Fixed Income Commentary

November 6, 2015

KEY TAKEAWAYS

Equity markets recovered from the summer rout as global economic data remained soft. The Federal Reserve opted not to raise rates twice over the last two months, but indicated that they're still on track for a 2015 rate hike potentially at December's meeting. Many European government bond markets have negative yields.

Key Rates	Dec 31 2014	Sep 30 2015	Oct 31 2015
Treasury Yields			
2 Year	0.66	0.63	0.72
5 Year	1.65	1.36	1.52
10 Year	2.17	2.04	2.14
30 Year	2.75	2.85	2.92
Credit Yields			
BBB Industrial 10 Year	3.42	3.87	3.86
Muni Yields			
AAA Ten Year	2.10	2.10	2.08
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.84	2.80	2.83

OCTOBER IN REVIEW

- Stocks posted their best October returns in four years
- Interest rates rose modestly. 10-15 basis points across the yield curve
- Spread sectors of the fixed -income markets, namely corporate bond, mortgage back securities and municipals, all narrowed in spread during the month

What Me Worry?

It's amazing how short-term focused and fickle investors' psyches and markets can both be. Just two months ago, the markets' consensus view was that China is melting down, commodity prices would continue to plummet, the Fed would commence to raise interest rates, and global stock markets were headed into the abyss after years of gains. Here we sit today and China didn't fall off the earth. In fact, the Shanghai Composite Index is up 5.5% in the last two months, the Fed has passed twice on raising interest rates due to soft economic data and stocks have pushed back to near record levels.

So why have markets turned around?

Weaker global economic growth and nonexistent inflation have allowed central banks to keep interest rates low. In terms of growth, global GDP continues at a very low to moderate pace and positive economic reports are quickly followed by negative data points. If interest rates act as a barometer of economic activity, it is clear that the global economy is nowhere near out of the woods. This can be seen in Exhibit 1.

The United States has the highest interest rates in the industrialized world, with the exception of Australia. It seems ironic then that the Fed seems to be so intent on raising interest rates. Many countries even have "negative" interest rates! Negative interest rates occur when investors pay more today for an investment than it's ultimately worth. For example, a U.S. Treasury Bill pays no interest and matures at $1,000. If you paid $1,010 today for the $1,000 at maturity, it would produce a return of -1%. Negative interest rates are basically a penalty for saving instead of spending. The European Central Bank, through quantitative easing, has contributed to this low– or negative interest rate environment. It is easy to conclude that policy makers are desperate to stimulate final demand. It is also symptomatic of a lack of investor confidence in the banking system.

EXHIBIT 1: SOVEREIGN INTEREST RATES (%)

Country	2-yr	5-yr	10-yr
USA	0.76	1.58	2.19
Canada	0.58	0.90	1.58
Mexico	-	2.85	3.62
UK	0.68	1.33	1.96
Australia	1.81	2.13	2.68
Japan	0.00	0.04	0.30
Spain	0.04	0.70	1.75
Italy	0.05	0.56	1.65
France	-0.26	0.12	0.92
Germany	-0.31	-0.06	0.56
Sweden	-0.48	0.00	0.63
Netherlands	-0.30	-0.03	0.73
Switzerland	-0.99	-0.88	-0.31

Source: Bloomberg Financial L.P.

Historically low/negative interest rates are no longer enough to stimulate global demand. Most Central Banks have little, if any, capacity left in terms of monetary policy via traditional measures. Global free trade and the internet have unleashed deflationary forces upon the world economy which may last for decades. Clearly, interest rates aren't anywhere near "normal" levels, but may still stay outrageously low for quite some time.

It is very possible that both stocks and bonds move sideways indefinitely. There will likely be periods of volatility, but they may be more the exception than the norm. The world may face a "lost decade" or two, similar to what Japan experienced in the 1990's. Moving sideways might be the preferred outcome.

State Budget Woes Continue

While most state budgets are in better shape than ever, the picture is not rosy everywhere. Illinois in particular has become the poster-child for state-level budgetary dysfunction. The fiscal stalemate, which is now in its fifth month, has forced the state to curb services and slow construction projects. The legislature and Governor Bruce Rauner have been unable to come to terms over taxes (which the legislature wants to increase) and excessive pension benefits (which the Governor would like to curb). The impasse has led to credit downgrades and a drop in prices for municipal bonds issued in the state.

Illinois is a case study in the hazards of lending to political entities. The state offers very generous pension benefits to its employees and these obligations are at the root of the budget problems. However, the legislature also amended the state constitution to prohibit any public entity, including the state, from cutting pension benefits as a means of correcting fiscal problems. This amendment has forced the state to raise its tax burden to one of the highest in the nation while prohibiting any modifications to a significant cause of the problem.

While this is bad for state taxpayers, it also threatens bond holders. Labor and statehouse leaders are demanding bond holders share in any compromise. The risk of principal loss has prompted many municipal bond holders, who tend to be individuals living in the state, to sell bonds and avoid buying new issues. As a result, yields on Illinois paper are soaring.

The impact of the Illinois pension crisis will hit local government bonds far harder than state G.O's. Illinois can default, but the debt cannot be dismissed since there is no provision in bankruptcy law for states to seek court protection from debts. However, default can be an effective tool to force a partial compromise with creditors. With so many politically connected constituents involved, such a move is not as unlikely as it may seem. Investors chasing yield should understand the growing risks associated with state municipal bonds.

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