FIXED INCOME COMMENTARY

January 6, 2017

KEY TAKEAWAYS

Bond markets finished the year with modest gains. The year was a tale of two halves for the bond market. Strong returns throughout the first six months were followed by poor returns over the remaining six months. In 2017 investors will be looking for signals on inflation and continued economic growth in the US.

Key Rates (%)	Dec 31 2016	Nov 30 2016	Dec 31 2015
Treasury Yields			
2 Year	1.19	1.11	1.05
5 Year	1.93	1.84	1.76
10 Year	2.44	2.38	2.27
30 Year	3.07	3.03	3.02
Credit Yields			
BBB Industrial 10 Year	3.68	3.72	3.99
Muni Yields			
AAA 10 Year	2.35	2.51	2.00
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.13	3.09	3.02

DECEMBER IN REVIEW

- High-yield was by far the best performing sector in the fixed income market in 2016, +17.13%.
- US Treasuries struggled in the back half of 2016, returning -4.11% over the last six months.
- The Fed raised the federal-funds target rate by 25 bps to between 0.50% and 0.75%, the second rate increase in a decade.

A Tale of Two Halves

It was a tale of two halves for the bond market in 2016. Bonds posted strong returns in the first half, lousy returns in the second and finished the year overall with only marginal positive returns. This trading activity mirrored the economic growth pattern of the year.

Real growth, as measured by Gross Domestic Product (GDP), grew at a very timid pace during the first half of 2016. This weak first half growth triggered a bond rally, as market participants viewed the Fed to be on hold until December. Interest rates fell 50-to-80 basis points for the first half of the year, with long duration assets posting the best returns. Other catalysts fueling the rally were the significant slowing of China's economy, the collapse in oil prices, and the US Unemployment rate, which held stubbornly steady at about 5%. Despite US nonfarm payrolls posting 74 consecutive months of positive increases, most investors felt the global economy was too fragile to handle a US rate hike. Of course, the "Brexit" vote helped solidify this view.

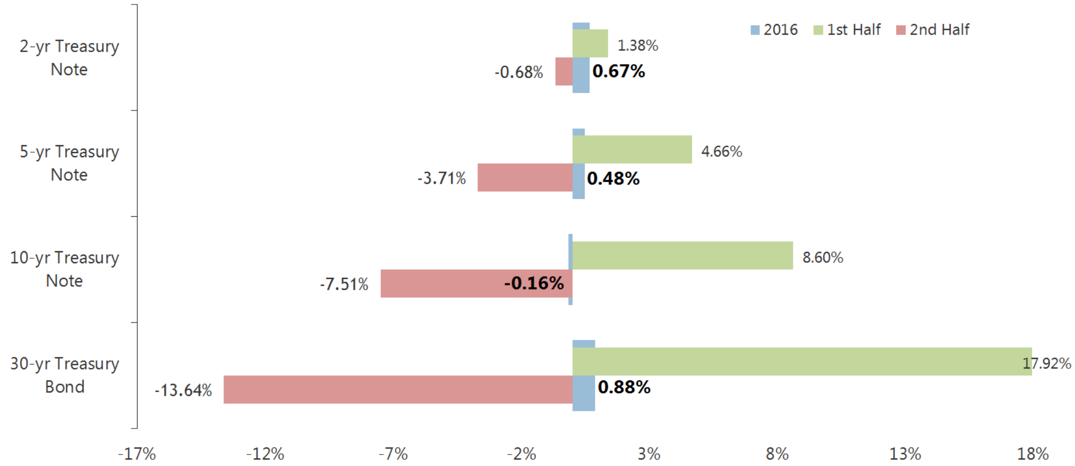
On June 23rd, 2016, Great Britain voted to leave the European Union, stunning the global financial markets and precipitating a massive global equity selloff. Chinese, US, and British stock market indices were down 3-to-4%, German, French, and Japanese markets lost 7-to-8%, while Italian, Spanish, and Greek lost in excess of 12%. This immediately prompted several central bankers to announce open-ended support for the financial system, leading to more buying in the bond market. Commodity prices rebounded sharply, the US Dollar strengthened significantly, and exporting countries were optimistic about future sales. Even the Federal Reserve Board decided to defer further rate action (yet again), awaiting more signs of economic growth.

A steady flow of positive US economic data and a growing consortium of Fed governors calling for an immediate rate hike caused rates to turn higher by the end of summer. The election of Donald Trump proved to be the final straw, as investors, either gleefully or grudgingly, acknowledged the likely efficacy of the pro-growth policies he has outlined.

This new paradigm reversed the gains of the first of the year and then some. **Exhibit 1** and **Exhibit 2** illustrate the striking tale of two halves, in terms of total returns, according to the Bloomberg Barclays Indices. Bonds generally had a strong first half and a lousy second half, with the sole exception being the high yield market, which was more correlated with equities than interest rates.

Bellwether US Treasuries, of all maturities, posted very modest returns due to the late year rise in interest rates. Other high-quality sectors, such as Mortgage-Backed Securities (MBS), also posted modest returns for the year.

EXHIBIT 1: US TREASURY MARKET TOTAL RETURNS

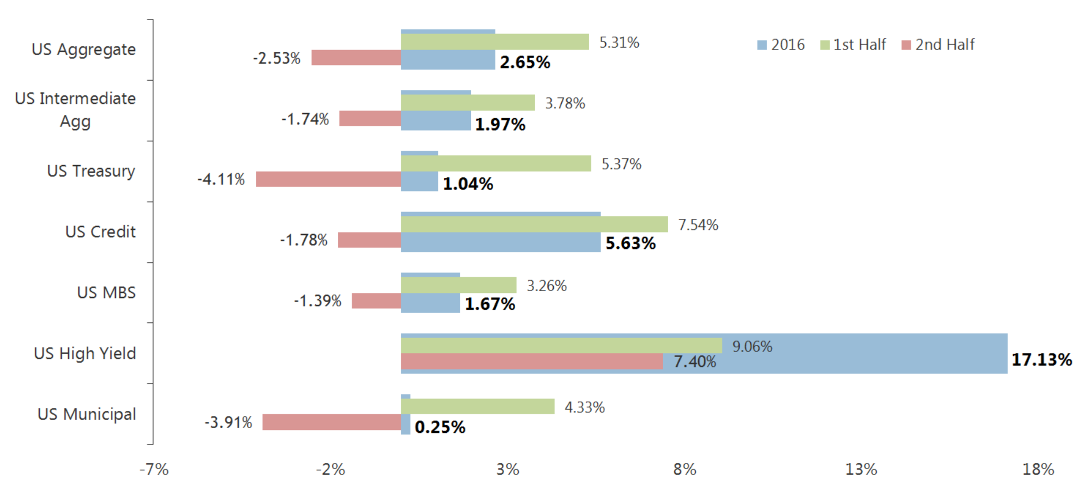


Source: Bloomberg Financial L.P. and Barclays Securities

The prospect of a stronger economy boosted earnings projections and benefited corporate bonds. Credit had a strong year relative to other investment-grade sectors, reflecting the same forces that buoyed both the high yield market and equities. Within the US Credit Index, BBB-rated bonds outperformed AAA-rated ones by a whopping 651 basis points. In general, the lower the rating, the better the bond performed.

Municipal bonds were probably the most striking example of last year's bifurcated market. Muni's outperformed in the first half of the year, helped by the apparent certainty of a November win by Hillary Clinton, a candidate advocating higher taxes and lower deductions for the affluent. The sector then got crushed in the second half on rising fears of credit deterioration and the recognition of huge unfunded pension obligations in many cities and states. Municipal bonds became the worst-performing sector for the year, following a post-election price collapse. This price reversal reflected President-elect Trump's promises to lower tax rates in the years ahead. Municipal bonds are more attractive to investors when tax rates are high and lose appeal when tax rates are low.

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

Looking ahead to 2017, we believe rising interest rate pressures will continue to weigh on fixed-income returns. While markets are still in a long term bottoming pattern, economic data, Federal Reserve policy statements and political agendas all suggest higher rates in the months ahead. It is interesting to note that interest rates were only up 15 basis points during calendar year 2016, yet returns were less than half of opening yield-to-maturity levels. Put another way, with rates still low by historical metrics, it will not take a dramatic rate movement to wipe out positive returns for the year.

We have probably already passed the inflection point where economic activity will be a more significant driver of bond returns than monetary policy. In recent years, the Fed has been able to maintain a "zero-bound" interest rate policy regardless of GDP growth rates. This is no longer possible, even if the Fed so desires. Stronger GDP numbers will move rates higher—at least for securities with maturities greater than two years—even if the Fed wishes rates to remain unchanged. Any decline in the Fed funds target rate following weaker data will likely only match what the market has already priced in and will not lead rates lower.

We start the new year with an economy that is in expansion mode. The announced policies of the President-elect—whether or not readers find them agreeable—should accelerate growth over the next year or two; a point acknowledged by the

Federal Reserve at its last meeting. While these policies will need time to flesh out and implement, the market is already pricing in the benefits of the proposed legislation. We expect to see a steady economy in the upcoming year.

Monetary policy will still remain a major focus in the months ahead. Rising commodity prices and continued wage pressures have pushed inflation levels ever closer to the Fed's 2% target range. This target has been a major hurdle for policy normalization, even as other indicators show that we are well out of the "emergency" range that prompted the Fed's "zero-interest rate" policy. The FOMC would be forced to take explicit action if inflation is sustained at this level for a quarter or two. Many, including the several FOMC members, now see three rate hikes as a strong possibility for 2017. The MCM projection is for two rate hikes by the Fed in 2017, although just one remains a strong possibility if growth does not materialize as expected. We believe both of these hikes will occur in the second half of the year.

The Fed also holds $3.8 billion of government bonds (Treasuries, agencies and agency-MBS) on its balance sheet; a legacy of the Quantitative Easing activities earlier in the decade. It will eventually have to allow these securities to mature (and not be reinvested) or be liquidated by outright sales. There is no easy way to add this large supply of bonds back to the market without disruption of some form. We expect the yield curve to steepen as this inventory is rolled off. The Fed has stated it would begin the process after the third rate hike. The next move will be the third hike off the ZIRP (zero interest rate policy) bottom. We expect this risk to gain more attention soon.

On a final note, geo-political risks remain a big unknown. As with Brexit, the Trump election reflects voter disdain for the status quo and illustrates a growing wave of nationalism in the world. This was again the theme in December, when Italy voted not to amend its 1948 constitution, forcing Prime Minister Matteo Renzi to resign and prompting new elections. It will continue to be an important force in the year ahead, as many political parties and nations actively try to expand their spheres of influence.

Virtually all spread sectors of the bond market are at or near their five year tights. It is hard for us to imagine the high yield sector being able to come close to the stellar returns posted in 2016. Lower-quality, investment grade corporate bond spreads (BBB) are pushing on 5-year narrows relative to high-quality AAAs; we do expect this relationship to widen in 2017. The spreads on MBS and high-grade corporate bonds, in general, are also tight, but should hold steady in the face of modest rate increases. Municipal bonds may be the best of the worst, since much of the bad news was priced in during the second half of 2016. We continue to like municipals, but they have their issues with credit deterioration, strained budgets, and an unknown tax policy. We intend to keep client portfolio durations on the short side of benchmarks and focus on security selection and sector selection to enhance returns.

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