FIXED INCOME STRATEGY HIGHLIGHTS

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THE U.S. FIXED INCOME MARKETS

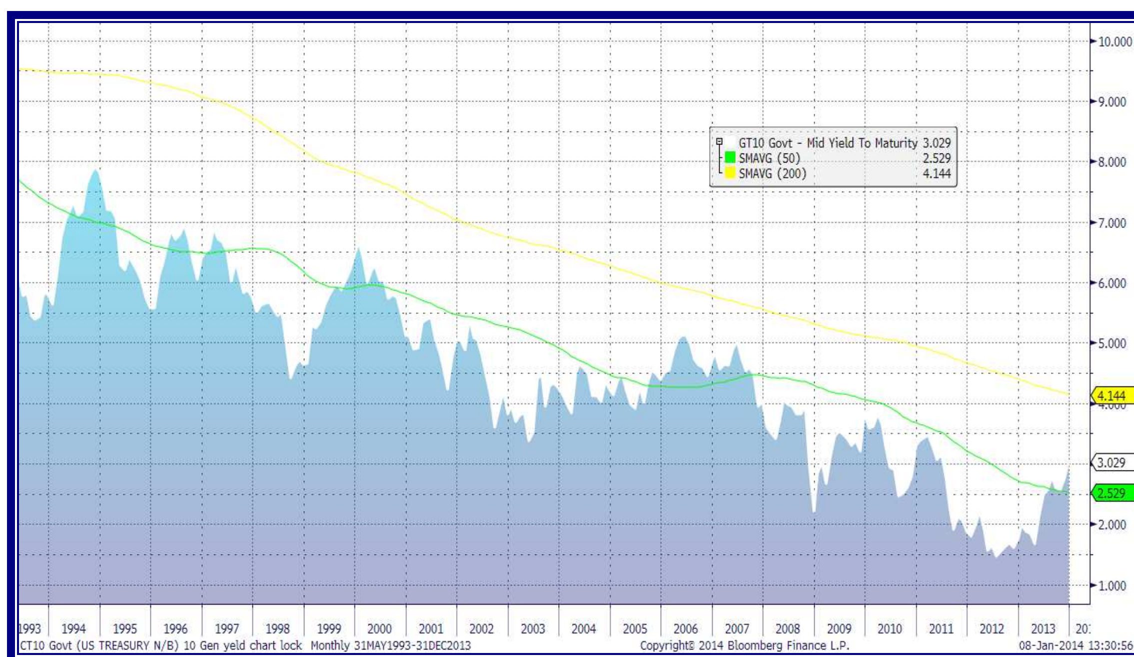
Brief Overview

In 2013, the markets got their first taste of the after post-crisis era. It was a year in which talk of "tapering" dominated the financial headlines – a reference to the U.S. Federal Reserve's plans to scale back its purchases of long-term bonds, as a first step toward reducing its balance sheet and accommodative monetary policy. The Fed first floated the idea last May, and the rate on the 10-year U.S. Treasury note backed up by about 100 basis points (bps), leading the rest of the bond market in a sell-off. As it turned out, the Fed did not go through with the tapering plans – at that time – and Fed members went out of their way to assure market participants that it would not end the long-term bond purchases prematurely.

The significance of the rate backup of 2013 was that it confirmed the beginning of the end of the Fed-managed market that had dominated the post-crisis era. Even though in May the Fed "walked back" its plans for the taper, the market only partially walked back its sell-off. The market was making a statement, in our view, that its own judgment on the economy was more important than Fed guidance, and that tapering at some point was inevitable. Indeed, the Fed has stressed for some time that its policy was "data dependent," and on December 18 formally announced the taper's start.

EXHIBIT I

10-Year Generic Treasury Yield

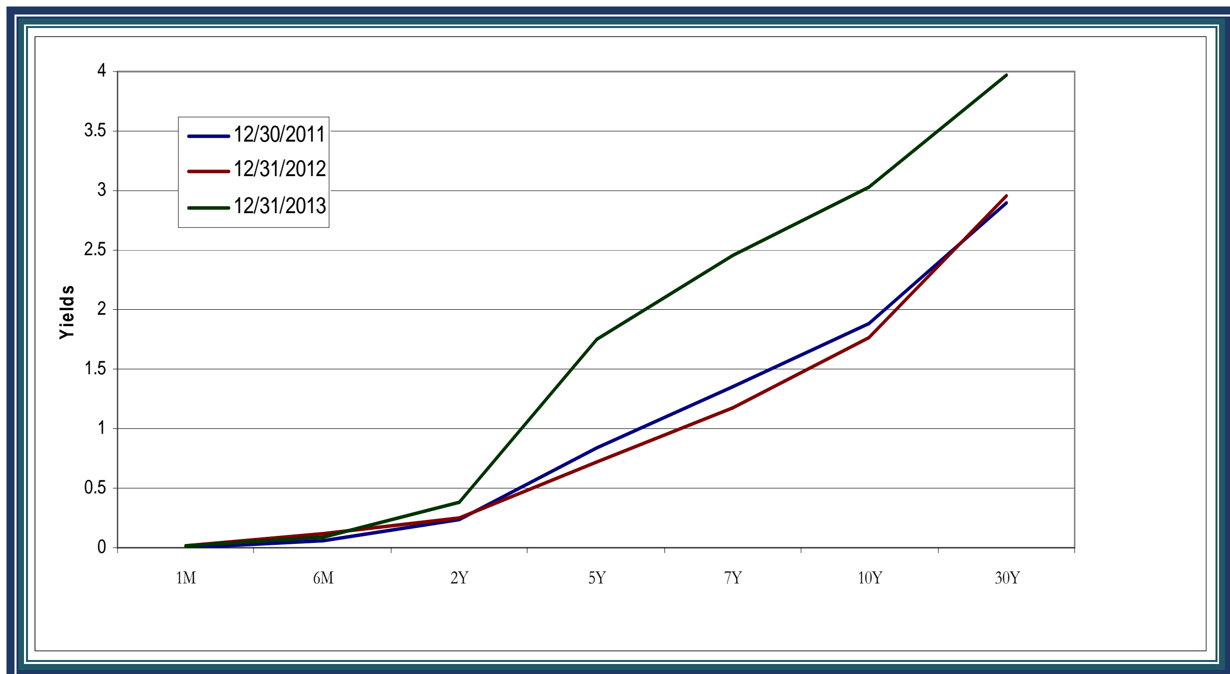


Source: Altman Investment Management Research and Bloomberg

The Fed's tapering talk and subsequent backup in rates upset the steady-state scenario. With the market decoupling from the expectation of unending Fed support, it resumed its traditional role of differentiation based on perceived relative value across income sectors – a stark contrast to the Fed-managed uniformly positive returns of 2012. In 2013, the sectors that were expected to benefit most from improving credit quality associated with the recovery – high-yield bonds and floating-rate loans – had positive total returns that were close to their initial yields; while other income sectors never fully recovered from the rate backup and ended their year in negative territory, not earning their initial yields. Emerging-market debt, both local and dollar-denominated, and long dated municipal bonds were at the bottom of the pack.

EXHIBIT II

Active U.S. Treasury Yield Curve



Source: Altman Investment Management Research and Bloomberg

Fourth Quarter Performance

The fourth quarter returns of the various asset classes within the bond market are as follows. Where index returns are unavailable, the relevant ETFs are used in their place:

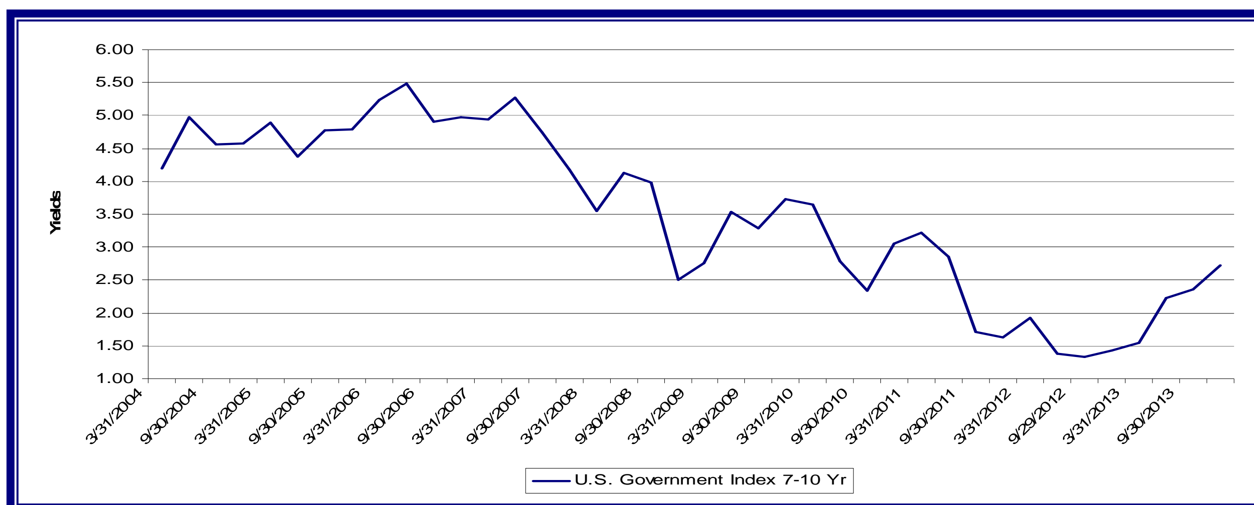
- **Investment-grade U.S. bonds** (Bank of America Aggregate Bond Index): -2.25%
- **Short-term U.S. Treasuries** (Bank of America 1-3 Year U.S. Government Index): .36 %
- **Intermediate-term U.S. Treasuries** (Bank of America U.S. Government Intermediate Index): -1.65%
- **Long-term U.S. Treasuries** (Bank of America U.S. Government Long Index): -12.4%
- **TIPS** (Bank of America U.S. TIPS Index): -9.35 %
- **Mortgage-backed securities** (Bank of America Mortgage Index): -1.48%
- **Municipal bonds** (Bank of America Municipal Bond Index): -2.89%
- **Corporate bonds** (Bank of America Corporate Investment Grade Index): -1.45 %
- **High yield bonds** (Credit Suisse High Yield Index): 6.30%

Government Securities

With the Fed finally moving ahead with the taper, what does this tell us about the course for interest rates in 2014? At the short end of the curve, rates are likely to be anchored near zero "well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the [Federal Open Market] Committee's 2% longer-run goal," according to the Fed's December 18th announcement. Fed officials have been quoted as saying that tightening at the short end of the curve is not expected until 2015 or even 2016.

EXHIBIT III

U.S. Government Index 7-10 year



Source: Altman Investment Management Research and Bloomberg

At the longer end of the curve, rate direction is likely to be data dependent and more volatile. The Fed has described its $10 billion lowering of monthly bond purchases as a modest step, with further incremental reductions to be decided at future meetings. The recovery continues to be characterized by mixed signals, like the higher-than-expected initial jobless claims number in December, coming after a series of positive economic readings in the fourth quarter. Inflation has been running well below the Fed's 2% target and unemployment falling slowly, so we continue to expect a slow if not temporary advance in longer-term rates in an uncertain pattern rather than the kind of 100bps spike of 2013. We therefore hold a below market position in Treasury and U.S. Government Agency.

Corporate Securities

We continue to maintain an overweight position in investment grade (IG) corporate bonds relative to a market weighting. Overall, IG bond spreads have widened this month by 15 bps as a result of a significant fall in benchmark rates following the December employment data. While IG total returns will likely be modest, IG will achieve higher returns than government bonds due to their yield pickup and our understanding that the market should expect that credit spreads will incrementally tighten. We foresee a total return of 1% to 2% over the next six months, with lower IG rating segments offering better return potential than higher-rated issues.

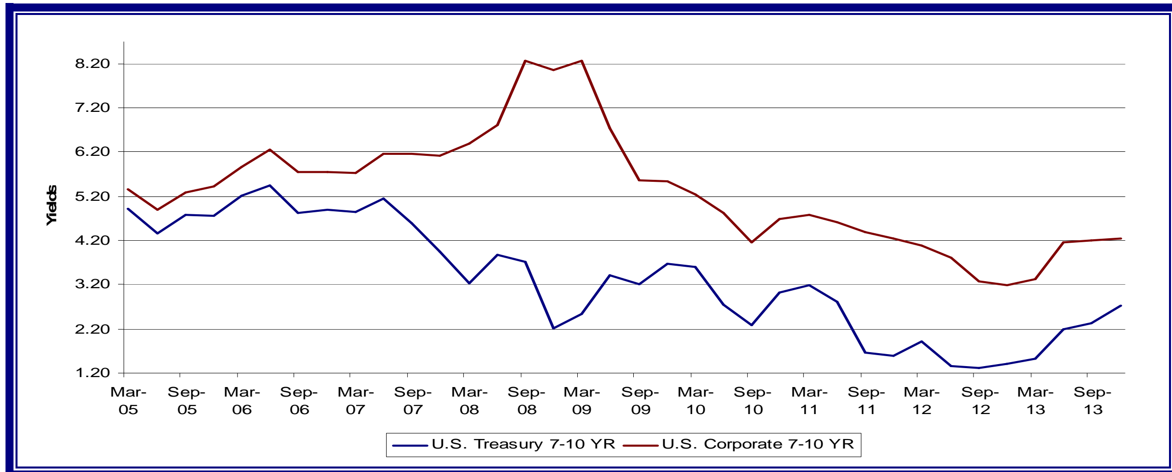
EXHIBIT IV

10-year U.S. Agency (Fannie Mae) Yield minus 10-year Treasury Yield

Source: Altman Investment Management Research and Bloomberg

EXHIBIT V

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



Source: Altman Investment Management Research and Bloomberg

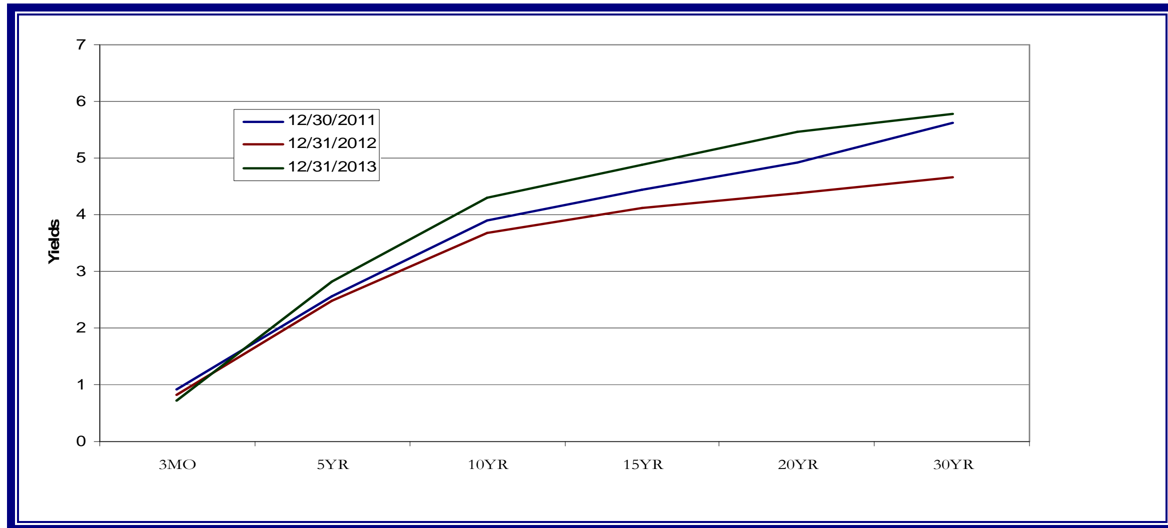
Municipal Securities

Yields on short-term maturities of five years or less haven't budged. And they likely won't move until the Fed decides to raise its short-term interest rate. Based on the Fed's recent statements, this isn't likely until 2015 at the earliest. Short-term munis shouldn't be ignored completely, in our view, as they offer low interest rate risk and liquidity. Shorter-term muni bonds may still make sense for the short end of laddered portfolios. But they won't generate much income until the Fed increases its short-term interest rate. Yields for longer-term AAA municipals have traded in a wider range, as compared to shorter-term municipals over the past 52 weeks. Currently they are near the higher end of that range. But the intermediate and longer part of the curve appears attractive.

Intermediate-term rates have already absorbed much of the Fed's slower pace of bond buying, in our view. It's also worth noting that just the mention of tapering during the summer of 2013 led to the significant rise in interest rates. Since December, when the Fed announced the taper, the yield on the 10-year MMA AAA municipal bond index has actually fallen from 2.93% to 2.82%.

EXHIBIT VI

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



Source: Altman Investment Management Research and Bloomberg

EXHIBIT VII

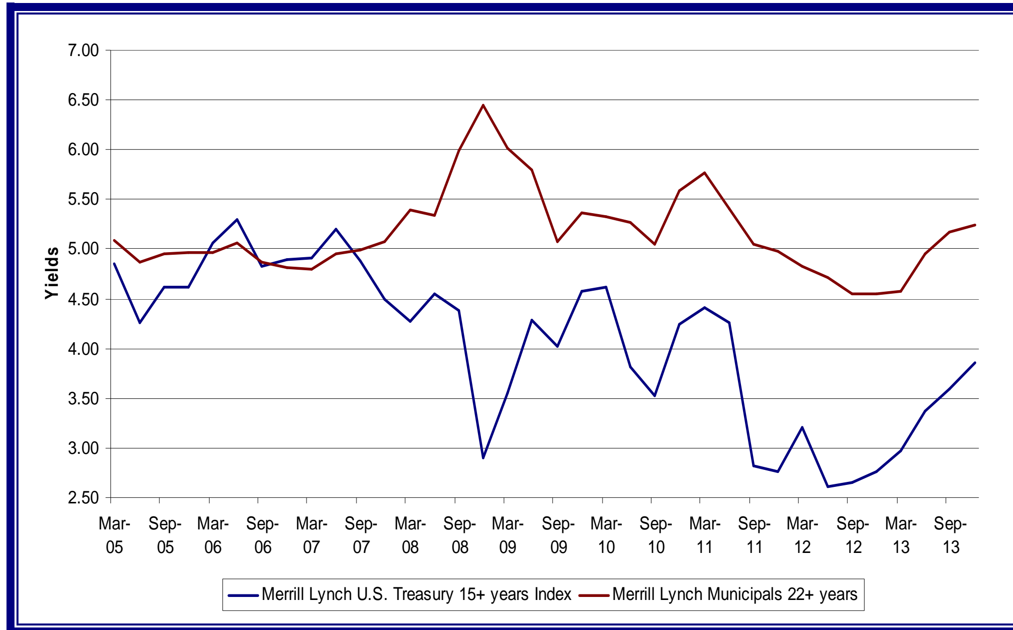
Fixed Income Sector Performance – Q4-2013

Fixed Income Sector Performance (2013 Q4)	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price Avg	Trailing12 Months - Total Return
Treasury	AAA/AA+	7.0	5.5	1.6%	N/A	$102.6	(3.4%)
Agency	AAA/AA+	5.0	3.9	1.5%	0	$104.4	(1.8%)
MBS	AAA/AA+	6.9	5.6	3.2%	160	$102.8	(1.5%)
Municipal	AA/AA	15.2	5.9	3.4%	180	$100.0	(2.9%)
Corporate	A2/AA	9.7	6.7	3.3%	170	$105.6	(1.5%)
High Yield	B1/B	6.6	3.7	5.7%	410	$103.3	7.4%

Source: Altman Investment Management Research and Bloomberg

EXHIBIT VIII

Long Term Municipal to Treasury Spreads



Source: Altman Investment Management Research and Bloomberg

Emerging Market Debt

Like most other emerging market assets, dollar-denominated bonds have performed poorly over the past month. But they at least have fared better than they did during last summer's sell-off. Spreads on both government and corporate securities generally have not risen as far as they did back then, and underlying Treasury yields have also fallen back.

Many emerging market currencies have fallen sharply as well since the start of the year, but so far only a handful of central banks have raised interest rates in order to shore up their currencies. The increase in emerging market local currency government bond yields stands in sharp contrast to the fall in yields on their developed market counterparts, as the latter have benefitted from investors' renewed risk aversion.

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