Fixed Income *Commentary*

August 1, 2014

"Float like a butterfly, sting like a bee…"

FAST READ...

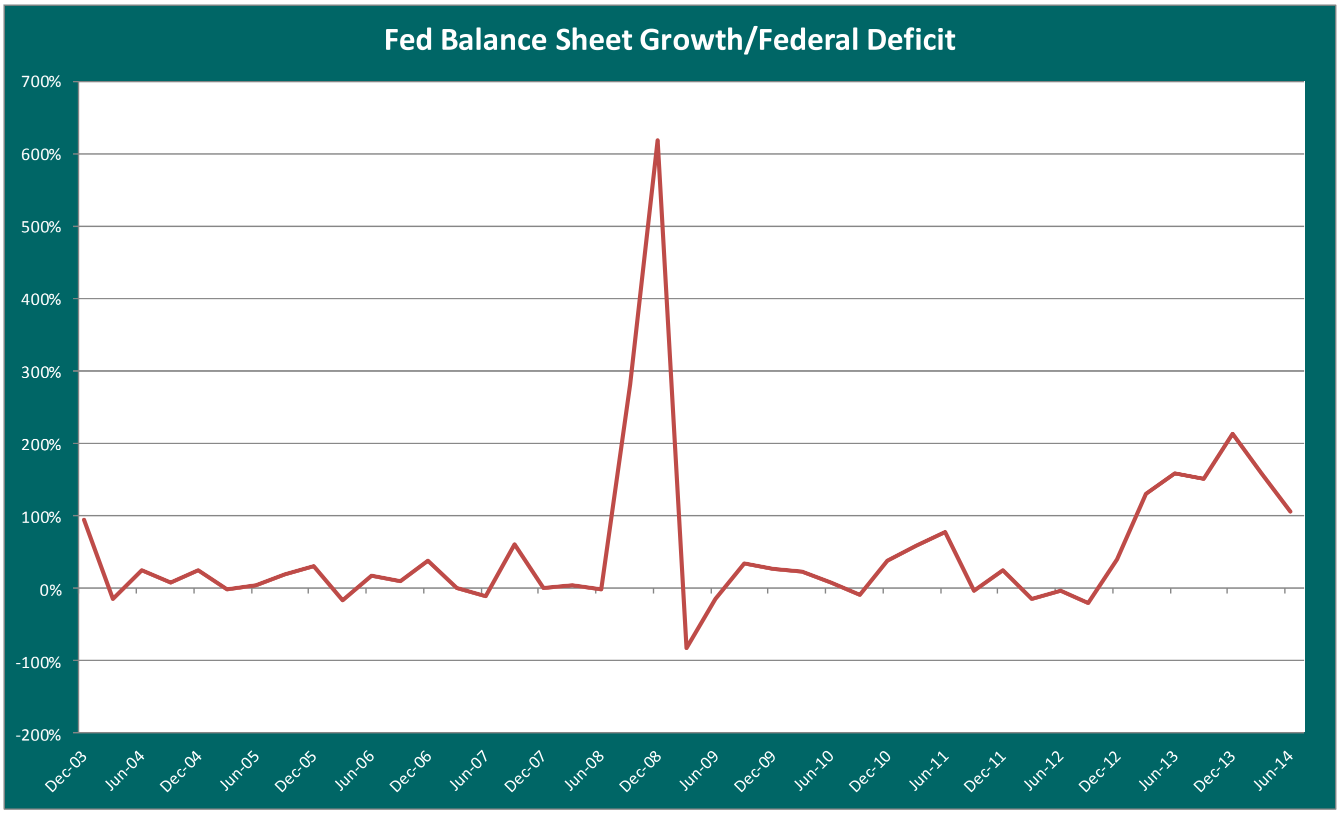
- In conjunction with an improving economy last month the Fed highlighted its desire to increase the fed funds rates in 2015
- This month the Fed continued its taper and we believe open market purchases of treasuries and MBS will end by early 2015
- You don't fight the Fed—the end of the taper will be a negative for the bond market
- We are preparing for higher rates, absent an unanticipated material slowdown in the US economy

On May 22, 2013 Ben Bernanke testified to congress that the Fed would likely start slowing—that is, tapering—the pace of its bond purchases later in the year, conditional on continuing good economic news. This message was repeated in subsequent communications. In response to the fear of a taper the treasury market sold off dramatically and the 10 year treasury rose to just over 3.0% by the end of 2013. The strong reaction of the market clearly surprised the Fed who went into damage control talking up its long term commitment to substantial accommodation as measured by a low fed funds rate and a large balance sheet. The Fed's forward guidance was successful as the 10 year rate recently fell to below 2.5%.

Actually, it was more than just talking that calmed the market. The Fed's level of balance sheet accommodation in the last few quarters has been historically high, despite the taper.

As we see in Chart 1 the Fed's recent accommodation is imposing, as measured by the increase in the size of the Fed's balance sheet relative to the Federal Deficit. Even with a continuing taper the Fed is providing more relative accommodation than at any time since the 2008 crisis. In fact, in the fourth quarter of 2013 the Fed's balance sheet increased 2x's as fast as the Federal Deficit. The Fed's actions have certainly helped drive down interest rates this year as well as investor complacency about the impact of the taper.

Chart 1—Growth in the Fed Balance Sheet Compared to the Federal Deficit



Source: Bloomberg

It is clear the Fed plans to end quantitative easing activities, but the end of the taper does not completely eliminate the Fed's balance sheet accommodation. This chart will not go to 0%. The Fed is maintaining its policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities and rolling over maturing Treasury securities. The Fed anticipates its large holdings of longer-term securities should maintain downward pressure on longer-term interest rates and support mortgage markets. We believe the end of the taper, the increase in the fed funds rates, and a slowly healing economy will place upward pressure on interest rates across the curve. All the pieces are starting to fall into place for a sustained increase in interest rates and an end to the 33 year old bond rally.

Fixed Income Markets in July – Mixed

July was generally lackluster in many fixed income markets.   Treasuries rates were mixed with short term maturities rising and longer term rates falling, see Chart 2. Markets believe the short end will rise, and we are seeing this trend of rising rates move out the yield curve. In credit markets, spreads were broadly unchanged in the cash market but slightly wider in the credit default swap "CDS" markets, see Chart 3, which sometimes acts as a forward looking indicator. Preferred stocks also moved sideways in this market, but the municipal market benefitted from its longer duration and higher quality bias.

Chart 2 —Treasury Yield Curve—Changes in July

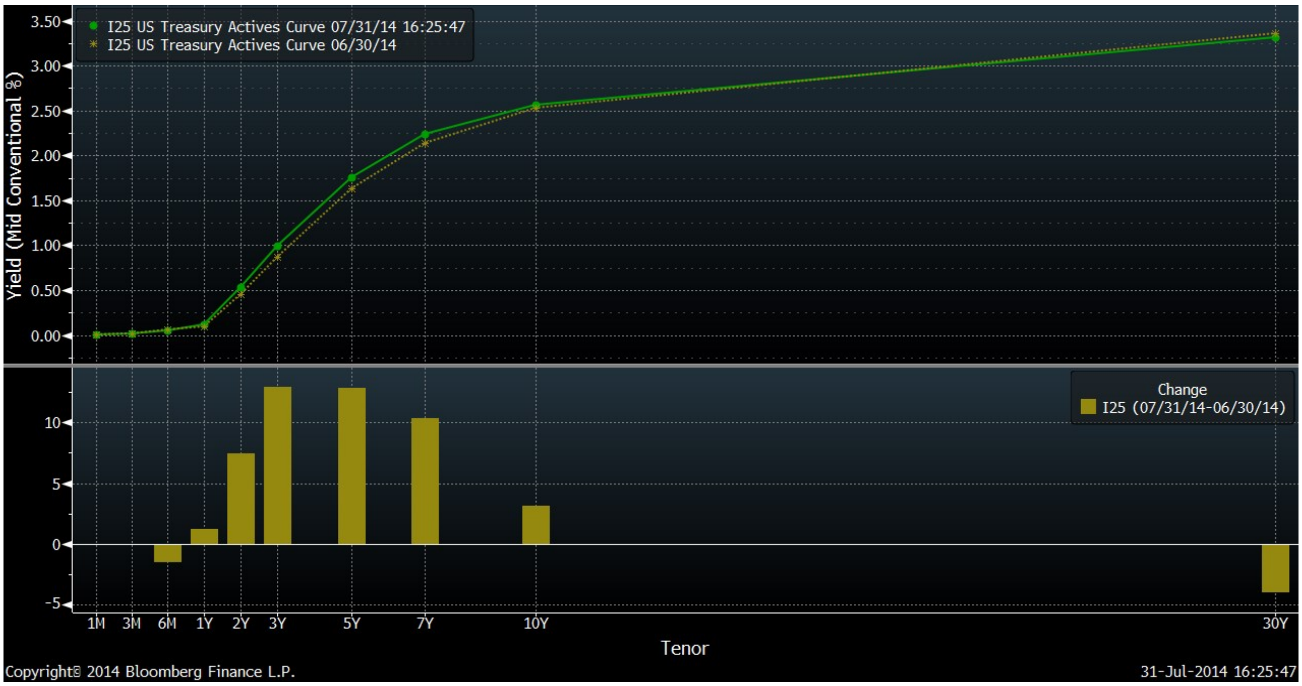
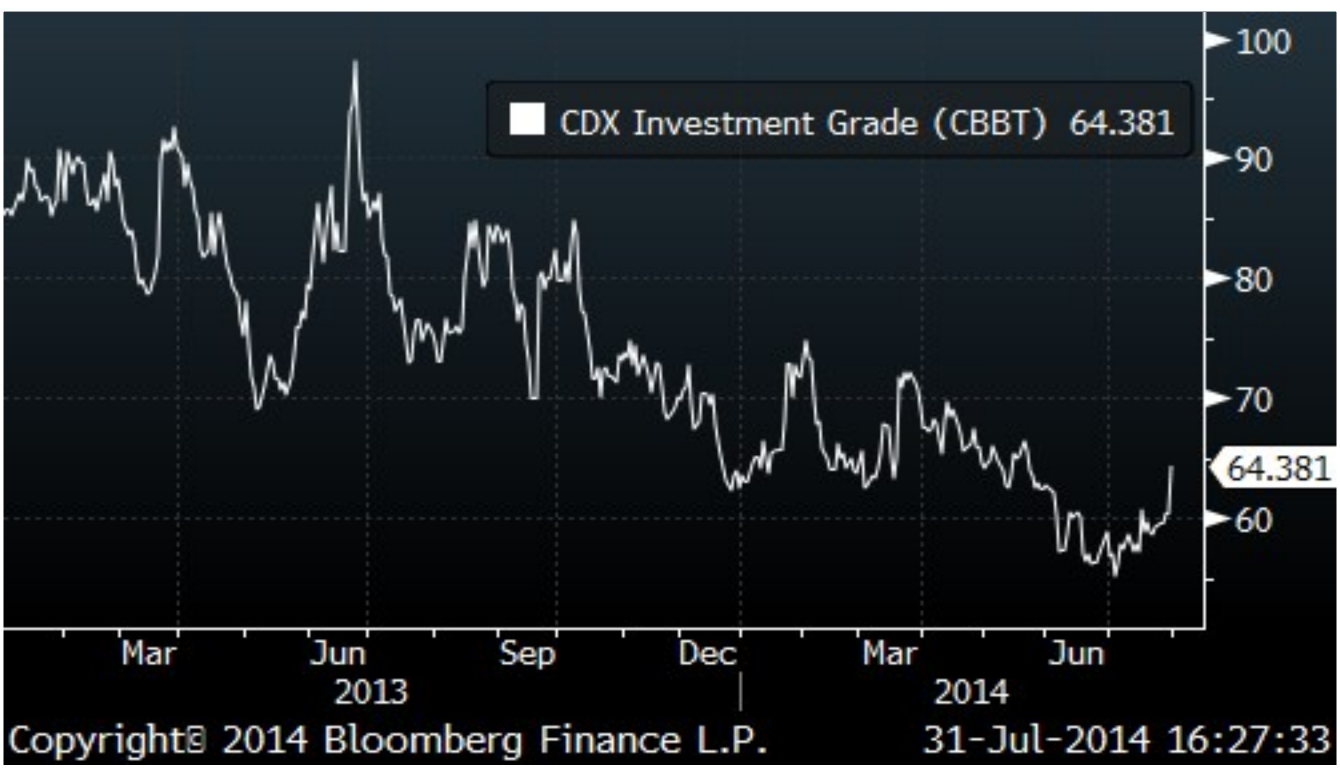


Chart 3—Five Year Investment Grade CDS Spreads



Strategy

Despite the lackluster performance in the fixed income markets this month, the year-to-date rally in Treasury prices and the continued contraction in credit spreads have been positive for fixed income portfolios. Unfortunately, higher bond prices make it more difficult to find securities with attractive yields.

In the short term, we continue to expect the intermediate segment of the yield curve to continue to offer the best relative performance. Intermediate maturities offer a significant yield pick up over shorter term securities and are partially protected from the risk of rising rates by "rolling down the yield curve" as maturities approach.

Taking some credit risk continues to be an attractive way to add value, if not for appreciation then for the carry of a higher yield. Corporate balance sheets continue to improve, liquidity is abundant and the Fed remains accommodative for now. To be safe, we remain comfortable having slightly more exposure to credit risk in the short end of the curve since short maturities will be least impacted when the credit cycle turns.

Municipal bonds remain attractive by historical valuation measures and would stand to gain with any increase in income tax rates. We believe it is more prudent to hold duration exposure in muni's than in corporates, especially since the average credit risk in municipals is lower than corporates.

As systemic risks continue to grow, we are increasingly looking at higher quality and lower duration assets and will continue to add these securities as conditions allow.

We remain optimistic about the risk/reward trade off in our bond portfolios. We are using sector selection, security selection and yield curve management to help mitigate interest rate and credit risks. Additionally, we are using high quality callable preferred stocks to add yield at the front end of the curve. Of course, we continue to scour the markets daily for cheap, safe and attractive yield in any sector.

As always, please call us with questions and comments.

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