ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JULY, 2016

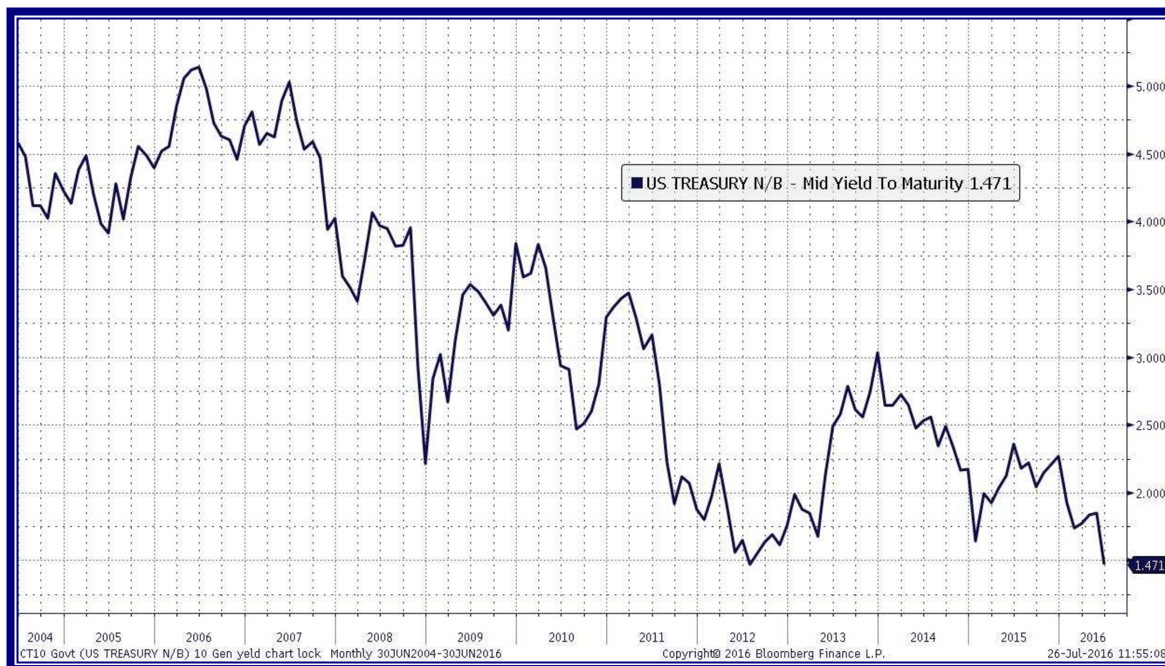
IN BRIEF: The U.S. Fixed Income Markets

At the close of the second quarter, central banks again took a back seat to geopolitics. The United Kingdom unexpectedly voted to leave the European Union, while anti–establishment candidates Bernie Sanders and Donald Trump gained traction in their respective political parties and Trump solidified the Republican presidential nomination. Although the fallout from the Brexit vote has yet to fully materialize, the process of the UK seceding from the EU has elevated macroeconomic and geopolitical uncertainties over continental Europe. Despite the significant backlash to the vote that elevated global financial market volatility, risk assets rebounded quickly to pre-Brexit levels with the U.S. equity market rallying to fresh new record highs. This was coincident with global yields declining to record lows in most countries with the yield on the 10-year U.S. Treasury touching an intra-day low of 1.32%. The precipitous drop in global bond yields resulted in a significant rally in higher yielding assets, with U.S. Corporate high yield and emerging market debt outperforming both equity and treasuries during the quarter.

This run into high yield caused the Federal Reserve to retreat to a more dovish posture in the second quarter, coincident with a softening in labor market data. At the June Federal Open Market Committee (FOMC) meeting, the Fed highlighted the increased level of uncertainty in global markets, which resulted in pushing down Fed rate hike expectations for the year. Following the Brexit vote, the markets almost completely price out any possibility of a rate hike in 2016.

EXHIBIT I

Ten-Year Generic Treasury Yield



Source: Altman Investment Management Research and Bloomberg

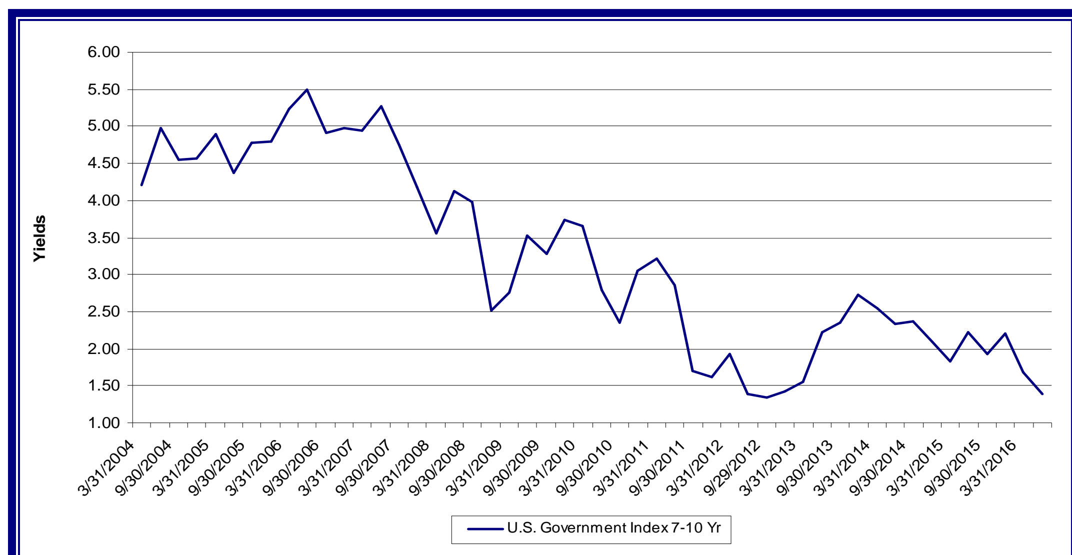
The adverse market reaction to a postponement in normalization policy on interest rates negatively impacted both the European and Japanese banking sectors, and reversed the earlier relative gains made in the first quarter by the U.S. banks as well. New data, released by the Bureau of Economic Analysis (BEA), at or below the targets on inflation and employment will permit the Fed to remain gradual in moving interest rates (fed funds target which is currently 0.25%-0.50%) back to normal (in the range between 3.00%-3.75%). The challenge facing the Fed is that if inflation rises and employment falls, the FOMC will need to satisfy both parts of its dual mandate (promoting economic growth and keeping inflation at low levels). According to fed funds futures, the Fed will raise interest rates (fed funds target rate) by 25 bps at its sixth meeting in 2017 (September 19-20, 2017). Last month futures indicated that the Fed would hike rates at its second meeting of the year on March 14-15, 2017. Economists surveyed by Bloomberg continue to indicate an increase in the fed funds target rate of 25 bps this fall and another 50 bps in 2017.

CLOSE-UP:

Government Bonds

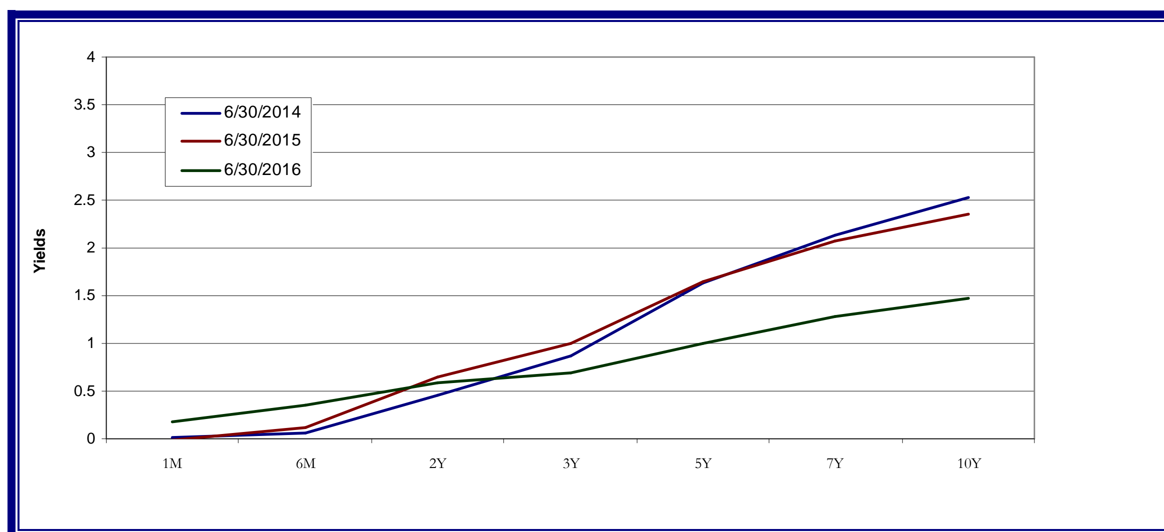
- **The performance record:** Fixed income sector spread levels, with the exception of high yield, have been little changed last quarter. High yield spreads spiked higher by 20 bps as the risk off trade was on list last week. Sector yields declined in line with Treasury yields, with the exception of MBS which fell 14 bps to 1.98% and high yield which rose 14 bps to 6.71%. Year to date returns for intermediate taxable bonds were 3.7% and 3.8% for intermediate municipal bonds.
- **Politics will continue to take center stage in the second half of the year, as the political response to the Brexit begins to take shape and the U.S. presidential cycle draws to a conclusion.** For the Eurozone, the main concern will be the nature of the UK secession resolution and the risk of additional defections from the Eurozone by other participants. Italy has already moved to a referendum vote scheduled for October. The U.S. election brings an additional level of uncertainty that could result in keeping the Fed on the sidelines - with regards to interest rate normalization - until after the election.

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

EXHIBIT IV
Fixed Income Sector Performance – Q2 2016

Fixed Income Sector Performance – 2016 Q2 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing1 12 Month Total Return
Treasury *	Aaa/AAA	8.2	6.4	1.1%	N/A	$108.6	6.7%
Agency	Aaa/AA+	5.0	3.5	1.1%	5	$108.3	3.9%
MBS	Aaa/AAA	4.0	3.7	1.8%	70	$106.0	4.4%
Municipal	Aa3/A+	4.6	3.5	1.1%	0	$112.7	4.2%
Corporate (Intermediate)	A2/A-	4.7	4.2	1.9%	80	$105.2	5.3%
High Yield	B1/B	6.2	4.1	7.5%	640	$95.2	1.7%

**Intermediate Duration*

Source: Altman Investment Management Research and Bloomberg

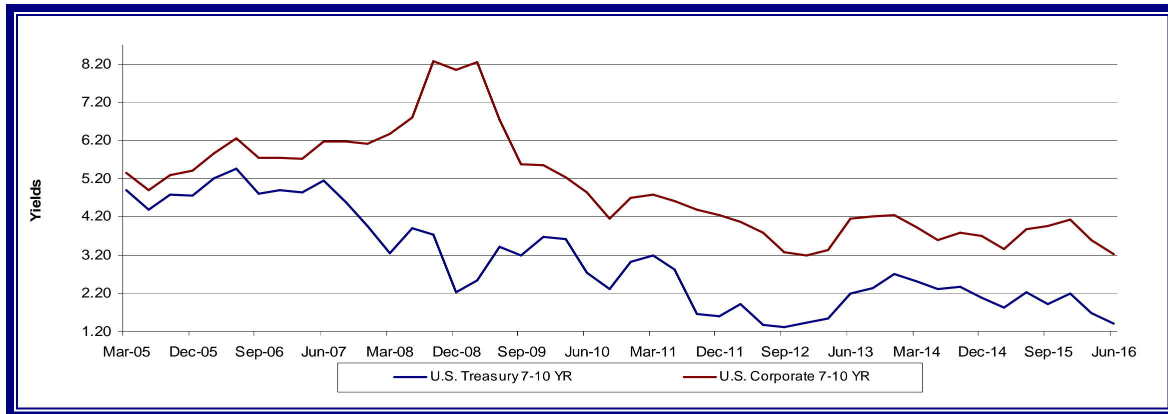
➢ Investment-Grade Corporate Bonds

Investment-grade corporate bond yields declined by five bps last month to 2.77%, while the spread level rose four bps higher at 145 bps over comparable Treasury yields. High yield spreads spiked higher by 20 bps to 540 bps last month, while the yield level increased by 14 bps to 6.71%. Investment-grade corporate bonds indices (duration of 7.5 years) have a 9.26% total return year-to-date and an 8.78% 12-month trailing total return, while high yield has a 12.01% total return this year and a 12-month total return of 4.98%, according to data from Barclay's. Issuance of new investment-grade corporate bond debt was solid as mega deals dominated the market with approximately $25.5 billion of issuance with two issuers accounting for about half of the supply. As has been the case the past few weeks, high yield supply was around $5 billion. Expectations are that supply the next several weeks should be strong as issuers get past the second quarter reporting cycle and very low interest rates are likely to drive issuance levels.

The supply of new corporate bonds cannot keep up with demand and secondary spreads grind tighter on any quiet supply day. This has been the case all summer and may likely continue, absent any major disruption. With a robust merger and acquisition environment, there are expected to be a number of deals in the coming weeks in order to finance these transactions – issuers that may be coming to market include Analog Devices, Bayer, Abbott, Sherwin-Williams, and more. Already on the calendar is Berkshire Hathaway, a deal which is likely to be oversubscribed.

EXHIBIT V

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



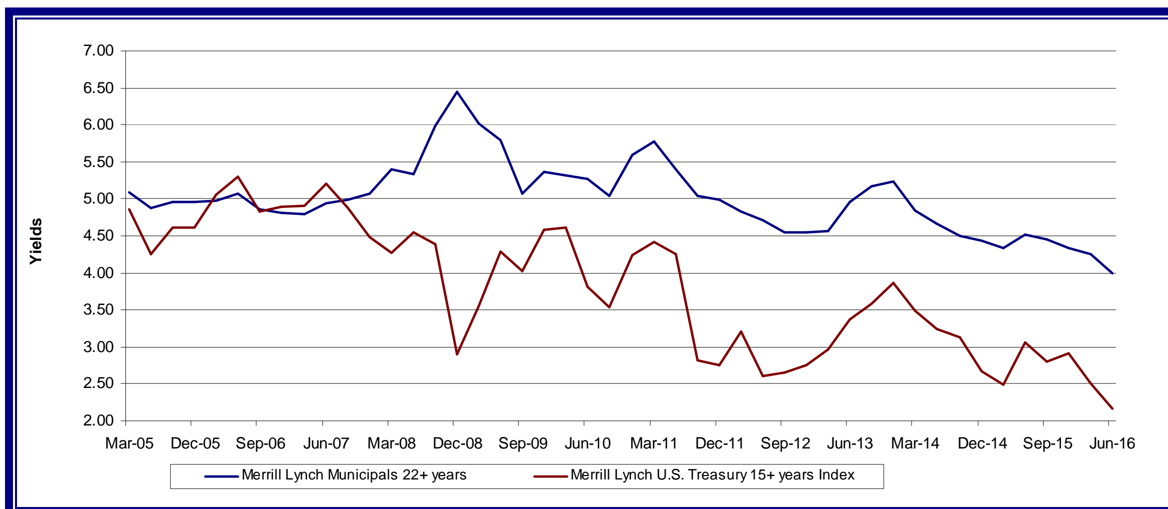
Source: Altman Investment Management Research and Bloomberg

➢ Municipal Bonds

A favorable supply/demand dynamic (specifically, net negative supply) continues to provide support and should help drive munis through the remainder of the summer. We remain positive on the asset class given this technical tailwind as well as munis' ability to act as high-quality, low-volatility portfolio diversifiers. Uncertainty over the Fed's path, U.S. economic data and the upcoming election, to name a few, will likely result in a fairly tight trading range. In this environment, we believe opportunities will be found in the primary market and in intermediate duration strategies. We remain constructive and continue to favor the A-rated space for general obligation bonds, revenue bonds, and the high quality housing, health-care and transportation sectors.

EXHIBIT VI

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

Lower for longer? The outlook for a neutral fed funds rate will once again be visited by Central Bankers at Jackson Hole in what has become a highly anticipated annual event. One issue that is likely to garner considerable attention during the symposium is the outlook for the neutral fed funds rate. Having fallen to record low levels, the neutral rate has garnered intense scrutiny from key Fed officials and the outlook has broad implications for both the likely future path of the fed funds rate and the way in which monetary policy will be conducted in the future.

Our view has not changed over the past quarter. We continue to expect moderate U.S. economic growth, with real GDP advancing at an annual rate of 2.0-2.5%, accompanied by additional employment gains and inflation trending slightly higher but remaining moderate. We still believe that one Fed move might occur after the election this year, and two rate hikes may still be an optimistic expectation for the year. Such an environment is not great for U.S. bonds and we remain cautious on duration. Long bonds yields are trading at all-time lows having produced the highest year-to-date returns in nearly 30 years.

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