Fixed Income Commentary

March 4, 2016

KEY TAKEAWAYS

The "lower for longer" rate theme continues to be relevant given recent economic data, which has been mixed at best. Chinese and Japanese selling on the front end of the U.S. Treasury curve to support their local currencies and European buying on the back end to escape negative short term yields has led to a dramatic flattening of the U.S. Treasury curve.

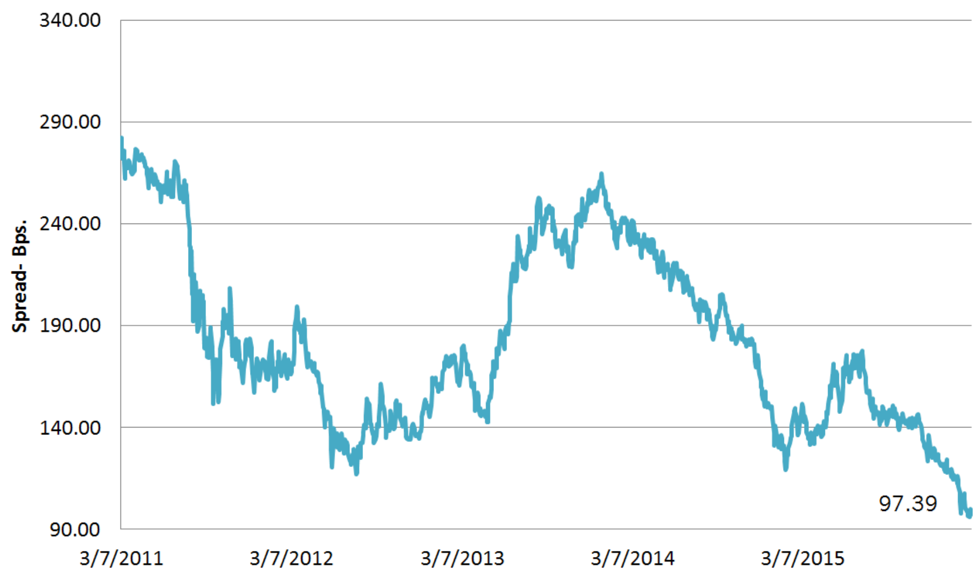
Key Rates	Feb 29 2016	Jan 29 2016	Dec 31 2015
Treasury Yields			
2 Year	0.77	0.77	1.05
5 Year	1.21	1.33	1.76
10 Year	1.73	1.92	2.27
30 Year	2.62	2.74	3.02
Credit Yields			
BBB Industrial 10 Year	3.66	3.79	3.99
Muni Yields			
AAA 10 Year	1.75	1.73	2.00
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.55	2.69	3.02

FEBRUARY IN REVIEW

- Continued global economic uncertainty and lack of yield alternatives has led to continued strength in the U.S. Treasury market.
- After widening for most of the month the Barclays U.S. Credit Index and Barclays High Yield Index rallied at month-end as commodity names stabilized.
- Economic data was mixed with weaker manufacturing and housing data contrasted by stronger employment reports.

U.S. Treasury securities have been the beneficiary of global equity market distress thus far in 2016. They are seen as a traditional safe haven for investors during turbulent times. This is even more marked today. Even as Japan and China have been forced to sell U.S. Treasuries to support their local currencies, domestic and other international investors have been strong buyers of longer-dated U.S. Treasuries, as most European sovereign credits trade at negative yields. Taken together, we have seen a dramatic flattening of the U.S. Treasury yield curve to levels not seen since 2007, as measured by the rate differential between the 2-year Note and the 10-year Note.

EXHIBIT 1: US TREASURY: 10-YR - 2-YR YIELD SPREAD



Source: Bloomberg Financial L.P. and Barclays Securities

Investors piling into perceived safe assets should be reminded that U.S. Treasuries can carry their own risk, too. In fact, with interest rates so low for so long, the duration, a risk measure of price sensitivity, of U.S Treasuries has risen sharply. Yields are so low that there is not enough income produced to offset price declines if interest rates rise. The following table illustrates this point. It shows the sensitivity of the U.S. Treasury term structure to produce a 0% return over a 1-year investment horizon.

EXHIBIT 2: TREASURY TERM STRUCTURE SENSITIVITY

Treasury	Duration	Beginning Yield (%)	Ending Yield (%)	Basis Point Change
2-yr Note	1.98	0.86	1.74	+88bp
5-yr Note	4.86	1.35	1.70	+35bp
10-yr Note	9.21	1.85	2.07	+22bp
30-yr Bond	21.04	2.68	2.81	+13bp

Source: Bloomberg Financial L.P. and Barclays Securities

For longer-dated U.S. Treasuries, it takes just a 13 basis point move in interest rates to wipe out the income benefit of the security and achieve a 0% return. Just one additional quarter point rate increase would produce a negative return for the investor, barring further flattening of the yield curve. We note the irony of the current situation, in which longer-dated U.S. Treasuries now appear to be return-free risk instead of risk-free returns.

The sweet spot here is the 2-year note, which can tolerate yields more than doubling before seeing a 0% return over a 1-year investment horizon, or roughly 3 moves by the Fed.

February performance within the fixed-income markets, according to the Barclays Indices, saw the U.S. Treasury Index once again lead the way. Treasuries were closely followed by the U.S. Credit Index, which had been creeping wider for most of the month, only to stage a sharp rally late in the month. High yield bonds also rose as credit fear subsided. Higher quality sectors of the market, such as MBS and Municipal Indices, lagged in relative performance after a nice start in January. The table below highlights the performance within the fixed-income markets based on the Barclays Indices.

EXHIBIT 3: FIXED INCOME MARKET PERFORMANCE

Index	January (%)	February (%)	Year-To-Date (%)
US Aggregate	0.55	0.71	2.10
US Intermediate Agg	1.25	0.45	1.71
US Treasury	2.13	0.89	3.04
US MBS	1.30	0.37	1.68
Municipal	1.19	0.16	1.35
US Credit	0.52	0.84	1.36
High Yield	(1.61)	0.57	(1.04)

Source: Bloomberg Financial L.P. and Barclays Securities

Going forward, we are adhering to our "lower for longer" theme with respect to interest rates. Recent economic data has been mixed. In particular, employment reports have been fairly strong on the surface, but weaker manufacturing and housing data suggest the economy is struggling to create high-quality, high-paying jobs. We believe this will keep the Federal Reserve on the sidelines for the foreseeable future. While corporate bond spreads staged an impressive narrowing in late February, we don't believe the carnage is over given the growing overhang of debt. We still favor the relatively stable high-grade municipal and MBS sectors of the fixed-income market.

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