Fixed Income Commentary

March 3, 2017

KEY TAKEAWAYS

While there is a lot that remains to be seen for financial markets to determine future direction, two items that are starting to show increased probabilities in the short term are increased rates by the Fed and the shrinking of the Fed's balance sheet. The latter has the potential to send rates much higher.

Key Rates (%)	Feb 28 2017	Jan 31 2017	Dec 31 2016
Treasury Yields			
2 Year	1.26	1.20	1.19
5 Year	1.93	1.91	1.93
10 Year	2.39	2.45	2.44
30 Year	3.00	3.06	3.07
Credit Yields			
BBB Industrial 10 Year	3.57	3.66	3.68
Muni Yields			
AAA 10 Year	2.30	2.31	2.35
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.15	3.19	3.13

FEBRUARY IN REVIEW

- High yield continues to be the outperformer in 2017, up 1.46% during the month.
- On a month over month basis, the 2-10 yield spread tightened 12 bps to 113 bps.
- Municipal bonds finished the month up .69%.

Time to Pay the Piper

During her Humphrey-Hawkins testimony before Congress in February, Federal Reserve Chairwoman Janet Yellen dropped two bombshells on the markets. Foremost, she used her opening comments to specifically address reducing the size of the Federal Reserve's balance sheet. The move was a rare public acknowledgement of a $3.8 billion policy issue that has received little attention in the media coverage of the global banking system. Her comments emphasized the unwinding would be slow and methodical. However, she made it clear the holdings would be reduced in the near future and this rattled markets.

The Fed is the largest single holder of government securities in the world and any move to place these holdings back on the open market would almost certainly drive interest rates higher. In what could only be viewed as a clear warning to the marketplace, Yellen emphasized there is "no unique level" the Fed funds need to reach before the Fed begins shrinking the balance sheet and that the US economy is "very close" to achieving the Fed's goals of growth and price stability.

The second bombshell she dropped was saying "Waiting too long to remove accommodation would be unwise, potentially requiring the FOMC to eventually raise rates rapidly, which could risk disrupting financial markets and pushing the economy into recession." This statement was a significant departure from the tone of prior comments, which routinely suggested that moving slowly was a prudent approach with few risks attached. Following this testimony, the market-derived probability of a March rate hike grew from essentially a zero chance to a whopping 82% likelihood of a move! Interestingly, longer term interest rates have declined 10-to-15 basis points over the same period.

The bond market seems to doubt the resolve of the Fed, even though several Fed governors have been going out of their way to inform the markets about the bank's intentions. The Fed, especially under Yellen, has long signaled warnings of pending rate hikes, only to back-pedal at the next FOMC meeting. The financial markets have heard "the Chair who cried wolf" too many times and now seem inured to risk the Fed might actually raise rates at a faster pace than expected. This has created an environment in which both the bond and equity markets may be caught off guard by a rate hike in March. **Exhibit 1** shows the yield differential between the 2

EXHIBIT 1: 2-10 YEAR US TREASURY SPREAD

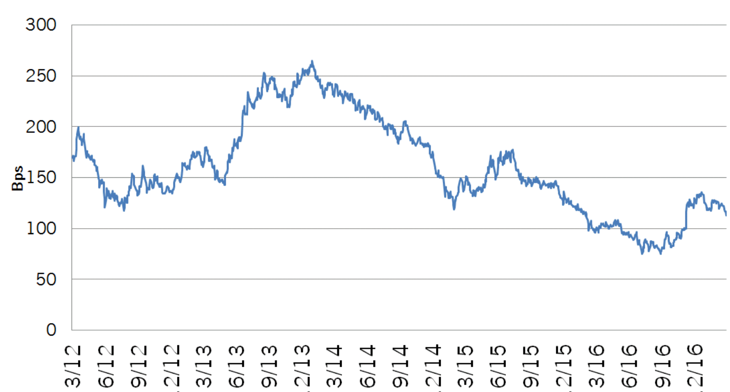
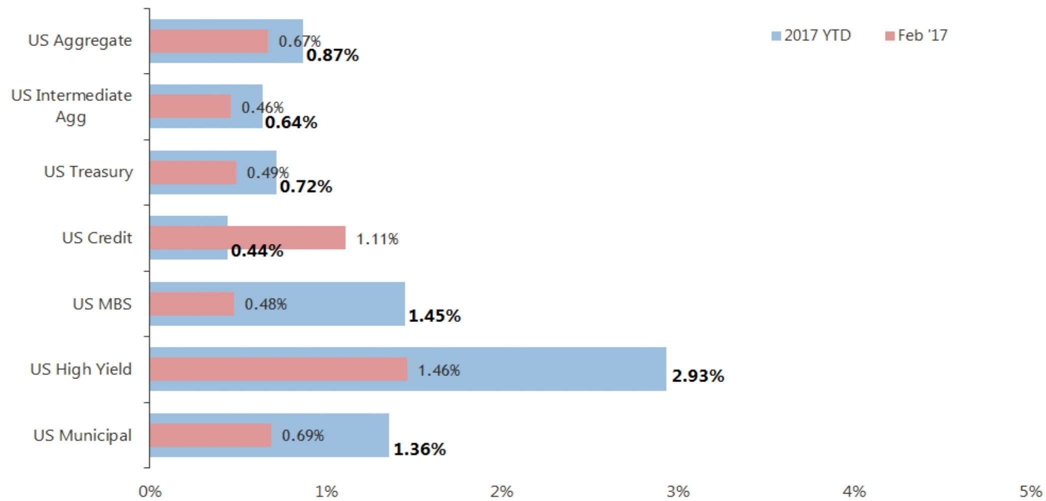


EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

-year and 10-year Treasury notes over the last five years. The short-end of the U.S. Treasury yield curve has essentially priced in a potential rate hike by the Fed in March, while the longer-end has not. We fear the markets may not be ready if this is the time the proverbial "wolf" actually appears.

Complacency may not be the only factor at work, as there are several reasons to see divergence between monetary policy actions and market price actions. The Fed is no longer the sole force in the bond market. Interest rate differentials between markets have made the U.S. bond market seem very cheap and attractive. The German 10-year government bond, for example, now pays 0.35% while the U.S. 10-yr Treasury note pays 2.50%. Not only are domestic yields more attractive, the dollar offers appreciation potential, with the U.S. growing faster and foreign capital fleeing the uncertainty of the Euro and government induced currency devaluations. To illustrate the scope of these risks, the German 2-year note, viewed as one of the safest cash hording vehicles available, recently traded at a yield of –0.95%! Investors are willing to lock in a guaranteed loss of nearly 1.90% to avoid the risk of a larger loss should their home country vote to leave the Euro (as France or Italy might) or to raise taxes sharply to service bloated national debt obligations (as Greece might).

The fear of fiscal policy missteps is not just a foreign concern. The new administration is clearly pro-growth, but how we reach that goal remains to be seen. The outline of President Trump's first budget includes a $54 billion increase in defense spending, infrastructure increases and some level of tax cuts, while making drastic cuts to domestic spending. What will actually pass remains a big unknown and the final budget will certainly face some very sharp battles before gaining passage. The bond market seems content to hold safer securities until these uncertainties are removed.

Since the global financial crisis of 2008, monetary policy has really been the only game in town. The Fed has been able to move rates lower as they pleased, but has repeatedly erred on the side of caution when it came to raising rates. This inertia has created the perception that the Fed now seems to react to short-term data points and is following the financial markets rather than leading them. By not taking action sooner, the Fed has placed itself in a precarious predicament where it must act to maintain price stability just when the unpredictability of fiscal policy under President Trump suggests the FOMC should show some restraint.

In terms of February fixed-income performance, bond returns were positive, with investment-grade corporate bonds and high yield bonds once again leading the way. The yield on the U.S. Treasury 2-year note rose 6 basis points to 1.26%, while the U.S. Treasury 10-year note fell 6 basis points to 2.39%. Quality spreads continue to narrow in the corporate bond market as Baa-rated securities have outperformed Aaa-rated ones by 123 basis points so far this year. **Exhibit 2,** above, highlights the relative performance within the fixed-income market according to the Bloomberg Barclays Indices during the month.

The Federal Reserve has made their intentions regarding a rate hike perfectly clear and we believe the market will not react harshly to a March increase. We are much more concerned about the Fed's shrinkage of their balance sheet. Given Yellen's recent comments, we worry that a gradual process to shrink the balance sheet will begin soon and send longer term interest rates much higher than expected in the months ahead. We feel it would be foolish to fight the Fed under these conditions, despite the tremendous uncertainty surrounding fiscal policy and negative interest rates across the globe. Consequently, we remain defensive on the bond market in the near term.

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