Fixed Income *Commentary*

May 7, 2014

"Someone's been eating my porridge and ate it all up!"

- Baby Bear

In the 1990's, the term "a Goldilocks Economy" was used to describe a scenario where the economy was not too hot (i.e. growing too fast) to trigger a Federal Reserve rate hike, but was not too cold (i.e. had enough growth) to curb economic expansion or earnings growth. Bond prices have been the Cinderella story in 2014, but Goldilocks may just be a common thief guilty of breaking and entering in this year's version of the story.

Fast Read......

- Bond prices continue to rise, defying year-end forecasts
- The Federal Reserve Open Market Committee (FOMC) continues to reduce bond purchases
- Systematic risks continue to build
- Markets are not pricing these risks into asset values

Recent economic data suggests growth is strong enough to allow the Fed to continue reducing quantitative easing (QE) bond purchases by $10 billion per month, despite persistently high unemployment rates. However, growth does not seem strong enough to spark demand driven inflation. In short, the economy is too hot to keep the Fed at bay, but not cold enough to slow the pace of reductions in QE operations.

The Fed has plenty of cover to continue tapering, even at the prevailing modest growth rate. While hotter growth would almost certainly prompt faster Fed action, it would take a significant cooling of economic growth to slow the schedule. Some analysts now predict QE will end as early as October, although we continue to believe the last bond will be purchased in the first half of 2015.

The impact of the Fed's bond buying program cannot be understated. The FOMC has been the largest single buyer of Treasury and agency mortgage-backed securities since 2009. At one point, FOMC bond purchases provided the U.S. monetary system with nearly 100% of the money needed to fund the Federal budget deficit. The absence of this support should have an impact on interest rates. It is little wonder Janet Yellen's words are so carefully chosen.

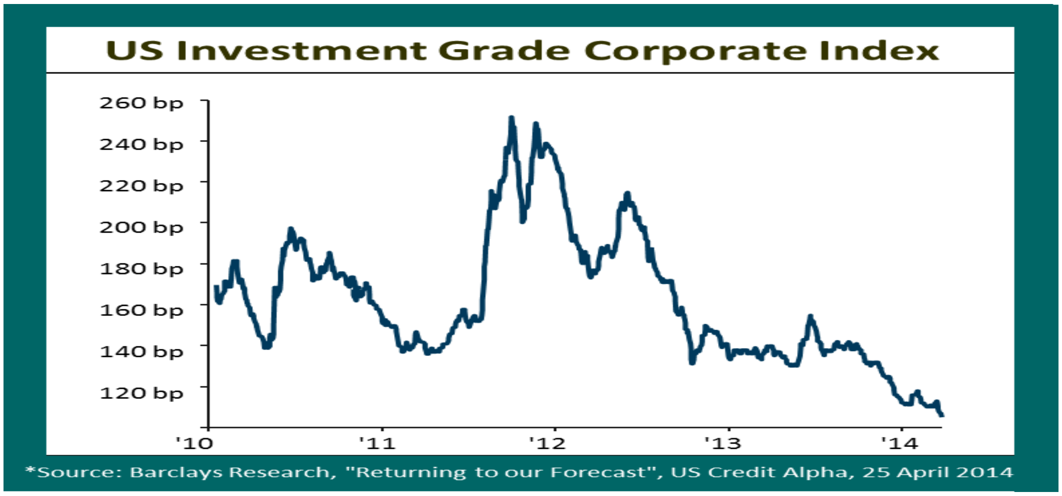
This may not bode well for investors. As quantitative easing comes to a close, interest rates should be pushed higher. Higher rates will eventually weigh on economic growth, corporate earnings and bond prices. Other asset classes, including stocks and real estate, will also come under pressure from rising rates. Given continued economic growth and tapering, there is little question as to whether or not rates will rise or about the negative impact of higher rates on asset prices. What is surprising is how calmly bond markets are reacting to the situation.

To be fair, the broader picture is still quite supportive of markets. There is no reason to suggest a financial crisis is imminent. However, buyers are pricing most assets as if the economic conditions of the past five years will continue for the next five years. There is little room for estimate error given these price levels.

Many forecasters, including the Fed's own staff, expected future growth to follow the same slow but steady pattern to which market participants have become acclimated, a bold projection since the current recovery is already long by historical standards. Given rising systematic risks, we expect to see more price volatility in the months ahead.

Corporate bonds remain one of the more attractive segments of the fixed income market. Yet corporate bonds may be at risk once interest rates rise. We do believe the credit cycle is already in extra innings (see our commentary from January 2014) and a sharp rise in rates or a much slower economy could end the game. Chart 1 shows the credit cycle is still alive and well, but we can anticipate the end to this rally.

Chart 1



One of the main reasons spreads continue to tighten is the perceived lack of risk in the marketplace. Many investors feel the economy will grow even faster in the months ahead. Many also believe the Fed will continue to support asset prices going forward. It is also widely held that corporate balance sheets are stronger than ever. Yet some of these assumptions will be hard to maintain as rates rise. Given the extreme level of "financial repression" today, we may need a healthy dose of cold Momma Bear economic news to avoid a rate shock.

Strategy

The recent flattening of the yield curve has generally been positive for our portfolios. We expect flattening of the curve to continue in the quarters ahead. The math is simple. The front end of the yield curve is roughly 200 basis points below normalized rates due to artificial suppression by Federal Reserve policies. The 10-year sector of the curve is only trading 100 basis points below our calculation of fair value.

In the short term, the yield curve might steepen as QE buying has been biased toward longer duration assets. The end of QE buying should pressure longer term rates while traditional monetary policy tools (Zero Interest Rate Policy, or ZIRP), should continue to hold the front end down. As these forces play out, we expect the intermediate segment of the yield curve to outperform from a total return standpoint. Intermediate maturities offer a significant yield pick up over shorter term securities and are partially protected from rising rates by "rolling down the yield curve" as maturities approach.

Taking some credit risk continues to be an attractive way to add value. Credit is supported by an improving economy, abundant liquidity and an accommodative Fed. We remain comfortable having slightly more exposure to credit risk in the short end of the curve. Short maturities would be least impacted if credit markets weaken.

Municipals remain attractive by historical valuation measures and with the anticipation of higher 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 assets and will continue to add these securities as conditions allow.

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

As always, please call us with questions and comments.

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