FIXED INCOME COMMENTARY

August 7, 2015

KEY TAKEAWAYS

The yield curve flattened were weaker in July as short-term interest rates rose and longer term rates fell. All eyes are now focused on the Federal Reserve as markets brace for the first increase in the federal funds rate in nine years. Higher volatility remains elevated in both the credit and equity markets.

Key Rates	Dec 31 2014	Jun 31 2015	Jul 31 2015
Treasury Yields			
2 Year	0.66	0.64	0.66
5 Year	1.65	1.65	1.53
10 Year	2.17	2.35	2.18
30 Year	2.75	3.12	2.91
Credit Yields			
BBB Industrial 10 Year	3.42	3.86	3.77
Muni Yields			
AAA Ten Year	2.10	2.37	2.30
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.83	3.10	2.91

JULY IN REVIEW

- Volatility continued in July.
- Ten-year Treasury rates fell 17 bps,, reversing much of June's decline.
- Fed Chair Janet Yellen reiterated the Fed's stance that the first steps towards normalizing interest rates should begin this year.
- Spreads on corporate bonds, mortgage-backed securities and municipals all widened slightly in July.

Enough With The Light Switch Already!

In July, bond prices recovered most of their previous month's losses as interest rates inched lower. Mixed economic data continued the on-again/off-again demeanor of the market, with respect to the commencement of the Fed's normalization of interest rates. Yields on the U.S. Treasury 10-year Note traded in a 2.18-to-2.46% range closing the month at the low. Spreads in other sectors of the fixed-income markets, namely corporate bonds, municipals, and mortgage-backed securities, were slightly wider during the month, failing to keep pace with comparable duration U.S. Treasury securities.

With at least temporary resolutions of global crises, markets may once again focus on economic fundamentals and Fed policy. Greece lost its game of chicken with the European Central Bank, China's stock market slide has been stabilized (albeit only with governmental short-selling curbs) and Puerto Rico has defaulted on its debt without disrupting markets. Completion of an Iranian nuclear agreement was also reached, reducing global tensions and placing downward pressure on world oil markets.

The Federal Reserve, which has stated its goal of raising the target Fed funds rate in 2015, has an accommodative background to act. In a "perfect storm" scenario for the Fed, wages in this country continue to rise while domestic consumer price inflation remains very low. The dollar continues its ascent against most global currencies, allowing the U.S. to import goods more cheaply and hold domestic prices low. Commodity prices have tumbled with oil, gold, and copper all hitting at least 5-year lows.

Copper prices are of particular interest as copper is often referred to as the "commodity with a PH.D in Economics" for its ability to act as a leading indicator of future economic activity. The trend in copper suggests any change in Fed policy will be gradual with little risk of a rate shock.

EXHIBIT 1: COPPER FUTURE PRICES— FALL 2010 TO PRESENT

Source: Bloomberg Financial L.P.

It is inevitable the Federal Reserve will begin to normalize U.S. interest rates, but the question of when remains unanswered. Based upon the implied probabilities of the Fed Funds futures contracts, there's a 50/50% chance that the Fed raises rates by at least 25 basis points in September, thus partitioning bond market participants into on-again/off-again camps. Proponents in the "on-again" camp point to a marked improvement in labor-market conditions with a 5.3% unemployment rate, 5-year low jobless claims, and a twelve-month average increase in non-farm payrolls of 244,000. "Off-again" advocates cite deflation concerns, falling commodity prices, weak consumer spending, and an extremely strong U.S. Dollar.

This division of bond investors has led to the recent gyration of yields in the bond market. Each release of new economic data adds fuel to the fire of one camp or the other. This is not a bond market to be penny wise and pound foolish and we continue to keep our bond durations short. There is one certainty: when the Fed does move, the bond market will immediately begin to price in the next rate hike.

As always, please contact us should you have questions.

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