FIXED INCOME COMMENTARY

June 6, 2016

KEY TAKEAWAYS

Expectations for a rate hike by the Federal Reserve in June quickly faded as the May employment report came in well below expectations. Prior to the May employment data release, rhetoric from various Fed Governors had been hawkish, even going as far as saying that a June rate hike was "likely" in the FOMC minutes if the economy warranted such a move. Now, as a rate hike seems to have been pushed out, there are concerns about the current state of the economy.

Key Rates	May 31 2016	Apr 29 2016	Dec 31 2015
Treasury Yields			
2 Year	0.88	0.78	1.05
5 Year	1.37	1.29	1.76
10 Year	1.85	1.83	2.27
30 Year	2.65	2.68	3.02
Credit Yields			
BBB Industrial 10 Year	3.32	3.29	3.99
Muni Yields			
AAA 10 Year	1.63	1.65	2.00
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.61	2.60	3.02

MAY IN REVIEW

- Modest fixed income returns in the month of May, led by high yield and municipals.
- The market based implied probability for a June rate hike is back to 4%, where it was on May 16th, despite touching as a high as 34% on May 25th.
- Nonfarm payrolls added 38,000 jobs in May, well below its 12 month average of 197,000, and well below consensus of 160,000- the lowest level since September, 2010.

Going Down The Road Feelin' Bad

In our May Fixed Income Commentary, we discussed the confusion felt by the markets with regard to the timing of the next move by the Federal Reserve. On May 18th, the Fed released the minutes of the April FOMC committee meeting and stated that most Fed officials saw a June rate hike "likely" if the economy warranted it. This occurred after a relatively benign April employment report. The initial market reaction was that interest rates rose a quick 15 basis points, equity markets were virtually unchanged, and the US Dollar soared. Hence, it left all eyes fixated on future economic data releases. Housing and retail sales data came in stronger than expected, manufacturing and production numbers were modest, and first quarter real GDP was revised upward to 0.9% from 0.5%. So, just when the market felt it had some clarity by the Fed, out comes the May employment report which was awful! Nonfarm payrolls rose a scant 38,000, well below the 197,000 previous 12-month average and the lowest level since September of 2010. Revisions to the previous two months showed an additional job loss of 59,000. The unemployment rate fell to 4.7%, its lowest level since November of 2007, but for the wrong reason as the labor force participation rate fell to 62.6%, close to its all-time low of 62.4%. Needless to say, interest rates moved lower on the report.

For May, U.S. Treasury rates rose very slightly led by the 2-year Note which rose 10 basis points over the month to 0.88%, while the benchmark 10-year Note rose just 2 basis points to 1.85%. The following table highlights the performance of the sectors of the fixed-income market according to the Barclays Indices:

EXHIBIT 1: FIXED INCOME MARKET PERFORMANCE

Index	May (%)	Year-To-Date (%)
US Aggregate	+0.03	+3.45
US Intermediate Agg	-0.03	+2.52
US Credit	-0.04	+5.14
US Treasury	+0.00	+3.09
US MBS	+0.13	+2.27
US Municipal	+0.27	+2.70
US High Yield	+0.62	+8.06

Source: Bloomberg Financial L.P. and Barclays Securities

As can be seen from the table above, fixed-income returns were very modest in May, with the best performing sectors being high yield and municipals. The high yield sector, being so dominated by energy-related bonds, benefited from the recovery in oil prices, while municipals did well on strong demand and limited supply.

The weak economic data of the first quarter had effectively stifled any talk of a rate increase before December. Yet, the April minutes showed a June move was very much alive in the minds of the FOMC. In the days following the release, Fed Governors appeared on seemingly every major news outlet to explain why a rate hike made sense. Investors were surprised, both by the extent of the coordinated effort to communicate the likelihood of a June hike and by the number of news shows that would actually include a Fed governor as a featured guest. While the bond market initially reacted negatively to this news blitz, prices have since recovered most of the late-May move.

The market-based implied probability of a June interest rate hike jumped from 4% on May 16th to 34% on May 25th, and is now back to a 4% probability today following the release of the May jobs report. The Fed desperately wants to begin the rate normalization process to curb the systematic excesses building up after years of a "zero bound" interest rate policy.

However, price action suggests a majority of market participants are not adjusting portfolios to reflect the increasing risk of a policy shift. Most investors still believe the global economy is too fragile to handle a U.S. rate hike. The market may be too complacent with this belief. It is worth noting the economy does not have to be strong for the Fed to move; the goal of the next rate hike is to deflate potential asset bubbles and the Fed may simply be looking for signs of economic stability rather than economic growth to justify a move. If June data is weak enough to maintain the status quo – and May's job report would certainly fall in that category, it would suggest the economic outlook has deteriorated sharply. To paraphrase the Grateful Dead, such negative data may push the next move down the road, but we will be heading there feeling bad about the economic situation.

Puerto Rico Update

The U.S. House of Representatives continues to move forward on a bill to allow some form of bankruptcy protection for the Commonwealth. The final legislation is expected to pass before the end of the summer recess, although the final version of the bill is still very much a work in progress.

Ironically, the latest opposition to the bill comes from the government of Puerto Rico itself. The island objects to the clause mandating a Federal oversight board. The proposed board would have broad authority to develop and enforce fiscal plans to rehabilitate all entities covered by the legislation. A recent amendment to the legislation would require all issuers to respect the "lawful liens" in place prior to the passage of the bill.

As we have noted in the past, passage of the legislation would be a significant erosion of the traditional promises and protections underpinning the foundations of the municipal bond market. The establishment of an oversight board will curb the ability of special interest groups to insert their constituents ahead of bond holders in "state" level bankruptcies. The final version of this bill is therefore critical to the working of the entire municipal bond market, especially with states like Illinois and New Jersey seeking similar protections. We will be watching these developments closely.

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