FIXED INCOME COMMENTARY

July 13, 2016

KEY TAKEAWAYS

Great Britain stunned the global financial markets by voting to leave the European Union on June 23rd. Global financial markets reacted negatively to the news of the UK's vote, with global equity markets selling off sharply. It is expected that financial markets will remain volatile as "official" talks to leave the EU evolve.

Key Rates	Jun 30 2016	May 31 2016	Dec 31 2015
Treasury Yields			
2 Year	0.58	0.88	1.05
5 Year	1.00	1.37	1.76
10 Year	1.47	1.85	2.27
30 Year	2.28	2.65	3.02
Credit Yields			
BBB Industrial 10 Year	2.98	3.32	3.99
Muni Yields			
AAA 10 Year	1.35	1.63	2.00
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.31	2.61	3.00

FEBRUARY IN REVIEW

- Great Britain voted to leave the European Union (EU), a vote that sent shocks through the global financial markets.
- U.S. Treasury 10- year note closed June with a yield of 1.47%, 30 bps. lower than March's closing yield.
- Mortgage-backed securities have been the weakest performing sector due to fears of an increase in prepayment risk.

United We Stand...Divided We Fall

Great Britain stunned global financial markets on June 23rd by voting to leave the European Union (EU) triggering a massive global equity market sell-off. Chinese, U.S., and British markets were down 3-to-4%, German, French, and Japanese markets lost 7-to-8%, while Italian, Spanish, and Greek markets lost in excess of 12%! Originally given a low probability of success, the "NO" (i.e. Leave) vote clearly caught many by surprise. Most European markets and the British Pound had rallied in the days just prior to the vote. The final results forced investors to re-evaluate their investment theses and macro-views of the global economy.

While the shock of Brexit sparked a global equity sell-off, it also ignited a sharp rally in bonds as it became clear that central bankers around the world were prepared to do whatever was needed to prevent the vote from sparking a crisis. Yields on government bonds plunged as investors sought safety. The German 10-year Bund yield, for example, turned negative – falling to -19 basis points as of the time of this writing - while the U.S. Treasury 10-year note hit a record low at 1.318%. The table found below in **Exhibit 1** highlights interest rate movements for the U.S. Treasury market for the second quarter of 2016:

EXHIBIT 1: TREASURY YIELDS

Issue	03/31/16	06/30/16	BP Change	Range	Total Return
2-yr Note	0.72%	0.58%	-14	0.58-to-0.92%	0.49%
5-yr Note	1.21%	1.00%	-21	0.98-to-1.41%	1.42%
10-yr Note	1.77%	1.47%	-30	1.44-to-1.93%	3.27%
30-yr Bond	2.61%	2.28%	-32	2.27-to-2.75%	7.93%

Source: Bloomberg Financial L.P. and Barclays Securities

As can be seen from above, longer-dated U.S. Treasuries outperformed shorter-duration notes. In terms of sector performance within the fixed-income markets, corporate bonds, both investment grade and high yield, achieved superior returns relative to the higher quality sectors.

Sector returns as reported by Barclays are provided on the following page in **Exhibit 2**. Mortgage-backed securities have been the weakest performing sector due to fears of an increase in prepayment risk as the US Treasury 10-year has fallen to historical lows. Municipal bonds have been performing well as demand continues to outstrip supply. The uncertainty of the vote will not blow over quickly.

EXHIBIT 2: FIXED INCOME SECTOR PERFORMANCE

Index	June (%)	Q2	Year-To-Date (%)
US Aggregate	1.80%	2.21%	5.31%
US Intermediate Agg.	1.23%	1.44%	3.78%
US Treasury	2.21%	2.10%	5.37%
US Credit	2.28%	3.48%	7.54%
MBS	0.81%	1.17%	3.26%
High Yield	0.92%	5.52%	9.06%
Muni	1.59%	2.62%	4.33%

Source: Barclays Securities

The referendum is not legally binding, as it will take an act of Parliament to commence the process, which will be highly contentious. The next British Prime Minister (David Cameron tendered his resignation after the vote) will then have to decide when to invoke Article 50 of the Lisbon Treaty. The whole departure process may take years to unfold, keeping the global financial markets hostage through the negotiations.

A departure will most likely leave both the UK and the EU worse off than they are today. Britain sends about half of its exports to Europe and may face tariffs going forward. Many banking functions will have to leave Britain.

London real estate is some of the most expensive in the world and the risk of soaring vacancy rates as financial firms relocate to the continent has caused at least six property-linked mutual funds to halt redemptions. There will also be pain on the EU side. It is losing its second-largest member, which will clearly have an economic impact.

Britain sends about 350 million Euros a week to Brussels and, if suspended, it puts a far greater onus on the stronger northern members of the EU who have been subsidizing the weaker southern members for years. Markets fear these transition pains will lead to a severe recession in Europe, one that may spread to other regions.

Despite the uncertainties surrounding Britain and the EU, it is difficult to understand the flight to government securities at these rate levels. It would only take a mere 17 basis point rate move higher to wipe out the twelve-month return of the U.S. Treasury bond, and most Treasury securities have positive yields! The downside is even worse for sovereign bonds with negative yields. The risk/reward profiles of government securities are highly skewed toward risk and remain extremely unattractive.

The trade-off makes sense to investors for two reasons. First, the global economy remains weak and interest rates may still move lower, particularly should the US economy slip into recession or if Europe fails to recover. More importantly, amidst all the unknowns, one thing seems to be certain: the Federal Reserve will likely remain on hold for the foreseeable future as global events unfold.

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