



## First Quarter Fixed Income Review

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### Overview

The first quarter of 2016 witnessed a wild start to the year with financial markets experiencing extreme levels of volatility. Investors exited risk assets early in the quarter to seek the safety of U.S. Treasuries as concerns over global growth (driven by weakness in commodities) decreased investor demand for risk. The selling peaked halfway through February before abruptly reversing course and rallying for the remainder of the quarter. Despite the volatile ride, equity and credit markets ended the quarter largely unchanged from where they entered the year.

### Economy, Markets, and FOMC

Economic data released in the U.S. during much of the quarter was mixed. Overall economic growth remains relatively subdued with GDP for the quarter expected to come in at 1.5% - below 2015's full year growth of 2%. The U.S. labor market continues to show solid participation, despite a soft report in February which added temporary fuel to the sell-off in risk assets. The housing and the service sectors, however, continue to recover and show solid gains with some weakness in manufacturing, primarily a result of the impact of a strong US dollar).

The markets entered 2016 with investors concerned about the health of the global economy. These concerns escalated as the quarter progressed driving investors out of risk assets and into U.S. Treasuries. Both corporate bonds (most notably high yield) and equities sold off in January and into February driven by fears associated with the following:

- **Oil Prices:** The price of oil continued its steady decline, trading below \$30 per barrel in some instances. Investors grew heavily concerned that a continued fall in the price would have a negative impact on both countries and corporations who rely on higher priced crude.
- **China:** Poor economic data, extreme stock market volatility, and the potential for currency depreciation sparked investor fears of a "hard landing" for the Chinese economy. After years of strong growth, a sharp slowdown of the Chinese Economy could result in a negative impact on growth globally.
- **Europe & Japan:** Both the European and Japanese economies have struggled to move beyond a tepid pace of growth. Although both fiscal and monetary policy efforts are in place, they appear to be slow in generating meaningful growth.

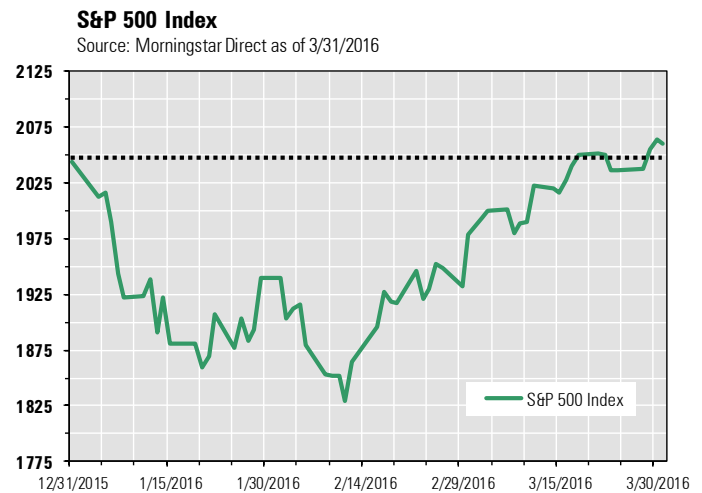
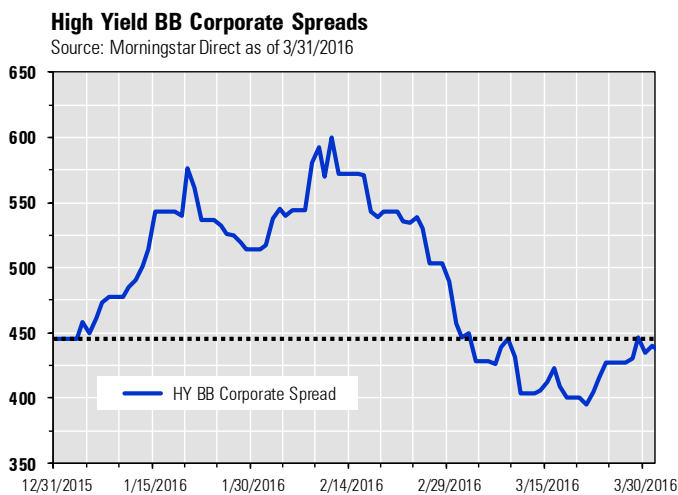
As the quarter progressed investors began to receive data that suggested their fears may have been overblown (a situation more readily viewed in the rear view mirror). Oil prices began to stabilize and slowly move higher from the \$30/barrel level. Better data and policy stimulus in China alleviated concerns of a sharp slowdown in their economy and monetary easing by the ECB and BOJ provided support that additional stimulus was still available to provide growth. As these factors began to unfold, investors realized they may have exited risk assets too quickly and reentered risk, driving markets higher from mid-February to the end of the quarter.

The Federal Reserve's March meeting saw Janet Yellen take a more dovish approach to policy despite a relatively stable U.S. economy, which provided additional support for markets. The expected pace of interest rate hikes was cut by 50%, with only two 25 bps hikes in the Fed Funds rate now expected during the year. Chairwoman Yellen and the FOMC's more dovish approach was attributed to uncertainty regarding global growth. With inflation in the U.S. remaining low and uncertainty overseas, the Fed will likely continue to take a very gradual path towards the normalization of interest rate policy.

## Taxable Market

- ◆ Treasuries rallied as rates fell across all maturities and the curve flattened
- ◆ Corporate bonds were subject to high levels of volatility, but generated positive returns for the quarter
- ◆ High yield spreads widened considerably before prices rallied strongly and spreads compressed

The Treasury curve flattened during the quarter, with rates moving downward on the flight-to-quality trade. Treasury yields did subsequently move off their lows as volatility subsided, but still ended the quarter substantially lower; this helped to fuel performance in the Barclays Aggregate Bond Index which is heavily weighted to Treasuries. Corporate credit came under pressure primarily due to concerns that an uptick in energy defaults due to the price of oil would spread to issuers in other sectors and industries. High yield spreads (the excess yield over U.S. Treasuries investors require) reached multiyear highs in February, before rallying back during the remainder of the quarter. Looking at the two charts provided below, one can note the high correlation between high yield bonds and equities.



Corporate fundamentals still appear strong, and spreads are relatively attractive versus the alternative of owning low-yielding Treasuries. However, many issuers continue to finance share buybacks and acquisition activity by issuing additional debt, so increasing leverage is a potential concern.

### U.S. Treasury Yields

Source: Morningstar Direct as of 3/31/2016

U.S. Treasury Yields	3/31/2016	12/31/2015	9/30/2015	6/30/2015	3/31/2015
2-year	0.73%	1.06%	0.64%	0.64%	0.56%
5-year	1.21%	1.76%	1.37%	1.63%	1.37%
<b>10-year</b>	<b>1.78%</b>	<b>2.27%</b>	<b>2.06%</b>	<b>2.35%</b>	<b>1.94%</b>
20-year	2.20%	2.67%	2.51%	2.83%	2.31%
30-year	2.61%	3.01%	2.87%	3.11%	2.54%

## Fixed Income Sector Returns<sup>1</sup>

Source: Morningstar Direct as of 3/31/2016

Taxable Sectors	YTD 2016	Q1 2016	Q4 2015	Q3 2015	Q2 2015
U.S. Aggregate Bond	3.03%	3.03%	-0.57%	1.23%	-1.68%
Short-Term Corporates	1.81%	1.81%	-0.29%	0.34%	-0.07%
Intermediate-Term Corporates	4.15%	4.15%	-0.44%	0.37%	-1.81%
Long-Term Corporates	6.87%	6.87%	-1.11%	0.48%	-7.16%
Mortgage-Backed	1.98%	1.98%	-0.10%	1.30%	-0.74%
High Yield	3.25%	3.25%	-2.17%	-4.90%	-0.05%
Bank Loan / Floating Rate	1.55%	1.55%	-2.10%	-1.35%	0.69%
Global Bond	8.26%	8.26%	-1.26%	0.64%	-0.83%

## Tax-Exempt Market

- ◆ Municipals rallied with Treasuries but not to the same degree
- ◆ Strong investor demand for tax-exempt bonds continued
- ◆ The Puerto Rico crisis escalated as the island's government moved to halt payments to bondholders

Municipals posted solid gains for the quarter but lagged the performance of Treasuries. With relative value in municipals entering the quarter strong, municipals had difficulty keeping up with the performance of Treasuries and saw their rally stall as yield levels approached historic lows.

The supply/demand relationship of the market was good with seasonal supply absorbed by strong investor demand. Overall supply for the quarter totaled \$89 billion which was offset by strong inflows into tax exempt mutual funds of almost \$15b for the period along with large seasonal reinvested redemptions and interest payments.

The Puerto Rico crisis continues to be highlighted in the headlines. The island is heading towards major bond defaults in May and July on its debt after Governor Padilla signed a law allowing the suspension of debt payments through January 2017. The governor has asked Congress to give his government legal powers to restructure the island's debt in court. Unfortunately, Congress is considering arguments from opposing investor groups who own the island debt and would like to see different restructuring plans. As we are in an election year, Congress does not want to appear to be picking one creditor group over another and therefore continues to drag its feet on any form of rescue plan. This makes it all but certain that the island will default on its May 1<sup>st</sup> debt payment...an event which some hope might create enough urgency to get Congress to act.

## Current Municipal Yields

Source: Morningstar Direct and Bloomberg as of 3/31/2016

Generic State G.O. AA Rated Municipal Bonds	Yield to Maturity as of					As % of U.S. Government Treasuries				
	3/31/2016	12/31/2015	9/30/2015	6/30/2015	3/31/2015	3/31/2016	12/31/2015	9/30/2015	6/30/2015	3/31/2015
2yr General Obligation	0.85%	0.85%	0.69%	0.76%	0.62%	116%	80%	108%	119%	111%
5yr General Obligation	1.27%	1.40%	1.41%	1.60%	1.37%	105%	80%	103%	98%	100%
10yr General Obligation	2.11%	2.22%	2.37%	2.64%	2.23%	119%	98%	115%	112%	115%
20yr General Obligation	3.06%	3.26%	3.52%	3.60%	3.22%	139%	122%	140%	127%	139%

<sup>1</sup> 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.

## Outlook

We continue to believe that 2016 will experience pockets of heightened volatility, although not necessarily to the extent to which we experienced in the first quarter. There are several factors that could impact credit spreads and general interest rates during the year, including: the price of oil, economic data both globally and in the U.S., FOMC actions, Central Bank policy overseas, BREXIT (Britain's possible exit from the EU), etc. That said, while there will be temporary spikes in spreads, interest rates, and prices, we feel that the strength of our economy combined with the attractiveness of U.S. Treasury yields relative to other developed countries (many of which are experiencing negative rates), should keep spreads and interest rates from moving significantly higher for a sustained period of time.

## Our Portfolios

One of the challenges we face managing the fixed income portion of our clients' overall portfolios is the high correlation that now exists between corporate bonds (both investment grade and high yield) and equities. When markets are moving higher it's euphoria...equities move higher, spreads tighten and corporate bonds move higher. Unfortunately, the reverse occurs when volatility spikes and investors sell risk. We are sensitive to this increased correlation, and given the low interest rate environment, we are becoming more cautious in our weightings to sectors that may offer higher yield but with a much higher correlation to equities. All things considered, we recognize there is the need to generate yield and therefore continue to look for opportunities to add to positions that offer some yield with a lower correlation to equities.

We look forward to updating you at the end of the second quarter. As always, please feel free to contact us with any thoughts or questions you may have.

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