Fixed Income *Commentary*

June 5, 2014

"Who Done It?" was, at the time, the highest-rated television episode in U.S. history. It was estimated that 83 million people watched the final "Dallas" episode of the 1980 season, more than the number of voters in that year's presidential election.

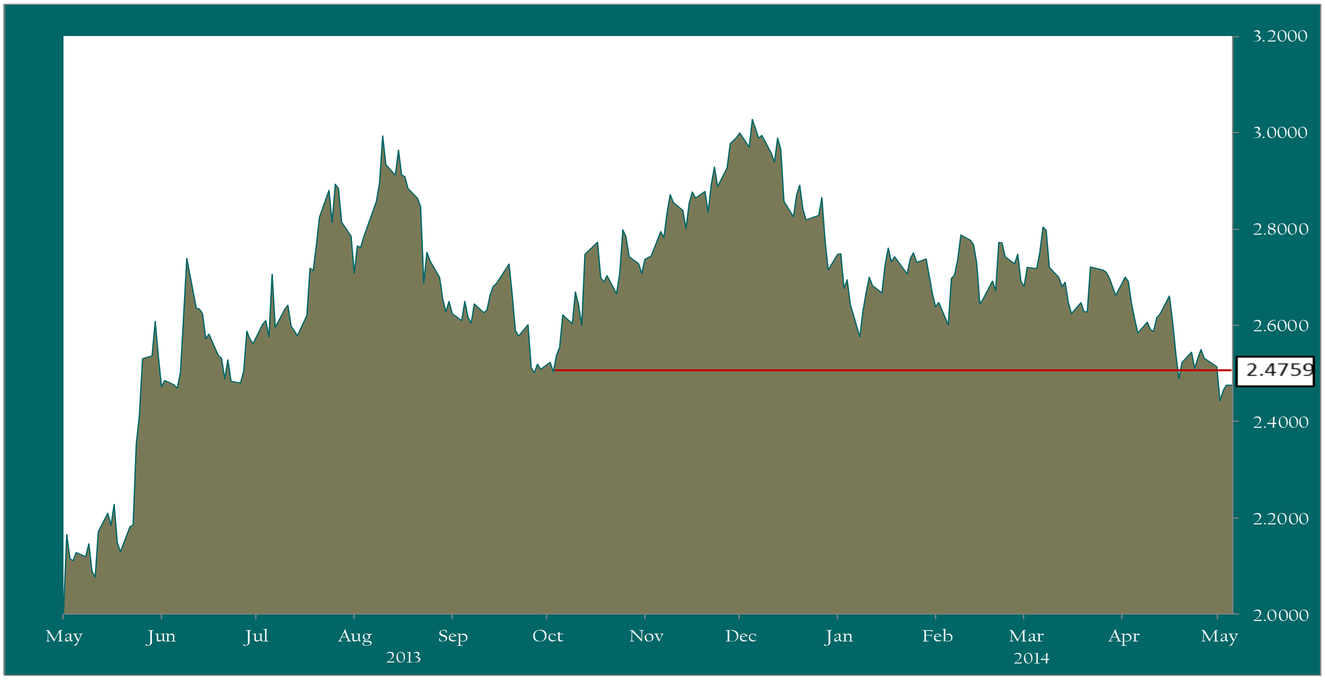
We waited all summer to find out who shot J.R. Unfortunately, it looks like we may never learn who shot bond yields!

Fast Read……

- Bond prices continue to rise and yields fell below the key support level of 2.5%.
- Treasury performance is outpacing riskier assets.
- Whoever shot rates is not talking -and the number of suspects is large.
- J.R. was viewed as a villain, much as the bond market is when rates are out of line.
- There are many suspects behind the drop in rates, but no clear killer.

By the end of May, the ten-year Treasury broke its key support level of 2.5%. Yields have been shot and are in serious condition. The price on the ten-year Treasury is up 5.7% at the end of May, a pretty stunning return for the humble Treasury note. It appears investors really like the safety of Treasuries or, at least, really dislike other asset classes.

Chart 1: Ten Year Treasury Yield Breaks Support



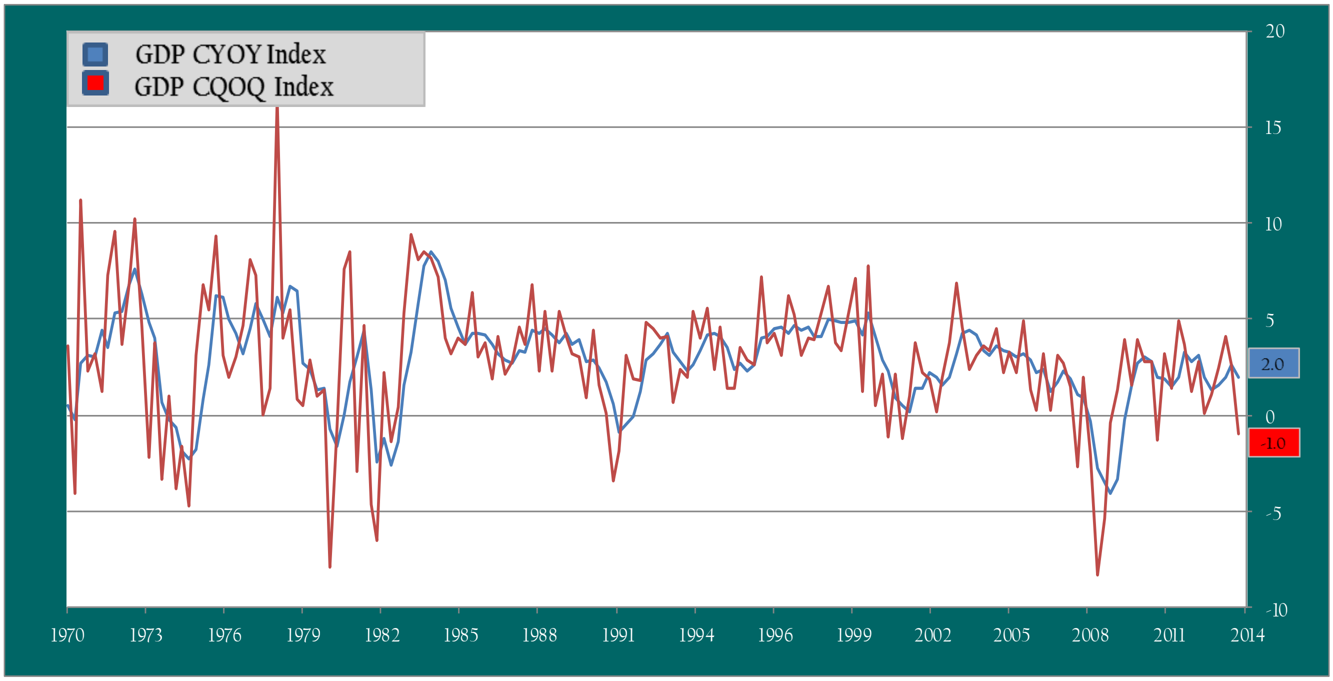
Year-To-Date Price Action – May 31st

Ten Year Treasury	5.7%
Investment Grade Corporate Bonds	5.7%
Gold	4.4%
S&P 500	3.9%
Copper	(6.8%)

We see lots of evidence and probable cause for bond yields to fall, but evidence is circumstantial and the case far from airtight. Let's review the suspects.

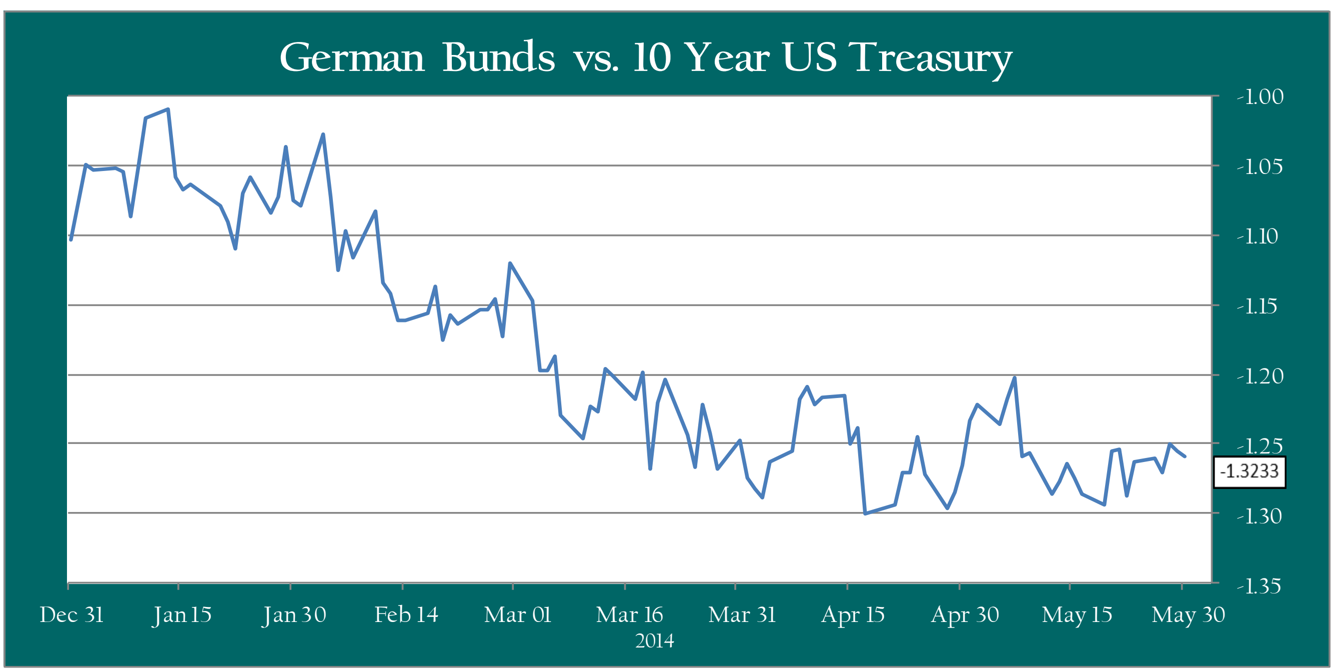
Fear of a U.S. recession Falling yields and a flattening yield curve are often a forewarning of weak economic growth ahead. U.S. GDP quarter over quarter data was revised down in the 1st quarter to a negative 1.0% and this is clearly a sign of weakness. However, the economy seems to be holding up. Year-over-year GDP is up 2.0% and many other data series are showing a continued economic recovery. Employment is improving, corporate earnings are strong and management guidance does not highlight major concerns. Furthermore, the stock market seems to be sending a positive message with the S&P 500 marking new highs and volatility approaching new lows.

Chart 2 U.S. GDP (Quarterly and Yearly Data)



Foreign investors are buying Treasuries Europe's growth and inflation are anemic and Mario Draghi, President of the European Central Bank ("ECB"), has all but promised the ECB will take accommodative action in the June meeting. Since Germany is so keen on price stability, any major action by the ECB is difficult and not without great deliberation. Perhaps Europeans prefer to buy U.S. Treasuries at 2.47% than German Bunds at 1.21%, especially as Draghi wants to weaken the Euro. We see in Chart 3 (below) how Bunds are at an increasingly steep discount to Treasuries. At the beginning of the year, Bunds were trading close to 100 bps inside of U.S. Treasuries Since then, the gap has widened to close to 125 bps inside of Treasuries – this is a historically high discount.

Chart 3 – 10 Year U.S. Treasuries and German Bunds



Fear of slowing growth in China Data from China continues to underwhelm. Growth is slowing, few seem to believe the goal of 7.3% GDP growth rate will be achieved this year, credit is being restricted as debt increases rapidly, and shadow banking lenders are starting to fail. We believe China's reserves and strong political leadership will help slow the decline, but any slowdown in the world's second largest economy will spread to other countries.

War and a flight to quality War is a hard risk to handicap, but it is becoming increasingly clear neither the U.S. nor Europe have the political will to challenge Putin and most certainly do not have the political or economic capital to intercede in a civil war in Ukraine or the Middle East. iWhile it seems unlikely regional conflicts will impact markets unless superpowers are actively involved, it is quite clear geo-political risks are increasing.

There appears to be no clear single reason why global interest rates have fallen so sharply. Bond prices have defied predictions in 2014. This is usually a concerning sign for the economic outlook and the broader financial markets. The investigation into why rates are so low could keep viewers glued to the next episode of the story.

Finally, no fixed income letter published this season can avoid a reference to Thomas Piketty's blockbuster economic tome, "Capital in the Twenty-First Century." We admit it's not as gripping as a good episode of Dallas, but - potential data errors aside - the book does remind us that the rapid world economic growth since World War II is a historical abnormality. We have all benefitted since WWII from mathematically unsustainably high levels of population growth, the rebuilding of Europe, the rapid industrialization of China and to a lesser extent India and the Soviet Union, as well as good productivity growth. Perhaps recent slow growth is closer to historical norms, perhaps many economist forecasters just lack a multi-generational frame of reference.

Strategy

The recent rally in Treasury prices and the continued contraction in credit spreads have been positive for fixed income portfolios. Unfortunately, rising 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. 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 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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