Fixed Income Commentary

April 2, 2014

Bears Come Out of Hibernation in the Spring!

At this time of year in Vermont, bears start to come out of hibernation. If the ski season runs late you can sometimes catch a glimpse of one while you are enjoying some great corn snow and sunny skies. At other times, the bears will come down from the hills into residential neighborhoods to eat from bird feeders and forage for other food. The bears really like to visit my neighbor because he stores vats of used cooking oil in his backyard over the winter to refine into bio-diesel during the summer. Used french fry oil must be a bear delicacy! After a few weeks of foraging at lower elevations, the bears go back to higher elevations on the mountains.

Bears at a distance are almost cute, but at close range they are dangerous.

In the bond market we are witnessing a "bear flattener" in the yield curve. Like hungry bears in the spring, we trust this is a seasonal sighting and we hope both will return to the hills sometime soon.

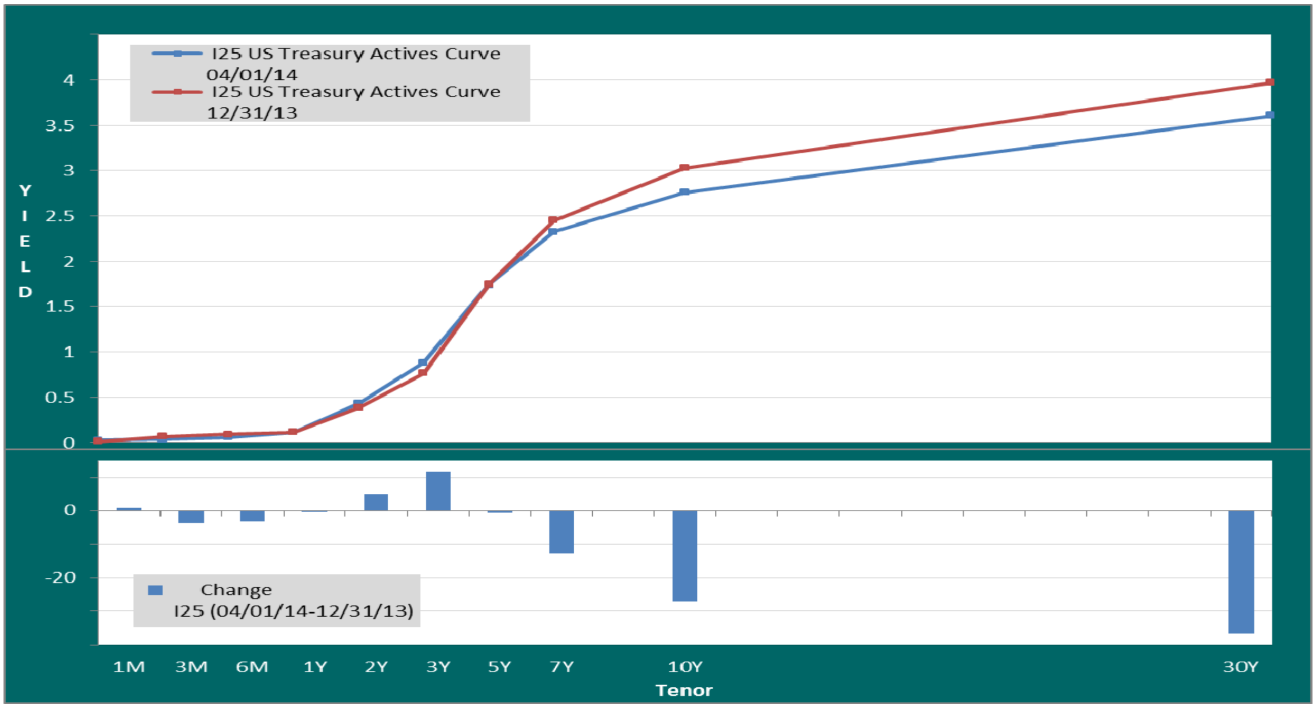
Fast Read……

- Short rates are rising and long rates falling – a bear flattener in bond parlance.
- The markets anticipate the end of Fed accommodation (causing short term rates to rise) and subdued inflationary pressures (causing longer term rates to fall).
- Many fixed income portfolios have benefited in 2014 as the 7-to-30-year Treasury yields have rallied and credit spreads tightened.
- However, if this bears sticks around too long it spells trouble.

The short end of the yield curve is rising as markets anticipate the end of Tapering and a gradual rise in the Federal funds rate. Janet Yellen, the new Federal Reserve Chairman made quite the gaff in her first press conference when she implied the Fed funds rate could begin to rise as soon as six months after the end of Tapering. Since this comment, Janet has taken great pains to reiterate the Fed will stay accommodative until the labor markets are fully engaged and inflation reaches their target of 2.0%.

Chart 1 shows a classic bear flattener with 2–and 3-year yields rising and 7-, 10- and 30-year yields falling since the end of last year.

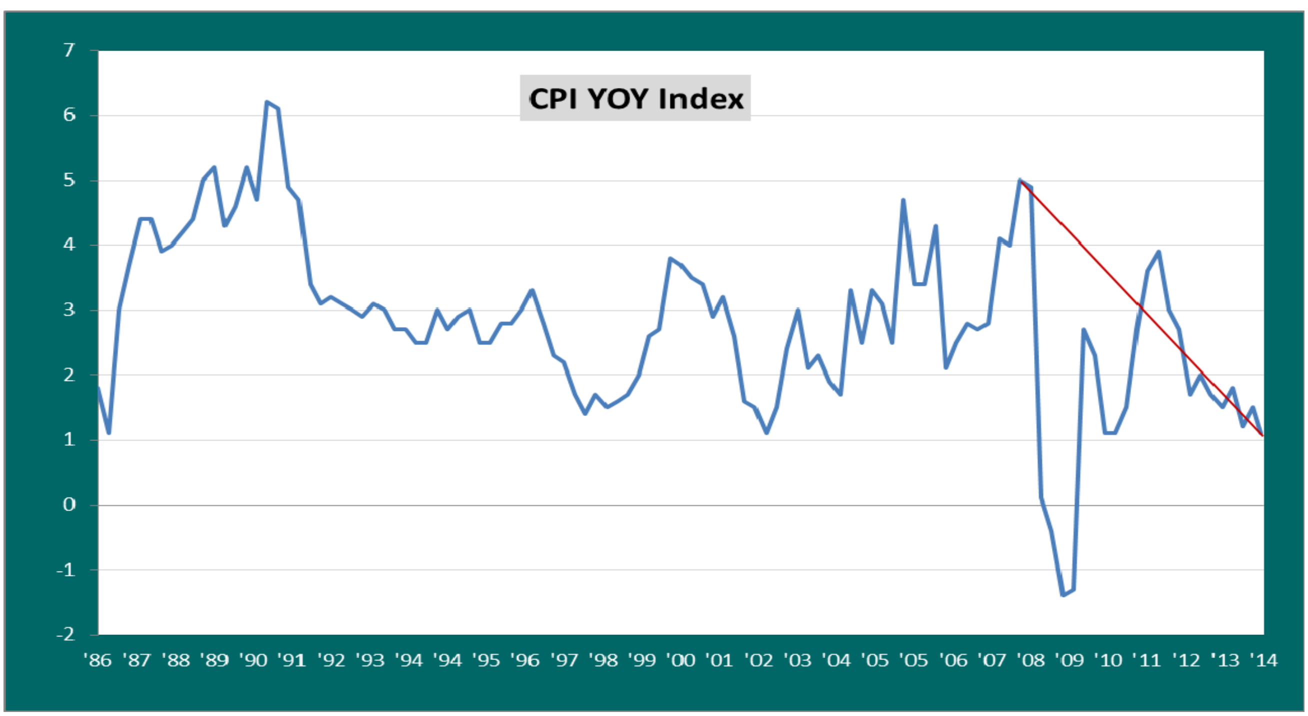
Chart 1: Bear Flattener – First Sighting – 1Q 2014



Source: Bloomberg

Yields in the intermediate and long end of the curve remain below our forecasts. We believe higher yields are dependent on the Federal Reserve's ability to generate inflation and reach its 2% target. However, inflation remains in a down trend despite the Fed's best efforts. The Fed will need to do better. Chart 2 highlights the falling levels of inflation in the United States.

Chart 2 – Losing the Fight for a 2% Inflation Rate – US Consumer Price Index



Source: Bloomberg

So far, the credit markets don't seem to mind the bear sightings. Credit spreads tightened in March and most investors appear heartened by the prospects of continued economic growth. Credit markets do not appear concerned about small increases in extraordinarily low short term rates as long as relatively cheap liquidity is supplied by banks and capital markets. Even falling longer term rates are viewed positively since lower borrowing rates benefit corporations, households, and the US government.

If this bear flattening lingers into summer it could mean something is wrong with the economy or monetary policy. Higher short term borrowing costs and a losing battle against the forces of deflation would be a bad combination for credit investors, the US economy or the world at large. A continuation or increase in the severity of a bear flattener usually only benefits those who purchase long duration Treasuries.

We believe the bears will eventually go back to the mountain. Our core projection assumes rates will rise with continued growth in the US economy and the efforts of the Federal Reserve to generate inflation. However, the outcomes for other scenarios are less rosy and we need to manage portfolios with an eye to all possible outcomes.

Strategy – Credit Risk and Preferreds in Shorter Maturities, Duration Risk with Municipals, and Active Yield Curve Management

We believe chasing yield by extending duration is a risky move. Interest rates should increase over time as the Fed tapers and eventually raises the Fed funds rate. However, the yield curve remains steep and hiding in short term maturities is detrimental to returns due to low real yields and foregone price benefits in the intermediate segment of the yield curve.

We seek to strike a balance between duration risk and low yield by purchasing intermediate maturities, a sweet spot on the yield curve. Intermediate maturities offer a significant yield pick up over shorter term securities and they are partially protected from rising rates since they "roll down the yield curve" as maturities approach.

Taking some credit risk continues to be an attractive way to add value. Credit is currently supported by an improving economy, abundant liquidity and an accommodative Fed. We remain comfortable having slightly more exposure to credit risk in the short end of the curve. If credit markets weaken short maturities would be least impacted.

Municipals remain attractive due to historically good valuations and anticipated higher tax rates. Our historical practice is to hold more duration in muni's than in corporates, especially since the average credit risk in municipals is lower than corporates.

In summary, we remain optimistic about the risk/reward trade offs in client portfolios. We are using sector selection, security selection and yield curve management to mitigate some interest rate risk. Additionally, we are using callable preferred stocks to add yield at the front end of the curve. We continue to source safe corporates with attractive yields as we scour the markets daily.

Please call us with questions and comments, or even if you want an update on recent bear sightings in Vermont!

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