ALTMAN INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

MAY, 2015

IN BRIEF: The U.S. Fixed Income Markets

The Federal Reserve's policy guidance after the mid-March FOMC meeting indicated that "patience" regarding the likely timing of an increase the Fed Funds rate - from near zero (where it has been maintained since December 2008) - is no longer necessary. Subsequent commentary by Chairwoman Yellen suggested that a move is probable this year, but contingent on the Fed's assessment of U.S. economic strength and inflation. Too little of either could stay their hand. Despite recent signs of slackness, our working assumption is that moderate growth will prevail in the coming months prompting one, or possibly two, modest increases in the targeted Fed Funds rate during the second half of this year. Additional rate hikes next year will again be dependent on the Fed's appraisal of the economic landscape at that time. Once the process of moving rates higher begins, we anticipate that the impact of each adjustment will be critically analyzed before a subsequent move is made. A "normalized" Fed Funds rate (some level above the prevailing inflation rate) seems unlikely for a year or more.

The measured tightening process we anticipate contrasts with the approach the Fed has typically taken in the past. There have been three periods of monetary tightening over the past twenty-plus years, each with significant increases in the Fed Funds rate over relatively short time periods. In early 1994 through early 1995, the Fed increased rates from 3.0-6.0%. In early June of 1999 through May of 2000, the Fed increased rates from 4.75% to 6.50%, and from June of 2004 through June of 2006 rates were increased from 1.0% to 5.25%.

One of the Fed's current goals is a 2% annual inflation rate. The year-over-year increase in the core inflation rate (excluding food and energy) was 1.7% through February. Current forecasts do not indicate much, if any, increase from this level. In fact, price pressures could subside somewhat in the coming months in response to limited U.S. wage growth and global sluggishness. A targeted Fed Funds rate above 1.5% to 2.0% seems unlikely in the foreseeable future.

Will Fed tightening push longer rates higher? Perhaps modestly, but we doubt there will be a dramatic impact. A backdrop of modest economic growth and limited inflation, combined with the safe harbor appeal of the U.S. markets in an unsettled world, argues for limited rate pressure. In addition, minimal returns offered in Europe and Japan (ten year German and Japanese government bonds are yielding, respectively, 0.20% and 0.37%) and the strength of the dollar continue to attract foreign investors. This added demand is acting to further restrain U.S. interest rate pressures.

EXHIBIT I

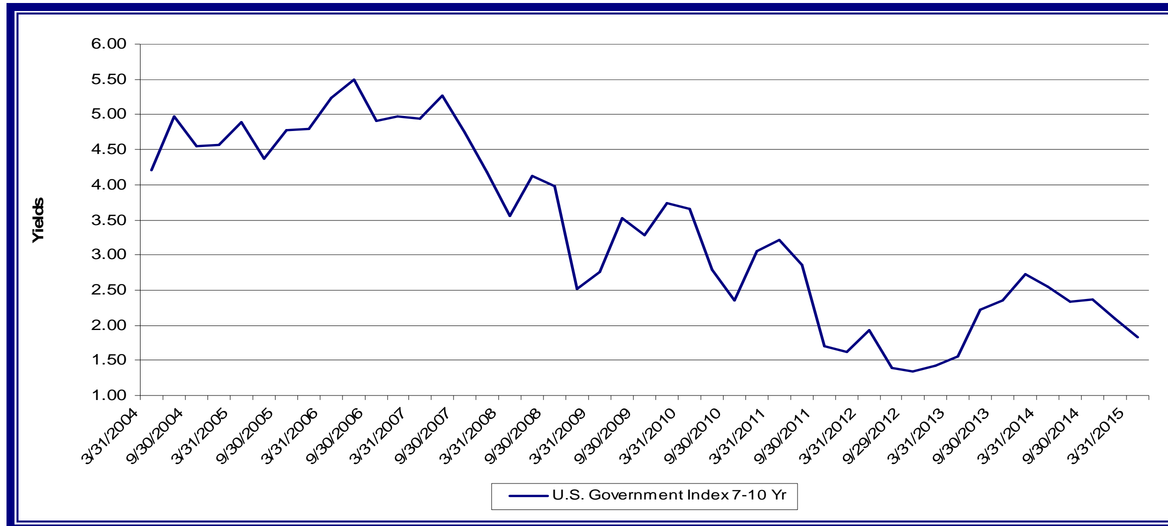
Ten Year Generic Treasury Yield

Source: Altman Investment Management Research and Bloomberg

Despite this benign rate outlook, caution is warranted in the low prevailing yield environment. As depicted in the attached chart illustrating the ten-year Treasury yield since the end of 2009, courtesy of Bloomberg, rate surges cannot be dismissed. An inflation surprise, or stronger than expected growth, could precipitate a rate jump. Our portfolio durations remain targeted at slightly over three years. We remain focused on principal protection.

EXHIBIT II

U.S. Government Index 7-10 Year



Municipal Market Activity

Despite the surge in issuance last quarter, tax-exempt yields remained in a relatively narrow range throughout the period. Market stability in the face of significant volume and relatively low yields reflects continued demand for tax-exempt income. The municipal market's safe harbor appeal further enhances the attractiveness of these investments. We expect demand to remain relatively strong over the course of the year.

Comment on Increased Market Volatility

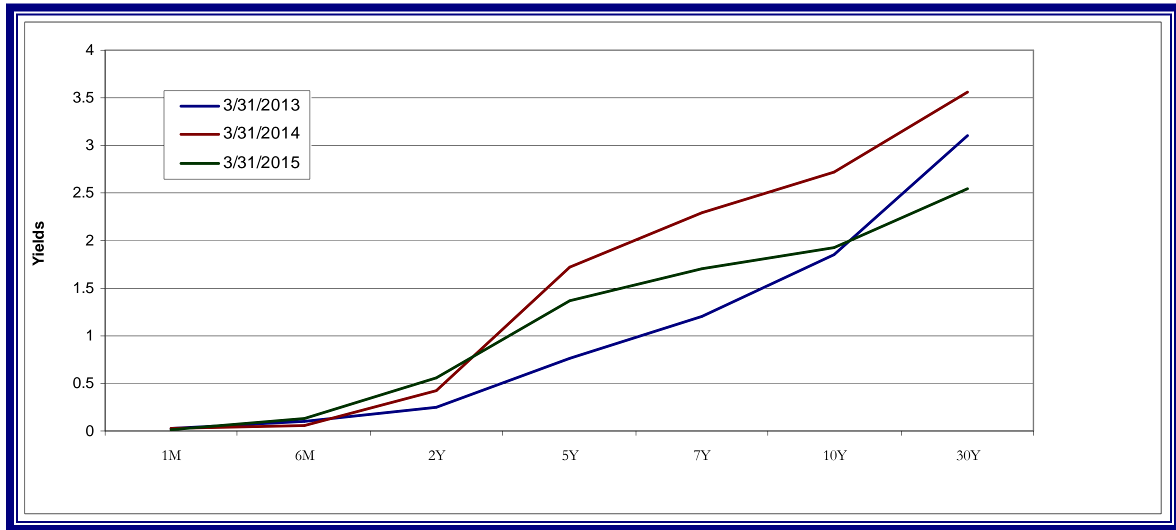
We have mentioned in recent newsletters that volatility could become more pronounced. Dodd Frank legislation mandated that major financial institutions increase reserves and reduce risk profiles. One result has been reduced capital allocations to trading desks. This creates thinner secondary markets, especially for lower quality and less actively traded bonds. An individual trade executed in a thin market can have an inordinate price impact. While volatility can cause market disruptions we look to take advantage of opportunities during these periods. Close attention to market dynamics and assessment of relative value can result in attractively priced securities being added to client portfolios, while bonds trading at unsustainable high prices can be swapped into securities providing better value.

CLOSE-UP:

➢ Government Bonds

Interest rates peaked on March 6th with a better-than-expected employment report pushing the 10-year briefly to 2.25%. Weakening economic data and much more dovish guidance from the Federal Reserve reversed those trends, leaving the 10-year to end the quarter at 1.92%, fueling positive bond returns for the quarter.

EXHIBIT II
Active Government Yield Curves



Source: Altman Investment Management Research and Bloomberg

Because of this modification in Fed guidance, markets became more in line with expectations. Reducing any potential negative market reactions produces a quality environment for the first increase in interest rates. Our outlook is that this lowers, but does not eliminate, the risks of rising interest rates this year in the front end of the curve. Reflecting this viewpoint, we place our yearend 2-year Treasuries forecast from 1.0% to 1.5% reflecting the lowered expectation for year-end 2015 Fed Funds rate, with our 10- and 30-year forecasts at 2.5% and 3.0%, respectively.

We note that lower bond yields in March came in an environment of steadily disappointing first-quarter economic data. The pattern of weak first quarter data has been the case for most of the past five years, while the second half of those years exhibited consistent outperformance. Notwithstanding these seasonal characteristics, the ongoing improvements in labor markets fueling rising incomes, falling oil prices fueling disposable income growth globally, and the rising confidence of business for capital expenditures and investments all point to a recovery in growth in the second half. Extrapolating lower rates from weak growth further supports the case that the Fed will resist tightening and appears misguided at this juncture.

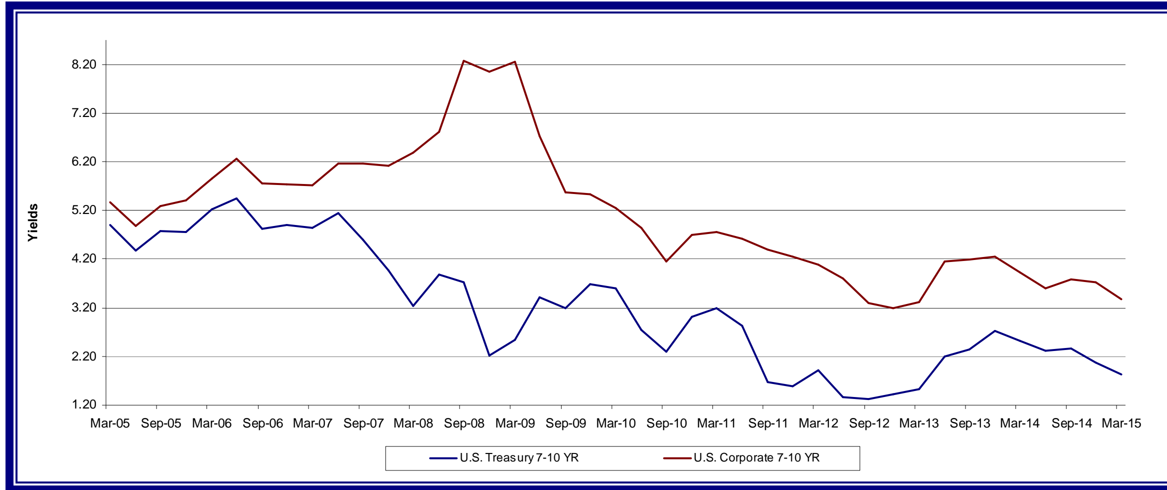
Going forward, our preferred strategy for interest rates reflects exposure in both the short end as well as the 7- to 10-year part of the yield curve, with preferences for curve flatteners on the front end versus curve steepeners on the long end.

➢ Corporate Bonds

So far this year, investment-grade spreads have tightened by 12 bps while high yield spreads have tightened by 48 bps, also according to indices from BofA Merrill Lynch. Investment-grade Financials are seven bps tighter this year at 122 bps, Industrials are 16 bps tighter at 137 bps and Utilities are four bps tighter for the year at 126 bps over comparable Treasury yields, according to BofA Merrill Lynch data.

EXHIBIT III

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



Source: Altman Investment Management Research and Bloomberg

Investment-grade corporate debt has a total return of 2.66% so far this year, while high-yield debt has a 3.90% total return. Leveraged loans have a total return of 3.20%. Preferred stock total return for the year has been 3.81%, all according to data from BofA Merrill Lynch. Investment-grade issuance year-to-date is 21% above 2014 issuance levels. High yield is running about 10% above issuance in 2014.

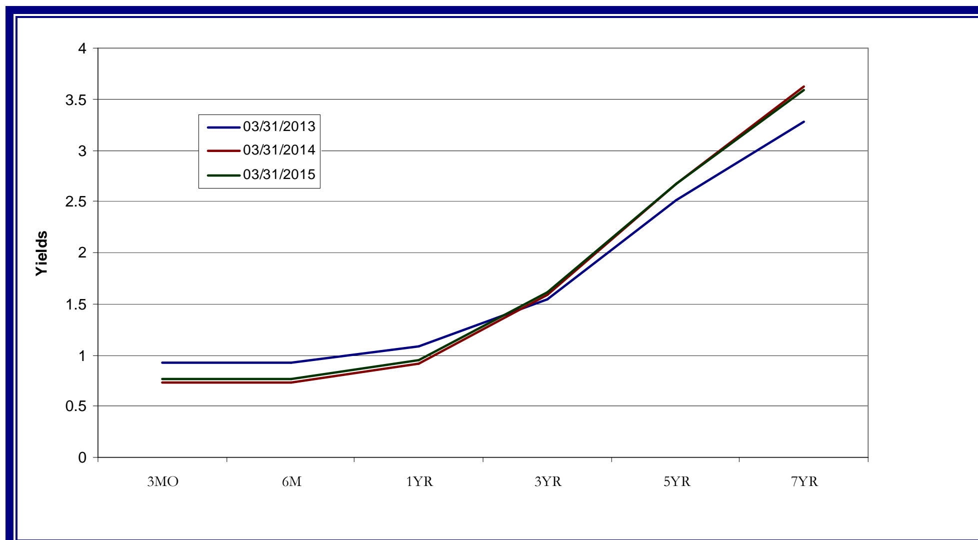
➢ Mortgage-Backed Securities (MBS)

Agency MBS has struggled in early 2015, driven by a confluence of factors. A dip in primary mortgage rates has re-introduced refinancing fears, while the Fed no longer adding MBS to its balance sheet has reduced this source of demand. And although the ECB's announcement appears bullish for spread assets, the purchases could pressure U.S. rates, a negative for the agency MBS market.

➢ Municipal Bonds

EXHIBIT IV

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



Source: Altman Investment Management Research and Bloomberg

New issue bonds are now up 58% year-over-year. Year to date, we saw a meaningful uptick in new-money issuance. Of late, current issuance was new money rather than refundings, which had represented the preponderance of supply in the first three months. Most of the outflows were in municipal money funds, due to tax season and not the core of the muni market. For the last month, municipals saw $691 million in inflows, bringing the year-to-date (YTD) figure to roughly $10.1 billion.

EXHIBIT V

Long Term Municipal to Treasury Yield Spreads

Source: Altman Investment Management Research and Bloomberg

EXHIBIT VI

Fixed Income Sector Performance – Q1-2015

Fixed Income Sector Performance – 2015 Q1 - Sector	**Rating**	**Maturity**	**Duration Mod Adj**	**Yield**	**Spread**	**Price Spread Avg**	**Trailing1 12Month Total Return**
Treasury	Aaa/AAA	4.1	3.9	1.3%	N/A	$103.7	3.4%
Agency	Aaa/AA+	5.1	3.8	1.2%	12	$107.5	4.1%
MBS	Aaa/AAA	4.8	4.3	2.1%	78	$106.4	5.4%
Municipal	Aa3/A+	4.9	3.7	1.3%	17	$112.4	2.9 %
Corporate	A2/A-	5.0	4.4	2.4%	110	$105.6	4.6%
High Yield	B1/B	6.6	4.0	6.2%	490	$100.0	2.1%

Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

We remain confident that the U.S. continues to grow at a 3% or higher rate, bolstered by the major economies beginning to climb out of recessions as their respective central banks ease monetary policy and the dollar continues to hold at current levels. We still believe the U.S. economy can stand on its own, yet still remain cautious of the economy's ability to consistently sustain growth above 3.5%, given the global economic picture and geopolitical uncertainties. We expect the Fed to change interest rate guidance by the third quarter coupled with persistent volatility in the markets. Given the potential headwinds, it remains to be seen just how soon the Fed is willing/able to begin raising short-term interest rates. As we indicated in January our biggest concern is deflationary forces emanating from the Eurozone. However, our long term view of interest rate normalization encourages us to maintain a slightly lower market duration.

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