Fixed Income Commentary

July 6, 2017

KEY TAKEAWAYS

As widely expected, the Federal Reserve raised rates for the second time this year in June, raising benchmark rates by 25 bps, to a range of 1.00-to-1.25%. The highlight from June's Fed meeting was the announcement of its blueprint for unwinding its $4.5 trillion balance sheet. The announced plan for unwinding will start with a maximum of $10 billion per month - $6 billion from Treasuries and $4 billion from mortgage-backed securities. Still uncertain, however, is the timing of when the unwinding will begin.

Key Rates (%)	Jun 30 2017	May 31 2017	Dec 31 2016
Treasury Yields			
2 Year	1.38	1.28	1.19
5 Year	1.89	1.75	1.93
10 Year	2.30	2.20	2.44
30 Year	2.83	2.86	3.07
Credit Yields			
BBB Industrial 10 Year	3.52	3.48	3.68
Muni Yields			
AAA 10 Year	1.96	1.90	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.03	2.94	3.13

JUNE IN REVIEW

- US Credit was the strongest performing fixed income sector in Q2, followed closely by high yield, up 2.35% and 2.19%, respectively.
- Municipals maintained their strong performance, up 1.96% in Q2 and up 3.57% on the year.
- The 10 yr. Treasury yield finished the quarter at 2.30%, down from March's 2.39%.

Watching the Paint Dry

As widely expected, the Federal Reserve raised the Fed funds target rate and the discount rate by a quarter point (25 basis points) at the June FOMC meeting. This was the second rate hike this year and the third since mid-December, 2016. More importantly, the Fed used the June meeting press release to lay out a clear outline of how it expects to unwind the $4.5 trillion of securities held on its balance sheet from quantitative easing (QE) activities earlier in the decade.

The plan closely mirrors the approach used to purchase the securities in the first place. Principal that is received from maturing securities and monthly mortgage pay downs are currently reinvested into new holdings. When the Open Market Committee (FOMC) begins to unwind the System Open Market Account (SOMA), the payments will only be reinvested if the amount exceeds certain thresholds. The Fed referred to these thresholds as "caps" on the amount of money that will be allowed to roll off. Initially, the plan is to limit the roll off to $6 billion maximum per month for U.S. Treasury securities and $4 billion for mortgage-backed securities.

These "caps" will be increased over time, per a set schedule, as conditions improve and more of the portfolio runs off. The upper cap, however, will be limited to $50 billion per month, at least as currently outlined. There is no mention of liquidation of securities if maturities do not reach the cap limit in a given month. This process will clearly take years to unfold. Assuming the roll offs happen according to the proposed plan, the process of normalizing the size of the Fed holdings will still take nearly eight years to unfold. Any delay from economic conditions or from lack of necessary maturities in any given month will slow the process even further. When announcing the plan, Fed Chairwoman Janet Yellen stated that the portfolio unwind would be so gradual and boring that it will be like "watching paint dry".

While the Chair might be correct from a spectator's point of view, she might have been under-estimating the impact a liquidation of any portion of the Fed's holdings would have from the market's standpoint. FOMC security purchases during the six years of QE absorbed nearly half of the new public debt (not to be confused with national debt) issued over the past eight years. The levels and the shape of the yield curve would undoubtedly look much different today had these purchases not taken place.

There has also been a bit of a multiplier effect to Fed actions, as other central banks tend to follow their lead at major decision points. The Fed tends to move first and fastest at these points. While this was a positive effect as the Fed tried to lower rates during the crisis, it will probably be a negative as rates normalize. Foreign central bankers have already been making comments that conditions have improved enough to curb emergency actions. The last week of June saw several hawkish comments, including those of Bank of Canada head Stephen Poloz, who stated that emergency monetary actions "had done their job." The ECB President went further, saying inflationary forces were now replacing deflationary headwinds and that the ECB should adjust its policy to "accompany the recovery."

EXHIBIT 1: TREASURY RATE CHANGE AND TOTAL RETURN

Treasury	3/31/17	6/30/17	BP Change	Range	YTD Total Return
2-yr Note	1.25%	1.38%	+13 bps	1.16 to 1.38%	0.38%
5-yr Note	1.92%	1.89%	-3 bps	1.70 to 1.94%	1.12%
10-yr Note	2.39%	2.30%	-9 bps	2.13 to 2.42%	2.11%
30-yr Bond	3.01%	2.84%	-17 bps	2.70 to 3.04%	5.61%

And this is where markets and central bankers differ. Central bank economists are generally positive on the economy, while the market remains skeptical. The Open Market Committee, for example, expects economic activity to expand at a moderate pace and labor market conditions to strengthen somewhat further. The unemployment rate currently stands at 4.3%, the lowest level since May 2001. The Fed expects inflation to remain slightly below 2%. However, bond investors have seen weaker data in recent releases and expect slower growth in the months ahead. The unemployment numbers, for example, have been weak for several months and the unemployment rate has been falling as much from lower workforce participation levels as from increased hiring.

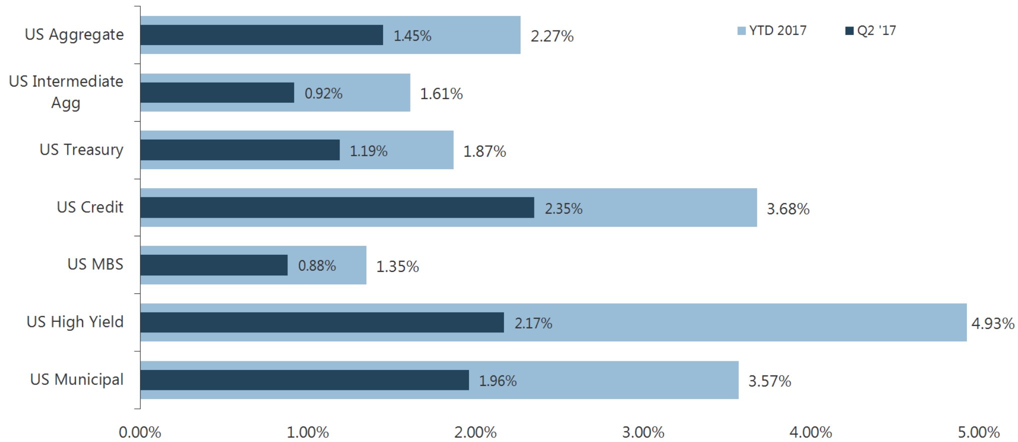
Going forward, both the bond and stock markets seem very complacent with regard to the Fed and global events. The third rate hike by the Fed isn't expected until December, at the earliest, although the unwinding of the balance sheet is likely to begin much sooner. As always, the Fed will remain data dependent. We suspect, however, that the bias is now towards policy normalization rather than policy accommodation. It will now need to see really weak data to stop asset liquidations, rather than needing really strong data to start a policy move. Patience is required for these markets and increasing portfolio risk at this point seems like a strategy destined to fail. It always feels good at the top.

Recent Fixed Income Trends

The recent trends in the fixed-income market remained intact during the second quarter of 2017. Specifically, we saw continued flattening of the U.S. Treasury yield curve, a narrowing of spreads in the corporate bond market, and a lagging performance of the mortgage-backed securities market. **Exhibit 1** highlights interest rate movements and performance of U.S. Treasury securities according to the Bloomberg Barclays Indices.

In terms of sector performance, credit again led the way, followed by municipal bonds. U.S. Treasuries and mortgage-backed securities lagged in relative performance both for the second quarter and on a year-to-date basis. The results, as reported by the Bloomberg Barclays Indices are found below in **Exhibit 2.**

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



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