

## Overview

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With the Brexit vote behind us and investor concern over repercussions of Britain's vote to leave the EU diminishing, the bond market turned its focus to the underlying fundamentals of the US economy.

Economic data for the quarter was generally solid, with the labor market showing continued signs of strength, housing continuing to improve, and manufacturing ticking up slightly. Oil prices continued to build a strong base and seemed to settle in the high \$40s to low \$50s range (per barrel)...a healthy rebound from the lows of February.

As investors digested each economic release, a shift to a more positive tone in the market began – along with the prospect for higher rates. As a result of the shift in tone and a refocus on economic releases, rates backed up during the quarter, with the 10-year US Treasury yield rising from 1.47% to 1.60% at quarter end (1.83% as of this writing). It is interesting to note that the 10-year was trading at 1.79% at the end of Q1 . . . essentially all of the Treasury gains of Q2 have been given back.

## Economy, Markets, and FOMC

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GDP growth for first half of the year averaged just over 1%; although well below the historical long-term GDP growth rate of 3%, the improvement in Q2 versus Q1 suggests some momentum in the economy. In general, labor market figures continued to improve steadily with actual changes in non-farm payrolls averaging 198k for the quarter versus an average consensus of 177k and unemployment holding steady at just under 5%. A lack of major headline news saw volatility remain low, and thus markets during the quarter were mostly stable. There was a brief selloff on concern that negative interest rates in Europe and Japan were failing to work which reduced confidence in global central banks, but this concern was assuaged by positive Fed comments, and markets quickly rebounded.

Oil seemed to have settled in the high \$40s to low \$50s range, with OPEC agreeing in principle to freeze production in order to firm up the market. The stabilization has served to improve the outlook for the energy sector and provided a bid for many names there. If the agreement holds, and oil prices remain stable (or increase) we could start to see an increase in inflation pressures. Bond markets traded well during the quarter and were readily accessible by issuers looking to take advantage of low rates before any potential FOMC action. In fact, investment bank earnings released subsequent to quarter end cited strong fixed income trading revenues as a significant contributor to earnings.

After coming into 2016 projecting four rate increases for the year, the FOMC again left interest rates unchanged at their September meeting (recall that the only rate increase by the FED since 2008 was a 25 basis point increase in December 2015). However, minutes of the September FOMC meeting suggest growing support among various members for a rate increase. Dissenting members (those in favor of a rate increase) have voiced concerns over the prospect of future inflation citing the strong labor market (in addition to a recovery in oil prices). Should headline inflation figures begin to move higher, FOMC members in favor of a rate hike could make a stronger argument at the December FOMC meeting.

## Taxable Market

- Yields rose as expectations for higher interest rates increased
- Corporate credit performed well on low volatility and solid economic data
- US High Yield was the best performing sector as risk assets outperformed

Yields moved higher across the curve during the quarter as expectations for a rate hike by the FOMC increased. However, low volatility and solid economic data helped to contribute to positive performance by investment grade bonds. High yield continued to perform well as investors continued to reach for yield in riskier assets. In addition, new money market regulations set to take effect in October forced selling of many ultra-short instruments by money market funds (due to redemptions of institutional prime and tax exempt money market funds) which resulted in additional demand for short term corporate bonds as investors redeployed their monies.

### U.S. Treasury Yields

Source: Morningstar Direct as of 9/30/2016

U.S. Treasury Yields	9/30/2016	6/30/2016	3/31/2016	12/31/2015	9/30/2015
2-year	0.77%	0.58%	0.73%	1.06%	0.64%
5-year	1.14%	1.01%	1.21%	1.76%	1.37%
<b>10-year</b>	<b>1.60%</b>	<b>1.49%</b>	<b>1.78%</b>	<b>2.27%</b>	<b>2.06%</b>
20-year	1.99%	1.86%	2.20%	2.67%	2.51%
30-year	2.32%	2.30%	2.61%	3.01%	2.87%

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

Source: Morningstar Direct as of 9/30/2016

Taxable Sectors	YTD 2016	Q3 2016	Q2 2016	Q1 2016	Q4 2015
U.S. Aggregate Bond	5.80%	0.46%	2.21%	3.03%	-0.57%
Short-Term Corporates	3.85%	0.56%	1.44%	1.81%	-0.29%
Intermediate-Term Corporates	9.27%	1.50%	3.37%	4.15%	-0.44%
Long-Term Corporates	16.97%	2.61%	6.67%	6.87%	-1.11%
Mortgage-Backed	3.72%	0.60%	1.11%	1.98%	-0.10%
High Yield	15.32%	5.49%	5.88%	3.25%	-2.17%
Bank Loan / Floating Rate	7.72%	3.08%	2.92%	1.55%	-2.10%
Global Bond	13.09%	1.03%	3.40%	8.26%	-1.26%

<sup>1</sup> Fixed income sectors shown above 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

# Tax-Exempt Market

- Municipals sold off during the quarter underperforming their taxable counterparts
- New money market regulations had significant impact on the short term tax exempt market
- Tax exempt ratios continue to suggest municipals are “cheap”

Municipals sold off across the curve as a backup in Treasury yields and a weak technical environment negatively impacted prices. The weak technical environment was driven by surge in supply during the quarter (an issuance of \$109 billion of municipal debt, up 18% year-over-year) as issuers attempted to come to market in front of any potential rate increase by the Fed. Typically, the front end of the yield curve is impacted less as investors seek security of shorter maturities. However, money market reform taking effect in October substantially increased selling on the short end of the municipal curve. The selling resulted in the SIFMA (Securities Industry and Financial Markets Association Municipal Swap Index – the index by which many municipal money market instruments are priced) to rise rapidly moving from 0.01% at the beginning of the year to 0.84% by quarter end...the result was a significant repricing of short term securities.

Overall municipal ratios remain above 100% of Treasuries suggesting municipals continue to be “cheap” versus their taxable counterparts. However, the forward looking supply suggests that the technical environment will continue to be weak and may weigh on yields further (absent a major increase in demand).

## Current Municipal Yields

Source: Morningstar Direct and Bloomberg as of 9/30/2016

Generic State G.O. AA Rated Municipal Bonds	Yield to Maturity as of					As % of U.S. Government Treasuries				
	9/30/2016	6/30/2016	3/31/2016	12/31/2015	9/30/2015	9/30/2016	6/30/2016	3/31/2016	12/31/2015	9/30/2015
2yr General Obligation	0.87%	0.78%	0.85%	0.85%	0.69%	113%	134%	116%	80%	108%
5yr General Obligation	1.17%	1.10%	1.27%	1.40%	1.41%	102%	109%	105%	80%	103%
10yr General Obligation	1.77%	1.77%	2.11%	2.22%	2.37%	111%	119%	119%	98%	115%
20yr General Obligation	2.65%	2.65%	3.06%	3.26%	3.52%	133%	142%	139%	122%	140%

## Outlook

As we noted in our second quarter newsletter, we do expect interest rates to slowly edge higher as investors evaluate the overall strength of the economy and the likelihood of a move by the FOMC in December. However, we continue to feel rates will not spike quickly or dramatically, as too many variables still exist working against this (global rates, cash on sidelines, demographics, etc). For now, Fed fund rate forecasts suggest one increase this year, potentially two in 2017 and three in 2018. In terms of the election, it appears that a split Congress is anticipated (as evidenced by the lack of volatility) which has been traditionally received well by the markets. We feel the Presidential candidates' views on infrastructure spending and tax reform will likely have an impact on certain sectors of the bond market but only to the extent that any proposal has a reasonable chance of bi-partisan support. As always, we will monitor these proposals and their implications closely.

## Our Portfolios

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We continue to feel credit will perform well over the next few quarters, and thus our portfolios, relative to the benchmark, remain underweight Treasuries in favor of credit. In general, our portfolios continue to be shorter in duration than the Barclays Aggregate Index (as we hold a reasonable allocation to ultra-short bonds/bond funds) and these short-term funds should provide a cushion as yields move higher and will ultimately be “dry powder” to reinvest at higher yields. On the tax-exempt side we continue to monitor the supply/demand relationship of the market and will selectively purchase bonds as the market reprices to higher yields. Ultimately, we feel the demand for municipals will increase as the topic of higher taxes becomes a focus for investors as we enter 2017.

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