Fixed Income Commentary

December 7, 2015

KEY TAKEAWAYS

After strong U.S. Employment reports in October and November, the Federal Reserve is set to commence their interest rate normalization process in December with the first increase since 2006. The ECB continues to lower rates due to stagnant economic growth. U.S. Treasury yields rose during November with the short end taking the brunt of the increase.

Key Rates	Dec 31 2014	Oct 31 2015	Nov 30 2015
Treasury Yields			
2 Year	0.66	0.72	0.72
5 Year	1.65	1.52	1.52
10 Year	2.17	2.14	2.14
30 Year	2.75	2.92	2.92
Credit Yields			
BBB Industrial 10 Year	3.42	3.86	3.92
Muni Yields			
AAA Ten Year	2.10	2.08	2.07
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.83	2.84	2.95

NOVEMBER IN REVIEW

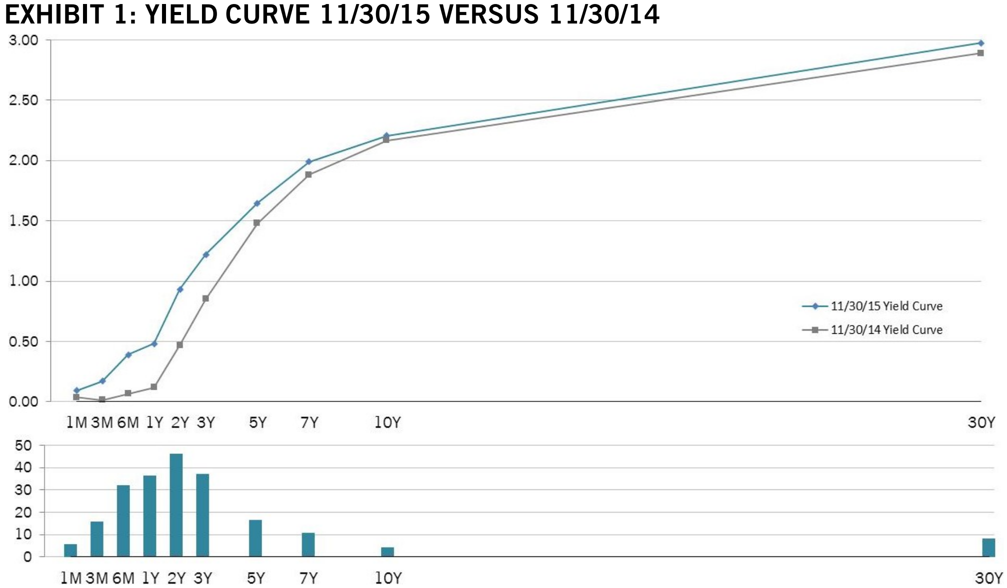
- Stocks were relatively flat.
- U.S. Treasury 2-year Note rose 20 basis points, the 5-year Note rose 13 basis points, while the 10-year Note just 6 basis points.
- The longer end of the U.S. Treasury yield curve has yet to price in the Fed interest rate hike.
- Corporate bonds, mortgage-back securities, and municipals, all contracted in spread relative to U.S. Treasuries.

Watching and Waiting

Interest rates were fairly-well contained during the month of November as bond markets wait for the Federal Reserve meeting on December 16th. Fed officials are ready to commence the interest rate normalization process, but remain adamant any moves will be data dependent. All eyes were on the economic data. The first major data point, the October Nonfarm Payrolls number released on November 6th, jumped 271,000, its strongest showing in 2015. The unemployment rate fell to 5%, the lowest level since 2008. On the inflation front, price pressures remained soft with the Producer Price Index falling -0.4% and the Consumer Price Index rising a scant 0.2% for the month. The price indices were aided by falling commodity prices with oil and copper declining -12% for the month, while gold was down -6.7%. Turning to growth indicators, the second look at real Gross Domestic Product for the third quarter was revised upward to 2.1% from an originally report 1.5% on an annualized basis. Housing was weak with housing starts falling -11% in November, while retail sales came in well below estimates.

Investors viewed these numbers as strong enough to keep the FOMC on track for a December rate move. Against this backdrop, yields on the U.S. Treasury 10-yr note traded between 2.14% and 2.34%, closing at 2.21%. However, the front-end of the U.S. Treasury yield curve rose steadily, as investors prepared for the looming interest rate hike. Yields on the U.S. Treasury 2-yr note rose 20 basis points to 0.93%, while yields on the 5-yr note rose 13 basis points to 1.65%. The following graph shows the U.S. Treasury yield curve movement over the last year. As can be seen, the front of the curve has adjusted more than the long end in terms of the anticipated interest rate rise. The yield curve remains extremely flat by historical

EXHIBIT 1: YIELD CURVE 11/30/15 VERSUS 11/30/14

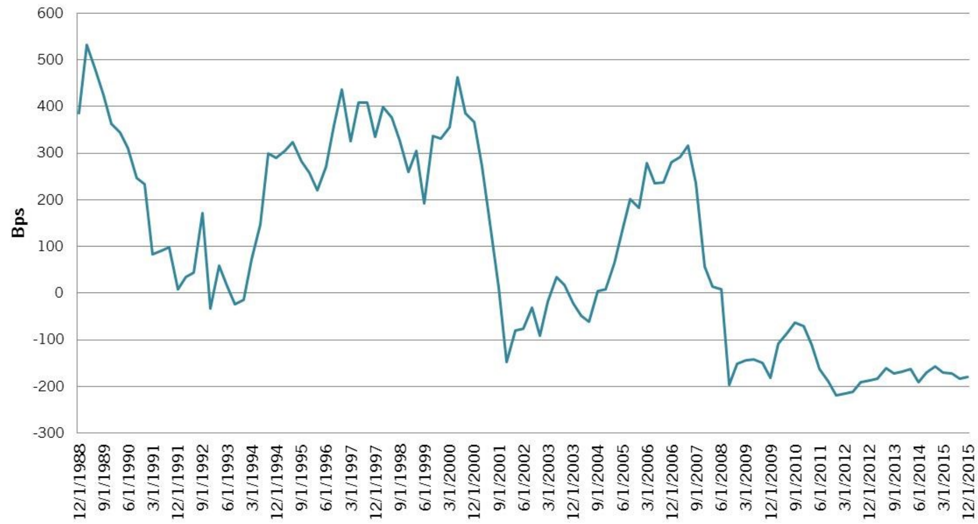


Source: Bloomberg Financial L.P.

standards. The spread sectors of the fixed-income markets, namely corporate bonds, mortgage-backed securities, and municipal bonds, tightened during the month by two-to-four basis points.

As of the time of this writing, the November employment report was released showing that nonfarm payrolls rose 211,000, well in line with market estimates, and the unemployment rate held steady at 5%. This was the last major economic release prior to the Fed's December meeting, clearing the runway for its interest-rate liftoff. Many market participants expect the Fed to raise rates 25 basis points a quarter for the foreseeable future.

EXHIBIT 2: DIFFERENCE BETWEEN FED FUNDS RATE AND CPI (YoY)



Source: Bloomberg Financial L.P.

This begs the question "what is a normalized fed funds rate?" The chart above shows the difference between the fed funds rate and the Consumer Price Index (ex food & energy YoY) on a quarterly basis going back to 1988. As can be seen, the Fed has kept the funds rate artificially low since the financial crisis of 2007-2008. However, as we look back over the full time period, the fed funds rate has averaged 1% higher than the inflation rate. Hence, with the current CPI (ex-food and energy) running at 1.9% year-over-over, we surmise that a normalized Fed funds rate should be about 3%. The Fed will not be this aggressive any time soon. The Fed has indicated it will be a slow process to normalization, as it does not want to tip the economy back into recession.

We also believe other aspects of the bond market will begin to normalize. The U.S. Treasury yield curve is still very flat by historical standards. In the initial phase of a monetary-tightening cycle, it is the front end that bears the brunt of the first few rate moves, flattening the curve further. Eventually, the long end will also move higher as investors no longer feel compelled to extend durations to increase yield. Hence, we expect the U.S. Treasury curve to eventually steepen over time.

We also expect quality spreads within the corporate bond sector to widen as investors are no longer forced into lower quality bonds in search of attractive returns. Non-investment grade bonds will be particularly hard hit by this move as many investors have allocated money to this sector in a desperate bid to gain a positive yield.

On the tax exempt side, we expect high quality municipal bonds to trend back to a normalized trading relationship versus comparable U.S. Treasury securities. Historically, municipal bond yields have traded through Treasury yields, and we have recently seen the relationship appear once again.

The mortgage-backed securities market should hold up well. We see a steady spread environment, as prepayment rates stabilize at lower rates, refinances and originations diminish, and the Fed continues its reinvestment in the sector in an environment of dwindling supply. Indeed, the biggest wildcard in the market now is whether or not the Fed will eventually let the size of its balance sheet begin to shrink. If it does, mortgage product might be hard hit.

We continue to keep portfolio durations low, but wait to opportunistically exploit bond market inefficiencies during the normalization process. The Fed has artificially distorted investor behavior and dislocations are inevitable as markets once again begin to seek their natural levels.

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