Fixed Income Commentary

September 9, 2016

All Eyes on the Fed!

Despite a fairly tame summer in the financial markets, with low volatility and prices continuing to climb, global financial markets remain on edge as investors await clarity on whether the Federal Reserve will raise interest rates in September. Speaking from Jackson Hole, Wyoming, Fed Chairwoman Janet Yellen said that she saw a stronger case for raising the Fed's benchmark interest rate, suggesting that the central bank was likely to act in the coming months. She cited continued solid performance of the labor market (with the unemployment rate at 4.9% and nonfarm payrolls showing 71 consecutive months of growth) coupled with their outlook for economic activity and inflation. She joined the litany of Fed Governors calling for a hike in benchmark interest rates in the near future. Recently, Fed fund futures probabilities implied a 20% chance of a rate hike in September, a 25% chance in November, and a 50% chance in December.

The Fed clearly wants to act, but economic events have not lent much support to the effort. Geo-political events have forced the Fed to remain on the sidelines for the first part of the year and slow economic growth may achieve the same end for the balance of the year. Recent economic data has been mixed, at best. Second-quarter GDP came in at a scant 1.1% following less than 1% growth in the previous two quarters. Durable goods orders and retail sales have been contracting and the ISM manufacturing index slipped into a contraction phase. Even last Friday's employment numbers pointed to slower-than-expected growth and a slowing manufacturing sector. The Fed is thinking that economic growth will rebound, but the bond market is clearly not of the same view. We continue to believe the Fed will not act until December, at the earliest.

For the month, according to the Barclays Indices, U.S. Treasuries were down -0.55%, posting their first negative return month since June 2015. The U.S. Treasury 10-yr note has traded in a 1.36% to 1.75% range this summer, settling in the mid 1.50's%. The spread sectors of the bond market, namely corporate bonds, mortgage-backed securities, and municipal bonds posted modest returns in August, ranging from 0.13 to 0.20% with the exception of the high yield market which was up 2.09%. **Exhibit 1** on the following page highlights the relative performance of the subsectors of the fixed-income

KEY TAKEAWAYS

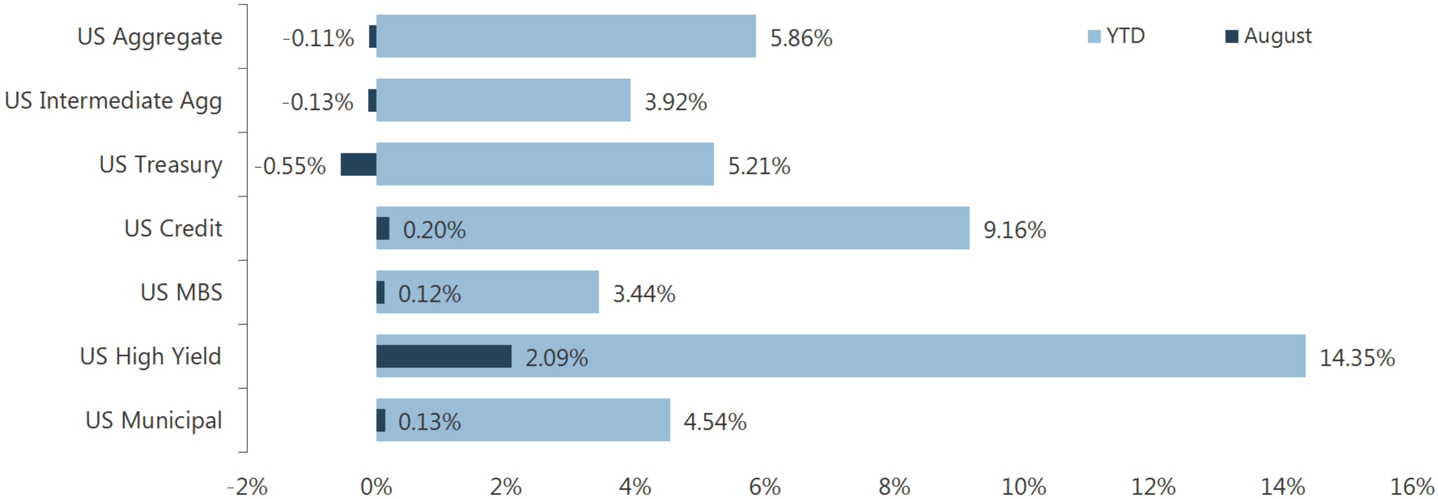
Financial markets continue to remain fixated on the Fed as the chorus for a rate hike in the short term loudens. The recent trend has been that every time probabilities increase for a rate hike in a given month that economic data comes in weaker than expected, pushing probabilities for a rate hike down the road.

Key Rates	Aug 31 2016	Jul 31 2016	Dec 31 2015
Treasury Yields			
2 Year	0.81	0.65	1.05
5 Year	1.20	1.02	1.76
10 Year	1.58	1.45	2.27
30 Year	2.23	2.18	3.02
Credit Yields			
BBB Industrial 10 Year	2.89	2.82	3.99
Muni Yields			
AAA 10 Year	1.43	1.45	2.00
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.38	2.28	3.02

AUGUST IN REVIEW

- Modest fixed income returns in the month of August, with the exception of high yield, which was up 2.09%.
- US Treasuries posted their first negative return month since August of 2015, falling .55%.
- The US Treasury yield curve, as measured by the 2-year Note and the 10-year Note yield differential, is at an 8.5 year low.

EXHIBIT 1: FIXED INCOME MARKET PERFORMANCE



Source: Bloomberg Financial L.P. and Barclays Securities

market as reported by the Bloomberg Barclays Indices for the month of August and on a year-to-date basis. As can be seen from above, corporate bonds, both investment grade and high yield have had stellar performance thus far in 2016.

The U.S. Treasury yield curve, as measured by the 2-yr Note and 10-yr Note yield differential, is at an 8.5 year low, as the front end is being pressured by potential Fed actions. This structure will likely continue for the foreseeable future, as most sovereign debt carries negative interest rates. The expectation for a continued flat yield curve in a potentially rising rate environment does not support extending duration trades. Investors now receive almost as much in shorter term assets as they do for longer duration securities. Extending maturities can only add meaningful gains if rates continue to move lower. Should this happen, one can only hope further rate cuts by the Fed will be enough to save the markets.

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