FIXED INCOME STRATEGY HIGHLIGHTS

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THE U.S. FIXED INCOME MARKETS

Brief Overview:

The third quarter reminded us once again that interest rates in the United States are not always about the U.S. economy or the Federal Reserve's current stance on monetary policy. Ongoing geopolitical conflicts with Russia and military efforts in the Middle East to slow down ISIS terror resulted in strong downward pressure on U.S. interest rates to levels not seen in over a year. Slowing growth, further declines in inflation in the euro zone and China, and growing expectations for more aggressive monetary policy easing from the European Central Bank exacerbated the decline in rates around the globe. As a result, the U.S. dollar saw significant appreciation against other major currencies.

The sharp rise in the U.S. dollar has been a concern by some of the FOMC members in the September meeting, as they fear that the strong dollar could worsen the U.S. trade deficit and push inflation lower. "Some participants expressed concern that the persistent shortfall of economic growth and inflation in the euro area could lead to a further appreciation of the dollar and have adverse effects on the U.S. external sector. At the same time a couple of participants pointed out that the appreciation of the dollar might also tend to slow the gradual increase in inflation towards the FOMC's 2 percent goal."

This leaves us to conclude that if the dollar gets much stronger, the Fed might delay starting the "lift off" of federal funds rate next year. This approach, we believe, would turn into a "one and done" rate-hike scenario because of the potential turmoil that could result in global financial markets. The delusion that the ultra-easy monetary policy has worked to lower unemployment would be the result of misplaced confidence that the Fed can easily implement an exit strategy from the current accommodative stance. We saw a clear example of a panic reaction by the markets to an FOMC policy of normalization. As the Fed unwound their position, markets turned bullish.

EXHIBIT I

DXY: Dollar Index Spot Price

Source: Altman Investment Management Research and Bloomberg

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When will the Federal Reserve Open Market Committee determine that the economic recovery has gained sufficient strength to begin moving the Federal Funds rate back to a "normal" level; i.e. at or above the prevailing inflation rate? Despite a reasonably steady decline in the unemployment rate, and gains in non-farm employment, Chairman Yellen outlined that the Federal Reserve was not ready to begin moving short rates higher. According to the Fed, economic growth remains less healthy than desired as evidenced by a sub-standard labor participation rate and part-time positions accounting for a significant component of recent job creations. Housing construction and consumer spending are trending moderately higher in the U.S., but slowing Chinese growth and stalling economies in parts of Europe could have a ripple effect that impairs U.S. growth. We have concluded that the Fed is signaling that short rates will remain low, probably through the first quarter or half of next year.

Longer rates are also likely to remain contained over the near term. Investor demand for fixed income securities remains strong in the modest economic growth, low inflation environment. The appetite for U.S. bonds is being augmented by foreign buying. With quantitative easing planned in Europe, rates on the continent are significantly lower than in the U.S. which makes the Treasury market a relative "bargain". The situation is similar in Japan where government yields are well below 1%. As we mentioned earlier, the strengthening dollar makes U.S. investments even more appealing. Foreign buying has included taxable municipals which are being acquired along with U.S. Treasury securities. We would not be surprised if the 10-year Treasury yield remains in a relatively narrow trading range, centered well below the 3.00% level for several more months.

EXHIBIT II

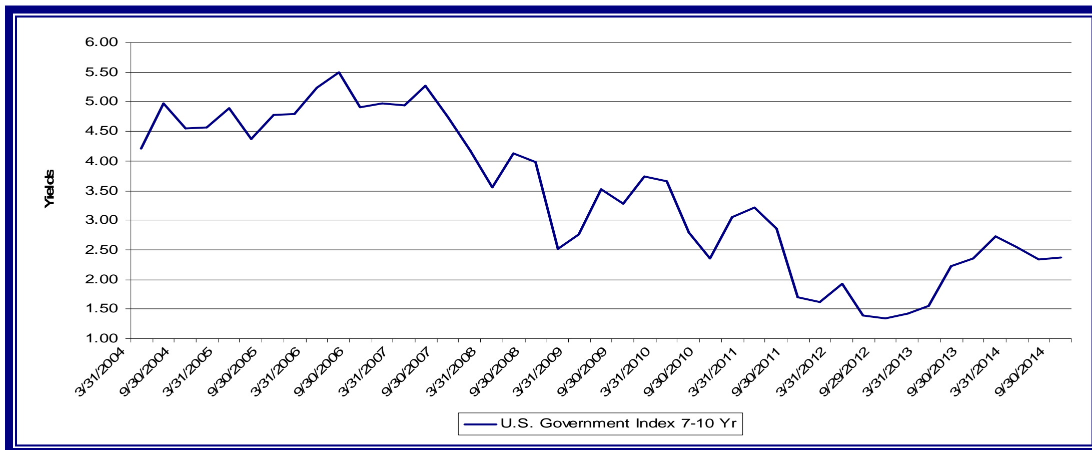
10- Year Generic Treasury Yield

Source: Altman Investment Management Research and Bloomberg

Increased interest rate volatility experienced over the third quarter resulted in a flattening of the yield curve as longer term yields declined and maturities in the 2-year to 7-year range all increased, led by the 3-year Treasury which rose 17 basis points during the quarter. The widely followed Barclays U.S. Aggregate Bond Index was up a mere 17 basis points (0.17%) for the quarter, while the primary investment grade sectors within this index posted mixed results on an absolute basis.

EXHIBIT III

U.S. Government Index 7-10 year



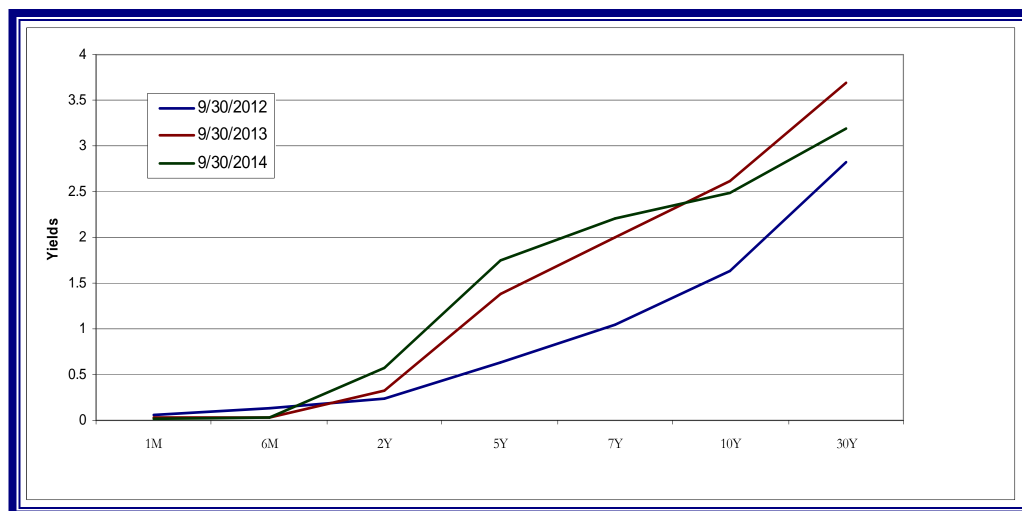
Source: Altman Investment Management Research and Bloomberg

Government Bonds

The U.S. Treasury market was range bound through the third quarter. Domestic economic data was mixed as growth was maintained but below historic levels. Through September, nonfarm payroll had exceeded 200,000 jobs and unemployment fell to 5.9%, although wage growth was still disappointing. Commodity prices continued to erode throughout the quarter and crude oil prices continued their downward slope hitting the 2012 low levels. Inflation expectations turned lower as reflected in the Treasury Inflation-Protected Securities (TIPS) prices. In addition, the consumer price inflation came below the Fed's targeted rate. On the international front, economic data released was largely disappointing with Europe teetering on a triple dip recession and deflationary worries resurfaced. Geopolitical tensions in the Ukraine diminished somewhat. The result was a largely unchanged U.S. Treasury market with the 10-year note yielding 2.5% or a similar level at the end of the second quarter.

EXHIBIT IV

Active Government Yield Curves



Source: Altman Investment Management Research and Bloomberg

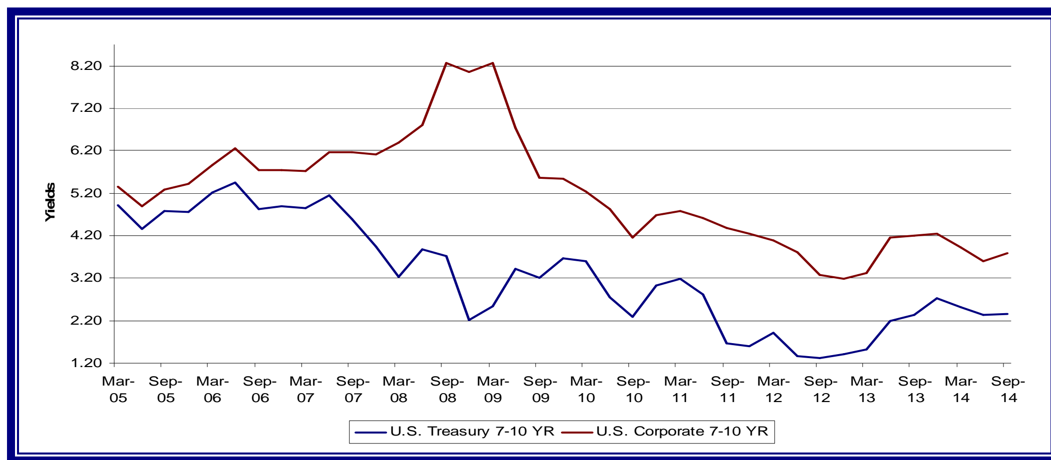
In anticipation of a turn in Fed policy, intermediate yields rose against a backdrop of a rally in the 30-year bond. The flattening in the curve resulted in a 3.12% on the 30-year bond, and a similar pattern with the highest returns at longer maturities. See Exhibit IV and Exhibit VI.

Corporate Bonds

Importantly, all non-Treasury sectors posted negative excess returns, led by corporate bonds during the quarter. Credit spreads widened relative to Treasuries as investment grade corporate supply remained robust while investors were facing geopolitical uncertainties. In responsive, fixed income investors positioned portfolios for higher rates as the Federal Reserve inched closer to additional policy changes. For the first time since the third quarter of 2013, excess returns on BBB-rated corporate bonds underperformed their single-A rated counterparts, according to the Barclays Capital U.S. Corporate Index. Additionally, high yield corporate bonds had a particularly difficult quarter, posting a -2.05% excess return. Both yield curve positioning and our overweight allocation to corporate bonds were negative contributors to relative performance for the third quarter.

EXHIBIT V

U.S Corporate 7-10 year versus U.S. Treasury 7-10 year



Source: Altman Investment Management Research and Bloomberg

Portfolio sector positioning for the quarter was largely unchanged as we continued to favor non-Treasury sectors of the fixed income market. Our largest overweight continued to be in investment grade corporate bonds and A-AAA rated muni's (for our tax-sensitive accounts). Corporate as well as public sector defaults remain low, aggregate credit fundamentals remain solid for this stage of the cycle and, with the spread widening in the third quarter, valuations look more attractive, in our view. Exposure to U.S. Treasury securities remains our largest underweight. We ended the third quarter with a shorter duration position relative to the benchmark.

EXHIBIT VI

Fixed Income Sector Performance – Q3-2014

Fixed Income Sector Performance – 2014 Q3 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price Spread Avg	Trailing 12 Mth Total Return
Treasury	Aaa/AAA	7.41	5.82	1.60%	N/A	$104.3	2.7%
Agency	Aaa/AA+	4.93	3.86	1.45%	10	$106.1	2.6%
MBS	Aaa/AAA	6.18	5.22	2.70%	110	$104.9	3.7%
Municipal	Aa3/A+	15.10	4.70	2.20%	120	$107.4	8.7%
Corporate	A2/A-	10.50	6.80	3.60%	110	$108.1	8.6%
High Yield	B1/B	7.10	4.60	5.10%	400	$104.0	7.8%

Source: Altman Investment Management Research and Bloomberg

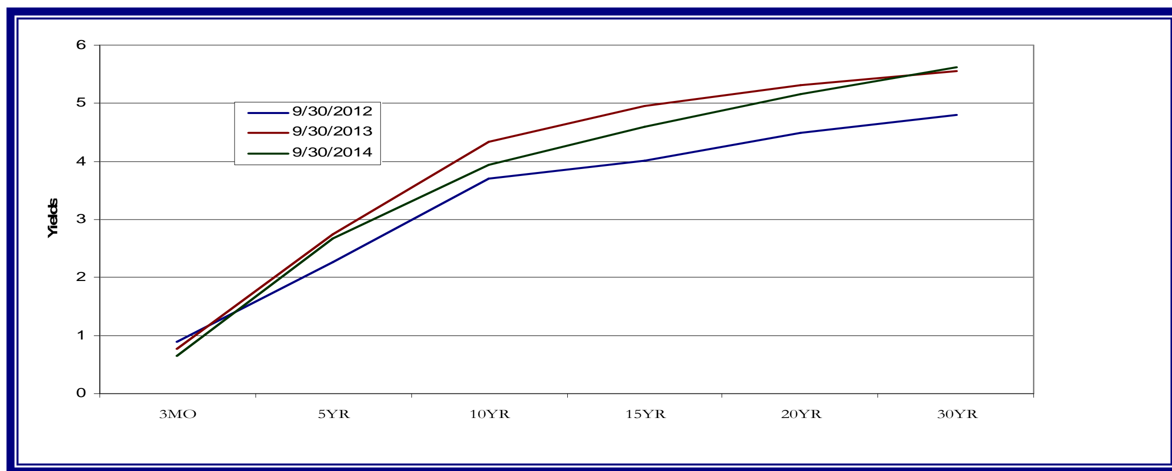
Municipal Bonds

The municipal market has been similarly influenced by the economic backdrop and additionally impacted by limited new issue supply. Volume through September totaled approximately $230 billion and is expected to end the year at about $295 billion. This year's projected volume is down significantly from the $375 billion average over the past ten years. Supply this year has been insufficient to satisfy the appetite of investors seeking tax-advantaged investments. Municipal yields have fallen faster than taxable rates and Treasuries are now out yielding prime tax-exempts throughout the yield curve. The 5-year municipal/Treasury yield ratio is currently 80%, down from 100% a year ago.

The yield curve chart below illustrates the decline in tax-exempt yields this year with long rates having dropped by over a hundred basis points in the face of strong demand.

EXHIBIT VII

Fair Market Yield Curve History: Generic Muni- General Obligation Insured Curves



Source: Altman Investment Management Research and Bloomberg

Despite the outlook for reasonably stable markets in the coming months, it is important to remember that interest rates can move quickly, especially given low prevailing yield levels. We are maintaining shortened portfolio durations and are watchful for signs of stronger than expected growth and/or building inflation that could unnerve the markets. Special focus is on labor costs as they are often a precursor of broader price increases.

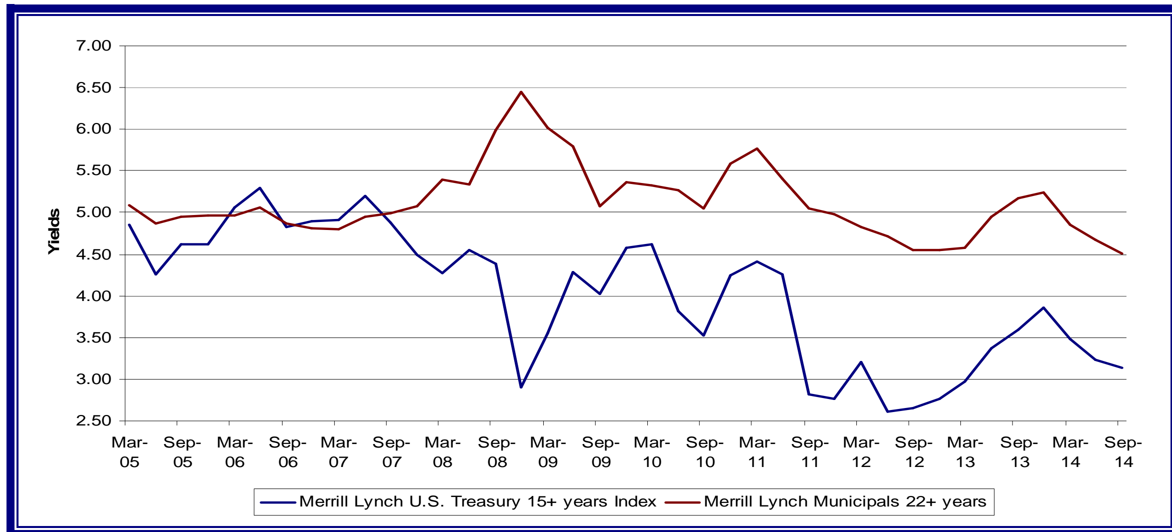
Keep in mind that The Federal Reserve is acutely aware of the yield surge that occurred in the spring and summer of last year that was precipitated by Chairman Bernanke's comments suggesting that a modest shift in Fed policy was being contemplated. The 10-year Treasury yield rose from the 1.66% level at the end of April to over 2% by the end of May and approached 3% in early September. Longer municipal yields rose by 150 basis points or more which produced a dramatic steepening in the yield curve and sharp declines in bond prices. The Barclays 10-year, 15-year and long municipal GO indexes suffered relative declines of 4.2%, 6.0% and 8.0% respectively in the three month period through August of last year.

However, we do not anticipate a similar reaction when the Fed eventually decides to tighten, but we should be prepared for a potential surprise. We expect a cautious approach by the monetary authorities with well telegraphed moves followed by assessments of the impact of each incremental move in the Fed Funds rate. Fewer market makers and less capital being allocated to fixed trading desks has reduced market liquidity - this could be a precursor for more abrupt yield adjustments and increased volatility.

An eventual rise in the targeted Fed Funds rate of a hundred or more basis points seems likely at some point. Fed tightening will influence longer segments of the yield curve, but probably not to the extent that short rates move, a classic yield curve flattening scenario. It's worth mentioning at this juncture that we have focused on high quality, liquid securities which should limit price declines associated with widening credit spreads that typically accompany rising rates. As in the past, we would expect our fixed income portfolios to perform well during periods of significant Fed tightening.

EXHIBIT VIII

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

Summary:

An important scenario to watch over the coming months will be if the U.S. can continue to grow at a 3% or higher rate, as other major economies slow, and their respective central banks ease monetary policy and the dollar potentially continues to strengthen as a result. We believe the economy can stand on its own now, yet remain cautious of the economy's ability to consistently grow at recent levels given the global economic picture and geopolitical uncertainties that continue to fester. With the Fed expected to change interest rate guidance by the end of the year, interest rate volatility is likely to increase. Given these potential headwinds, it remains to be seen just how soon the Fed is willing/able to begin raising short-term interest rates. As a result, one of our primary focal points over the coming quarters will be yield curve positioning, that is, adjusting the level of interest rate risk relative to the benchmark. Additionally, as the macro and geopolitical environments evolve, we will actively adjust sector allocations in an effort to position portfolios to benefit from this ever changing landscape.

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