ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

OCTOBER, 2015

IN BRIEF: The U.S. Fixed Income Markets

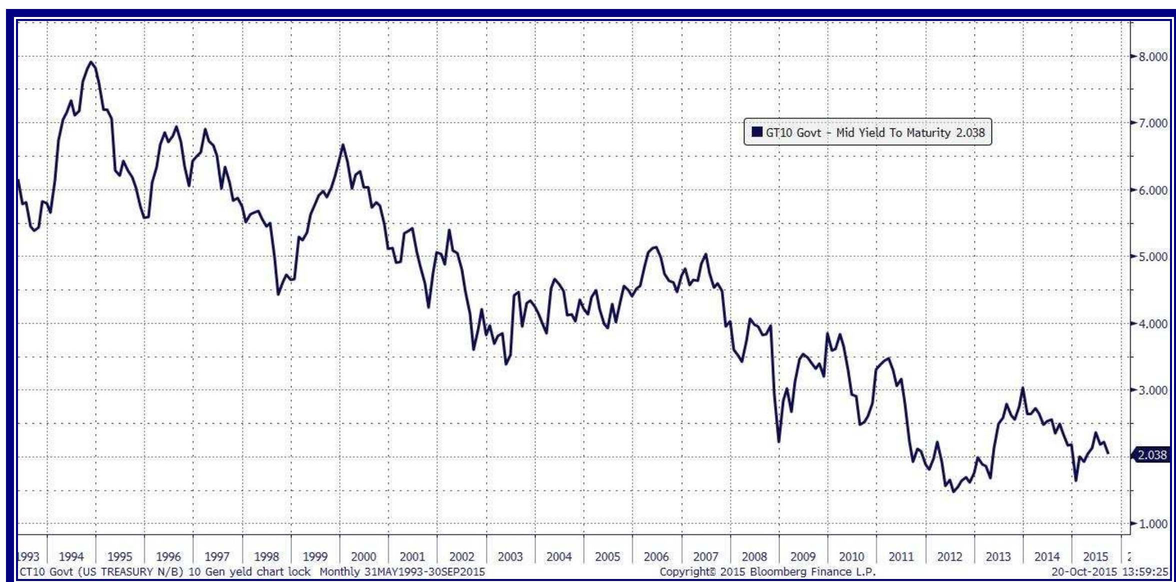
During the third quarter, the U.S. economy showed continued progress coupled with a decline in the U.S. unemployment rate to 5.1%, yet the Federal Reserve postponed moving the Federal Funds rate at the September FOMC meeting. We believe that a strong dollar, restricting U.S. exports, and sluggish global growth has influenced the Fed's decision. A falling Chinese growth rate combined with lackluster European economic activity, and a slowdown in many emerging countries due to the drop in demand for commodities, is impacting worldwide economic activity as well. This has resulted in a targeted federal funds rate near zero since December 2008. The FOMC decision to hold off was confirmed in October, with a weaker than expected employment increase of 142,000 in September along with downward revisions in July and August.

A domestic inflation rate below the desired target of 2% is also an issue for the Fed. The core CPI is currently advancing at about a 1.8% annual rate and the Personal Consumption Expenditure Index at roughly 1.4%. Weak energy prices, limited wage growth and dollar strength are curtailing price pressures. Economists have suggested that the sluggish wage growth, high levels of part time employment and the low labor force participation rate argues that any concern is currently unwarranted.

Despite the Fed's postponing the rate hike last month, Chairwoman Yellen did comment in a recent speech that the Fed plans to move before year-end. There is one remaining FOMC meeting this year, in mid-December. Recent speculation has focused on the Fed moving at the December meeting, but late year timing could be complicated by Congressional politics. The speaker of the house decision to resign from Congress at the end of October provided flexibility to enact a stopgap funding bill that finances the government through December and circumvented a possible government shutdown over Planned Parenthood funding. What Congress does in December remains to be seen; but from the Fed's perspective moving rates at the same time as a budgetary battle is being waged, in our judgement, would not be an opportune time.

<u>EXHIBIT I</u>

<u>Ten-Year Generic Treasury Yield</u>



Source: Altman Investment Management Research and Bloomberg

CLOSE-UP:

➢ Government Bonds

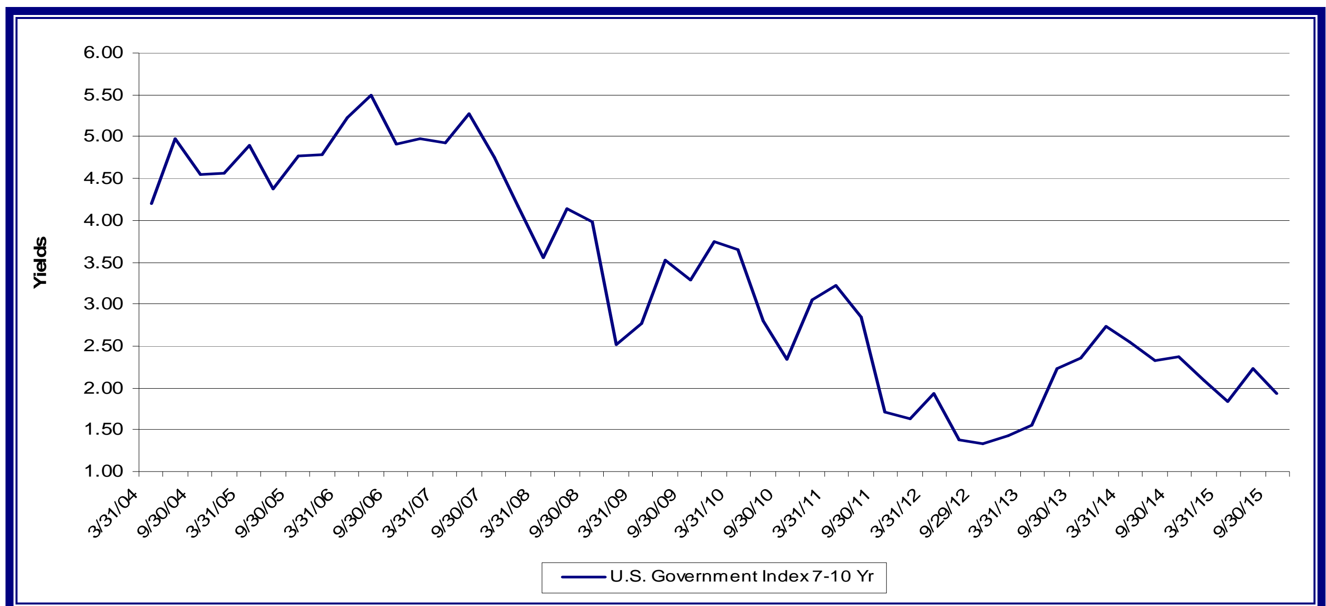
During the quarter, interest rates have traded in a relatively narrow band as monetary policy was put on hold. The ten-year Treasury yield remained in the 2.00% to 2.25% range during most of the quarter, but we witnessed a momentary drop in rates just under 2.00% at the start of October, in response to the weak September labor report. Tax-exempt yields also traded in a narrow range during the past quarter and followed the Treasury market's lead. *Exhibit II* shows that yields trended lower throughout the quarter resulting in year-to-date positive returns.

The increase in the probability of another delay by the Federal Reserve to commence their rise in short term lending rates has resulted in a 20 basis point decline from the previous interest rate rise for longer term obligations. While yields on short duration Treasury obligations remained relatively unchanged over the period during third quarter, yields on longer-dated Treasuries declined as much as 30 basis points over the same time period. A similar trend took place in many foreign bonds, with yields on 10-year sovereign obligations declining as much as 40 basis points over the same three month period.

As we mentioned, it was highly probable that a delay, until December or the first quarter of 2016, would occur to the first increase in short term interest rates by the Federal Reserve. However, there is no change in expectations that the pace of further interest rate increases will be quite gradual. Over the next several years, a very slow rise in long term interest rates remains the most likely scenario, although the timing of the increase appears less certain than was the case earlier this year. Given this outlook, we continue to maintain a somewhat shorter than average duration in our taxable and tax exempt portfolios with emphasis on higher quality obligations. New purchases for our portfolios remain focused on obtaining the best value available in both the new and secondary debt markets.

EXHIBIT II

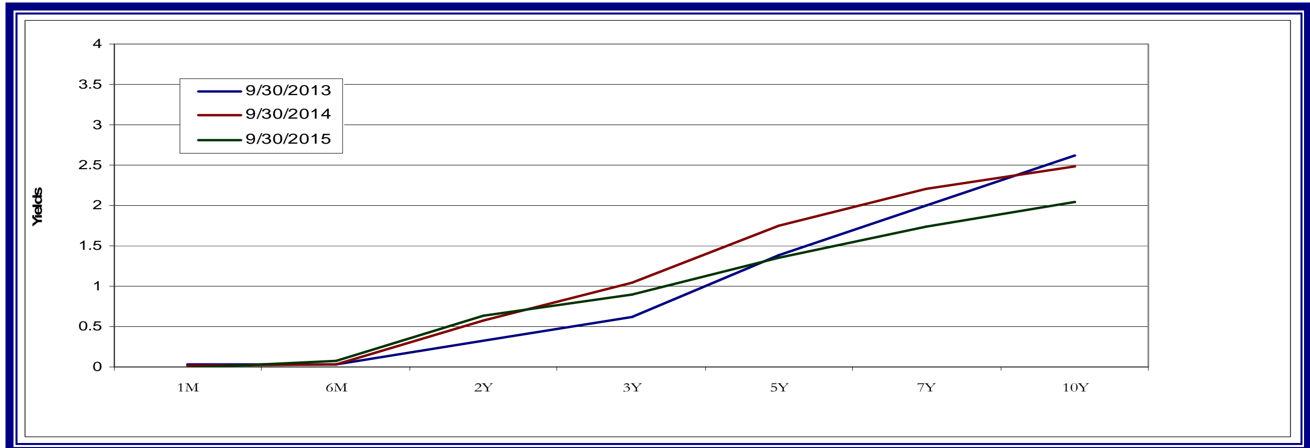
U.S. Government Index 7-10 year



Source: Altman Investment Management Research and Bloomberg

EXHIBIT III

Active Government Yield Curves



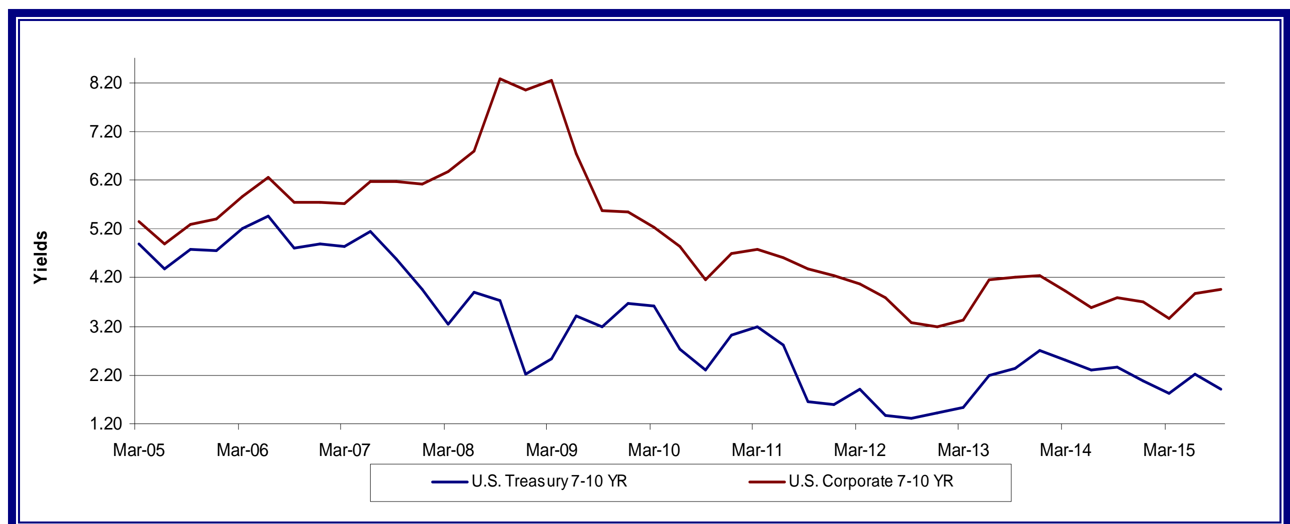
Source: Altman Investment Management Research and Bloomberg

Investment-Grade Corporate

So far this year, investment-grade corporate spreads are 28 bps wider, while high yield spreads are 85 bps wider. High yield energy spreads, at 939 bps over comparable Treasury yields, are now just 199 bps wider so far this year, according to data from Barclays. Investment-grade Financials are 22 bps wider this year at 140 bps, Industrials are 32 bps wider at 171 bps, and Utilities are 25 bps wider for the year at 146 bps over comparable Treasury yields, according to data from the Barclays Indices. Investment-grade corporate debt has a total return of 0.76% year-to-date while high-yield debt has a 0.31% total return as Energy (about 15% of the high yield index) has a negative total return of 8.61% year-to-date, according to data from Barclays. Only the subsector of Metals and Mining has worse performance with a negative 12.20% total return year-to-date. Year-to-date investment-grade corporate bond issuance has passed the $1 trillion mark which exceeds issuance for the full year in 2014. High yield issuance has been running at half the rate as last year's quarter. Year-to-date high yield issuance is $294.5 billion which is about 15% less than the $348.4 billion issued during the same time period in 2014.

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)

A quick turnaround and recovery in the basis, created by a weaker than expected September Labor number, set the stage for a sustained rally mid-month. A meaningful drop in realized volatility helped reduce the spreads between agency MBS and Treasuries. Lighter than expected housing starts demonstrated that the housing recovery is still tepid, yet the balance of data did not rile markets prior to the FOMC interest rate announcement. The Fed ultimately struck a dovish tone, choosing not to raise interest rates due mostly to concerns about global growth and the lack of inflation. The initial reaction of the basis at the announcement was to grind tighter, the result of a long-standing market reaction of agency MBS taking Federal Reserve dovishness constructively. Within 24 hours the tables had been turned, with fears that the dovish stance by the FOMC might be a harbinger of a global risk off move. The result was rallying Treasuries, which sent the basis wider due to prepayment concerns coming to the forefront once again. FOMC officials tried to assuage market concern of a broad-based economic decline to varying degrees of success as the end of the month approached. The result was volatility picking up once again.

Municipal Bonds

As fixed income assets rallied in September, there was particular strength in municipal bonds, led by longer duration and high yield credits. Munis' positive performance was further aided by the lightest September issuance in over a decade. New supply for the month came in at $18.3 billion, which was 23% below the five-year average and 31% lower than the 10-year average. Meanwhile, the demand trend seemed to point to a looming sense of investor uncertainty, with negative flows turning decidedly positive after the Fed's decision, only to resume outflows in the final week of the month. In all, September was marked by $1.25 billion in outflows, though flows remain positive year-to-date at $5.6 billion. Given the prevailing global backdrop, we continue to expect a low for-longer interest rate environment in which high-quality fixed income assets will be a preferred choice among investors.

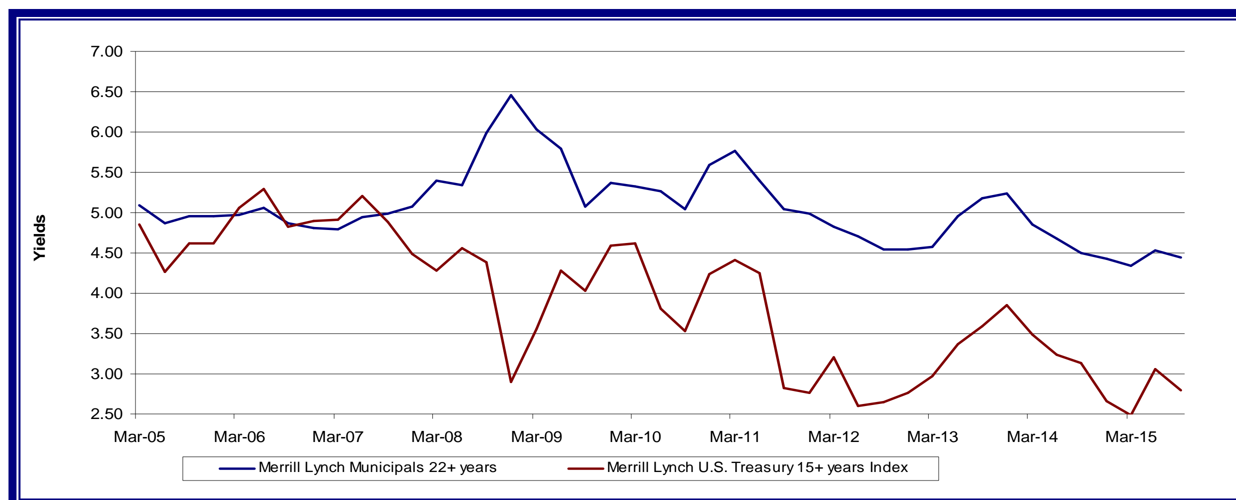
During the year, we have commented that a heavy flow of refunding issues produced a surge in tax-exempt supply during the winter and early spring months or an issuance totaling $217 billion during the first half. As we pointed out, new issue volume fell to under $100 billion in the past quarter and appears to be on track to total about $410 billion for the year. Assuming rates do not decline significantly, we anticipate that demand for tax-exempt income will allow the new issue flow to be absorbed with little difficulty. As you may be aware, households remain the largest holders of municipals owning over 42% of outstanding securities. On the other hand, mutual funds, which are largely held by individual investors, accounted for about 18.5% of the market while money market funds hold close to an estimated 7% of outstanding assets. Banks, casualty and life insurance companies and other corporations hold much of the remainder. Foreign buyers have also been buying municipals. According to a Federal Reserve report, non-U.S. investors owned $85.7 billion tax-exempt bonds in the second quarter which represented 2.3% of the $3.72 billion market. Given low interest rates in Europe and Japan (e.g. ten year German and Japanese government bonds are yielding, respectively, 0.50% and 0.35%), municipals offer very competitive returns.

Mutual funds experienced weekly outflows during much of the quarter following the trend seen earlier in the year. Investor concern regarding Puerto Rico holdings in many funds, which in some instances are quite significant, is prompting movement. Potential volatility risk is also of concern for many funds that utilize large components of long duration bonds in their attempt to maximize fund yields. These concerns are reflected in closed end municipal fund pricing. Closed end funds typically trade at moderate 7% to 8% discounts from their net asset values. Some discounts now exceed 15%.

We anticipate that municipal rates will also remain in a narrow range near term. Absent some shock, we do not expect that yields will decline significantly from current levels. Investor demand tends to wane when ten-year AAA municipal yields fall below 2.00%.

EXHIBIT V

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

EXHIBIT VII

Fixed Income Sector Performance – Q3'15

Fixed Income Sector Performance – 2015 Q3 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing 12 Month Total Return
Treasury *	Aaa/AAA	7.7	6.1	1.4%	N/A	$105.7	4.1%
Agency	Aaa/AA+	5.1	3.6	1.3%	(10)	$107.0	2.9%
MBS	Aaa/AAA	5.4	4.7	2.4%	100	$105.5	3.3%
Municipal	Aa3/A+	5.6	3.9	1.5%	20	$111.8	2.0%
Corporate *	A2/A-	9.6	6.6	3.0%	160	$105.4	2.7%
High Yield	B1/B	6.3	4.3	8.1%	670	$92.2	(3.6)%

*Intermediate duration

Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

At some point the Fed will begin to raise interest rates. If Chairwoman Yellen's latest projection proves correct, a move in December would not be surprising. She has also indicated that the pace of subsequent rate increases will be dependent on the board's assessment of economic and market conditions. The bias will be towards higher rates, although Fed moves are likely to be slow and steady over the next year assuming the economy continues to grow at a modest pace and inflation remains subdued. Higher short rates may cause longer yields to be nudged a bit higher, but we doubt that the impact along the curve will be significant. A flatter yield curve is most likely. This is especially true in the municipal market that is trading at attractive levels relative to Treasuries. Longer maturity municipal yields are at or above Treasury levels. In an environment where rates rise moderately and the yield curve flattens, our fixed income portfolios tend to outperform. The bonds we utilize limit price risk due to their short effective durations. We are targeting portfolio durations at about 3.6 years, about 12% below neutral. While we do not expect longer rates to move dramatically higher over the near term, we feel it prudent to limit volatility risk in the current low nominal rate environment.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.