ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JULY, 2015

IN BRIEF: The U.S. Fixed Income Markets

During June, much attention was given to the future of Federal Reserve policy as minutes released from the Federal Reserve Open Market Committee (FOMC) showed members voted in favor of keeping the Federal Funds Rate unchanged. Speculation continues regarding the timing of an increase in the Federal Funds rate. Early in the year a move in June was viewed as possible, but weather induced negative growth in the first quarter caused the FOMC to delay action. Discussion now is focused on the fall, but fallout from the Greece-induced Euro zone turmoil and China's stock market implosion could again cause the monetary authorities to further postpone taking action.

Ignoring international developments, building U.S. economic momentum (albeit at a moderate pace thus far) and declining unemployment provide an argument for a move. However, these trends remain offset to some degree by sluggish wage growth, higher than desired part time employment for economic reasons, a low labor participation rate and a lower than desired inflation rate. There is also a concern that dollar strength relative to the Euro could impact U.S. exports and diminish GDP growth prospects to some extent.

We would not be surprised if the Fed decides to hold off a bit longer on their first move until they have additional evidence of sustainable U.S. growth, and witness some calming of the global turmoil. However, we do expect that the first tightening from the near-zero Federal Funds rate level that has been maintained since late 2008 will be taken in the not-too-distant future. Fed Chair Yellen has indicated that a move this year is probable.

We anticipate the Fed's first move will be well announced and subsequently evaluated before additional moves are made. We also expect that an increase in short rates will cause some modest pressure on the longer component of the yield curve. As shown in Exhibit I, the ten-year Treasury yield rose, from a low of 1.68% in early February of this year to 2.50% in June, in response to quickening economic activity and the expectation of a Fed move. This benchmark rate has declined in the recent months as investors opted for safe harbor investments in response to global developments.

A move above the 2.50% level early next year would not be surprising as conditions settle. We are therefore maintaining relatively low portfolio durations. Principal protection remains a major focus in our management of client assets.

Impact of Rising Rates

As noted above, we anticipate that the Federal Reserve will begin to increase interest rates within the next several months. What impact might this have on your fixed income portfolios? No portfolio is totally immune from rising interest rates, but the defensively structured accounts we manage should be relatively insulated, especially in an environment where tightening occurs gradually.

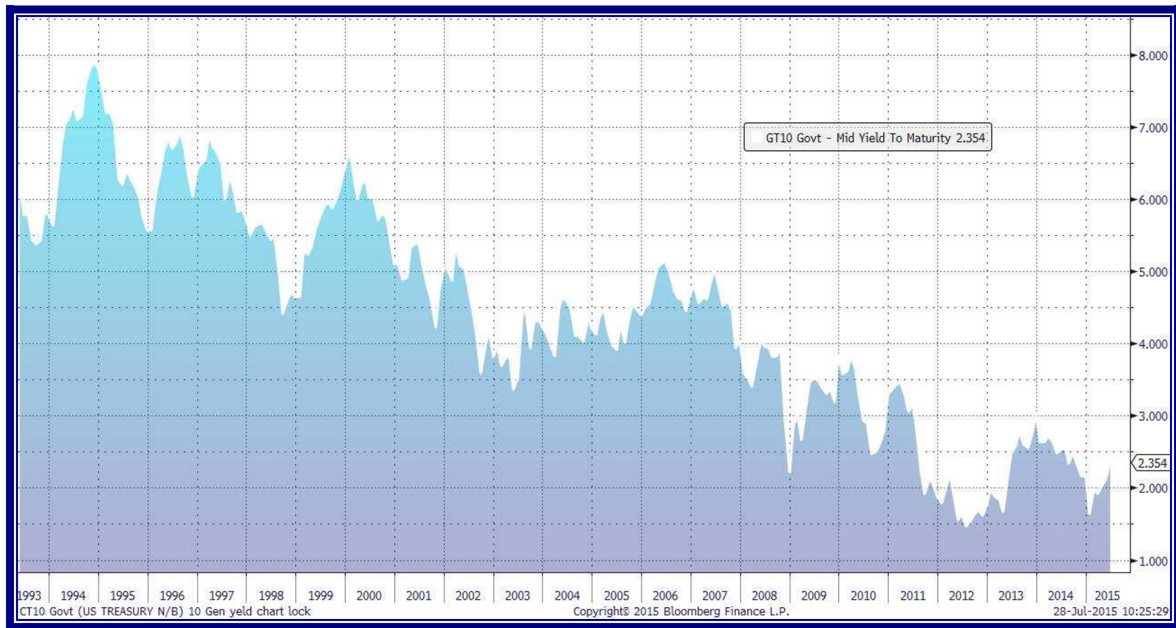
CLOSE-UP:

➢ Government Bonds

The most recent minutes of the FOMC indicated a possible increase in overnight rates in September. However interest rates fell as economic data was somewhat underwhelming, especially the employment cost index. The yield on the benchmark 10-year Treasury note has traded as low as 2.18% (bps), while the yield on the two-year note fell two bps to 0.66%, creating a 2s/10s spread (yield curve slope) of 152 bps. Yields on fixed income spread products were also lower, in the three-to-seven bps range.

Most sector spreads widened against Treasuries, with the high-yield indices changing the most in the second quarter. There was some slight change in the wording in the FOMC statement that led Fed watchers to surmise that the Fed will raise its target funds rate by 25 bps at its next meeting in September. However, one of the recent economic releases was the Bureau of Labor Statistics (BLS) release of the employment cost index for the second quarter which showed compensation costs were "little changed" at 0.2% and only a 2.0% increase over the past year. Expectations were for compensation costs to rise by 0.6%.

EXHIBIT I
Ten-Year Generic Treasury Yield

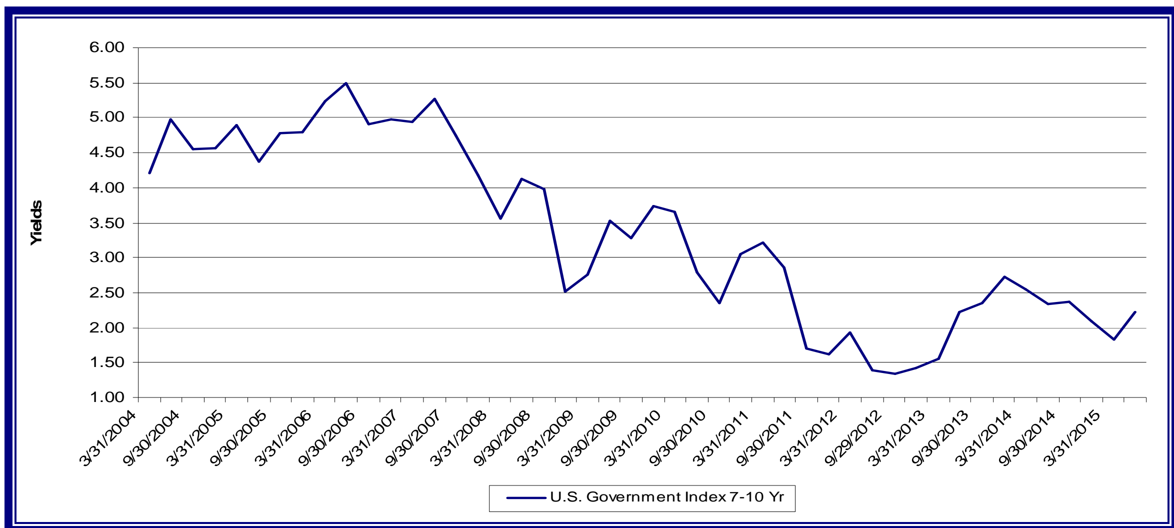


Source: Altman Investment Management Research and Bloomberg

The focus of the fixed income market will be the release of the July employment report. Expectations are for job growth of 225,000 following growth of 223,000 in June. The unemployment rate is expected to be unchanged at 5.3%, as measured by the Labor Department's U-3 measure - and the underemployment rate is expected to also be unchanged at 10.5%, as measured by U-6 number. Average hourly earnings are expected to rise 0.2% in July, after being flat in June, which would result in a 2.3% increase year-over-year. The average weekly hours is expected to be unchanged at 34.5. We would not expect to see much in the way of interest rate movement based on the report if job growth is in the 200,000- to-250,000 range, but growth lower than the 200,000 could result in the 10-year note falling to as low as the 2.00% level. Any point higher than 250,000 could result in the 10-year hitting the 2.30%-to-2.35% level.

EXHIBIT II

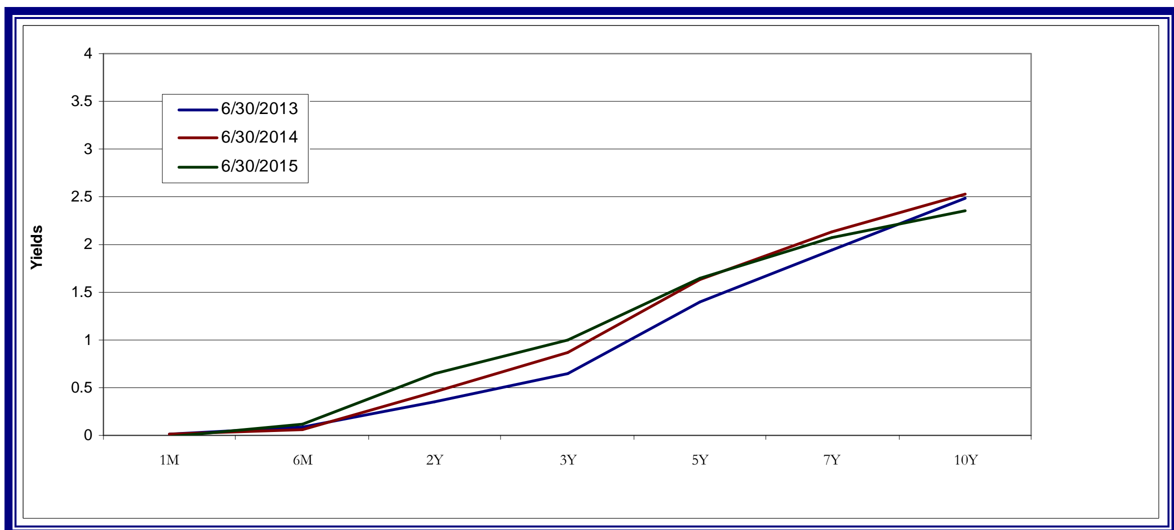
U.S. Government Index 7-10 year



Source: Altman Investment Management Research and Bloomberg

EXHIBIT III

Active Government Yield Curves



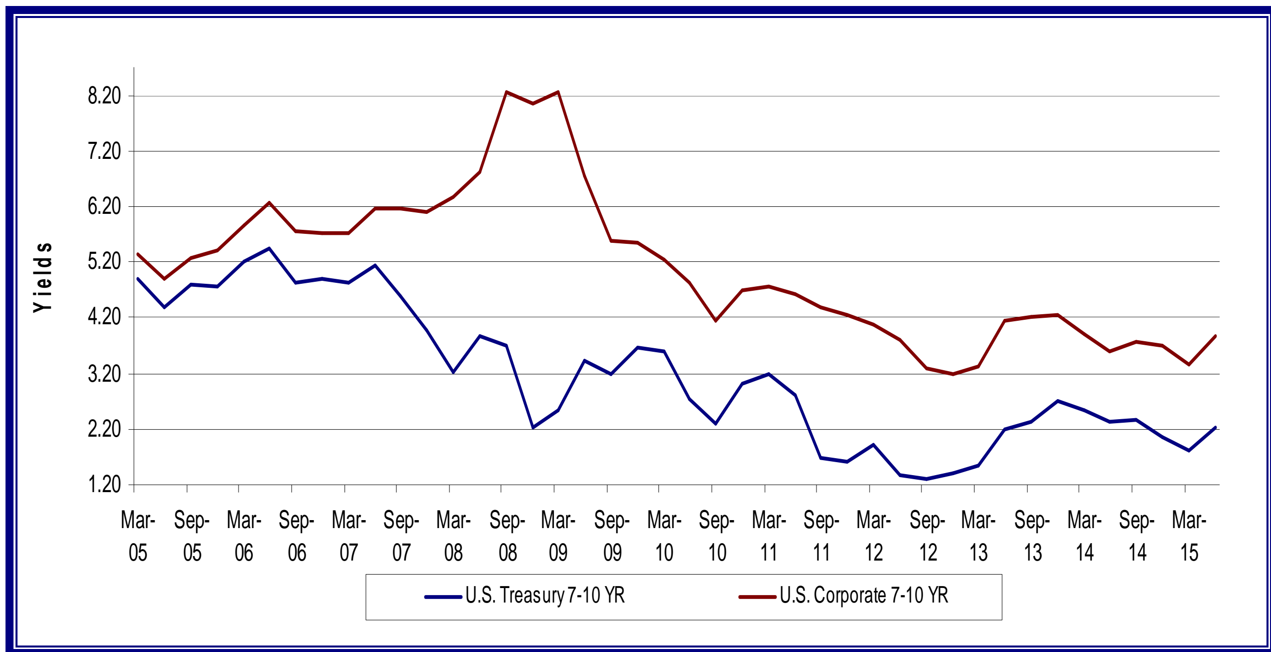
Source: Altman Investment Management Research and Bloomberg

➢ Investment Grade Corporate Bonds

Investment-grade spreads are currently 158 bps over comparable Treasury yields, while high-yield spreads are at the 536 bps level. So far this year, investment-grade spreads are 14 bps wider, while high-yield spreads are 32 bps wider. Investment-grade Financials are 14 bps wider this year at 143 bps, Industrials are 12 bps wider at 165 bps and Utilities are 18 bps wider for the year at 148 bps over comparable Treasury yields, according to BofA Merrill Lynch data. Investment-grade corporate debt has a negative total return of 0.07% so far this year, while high-yield debt has a 1.86% total return. Leveraged loans have a total return of 3.35%. Preferred stock total return for the year has been 3.87%, all according to data from BofA Merrill Lynch. Year-to-date investment-grade new issuance is running at $790 billion, which is $200 billion more in issuance for the same period in 2014. The spike in issuance this year has been driven by M&A activity that has been financed by massive debt deals.

EXHIBIT IV

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



Source: Altman Investment Management Research and Bloomberg

➢ Mortgage-Backed Securities (MBS)

The supply/demand dynamic within MBS remains just as important as the direction and level of interest rates in determining future performance of the sector. Even though we are nearly seven years past the Financial Crisis, the MBS market continues to receive considerable support from the Federal Reserve. The Fed owns 30% of the outstanding MBS market and has purchased 30% of YTD new supply through reinvestment of cash flows from its massive QE (quantitative easing) purchase program.

A key debate within the market is when reinvestment of the pay-downs will slow. Consensus opinion estimates the tapering of reinvestments will occur within nine to twelve months after the first Fed hike. Consequently, if the Fed was to increase its policy rate in 2H15, the taper would likely not occur until June or December of 2016. Though supply surprised to the upside in 2Q15, MBS origination remains well below the pre-crisis peak. The apparent re-emergence of first-time home buyers and cash-out refinancing mortgages have both increased in 2015, deserving close attention. Any additional supply/demand uncertainty could be a negative for MBS. In a rising rate environment, prepayments tend to slow, which is beneficial from an income perspective and coincides with our overall emphasis on carry versus spread compression.

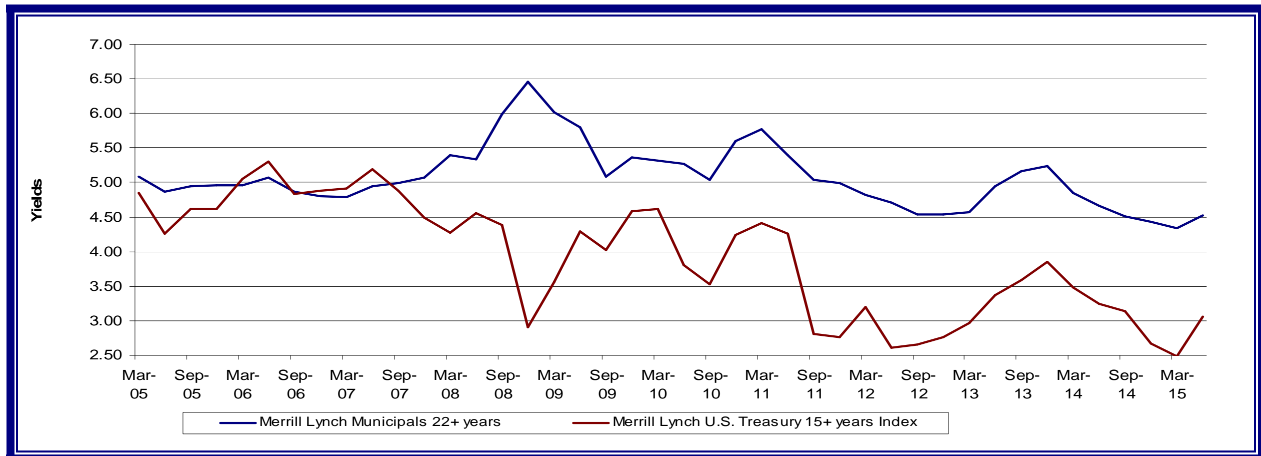
➢ Municipal Bonds

A heavy supply of refunding bonds in the first four months of the year pushed issuance to an annual rate near $450 billion. The pace of new issue sales declined in the past two months and volume in the first half totaled a still large $217 billion. We anticipate that sales will continue to moderate in the second half and total perhaps $380 billion for the year. With demand for tax exempt securities remaining strong, we expect that this volume will be absorbed with little difficulty. As is typical, the trend in tax-exempt rates followed the Treasury market's lead with the lows reached in late January and highs in mid-June. Municipal mutual fund outflows have been persistent over the past two months, likely reflecting investor credit concerns (i.e. Puerto Rico) and the desire to avoid the principal risk inherent in most funds in a rising rate environment.

We continue to be positive on the asset class amid still attractive ratios vs. U.S. Treasuries and solid fundamentals, but recognize that the prevailing macro backdrop warrants a neutral duration stance. Some of the risk aversion expressed via fund flows was due to developments in Puerto Rico and, to a lesser extent, Illinois (Chicago) and New Jersey. We see positive developments in August, including a continuation of net negative supply and a historically favorable pattern. Going back to 2000, positive July performance has typically been followed by a positive August (except for 2007); and in all but two cases, August outperformed July. As last month, we will look for opportunities in the primary market and to capitalize on any weakness created by inflated headlines around the creditworthiness of the asset class.

EXHIBIT V

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

The S&P Municipal Bond Intermediate Index returned .69% year-to-date. Longer-duration securities outperformed, as did mid-tier (A-rated) credits. High-yield was challenged again; this was little surprise since Puerto Rico makes up 28% of the high yield index. Municipals modestly underperformed Treasuries, sending ratios slightly wider. Yields remain compelling on a relative basis, especially for the longest maturities. The 30-year muni-to-Treasury ratio ended July at 107%.

In all year-to-date fund flows remained positive to $7.8 billion. Munis still offer a positive investment case, but we are cognizant that crossover buyers (taxable investors) have more investment choices as corporate bond prices cheapen. As such, we expect a traditional retail buyer base to drive the market in the near term.

EXHIBIT VI

Fixed Income Sector Performance – Q2 2015

Fixed Income Sector Performance – 2015 Q2 - Sector	**Rating**	**Maturity**	**Duration Mod Adj**	**Yield**	**Spread**	**Price**	**Trailing1 12 Month Total Return**
Treasury	Aaa/AAA	7.6	6.0	1.5%	N/A	$105.1	2.6%
Agency	Aaa/AA+	4.9	3.7	1.4%	(15)	$106.4	2.1%
MBS	Aaa/AAA	5.7	4.9	2.5%	127	$105.2	2.2%
Municipal	Aa3/A+	14.7	4.8	2.3%	110	$107.0	3.9%
Corporate	A2/A-	10.3	6.8	3.3%	150	$104.8	1.7%
High Yield	B1/B	6.4	4.1	7.2%	573	$97.2	(.55)%

Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

The U.S. economy is growing at a below-average rate by historical standards, but nevertheless there appear to be no impediments to future growth and so we expect a longer than normal business expansion. We remain confident that the U.S. continues to grow, albeit below historic trend-line, bolstered by the major economies beginning to climb out of recessions as their respective central banks ease monetary policy and the dollar begins to retrace its upward bias. 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. Should the Fed begin to hike rates in September, we are expecting a one-and-done approach. The members of the FOMC continue to talk about raising rates even as commodity prices plummet and global economic activity slows. In our opinion, Yellen will soften the blow at her press conference that follows the September meeting by suggesting that the next rate hike may be months away and not inevitable. If so, then the dollar could weaken, while commodity prices could firm.

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