ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JANUARY, 2016

IN BRIEF: The U.S. Fixed Income Markets

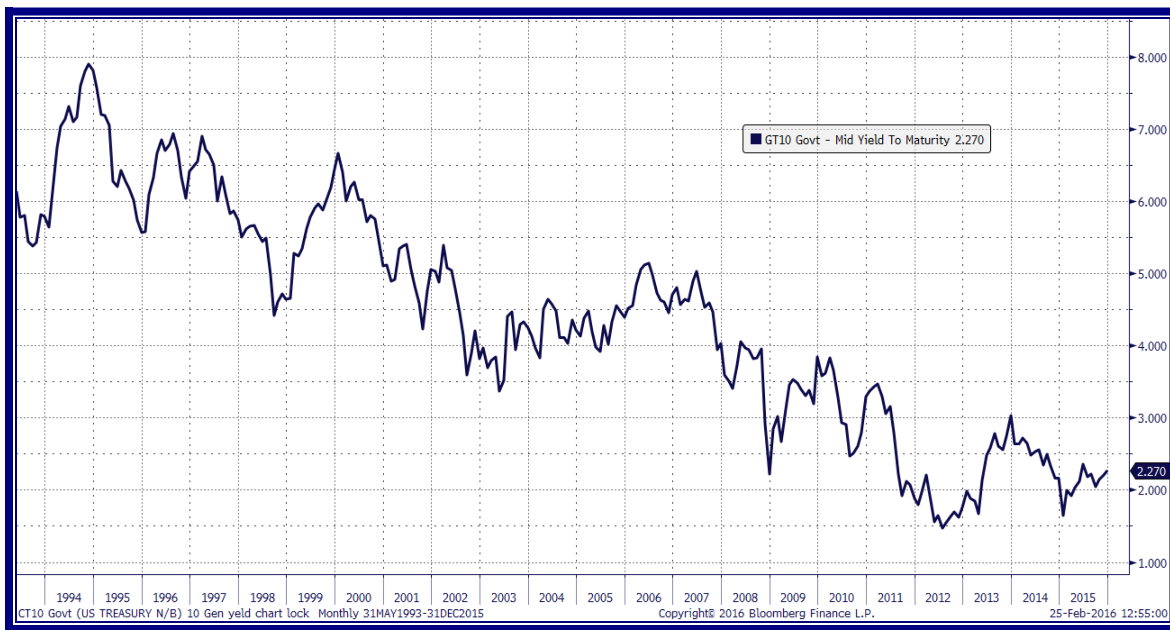
After seven years of aggressive monetary stimulus, with near zero short term interest rates and successive rounds of quantitative easing, the Federal Reserve took a well forecasted baby step on December 16th and notched the Federal Funds rate higher by a quarter of one percent. The new targeted range is 25 to 50 basis points. Fed Chair Yellen has indicated that additional increases are likely this year, but dependent on the pace of economic activity and an increase in core inflation to near the Fed's desired 2% desired pace.

The FOMC's current projection is for four additional increases this year, but that seems aggressive given the fragility of the world economy with limited, if any, growth in Europe and declining growth in China. With deflation a concern in parts of the world, it is questionable whether U.S. inflation will move meaningfully higher given sagging energy prices and limited wage growth. Our working assumption is that U.S. growth will remain positive but subdued with real GDP tracking at a 2+% rate spurred by some strengthening in consumer demand, but also negatively impacted to some degree by a sluggish manufacturing sector and curtailed exports due to dollar strength.

This suggests an environment where some modest additional pressure is likely to develop on the short end of the yield curve, in response to one or two Fed moves, but it is questionable as to how much impact there will be on longer rates if growth remains modest and inflation subdued.

EXHIBIT I

Ten-Year Generic Treasury Yield



Source: Altman Investment Management Research and Bloomberg

CLOSE-UP:

➢ Government Bonds

Subsequent to the Federal Reserve interest rate increase on December 16th, yields across the Treasury curve are actually lower, with some seeing significant declines of 10 basis points or more. What is the market evaluating? A combination of volatile equity markets, weak oil prices, Middle East tensions, weak/false economic reporting and bans on short selling being lifted in China pushed equity markets lower across the globe. This has been the worst opening for stocks in history with U.S. stocks losing $1.26 trillion in value in the first two weeks, with major indices down 6% or more. Meanwhile, to the surprise of some, the bond market is chugging along and posting some decent year-to-date returns. The broad intermediate bond index is up 90 bps so far. Thanks to the global "flight to quality", investment grade corporate credit is positive across the board with higher quality AA-rated paper slightly outperforming A and BBB-rated peers, with each group returning >70bp in the first weeks of trading.

As a result, market participants are now beginning to wonder if the Fed's timing was off and are now anxiously debating what the committee will do next. As before, the committee remains data dependent and will consider global circumstances in any further changes in monetary policy. For example, Fed Vice Chairman Stanley Fischer noted that China's slowing economy is clouding the outlook for economic growth making it very difficult to predict the path of monetary policy. Although Fed officials see the possibility for four quarter-point hikes in 2016, the markets are betting otherwise; Fed funds futures are now implying that any hike before June is less than a 50/50 shot. For comparison, on New Year's Day the probability of a hike was >50% for a March hike.

This abrupt "market-change" has investors wondering what is in store for 2016 and whether the first weeks of trading will bear any indication of what will occur in the next twelve months. If anything, this is a helpful reminder why bonds matter to investment portfolios no matter what the prevailing interest rate environment looks like. Whether rates are high or low, the Fed is hiking or cutting rates, bonds will generally act as a downside hedge or volatility cushion for those owning any type of long-duration assets. For much of 2015 and now YTD 2016, the relatively unloved bonds are outperforming the equities.

The impact of last year's late Fed raise is not at all what one might expect … as it is being dimmed by a multitude of market dynamics including: the lack of inflation, global diversity with monetary policies, China's retreating growth, tumbling oil prices, terrorist fears and the strong dollar. Thus far, the entire curve is lower in rates, including the short-end.

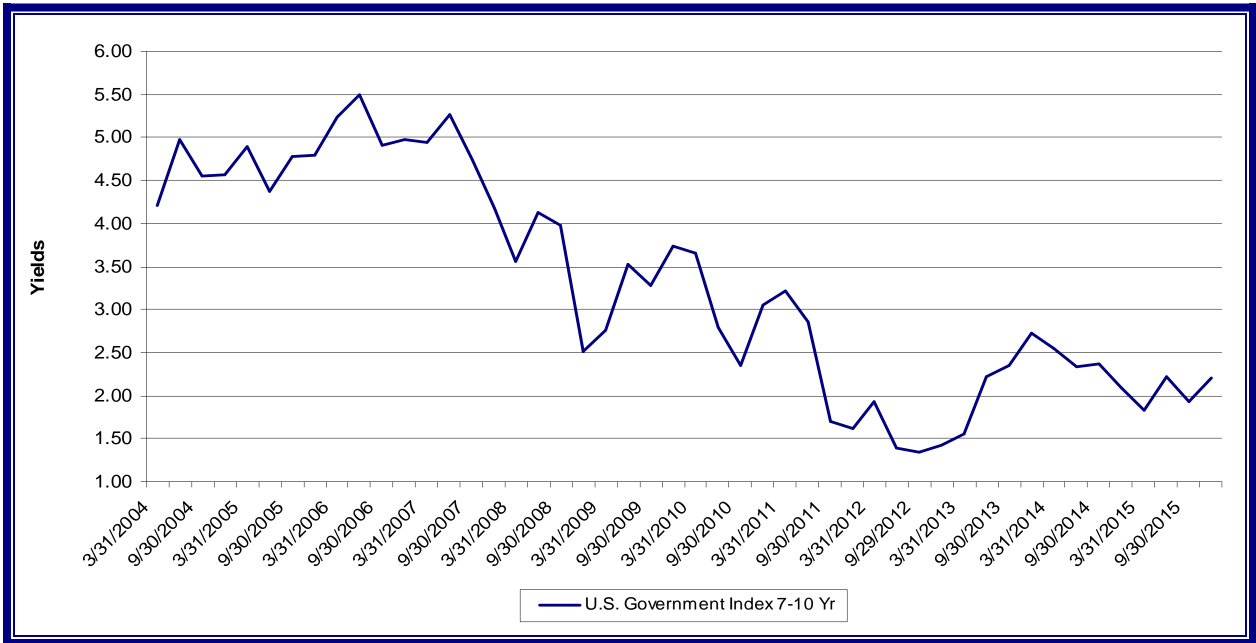
EXHIBIT II

Yield and Returns - YTD

	12/31/15	01/19/16	
1 yr	0.600%	0.487%	-11.3
2 yr	1.050%	0.868%	-18.2
3 yr	1.308%	1.108%	-20.1
5 yr	1.761%	1.479%	-28.1
7 yr	2.092%	1.821%	-27.2
10 yr	2.270%	2.060%	-20.9
30 yr	3.016%	2.837%	-17.9

EXHIBIT III

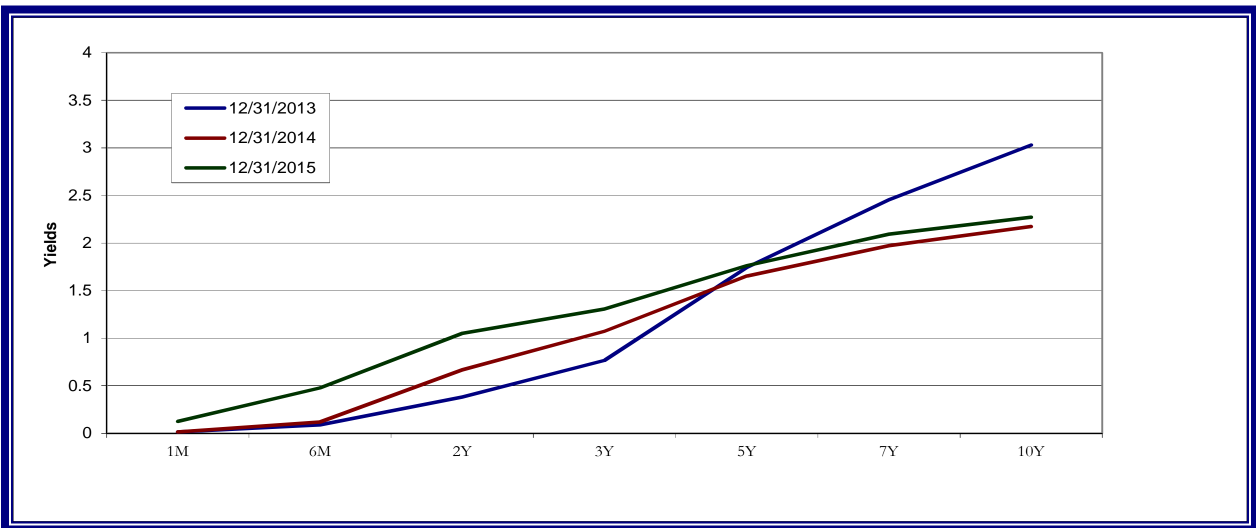
U.S. Government Index 7-10 year



Source: Altman Investment Management Research and Bloomberg

EXHIBIT IV

Active Government Yield Curves



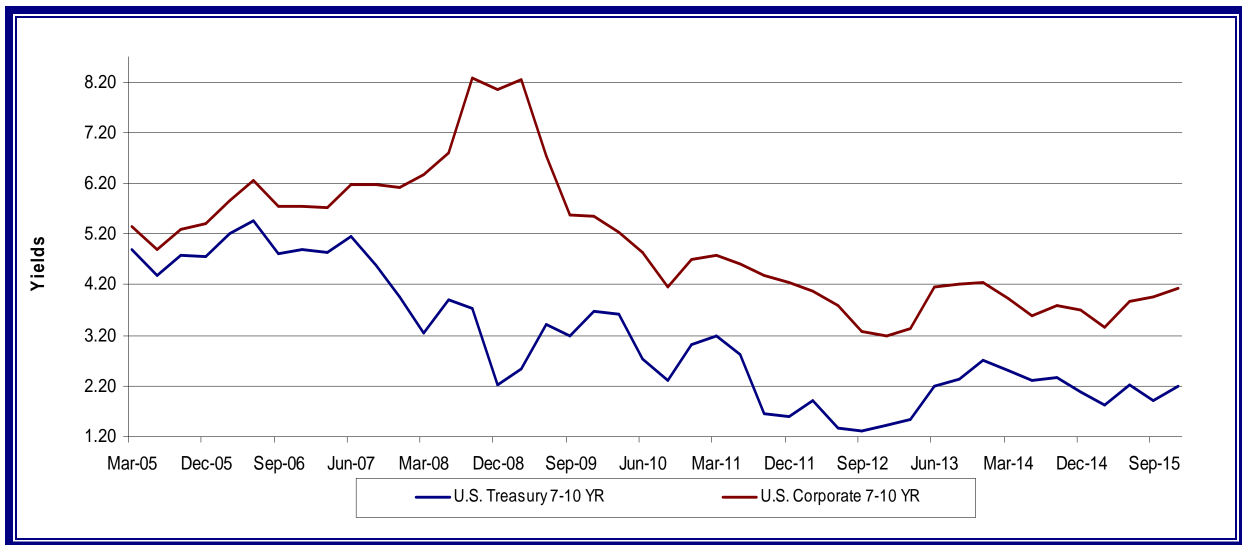
Source: Altman Investment Management Research and Bloomberg

➢ Investment-Grade Corporate

New issue performance on the year has been difficult as on-the-run bonds have been issued into a spread widening environment. But in terms of performance versus other asset classes, it has underperformed the market with equities faring the worst and Treasuries doing best. The general corporate market is up less than 0.50% on the year. Corporate spreads weakened with the rest of the market, continuing in the same pattern so far all year. Earnings are starting to come in and have been so far mixed, with Shell representing weakness in the energy space, as its fourth quarter earnings were as much as 50% lower than the year earlier. The Corporate Index Option-Adjusted Spread (OAS) finished the week at +192 basis points, 15 bps wider on the week. Overall, Metals/Mining was 32 bps wider as commodities continued their losing streak; energy was 49 bps wider with oil prices trading below $30. Senior and sub financials were 10 bps wider. Industrials were 14 bps wider and Utilities outperformed the rest of the market, only widening by one.

EXHIBIT V

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



Source: Altman Investment Management Research and Bloomberg

➢ Mortgage-Backed Securities (MBS)

Agency mortgage-backed securities outperformed U.S. Treasuries in Q4 with a total return of -0.10% and an excess return of +61 bps. For 2015, the agency MBS sector returned a positive 1.51% with an excess return of -5 bps. Despite periods of volatility, MBS spreads over U.S. Treasuries tightened in Q4 and ended the year close to unchanged relative to beginning-of-year levels. At current levels, MBS spreads are now tight relative to U.S. Treasuries and relative to other high-quality fixed income sectors. In the coming quarter, MBS spreads could remain supported by the Fed's mortgage buying program but will likely be buffeted by expectations of the Fed's rate hike path. Prepayments should remain muted baring a sharp interest rate rally or resurfacing of government policy risk.

➢ Municipal Bonds

The municipal market outperformed both Treasuries and corporate bonds in December, propelled once again by favorable supply/demand dynamics. The yield curve flattened significantly, with the short end rising as the Fed lifted its target short-term interest rate for the first time since 2006 and the long end holding steady as global growth disappointed and oil prices approached a six-year low, muting inflation expectations. Issuance was unseasonably low for the fourth straight month, at $22.2 billion, down 41% year over year and 29% below the 10-year average. On an annual basis, supply was up vs. 2014 and the historical averages, though it should be noted that 55% of new issues were refunding. Meanwhile, demand continued strong, with $5.9 billion in inflows recorded in December. This capped 13 weeks of positive flows and brought the 2015 total to $16.3 billion. We expect this technical tailwind to hold in January and February, which should allow the traditional retail buyer to absorb supply and carry the market with less reliance on non-traditional and crossover (taxable) buyers.

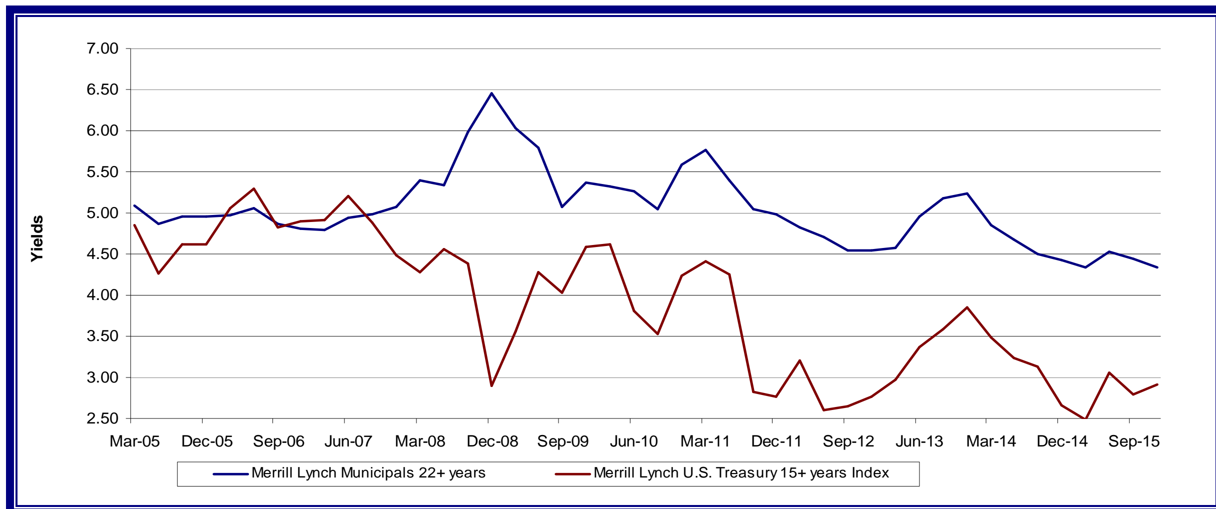
We have a constructive outlook for municipals in 2016, given their high-quality nature and unique ability to provide tax-free income and solid risk-adjusted returns with less volatility than other fixed income assets. Demand should remain robust while issuance likely wanes, as issuers accelerated some deals ahead of Fed liftoff and debt issuance is typically lighter in election years. We see the A-rated sector as a "sweet spot", and maintain favorable views of the Healthcare and Transportation sectors. Overall, state and local creditworthiness appears solid, despite idiosyncratic headlines around pensions, oil impacts and Puerto Rico. These do nothing to diminish the opportunity in the broader municipal space, but only speak to the importance of credit research and differentiation in 2016.

Public Pension Funds Investment Returns Challenged

Much has been written about the "new normal" investment returns in an environment of challenging equity markets and paltry fixed income yields. As an example, it was reported that the California Public Employees Retirement Fund earned 2.4% for the twelve months ended last June. When returns fall below targeted levels (7.0% and 7.5% expected returns are typical), actuarially required contributions increase. This could be a growing issue if investment returns remain low over the next few years and represents an additional credit risk that must be monitored. Assessment of defined benefit plan funding levels as well as postemployment healthcare funding remains an essential component of our credit analysis.

EXHIBIT VI

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

EXHIBIT VII

Fixed Income Sector Performance – Q4 2015

Fixed Income Sector Performance – 2015 Q4 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing1 12 Month Total Return
Treasury *	Aaa/AAA	7.8	6.1	1.8%	N/A	$104.1	.8 %
Agency	Aaa/AA+	5.0	3.8	1.6%	(20)	$105.7	2.9%
MBS	Aaa/AAA	5.9	5.1	2.6%	80	$104.7	1.5%
Municipal	Aa3/A+	5.6	4.1	2.0%	20	$111.9	2.3%
Corporate *	A2/A-	10.1	6.6	3.7%	190	$102.1	(.6)%
High Yield	B1/B	6.6	4.3	8.9%	710	$88.4	(2.1)%

*Intermediate duration

Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

In the short term, bond sentiment has become too optimistic. Historically, bond prices have pulled back from these levels, on average. In recent years, momentum surges have been followed by consolidations, suggesting limited downside price risk after the extreme optimism is corrected.

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.

ALTMAN INVESTMENT MANAGEMENT, LLC
33 Witherspoon Street, 2nd Floor – Princeton, NJ 08540 – (609) 252-0048 – www.AltmanInvest.com