Fixed Income Commentary

September 2, 2014

"Summertime, and the livin' is easy…"

Lake Champlain, Burlington Vermont

FAST READ...

- Summer was easy for fixed income investors despite some rainy days. Trends are positive and year-to-date investment grade credit spreads are 13 bps tighter and the 7-year Treasury yield is 41 bps lower. Both risk and duration are winners!
- We all know summer will not last forever, yet central bankers will try to extend the good times through continued accommodative policies in the U.S., the EU, Japan and in China.
- Policy driven gains in the fixed income markets will come under pressure through higher treasury rates and/or wider credit spreads. Pressure may come sooner rather than later.
- We are preparing for winter by actively managing interest rate and credit risk.

It is good to be invested in fixed income in 2014. In August, we saw price gains in major credit oriented fixed income asset classes, swelling strong overall gains in 2014. In Chart 1 we highlight these gains. Year-to-date preferred stocks are up 8.6%, intermediate muni's are up 5.7%, intermediate investment grade fixed income is up 3.3% and short corporates are up 1.8%. Lower interest rates and tighter credit spreads both contributed to gains.

Credit related securities recovered nicely after a rocky start in August. Corporate bonds rated “A” and “BBB” are only 2 bps wider for the month while credit default swaps (CDS) are 7 bps tighter. Year-to-date “A” quality corporate bonds are 7 basis points (bps) tighter and “BBB” quality are 24 bps tighter. Crossovers, less liquid issues, and story bonds are performing even better. In August, 2, 5, and 10-year Treasury rates were 5.5 bps, 9.0 bps and 6.5bps tighter respectively, while year-to-date the 2-year is 9.2 bps wider, and the 5 and 10-year are 7.9 bps and an impressive 53.6 bps tighter. Proper positioning on the curve matters!

Chart 1—Fixed Income Asset Class Returns – 2014 Year-To-Date

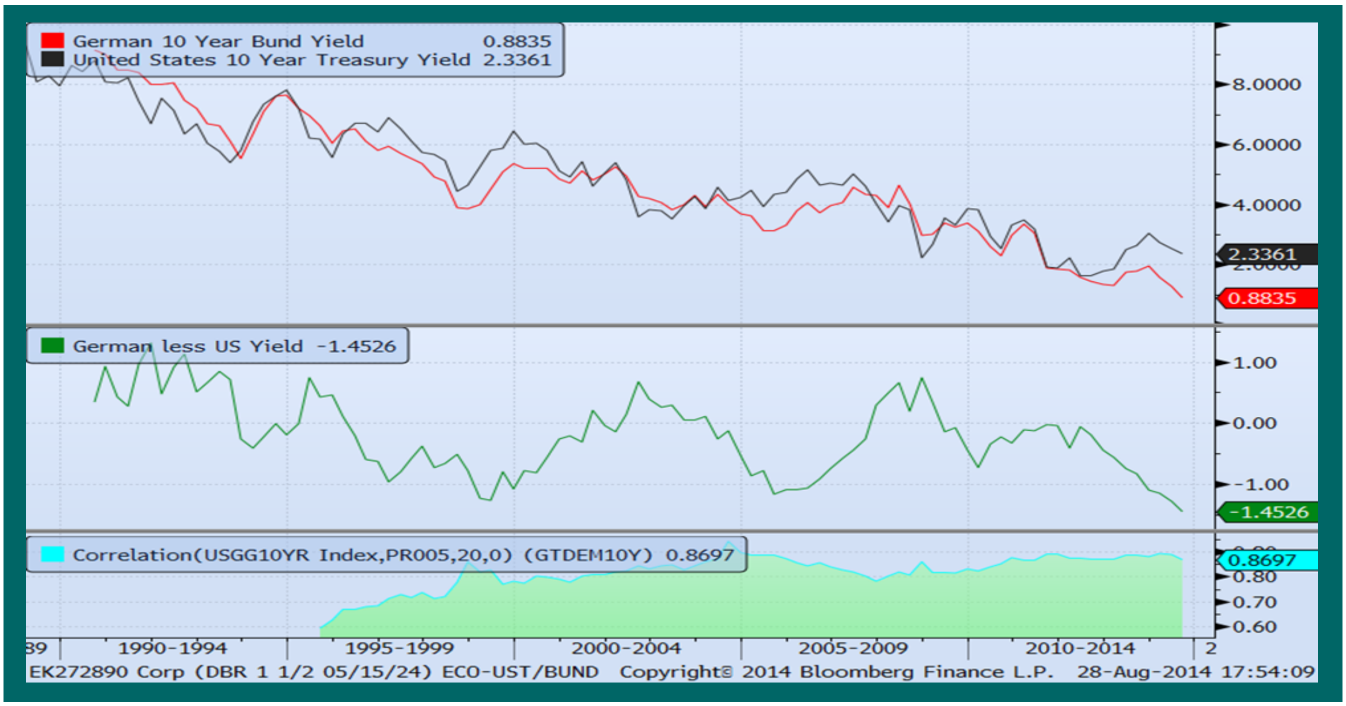
Source: Bloomberg

As we reflect on these gains at the end of a glorious summer in Vermont, we wonder when rates will finally begin to rise. Over the last year, we have been vocal in our belief that interest rates in the United States would stay low longer than expected despite the Fed’s plan to raise the fed funds rate and the rapid increase in the money supply through monetization of the public debt. Our forecast is based on our belief the U.S. economic expansion would be slower than consensus expectations. We have also warned the rise in rates could be delayed by the threats of deflation and recession blowing in from the EU and Japan and the prospect of slower growth and a real estate led correction in China.

This summer saw stronger economic data domestically, but also a sharp rise in foreign risks. The EU in particular is struggling with the threats of deflation and recession, along with heightened geopolitical risk. EU economic growth is flat to negative and inflation recently reached a new five year low of 0.3%. The European Central Bank is currently losing the battle. These trends are reflected in far lower yields on German bunds.

As we see in Chart 2, the yield on the 10-year German bund is now only 87 bps and is at a historically wide discount to the U.S. Treasury yield. The correlation between bunds and Treasuries is very high, implying economic threats in Europe are pushing down U.S. Treasury yields. The EU is increasingly worried about deflation and recession and we may soon see an announcement concerning further policy accommodation in the form of asset purchases by the European Central Bank. The *Financial Times* reported last week that the investment management firm Blackrock was hired to help in any asset purchasing process. We may be able to attribute some portion of lower rates to the so called "flight to quality" trade resulting from heightened geopolitical risks. However, we note the VIX and gold prices do not reflect much fear.

<u>Chart 2: New Lows for German Bund, Discount to US treasuries, and Correlation</u>



Source: Bloomberg

The outlook for interest rates is being buffeted by cross winds, but the outlook on credit is a bit calmer. Credit spreads in the U.S. are still supported by domestic economic growth, high profit margins, manageable debt levels, continued low interest rates, and a banking system with high levels of capital and a willingness to lend. We are concerned about stretched valuations and the winds of deflation and recession coming from around the world, but we continue to be comfortable in our view that credit trends remain favorable, baring a systemic shock. Still, the days of material tightening in credit spreads are likely over.

Strategy

Good performance in both rates and credit in August and year-to-date have been positive for fixed income portfolios. Unfortunately, as prices go up, yields go down and it is increasingly 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. Short-term securities with little yield are at risk if short-term interest rates continue to rise with the normalization of the fed funds rate.

Taking some credit risk continues to be an attractive way to add value, if not for appreciation then for a higher yield. Corporate balance sheets for non-financial companies are stable, 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 prudent to hold more 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 and lower duration assets and will continue to add these securities as conditions allow. For example, we took gains this month by selling our Lucadia 5.5% bonds due 2023 (f/k/a Jefferies) as both credit spreads and treasury yields have tightened materially since our purchase last year. Over the ten month holding period the annualized return was 13%. These bonds were held in many accounts depending on guidelines and needs; we will reinvest proceeds in securities with lower duration and credit risk.

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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