is tracking to 1.5 – 2% while inflation is running at 1 – 1.5%. So, last week's rise in yields to around 3% places it right in the middle of the range of the "normal" level for the 10-year Treasury, despite the effects of the Federal Reserve's soon to be wound down bond buying program.

No doubt, if interest rates slow—or even reverse—their recent steep climb, investors will still have plenty of other risks to turn their focus to: potential military action in Syria, sluggish global economic growth, Congress' fiscal fight over the debt ceiling and funding for the federal government, among others. But any easing in the one big risk on investors' minds right now would likely be a plus. ■

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. All indices 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.

Stock investing involves risk including loss of principal.

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.

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

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Interest rate risk is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship. Such changes usually affect securities inversely and can be reduced by diversifying (investing in fixed-income securities with different durations) or hedging (e.g. through an interest rate swap).

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

No strategy assures a profit or protects against loss.

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 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.

The S&P Consumer Discretionary Index is comprised of companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

The S&P Consumer Staples Index is comprised of companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

The S&P Energy Index is comprised of energy companies that primarily develop and produce crude oil and natural gas, and provide drilling and other energy related services.

The S&P Financials Index is comprised of a wide array of diversified financial service firms are featured in this sector with business lines ranging from investment management to commercial and investment banking.

The S&P Healthcare Index is comprised of companies in this sector primarily include healthcare equipment and supplies, health care providers and services, biotechnology, and pharmaceuticals industries.

The S&P Industrials Index is comprised of companies whose businesses: Manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

The S&P Information Technology Index is comprised of stocks primarily covering products developed by internet software and service companies, IT consulting services, semiconductor equipment and products, computers and peripherals, diversified telecommunication services and wireless telecommunication services are included in this index.

The S&P Materials Index is comprised of companies that engage in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

The S&P Telecommunications Index is comprised of companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

The S&P Utilities Index is comprised primarily of companies involved in water and electrical power and natural gas distribution industries.

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