Fourth Quarter Fixed Income Review
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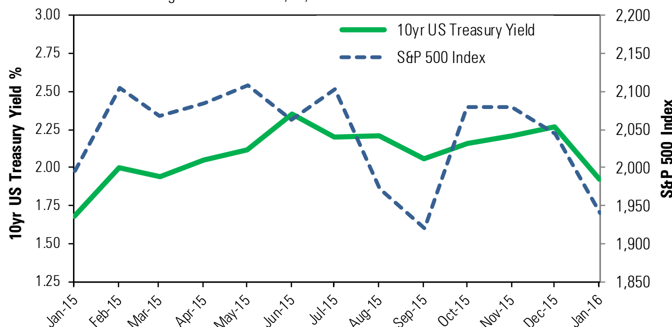
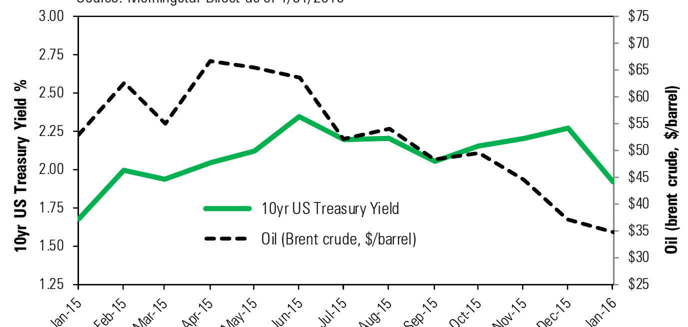
Overview

The fourth quarter saw the Federal Reserve raise interest rates for the first time since 2006, signaling an end to the zero interest rate environment of the last several years. At the December FOMC meeting, Chairwoman Janet Yellen increased the federal funds rate by 25 basis points, moving the target range to 0.25% - 0.50%. Despite investor anxiety regarding the liftoff of interest rate hikes, the market's reaction was muted as the impact of the initial hike was largely priced in.

The move by the Federal Reserve to tighten monetary policy stands in contrast with the rest of the world, where the European Central Bank, Bank of Japan, and People's Bank of China remain committed to easing policy in an attempt to stimulate their economies. Indeed, it was largely concerns over growth overseas and the severe decline in energy prices that moved markets over the course of the quarter, rather than expectations of tighter monetary policy in the US.

Subsequent to the end of the fourth quarter, both the price of oil and the value of risk assets fell sharply in response to poor economic data and market volatility overseas. As a result, US Treasury yields fell as investors flocked to safe-haven assets. In addition, some government debt in Europe and Japan has begun to trade at negative yields, signaling a significant "risk off" trade by overseas investors.





Economy, Markets, and FOMC

Economic data for the quarter was largely positive, although we did see a divergence within the US economy as manufacturing remained weak, buffeted by soft overseas demand and a strong dollar which put pressure on exports. The unemployment rate at 5% is close to what economists generally consider to be full employment, and December payrolls were unexpectedly strong with the economy adding 292,000 jobs. Housing data and consumer spending were also positives, particularly auto sales. Yet inflation still remains below the Fed's target, and evidence of significant wage growth has been limited.

As has been widely reported, oil prices continued their downward slide during the fourth quarter, and as we enter 2016 continue to descend. Much has been written regarding the impact of oil on the global and domestic economies. One argument contends that low prices will continue to pressure the economies of oil producing countries and will reduce global growth. In addition, companies in the energy sector will be forced to cut spending (capital expenditures, labor) which will have a direct effect on the economies they operate. The other argument is that a decline in oil prices is a boon for the consumer, as it provides more discretionary income from savings on gas and other oil related products. In addition, the decline would help those industries whose input costs are directly associated with oil or whose products are impacted by cheap gas such as automobiles. For now, it appears the first argument is prevailing as each drop in the price of oil is met with selling in risk assets.

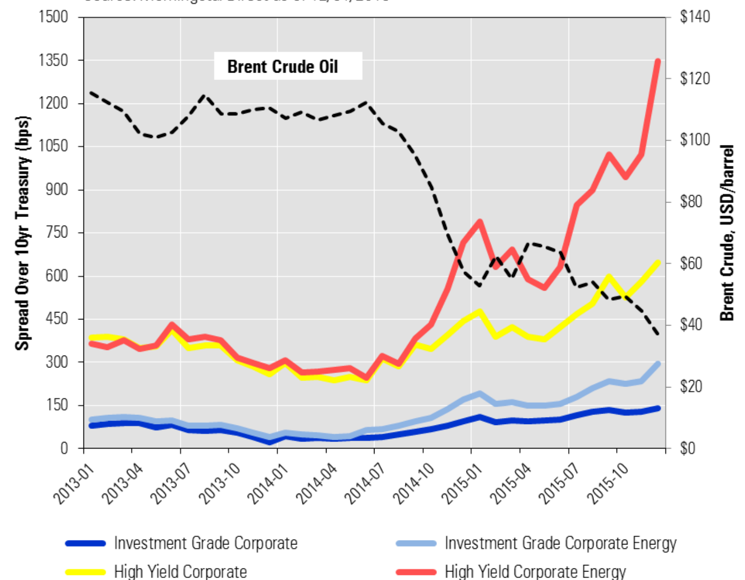
The Fed has stated that they will be closely watching economic conditions and inflation which will determine the speed and degree at which they raise interest rates. Rising inflation would generally be considered a positive for the economy as it would indicate that growth is accelerating from the fairly slow pace we have seen during the recovery. However, the oversupply in oil (driven by the major oil producing countries' reluctance to cut production) has driven down the price of crude which has helped to keep inflation pressures subdued. In addition, the current market turmoil has raised concern that growth domestically may slow as consumers react by reducing spending. FOMC forecasts had originally called for four rate increases in 2016, however the market is pricing in a slower pace with only two rate increases for the year.

Taxable Market

- **Treasury yields rose across the curve during the quarter in response to an increase in the federal funds rate**
- **Credit markets saw elevated volatility, with negative performance for investment-grade and high-yield in 2015**
- **High-yield and non-USD denominated debt were the major underperformers for the quarter and year**

The Treasury curve flattened during the quarter as yields rose across all maturities, with yields rising more significantly on the shorter end of the curve. Short-term rates are influenced primarily by monetary policy while long-term rates are more sensitive to inflation expectations; hence the larger move in short-term yields in response to Fed rate hikes and the more muted reaction on the longer end as inflation expectations remain low. The relative attractiveness of US yields also played a part in keeping the long end in check. With the Fed tightening and strong dollar, US Treasury yields are significantly higher than government bond yields in developed markets overseas, and thus have seen strong demand from foreign buyers.

Despite an environment in 2015 which would typically be supportive of credit (slow but positive economic growth) the selloff in commodities pressured both investment-grade and high-yield spreads, with companies in the energy and natural resources industries seeing the greatest widening. Increased bond issuance also put pressure on the market, as companies looked to issue debt prior to the beginning of the Federal Reserve's rate hiking cycle. These factors continue to impact spreads as we enter 2016.



High-yield performed poorly during the quarter as spreads widened across most sectors in sympathy to heavy selling in energy. The lack of liquidity exacerbated the situation as managers, looking to meet redemptions, were forced to sell positions into a market with few buyers. High yield has often been viewed as leading indicator for the equity market and the economy in general. It remains to be seen if the weakness in high yield is signaling broader troubles ahead for the domestic economy and stocks or if the selloff is simply a temporary pullback in a sector chased for yield.

Global bonds also underperformed for the year, mainly due to exchange rate movements. With the USD rising against the Euro, Yen, and many other developed and emerging market currencies, returns in foreign currencies are negatively affected when translated back into USD terms.

U.S. Treasury Yields

Source: Morningstar Direct as of 12/31/2015

U.S. Treasury Yields	12/31/2015	9/30/2015	6/30/2015	3/31/2015	12/31/2014
2-year	1.06%	0.64%	0.64%	0.56%	0.67%
5-year	1.76%	1.37%	1.63%	1.37%	1.65%
10-year	**2.27%**	**2.06%**	**2.35%**	**1.94%**	**2.17%**
20-year	2.67%	2.51%	2.83%	2.31%	2.47%
30-year	3.01%	2.87%	3.11%	2.54%	2.75%

Fixed Income Sector Returns[1]
Source: Morningstar Direct as of 12/31/2015

Taxable Sectors	2015	Q4 2015	Q3 2015	Q2 2015	Q1 2015
U.S. Aggregate Bond	**0.55%**	-0.57%	1.23%	-1.68%	1.61%
Short-Term Corporates	**1.27%**	-0.29%	0.34%	-0.07%	1.28%
Intermediate-Term Corporates	**0.78%**	-0.44%	0.37%	-1.81%	2.71%
Long-Term Corporates	**-4.87%**	-1.11%	0.48%	-7.16%	3.12%
Mortgage-Backed	**1.51%**	-0.10%	1.30%	-0.74%	1.06%
High Yield	**-4.64%**	-2.17%	-4.90%	-0.05%	2.54%
Bank Loan / Floating Rate	**-0.69%**	-2.10%	-1.35%	0.69%	2.13%
Global Bond	**-6.02%**	-1.26%	0.64%	-0.83%	-4.63%

Tax-Exempt Market

- **Municipal bonds performed strongly during the fourth quarter, weakness in the taxable market notwithstanding**
- **Supply/demand factors contributed to performance as investors sought the stability of municipals in a low supply environment**
- **Credit quality remained favorable across the general market, with exceptions known to investors**

The municipal curve flattened during the quarter as short-term yields rose while long-term yields declined. Technical factors were the major drivers of outperformance as increased demand for the stability of municipal bonds, as evidenced by strong fund flows, combined with low issuance resulted in municipal ratios dropping across the entire curve. Many investors view high quality municipal bonds as a tax-exempt option to Treasuries and gravitate towards them during periods of market turmoil. While less liquid than Treasuries, the tax-exempt feature does provide compensation for this. Going forward, municipal performance will be driven more so by movement in Treasury yields as Municipal/Treasury ratios have shifted closer to "rich" vs "cheap" levels.

Generally, fundamentals in the broader market remained strong, with tax revenues rising 5% for the year and credit upgrades exceeded downgrades for municipal issuers by 7%.[2] Troubled issuers such as Puerto Rico and Illinois continued to make headlines, but the market has been aware of these issues for a while and seems to have treated these problems as being "contained" and not infectious of the entire market for now.

Current Municipal Yields
Source: Morningstar Direct and Bloomberg as of 12/31/2015

Generic State G.O. AA Rated Municipal Bonds	Yield to Maturity as of					As % of U.S. Government Treasuries				
	12/31/2015	9/30/2015	6/30/2015	3/31/2015	12/31/2014	12/31/2015	9/30/2015	6/30/2015	3/31/2015	12/31/2014
2yr General Obligation	0.85%	0.69%	0.76%	0.62%	0.69%	80%	108%	119%	111%	103%
5yr General Obligation	1.40%	1.41%	1.60%	1.37%	1.44%	80%	103%	98%	100%	87%
10yr General Obligation	2.22%	2.37%	2.64%	2.23%	2.30%	98%	115%	112%	115%	106%
20yr General Obligation	3.26%	3.52%	3.60%	3.22%	3.31%	122%	140%	127%	139%	134%

Outlook

The year ahead should continue to be one of elevated volatility in the markets, as investors adjust to a new environment. Diverging monetary policy worldwide, a slowing economy in China, and the impact of low oil prices will provide the ingredients to sustain volatility in the markets. Ultimately, the US economy should remain relatively strong with GDP growing albeit slowly. While the

[1] Fixed income sectors shown in Figure VI are represented by the following indices: U.S. Aggregate Bond: Barclays U.S. Aggregate Bond; Short-Term Corporates: BofAML U.S. Corps 1-5 YR; Intermediate-Term Corporates: BofAML U.S. Corps 5-10 YR; Long-Term Corporates: BofAML U.S. Corps 10+ YR; Mortgage-Backed: Barclays U.S. MBS; High Yield: BofAML U.S. Corps HY Master II; Bank Loan/Floating Rate: S&P/LSTA Leveraged Loan 100; Global: Barclays Global Aggregate ex-USD; Emerging Market: JPM EMBI Global USD.
[2] Investment Strategy Group. "Goldman Sachs Investment Management 2016 Outlook." Goldman Sachs. January 2016.

Fed increased its benchmark rate during the quarter and has prepared the market for future increases we believe it will be very cautious in raising rates from here. We feel the market is probably more accurate in its estimates of two rate increases during the year and we may in fact see less than that. With regard to credit, the market continues to focus its attention on economic data, commodity prices and central bank policy as all are interrelated. We think that credit spreads are approaching levels that are very attractive and that there has been a significant amount of issuers whose spreads have widened purely out of sympathy with the rest of the market. That said, we would add to credit exposure slowly and on a name by name basis.

Our Portfolios

Our portfolios were not unaffected by the weakness in high yield credit and the adverse currency impact from owning non-USD denominated debt, as we do have satellite allocations to both sectors. During the quarter we repositioned our portfolios slightly, increasing our weight to higher quality intermediate investment-grade corporate and municipal debt while reducing our positions in short-term investment-grade and our multisector fund (which has exposure to high yield and non-USD debt). For now, we feel credit and non-USD debt has weakened to levels considered cheap and are therefore maintaining our current weightings. We will continue to evaluate exposures and make adjustments as necessary.

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