Fixed Income Commentary

October 4, 2016

KEY TAKEAWAYS

The Federal Reserve kept rates unchanged in September for the sixth straight meeting this year. Despite acknowledging a stronger case for a rate increase the Federal Reserve made the decision to wait for additional data that demonstrates "further evidence of continued progress."

Key Rates (%)	Sep 31 2016	Aug 31 2016	Dec 31 2015
Treasury Yields			
2 Year	0.76	0.81	1.05
5 Year	1.15	1.20	1.76
10 Year	1.59	1.58	2.27
30 Year	2.32	2.23	3.02
Credit Yields			
BBB Industrial 10 Year	2.95	2.89	3.99
Muni Yields			
AAA 10 Year	1.52	1.43	2.00
Mortgage Backed Securities			
30 Year FNMA Current Coupon	2.36	2.38	3.02

SEPTEMBER IN REVIEW

- High yield continues to be an outperformer as investors reach for yield, +.67 in September.
- US Treasuries posted their second consecutive negative return month, -.13%.
- Odds are pointing to December for the next rate hike with probabilities +50%.

The Fed Passes, Again!

For the sixth straight meeting this year the Federal Reserve opted to not increase interest rates. Despite strength in the labor market and improving economic growth, the Fed Governors noted that business fixed investment has remained soft and inflation has remained well below its 2% target. In their statement, the Fed said "The Committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives." Tepid September economic data certainly helped support the doves, who seemed to be in minority view leading up to the meeting. Despite the outcome, the vote was not unanimous as three Fed Governors voted for an immediate rate hike, a notable increase from just one in July.

With the decision to not hike, the Federal Reserve has once again forced the financial markets into a state of data-driven limbo. Markets are back to a wait-and-see mode of sifting through future economic data to discern clues of when the Fed will move next. According to the federal funds futures probabilities, the Fed is unlikely to move in November, but odds for December are at 59%, as of this writing.

In the meantime, the markets have two free months of carry as investors await the Fed's intentions. Portfolios sitting in cash and short term securities will likely underperform in the next few months. However, it will not take much of an interest rate increase for bonds to post negative returns and curve steepening may occur even without Fed action. For longer dated securities, a 25 basis point rate move will produce a negative total return over the next year. As such, we are committed to keeping our clients' duration relatively short and focusing on incremental returns via security selection and sector positioning strategies.

U.S. Treasury securities posted their second consecutive month of negative returns in September, as markets remained on edge over interest rate uncertainty. The table on the following page in **Exhibit 1** highlights the interest rate movement and total returns of U.S. Treasury securities according to Bloomberg.

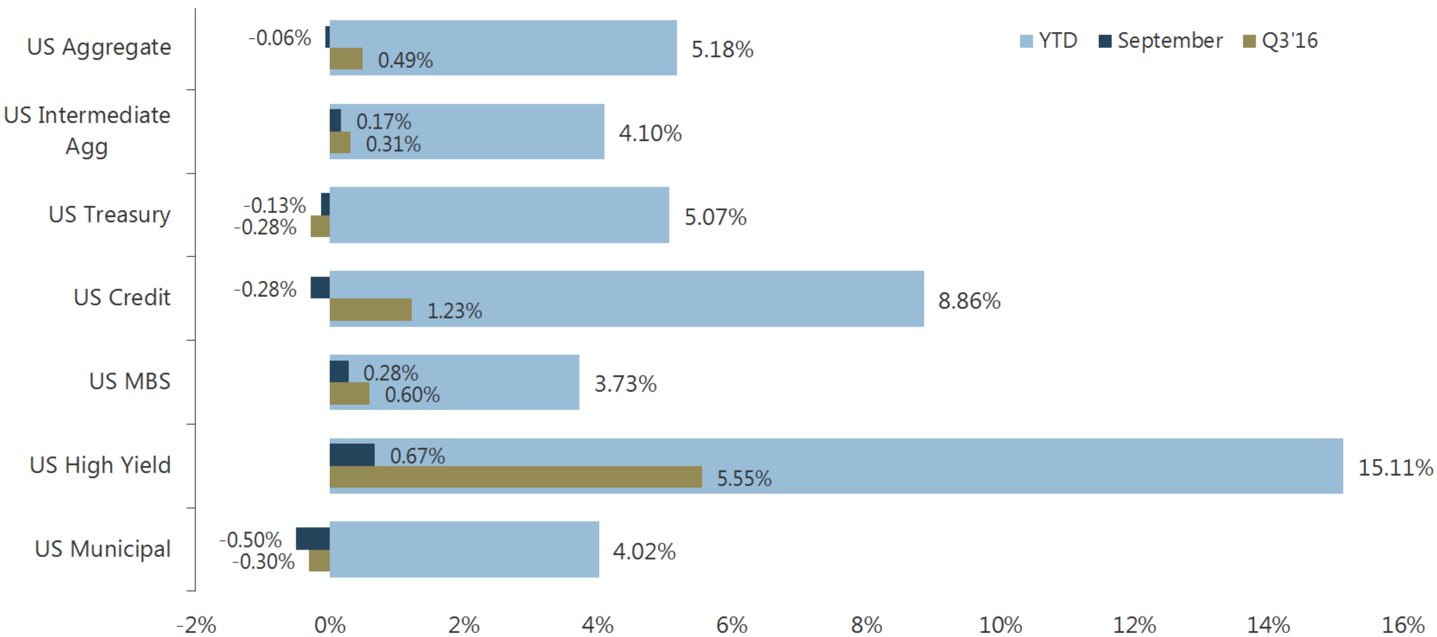
EXHIBIT 1: TREASURY YIELDS

Issue	06/30/16	09/30/16	BP Change	Total Return
2-yr US Treasury Note	0.58%	0.76%	+18	-0.09%
5-yr US Treasury Note	1.00%	1.15%	+15	-0.28%
10-yr US Treasury Note	1.47%	1.60%	+13	-0.60%
30-yr US Treasury Bond	2.28%	2.32%	+3	0.10%
US Treasury 2-10 Spread	0.87%	0.83%	-4	n/a

Source: Bloomberg Financial L.P. and Barclays Securities

Credit continues to dominate returns in this low interest-rate environment. As investors continue to reach for yield, credit spreads have tightened dramatically. Lower rated segments of the bond market continue to outperform higher grade issues. In a striking move, high yield (i.e. junk) bonds surged 5.55% while Treasuries produced negative total returns in the third quarter. Sector performance, as reported by the Bloomberg/ Barclay's indices, is shown below in **Exhibit 2**.

EXHIBIT 2: FIXED INCOME MARKET PERFORMANCE



Source: Bloomberg Financial L.P. and Barclays Securities

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