

# FixedIncomeQuarterly

MARKET PERSPECTIVES – FIXED INCOME SERVICES

“Be at war with your vices,  
at peace with your  
neighbors and let every  
new-year find you a better  
man.”

– Benjamin Franklin

## Fixed Income Outlook 2016

*In 2016, expect the Treasury yield curve may continue to flatten, due in part to the Federal Reserve’s (Fed’s) “liftoff” intervention on the very short-end, but don’t necessarily expect meaningfully higher intermediate or long-term rates. The fixed income outlook may be a slightly refurbished version of its 2015 prototype: “Looking ahead for 2015, don’t expect rates to rise”. That foreshadowing proved accurate where beyond three years, there were immaterial changes in interest rates throughout the year. Despite small intermittent periods of volatility, the 5- to 10-year part of the curve ended virtually unchanged for the year.*

## **Global Forces**

The bond market is now heavily influenced by global forces, economies, unrest and wars, in addition to more traditional factors such as domestic economic data, politics, and central bank intervention. All of these factors are likely to play a part in how 2016 unfolds.

It may be wise to de-emphasize the use of historic occurrences and/or forecasting models when predicting the market’s future. Formulas are changing. We have entered an era where worldwide central bank intervention is at an unprecedented level. The Federal Reserve’s balance sheet has ballooned from \$880 billion in January 2008 to \$4.4 trillion in November 2015. At a time when the U.S. is beginning to raise short-term interest rates, a wide divergence with international monetary policy exists.

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Interest rate nonconformity will likely tempt large institutions and/or sovereignties to seek the higher rates of U.S. Treasuries, pumping up demand and tempering any quick rise in the world's largest and most liquid market. In addition, Europe is increasing its quantitative easing program, and the general global policy outside the U.S. is one of easing. Japan is the latest country to implement negative rates. One could argue that several Fed rate hikes would merely dampen the U.S. easing policy and not yet be one of tightening.

### Supply

Treasury debt supply will likely be falling in 2016. Furthermore, supply that is issued is projected to be weighted more heavily in bills or short-term notes. The lower supply, long bonds in particular, would contribute to downward pressure on long-term interest rates.

It's not just rates that remain subdued; after four significant rounds of U.S. monetary easing, economic growth remains positive yet muted, perhaps signaling a "new norm".

### The Outlook

It certainly can be argued that the markets have been propped up by artificial means via central bank intervention, leading to limited investment options for those seeking income. Many investors have generally endorsed greater risk, pressing to achieve higher yields while ignoring the safety and stability of traditional fixed income. This works until it doesn't and when it doesn't, the fallout can be loss of capital and wealth (e.g. year-to-date global equity decline).

What bears repeating is that although rising interest rates are alleged to have a destructive total return impact to investment portfolios, in reality they typically have no "realized" negative impact on an investor's wealth. A diversified portfolio of investment-grade bonds is perhaps the only investment that will provide continuous cash flow and income streams as well as return of principal at an agreed upon point-in-time, *regardless of interest rate changes, thus being the ideal asset class to help safeguard one's wealth.*

With all the world's headwinds, it can be anticipated that 2016 will present a large swing toward safety or preservation of wealth. The U.S. is poised to be the market of choice due to its size, liquidity and favorable interest rates. Beyond all the economic factors, the world is well entrenched with its war on terrorism. Nearly every western society and major economic power is affected. With commodity prices falling, MLP and other limited partnerships dropping in value and the reality of an equity pullback, there may be a considerable argument in 2016 to forgo "potential" appreciation and lock in cash flow and yield.

### World Interest Rates

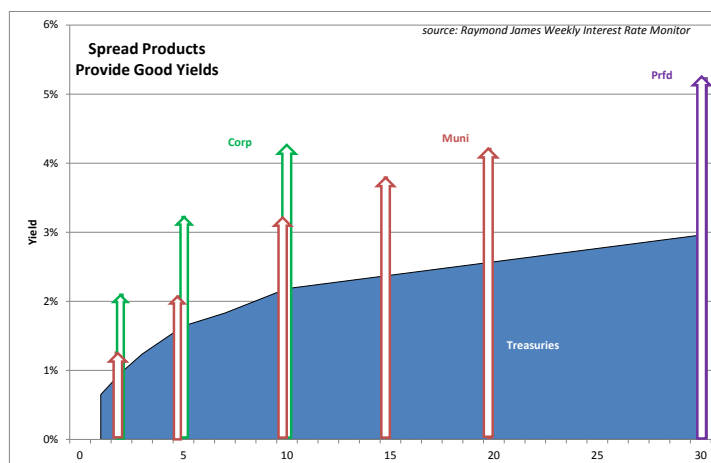
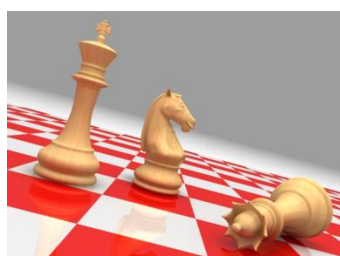
	5-Yr	10-Yr
U.S.	1.297%	1.879%
U.K.	0.889%	1.541%
France	-0.134%	0.640%
Germany	-0.312%	0.305%
Italy	0.444%	1.483%
Japan	-0.111%	0.073%
China	1.126%	1.513%

source: Bloomberg 2/2/16



### The Takeaway:

- Individual bonds are perhaps the only investment that will provide continuous cash flow as well as return of principal regardless of interest rate changes.
- Treasury rates are publicly touted as being low, but spread products enjoy attractive yields.
- A most appropriate plan of action for many investors in 2016 will continue to be a laddered fixed income structure, which levels income and cash flow streams.



### Strategies

A most appropriate plan of action for many investors in 2016 will continue to be a laddered fixed income structure which generally levels income and cash flow streams. Providing continuous and controlled roll-off at regular intervals and may reduce risk and provide reinvestment opportunity. In addition, as interest rates rise, investors can take advantage of higher income/yield when reinvesting.

Credit and duration will continue to be important bond characteristics. Income and cash flow investors who reacted to predictions for higher interest rates may have paid a rather large penalty: they have unnecessarily lowered their yields and created undesirable short reinvestment periods (often into flat or lower interest rates). Listen to your needs, not forecasting hype.

Being too conservative has proven to be a formidable adversary against appropriate portfolio distribution which may capitalize on the belly of the curve. Sixty-two percent of the curve's slope is captured at the 10-year; however, this does not purport that the 10-year is some magical benchmark. Treasury rates are publicly touted as being low but spread products such as corporate bonds, preferred securities and municipal bonds enjoy attractive yields.

Many lower tier investment-grade corporate bonds provide sufficient yield pick-up to higher investment-grade alternatives with only a slight increase in risk. For risk tolerant investors, the high yield corporate space is widening out towards more normalized levels. Supply will continue to challenge investors in 2016. This may be particularly true with longer maturing, higher quality 'credit safe' municipal bonds (10 to 20 year) that provide higher tax-equivalent yields versus most fixed income alternatives.

Overall, successful fixed income strategies rely less on market timing and more on customization. As with last year, the most prominent fixed income dynamic may be the continuation of low interest rates. ■

## 2016 Outlook Credit Perspective

### Low oil prices sharpen regional economic differences

Characteristics of Oil States Vary - Alaska Most Exposed to Low Prices and Declining Activity

	General Fund Reliance on Oil Revenues	Financial Reserves as % of Operating Revenues	Financial Flexibility	Industrial Diversity
Alaska	89%	353.2%	Average	0.19
Louisiana	16%	4.0%	Below Average	0.66
New Mexico	19%	11.7%	Average	0.69
North Dakota	6%	51.3%	Average	0.43
Oklahoma	4%	5.3%	Below Average	0.68
Texas	11%	19.3%	Above Average	0.85

\* Data as of fiscal 2014

Sources: State budget information, audited financial statements and Moody's Investors Service

"Gambling: The sure way of getting nothing from something."

— Wilson Mizner



## Moody's 2016 Public Finance Outlook

Government	Outlook	Notes
States	Stable	State tax revenues to rise 4-5% on average. Most states continue to budget conservatively and maintain reserves.
Local Governments	Stable	Property taxes expected to rise 2-3%. Growing property tax revenue and improving fund balances demonstrate sector's stability
Water & Sewer Utilities	Stable	Debt service ratios to remain in-line with norm. Utilities' willingness and ability to raise rates will support the sector.
Not-for-Profit Healthcare	Stable	Cash flow growth 3-4%. Strong current growth in patient volumes will normalize.
State Housing Finance Agencies	Stable	Margins to remain in 13-15% range. Strong financial performance supported by increase in short-term interest rates and spread widening between assets/liabilities.
Higher Education	Stable	Operating revenue to grow ~3%
Community Colleges (w/Revenue Bonds)	Stable	Revised to stable outlook. Revenue growth 1-3%, stabilizing net tuition revenue.
Not-for-Profit Organizations	Stable	Revised to stable outlook. Operating revenue to growth ~3%.
Independent K-12 Schools	Stable	Operating revenue to grow ~4%. Persistent demand, pricing power.
Transportation Infrastructure, Project Finance and Power Companies		
US Airports	Positive	Airlines will add more seats in 2016, supporting enplanement growth. US economic growth will support demand for US travel.
US Ports	Stable	Container volume expected to rise 3-4%. Low fuel prices and excess container capacity will keep shipping costs low, supporting cargo growth.
US Toll Roads	Positive	Traffic growth expected to grow 3%. Low gas prices and higher toll prices will support toll revenues.
US Public Power Utilities	Stable	Coverage ratios to remain stable and liquidity on hand averages 215 days.

(Source: Moody's, Raymond James)

## Moody's 2016 Corporate Outlook

Financials - Banking		Outlook	Notes
Asset Managers	Stable	Transition to higher interest rate environment, rising demand. Higher costs and leverage but profitability can offset cost stresses.	
Banking	Stable	Capital and liquidity remain sound in response to regulations. Improving labor and housing market support economic growth. Earnings could remain challenged and benefits of any rate rise will be moderate.	
Global Investment Banks	Stable	Capital and liquidity are strong. Tail risks remain from legacy portfolios. Efficiency and profitability will gradually improve. Potential rise in interest rates will alleviate net-interest margin pressures and help fixed income businesses.	
Financials - Insurance			
Life Insurance	Stable	Reduced emphasis on spread-based and guaranteed products will partly offset declining investment margins. Robust equity markets will support income from fee-based services. Stable/declining unemployment should boost demand for sales.	
Property & Casualty	Stable	Continued growth in advanced economies. Low interest rates constrain investment income but promote underwriting discipline.	
Reinsurance	Negative	Excess capital and weaker demand puts pressure on prices.	
Commodities - Oil & Gas			
Drilling & Oilfield Services	Negative	EBITDA down at least 20%. Domestic activity soft, international weakening. Overcapacity and weak demand putting pressure on both business lines.	
Exploration and Production	Negative	EBITDA declines of 20-25%. Pricing uncertainty. Cost reductions being realized. Commodity hedges rolling off adds to cash flow pressures.	
Integrated Oil & Gas	Negative	Slight recovery in EBITDA. Negative free cash flow across group. CapEx spending cuts expected. Debt and asset sales needed to cover negative cash flow.	
Midstream and MLPs	Stable	EBITDA growth flat. Growth capital spending is slowing. De-leveraging becoming more costly as equity markets face volatility.	
Refining & Marketing	Stable	EBITDA to flatten. Reduced distillate demand offsets modest gasoline demand.	
Commodities - Base Metals	Negative	Expect 10-15% decline in EBITDA. Earning contraction, low prices. China slowdown.	
Utilities			
US Public Power Utilities	Stable	Steady leverage coverage. Liquidity on hand is high.	
US Regulated	Stable	Steady cash flow to debt. Cost-recovery and expense cutting will help offset weaker demand.	
US Unregulated	Negative	Power prices are falling. Supply/demand weak in most areas amid new capacity and stagnant growth. Coal and nuclear plants under financial stress.	
Industrials			
Aerospace & Defense	Positive	Profit up 3.5-4.5%. Large commercial aircraft deliveries to grow 4-5%. Global defense spending to grow 2-3%.	
Automotive			
Global Auto Manufacturers	Stable	Light vehicle sales to grow 2.5%.	
North American Automotive Parts	Stable	Increase in light vehicle sales and EBITA growth 3-4%.	
Consumer Discretionary			
Apparel	Stable	Profit to grow 3-5% but USD FX will reduce margins.	
Gaming	Stable	Revenue and profitability have stabilized.	
Lodging & Cruise	Positive	Healthy EBITDA growth of 6-8%. Cruise growth through capacity expansion.	
Restaurants	Stable	Profit expected +2-4%. Cost pressures will weigh on margins. Low gas prices and improving labor markets should support consumer spending.	
Retail	Positive	Operating profit to remain at 5% thanks to efficiencies, sales growth expected +5%.	
Healthcare			
Global Pharmaceuticals	Positive	EBIDA growth 4-5%. Modest patent exposure. Renewal of R&D innovation. Ongoing cost reductions and favorable US pricing trends.	
US Medical Products & Devices	Positive	4-5% EBITDA growth. New products to help offset pricing pressure. Synergies from large-scale M&A. Improved inpatient trends and Medicaid expansion and ACA.	
Homebuilding			
Homebuilding	Positive	Homebuilding sector revenues to grow by >10% for 12-18mo. Margins to expand.	
Building Materials	Positive	Operating income to grow >7% over 12-18mo. Momentum in construction continues.	
Paper & Forest Products			
Market Pulp	Stable	Earnings to grow 1-3%. Lower international prices.	
Paper Packaging & Tissue	Stable	Earnings to grow 0-4%. Packaging demand driven by economic outlook and food consumption. Tissue demand linked to population and hygiene standards.	
Priting & Writing paper	Negative	Earnings to decline 1-4%. Secular paper consumption to decline 5% in mature markets.	
Wood Products/Timberland	Stable	Operating earnings to grow 0-4%. Slower than expected US home construction and weaker log/wood product exports to China.	
Technology, Media & Telecommunications			
Broadcast	Stable	Core ad revenue to grow 0.5-2.5%. Strong political ad revenue.	
Cable	Stable	EBITDA to grow 3-4%, broadband gains offsetting video. Stable margins.	
Information Technology	Stable	Revenue to grow 3%, operating profit 4%.	
Newspaper & Magazines	Negative	EBITDA down, declining demand, consolidation.	
Telecommunications	Stable	Operating income +2%. Wireless revenue 3-4% growth. Stable wireless margins but offset by wireline services.	
Transportation			
Airlines	Positive	Operating margins sustained above 10%. Revenue per passenger to grow.	
Global Shipping	Stable	Single-digit EBITDA growth, mostly due to lower costs. Positive on tankers.	
North American Railroads	Stable	Industry revenue growth of 2.5-3.5%. Higher freight volume and strong core pricing. Headwinds in oil, metals and agriculture.	

(Source: Moody's, Raymond James)

State Tax Rates, Ratings & Relative Strength						
	Highest Tax Rate	Moody's Rating	S&P Rating	Cities	School Districts	Counties
Alabama	5.00%	Aa1	AA	Strong	Strong	Strong
Alaska	0.00%	Aaa	AA+ Jan downgrade	NR	NR	Strong
Arizona	4.54%	Aa2 May upgrade	AA May upgrade	Strong	Moderate	Strong
Arkansas	6.90%	Aa1	AA	Moderate	Moderate	NR
California	13.30%	Aa3	AA- July upgrade	Moderate	Moderate	Moderate
Colorado	4.63%	Aa1	AA	Strong	Moderate	Strong
Connecticut	6.99%	Aa3	AA Mar negative outlook	Strong	Strong	NR
Delaware	6.60%	Aaa	AAA	Strong	NR	Strong
Florida	0.00%	Aa1	AAA	Strong	Moderate	Strong
Georgia	6.00%	Aaa	AAA	Very Strong	Strong	Very Strong
Hawaii	11.00%	Aa2	AA	NR	NR	Strong
Idaho	7.40%	Aa1	AA+	Strong	Moderate	Strong
Illinois	3.75%	Baa1 Oct downgrade	A- Dec negative outlook	Moderate	Moderate	Moderate
Indiana	3.30%	Aaa	AAA	Moderate	Moderate	Moderate
Iowa	8.98%	Aaa	AAA	Very Strong	Strong	Very Strong
Kansas	4.60%	Aa2	AA	Strong	Moderate	Strong
Kentucky	6.00%	Aa2	A+ Sept downgrade	Strong	Moderate	Strong
Louisiana	6.00%	Aa2	AA Feb negative outlook	Strong	Strong	Strong
Maine	7.15%	Aa2	AA	Strong	Strong	Moderate
Maryland	5.75%	Aaa	AAA	Very Strong	NR	Strong
Massachusetts	5.10%	Aa1	AA+ Nov negative outlook	Strong	Moderate	Moderate
Michigan	4.25%	Aa1	AA- July positive outlook	Moderate	Weak	Moderate
Minnesota	9.85%	Aa1	AA+ Aug positive outlook	Strong	Moderate	Strong
Mississippi	5.00%	Aa2	AA	Strong	Moderate	Very Strong
Missouri	6.00%	Aaa	AAA	Strong	Strong	Strong
Montana	6.90%	Aa1	AA	Strong	Strong	NR
Nebraska	6.84%	Aa2	AAA	Strong	Moderate	Very Strong
Nevada	0.00%	Aaa	AA	Strong	Moderate	Strong
New Hampshire	5.00% *	Aa1	AA	Strong	Strong	Strong
New Jersey	8.97%	A2	A	Strong	Moderate	Strong
New Mexico	4.90%	Aaa	AA+	Moderate	Moderate	Strong
New York	8.82%	Aa1	AA+	Moderate	Moderate	Moderate
North Carolina	5.75%	Aaa	AAA	Very Strong	NR	Very Strong
North Dakota	2.90%	Aa1	AAA	Strong	Moderate	Strong
Ohio	5.00%	Aa1	AA+	Moderate	Moderate	Moderate
Oklahoma	5.25%	Aa2	AA+	Moderate	Moderate	Moderate
Oregon	9.90%	Aa1	AA+	Strong	Moderate	Strong
Pennsylvania	3.07%	Aa3	AA-	Strong	Weak	Strong
Rhode Island	5.99%	Aa2	AA	Moderate	Moderate	NR
South Carolina	7.00%	Aaa	AA+	Strong	Strong	Strong
South Dakota	0.00%	Aa2	AAA May upgrade	Strong	Strong	Strong
Tennessee	6.00% *	Aaa	AA+ Oct positive outlook	Very Strong	Strong	Very Strong
Texas	0.00%	Aaa	AAA	Strong	Strong	Very Strong
Utah	5.00%	Aaa	AAA	Strong	Strong	Strong
Vermont	8.95%	Aaa	AA+	Very Strong	NR	Very Strong
Virginia	5.75%	Aaa	AAA	Strong	Moderate	NR
Washington	0.00%	Aa1	AA+	Strong	Strong	Strong
West Virginia	6.50%	Aa1	AA	Strong	NR	Strong
Wisconsin	7.65%	Aa2	AA	Moderate	Strong	Strong
Wyoming	0.00%		AAA	Strong	NR	Strong
* Interest and dividends only. All noted rating changes occurred in 2015 except Alaska.						
Source: State Websites, Moody's Senior Most Tax Backed Rating, Standard & Poor's Rating Service January 7, 2016. Highest tax rates are as of date of publication and are all subject to change.						

### *Strategy Talk Simplified*

For many years we've been bombarded with the idea that interest rates have but one way to go... up; however, the reality is that all those predictions have been wrong. Decisions are often made with considerations that become discarded certainties. Numerous recommendations have suggested either lowering duration or completely staying out of fixed income securities, both suggestions that have not fared well over the past several years.

Our *strategy talk* suggests leaving prognosticating out of the equation. The one constant over the years is that we all are terrible at predicting the future. Know what you own and why you own it. A portfolio's allocation to fixed income preserves wealth and provides the predictable cash flow and income to do so. Trying to achieve this through other means doesn't always work out. According to a January 2016 article appearing in the Chicago Tribune (*Choe, Stan. "Dividends on the Chopping Block as Profit Growth Peters Out" Associated Press*), about 500 companies cut or halted their dividends last year. In addition to a board of directors determined dividend, those companies that cut dividends usually don't do so because profits and growth of the company are thriving, suggesting that the equity price may be under equal stress. Monies committed to growth should be in growth potential assets just the same as monies dedicated to preservation of wealth and/or income may be better invested in individual fixed income investments.

Among all the reasons that fixed income protects wealth, the two key characteristics to invoke are: the stated maturity and the predictable cash flow and income. When a company announces the amount of dividends they will pay their stockholders, it is determined only after their non-optional interest payments are made to bond holders. The feast and/or famine payments that make growth assets desirable for growth reasons are just different than the more predictable wealth preservation assets. Again, know what you own and why you own it.

**Effective Maturity vs. Stated Maturity:** A stated maturity is simply when the bond is scheduled to mature. If a bond includes a call option and that call is likely to happen, the shorter effective maturity will reflect when the face value is likely to be returned. In a rising rate environment, bonds that once were "expected" to be called and reflect a shorter effective maturity, may all of a sudden extend out, creating a very different time line (longer) than what may have been expected.

What to do: Consider bonds with longer or no calls to provide an effective maturity closer to the stated maturity. This will allow the portfolio to generate and collect the income longer which is desirable in a flat and/or falling interest rate environment. ▀

"The journey of a thousand miles begins with one step."

– Lao Tzu





$$\begin{array}{c} \text{Coupon} \\ \times \\ \text{Face Value} \\ = \\ \text{Cash Flow} \end{array}$$

### Accuracy of Predictions?

“As the Olympic torch neared Lake Placid, N.Y. in 1980, signaling the opening of that year’s Winter Olympics, newspapers and magazines throughout the world offered predictions who would win medals in the major sports. Not a single publication gave the American men’s hockey team a chance against the world powers.”

– Don Yaeger

$$\begin{array}{c} \text{Yield} \\ \times \\ \text{Dollars Invested} \\ = \\ \text{Income} \end{array}$$

**Cash Flow vs. Income:** Income is what a bond earns (the yield) and cash flow is what money a bond is paying (the coupon). The coupon times the face value of a bond determines the amount of cash flow generated by a bond. In practice, some of this cash flow may represent income and some of it may represent return of premium paid. Income is calculated by multiplying the yield times the amount of an investment. Income or yield is what the bond holder is earning.

What to do: Always remember that yield trumps all other characteristics. Do not sacrifice yield for other characteristics which are usually coveted because of their beneficial features under certain circumstances. For example, we have preached the benefits of a high coupon bond in that it generates a greater cash flow which in turn may be invested more quickly in a rising interest rate environment. The assumption is that given a choice between two bonds with the same yield where one is a high coupon (say 5.00%) and one is a lower coupon (say 3.00%), the higher coupon bond will benefit the investor as interest rates rise. High coupon bonds have afforded similar or even better yields; however, if a lower coupon bond provides a significantly better yield, that income is realized (actual) and not predicated on whether rates will rise. The market has shifted and the yield-to-worst and sometimes the yield-to-maturity on many higher coupon bonds pale by comparison.

**Duration Drift:** *Modified duration* measures the price sensitivity of a bond. A duration of 2, in simplified terms, means that for every 1% or 100 basis point (bp) move in interest rates, a bond holder can expect about a 2% move in the bond’s market price. In other words, if interest rates rise 1%, the bond price will fall about 2% for a bond with a duration of 2. In a low interest rate environment, it may be assumed that a high coupon bond will get called before the stated maturity on its call date. If interest rates rise significantly, that assumption may go away. The bond may now “drift” to its much longer stated maturity, increasing its duration and subjecting it to a much greater price fluctuation.

What to do: Again, know what you own. If interest rates remain flat and low, many of the call options will play out and the bonds will be redeemed early. If interest rates rise, some bonds will extend to being redeemed on their longer stated maturity dates. Look for bonds with more call protection or with no calls to reduce or eliminate duration drift. ■



### A Deeper Dive Into Yield

Finding portfolio appropriate bonds encompasses a wide variety of criteria including: maturity, duration, coupon, issuer, rating, optionality, sector, and yield. Individual goals (purpose) and risk tolerance are driving forces for bond suitability. There is no “perfect” bond. For example, the bond perspective of a 50 year old not requiring any income from a \$2,000,000 portfolio is very different than that of a 75 year old, dependent solely on income sourced from a \$500,000 fixed income portfolio. The point is that all bond characteristics require independent analysis for each unique investor.

Optimizing yield is the ultimate goal, yet a more insightful way to view this would be the goal to optimize yield given an individual’s risk profile. Working backwards, a bond’s yield may be a very telling piece of information in that yield reflects a bond’s worth based on the combination of all the characteristics of maturity, duration, coupon, issuer’s credit worthiness, etc.

Assume there are two seemingly similar bonds with the same coupons, similar call structures and the same maturities, yet one is yielding 2.5% and the other 6%. Obviously there is a difference of risk not explained by the bond structures. The yield difference alerts us to further inquiry.

Perhaps one of the issuers is exposed to a possible takeover or merger. Maybe a sector is exposed to market barriers. It may be pending litigation or overexposure to an emerging market economy that is struggling. There are many reasons potentially explaining why two seemingly similar bonds with similar characteristics have this yield divergence but that discrepancy can direct the attention to defining the risks and determining appropriateness.

By defining risk and evaluating whether that risk is acceptable, an investor can optimize their return (yield). Although Treasury yields are flat to falling, most buy-and-hold investors purchase spread product such as corporate bonds, municipal bonds, CDs, preferred securities and agency bonds. Spreads are widening meaning the yields on spread products are holding despite the general Treasury yield decline. ■

Corporate Spreads Widening			
Sector/AvgMat	Now	1yr Ago	YTM
<b>AA-Rated 9y</b>	109	82	2.63%
Finance 6y	92	78	2.16%
Industrial 10y	113	84	2.75%
Utility 14y	130	79	2.99%
<b>A-Rated 10y</b>	142	82	3.04%
Finance 7y	128	78	2.70%
Industrial 11y	152	84	3.19%
Utility 16y	143	79	3.46%
<b>BBB-Rated 10y</b>	261	191	4.24%
Finance 8y	194	174	3.41%
Industrial 11y	312	203	4.78%
Utility 13y	213	161	3.93%

source: YieldBook, Raymond James as of 2/1/16

AAA Municipal G.O.			
	YTM	TEY	1yrAgo
1yr	0.40%	0.66%	0.23%
2yr	0.66%	1.09%	0.68%
5yr	1.00%	1.66%	1.56%
10yr	1.71%	2.83%	2.90%
15yr	2.16%	3.58%	3.58%
20yr	2.44%	4.04%	3.94%
25yr	2.69%	4.45%	4.12%
30yr	2.75%	4.55%	4.21%

taxable equivalent yield based on 39.6% bracket

source: Bloomberg, MMD, Raymond James 2/1/16

“Never make predictions, especially about the future.”

– Casey Stengel

### Muni Default Rates

IG Moody's Rated Issuers			
	1-Yr	5-Yr	Issuers
General Obligation			8,600
AAA	0.00%	0.00%	
AA	0.00%	0.00%	
A	0.00%	0.01%	
Baa	0.01%	0.03%	
Non-GO			8,400
AAA	0.00%	0.00%	
AA	0.00%	0.01%	
A	0.01%	0.06%	
Baa	0.02%	0.29%	

source: Moody's Data Report July 2015

### Corporate Default Rates

Investment-Grade Default Rate			
	1-Yr	5-Yr	Issuers
Global	0.06%	0.90%	8,857
N. America	0.00%	0.07%	4,146
Europe	0.00%	2.38%	2,517
Asia-Pacific	0.00%	0.00%	1,165
Industrials	0.00%	0.00%	4,122
Finance	0.00%	1.85%	3,038
Utilities, Sov & Project Fin	0.21%	0.25%	1,691

source: Moody's Data Report January, 2016

### Trending News:

#### Public Finance

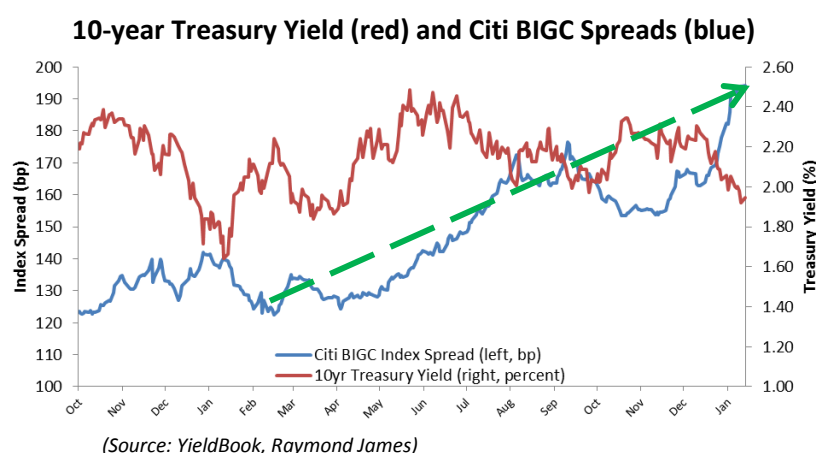
- S&P's 3<sup>rd</sup> quarter 2015 marked the 12<sup>th</sup> straight quarter of more upgrades versus downgrades. (S&P)
  - Stronger finances reason in 198 of 285 upgrades.
  - Deteriorating finances and liquidity main reasons for downgrades.
  - California led way with 90 upgrades.
- Seven rated bond issues defaulted. (S&P)
  - Puerto Rico Public Finance Corporation defaulted on 4 series (August).
  - Dowling College, Charter School of Boynton Beach and Stockton Redevelopment Agency, CA each defaulted.
- S&P 3<sup>rd</sup> quarter upgrade/downgrade: Local governments 159 upgrades/50 downgrades; Utilities 29 upgrades/21 downgrades; Not-for-profit health care 18 upgrades/4 downgrades; Higher education 10 upgrades/18 downgrades; Charter schools 2 upgrades/5 downgrades; Transportation 11 upgrades/2 downgrades.
- States upgraded 2015: Arizona (Aa2/AA, Moody's/S&P); California (AA-, S&P); South Dakota (AAA, S&P).
- States downgraded 2015: Illinois (Baa1, Moody's); Kentucky (A+, S&P); Alaska (AA+, S&P/2016).
- Federal budget (2016) maintains Public Housing Capital Fund appropriation at \$1.9 billion (4<sup>th</sup> consecutive year). Protects revenue stream of Public Housing Authorities (PHAs). Historically, capital funding for public housing is vulnerable to appropriation cuts. Levels cut 8 times from 2001-2013. It stabilized in 2013 and has remained flat. This has been credit positive. (source: Moody's)

#### Corporate

- Moody's placed 175 energy and mining companies on review for possible downgrade (January 21).
- Moody's lowered their forward price projections across the commodities spectrum. The range of possible outcomes upon conclusion of the review for given issuers varies from possible confirmation of ratings to multi-notch downgrades.
- North American one-year investment-grade corporate default rate = 0.00%. Five-year = 0.07% (source: Moody's)
- North American one-year [Caa-C] default rate = 4.90%. The five-year default rate [Caa-C] = 23.26%. (source: Moody's) ■

## Corporates: Sector Analysis and Current Value

**Treasuries are flat, corporate yields are UP!** The Fed “liftoff” in December did help the shortest part of the yield curve move higher, but the longer-end has a mind of its own. One of the most popular benchmarks, the 10-year Treasury yield<sup>1</sup> is down by 61bp since October 2014 when we first ran this scan and YTD is down ~41bp. Market pundits and financial journalism will focus on the Treasury market as a proxy for yields, but this is only one side of the story. For those looking for higher yields, look no further than the corporate bond market; yield spreads have increased considerably helping to offset stubborn Treasury yields. As proof, the Citi Broad Investment Grade Credit Index (Citi BIGC) has a current spread of +195bp, the highest level in the post-recession and post-Quantitative Easing (QE) era<sup>2</sup>. This is up from the +140bp level seen this time last year and well above the +120bp seen in late 2014.



As noted in the chart above, nearly any way you look at it, the 10y Treasury yield (red line) is roughly flat while credit spreads are up dramatically. Remember the premise: Treasury + spread = corporate yield. Therefore, yields in corporate credit are actually up. Putting it all together; Treasury yields are flat or slightly down, but spreads are wider (higher) meaning corporate bond yields are higher in 2016.

Next, we examine which specific industries offer the most compelling opportunities in the corporate sector. The Citi BIGC Index is comprised of three broad industries: industrials, utilities and finance, which are comprised of 45 smaller and more specific sectors.

*(continued on next page)*



**GOOD NEWS!**  
This section will now be updated each quarter!

### A refresher on spreads:

Within fixed income, spread is the comparison between two bonds where one bond is the base rate or index. Often, Treasuries are the base rate of comparison. If the 10-year Treasury yield is 2.00% and a comparison 10-year corporate bond is trading with a spread of 150 basis points (150bp), it means the corporate bond is trading with a yield of 3.50% (2.00% Treasury yield + 150bp (spread) = 3.50% corporate yield).

“I figure lots of predictions is best. People forget the ones I get wrong and marvel over the rest.”

– Alan Cox

<sup>1</sup> As of 2/5/16. The 10-year Treasury was chosen as a comparable benchmark as it bests matches the 10.5 year average maturity of the BIG Credit Index.

<sup>2</sup> This is the highest sustained level since the Sep-Dec 2011 period.

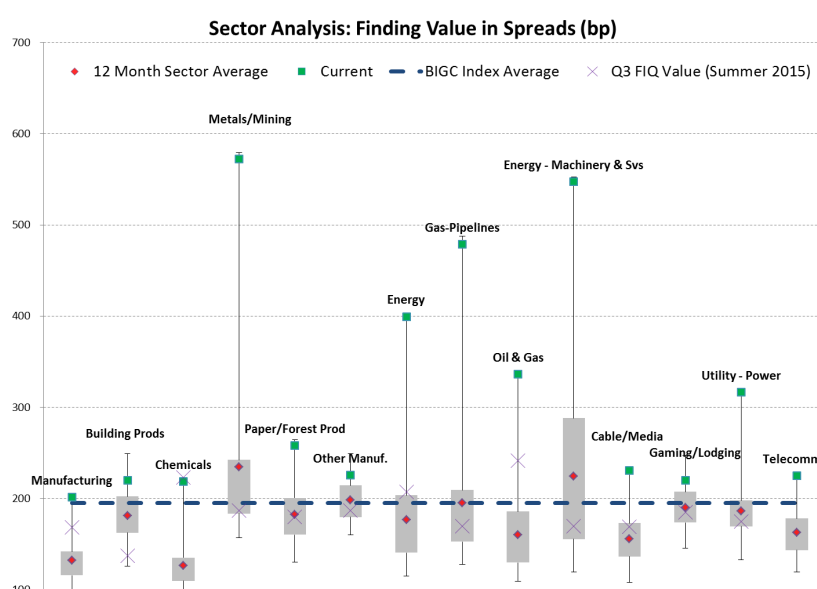


“Price is what you pay.  
Value is what you get.”

– Warren Buffet

**The Takeaway:** Treasuries provide a base rate but spread products, such as corporate bonds, provide a considerable yield pick-up to Treasury rates.

The chart below details those sectors that currently provide yield spreads above the 195bp offered by the broad index (the dotted blue line). For comparison, the year-over-year average index spread is 140bp. Each sector is represented by a grey box (middle 50% of observations) as well as two “whiskers” representing the high and low spreads seen over the last year. The green and red markers are the current and average yield spread respectively. What does the chart show us? Each of the highlighted sectors currently has yield spreads (green dot) above its own multi-year average (red dot), many substantially so. For those investors seeking yield and where it is appropriate, these sectors offer yields well above their investment grade peers. Keep in mind, additional spread may indicate additional risk.



The Basis and Spreads associated with this graph are explained in the paragraphs above. Larger view available on page 16. (Source: YieldBook, Raymond James)

So what is the highlight from the chart? Sectors including: building products, chemicals (new to the list), metals/mining, paper/forest products, manufacturing, gas-pipelines, energy-machinery, cable/media, utilities and telecomm all have spreads higher than the index average and provide outsized yields for those willing/able to assume additional risk/volatility.

We continue to live in a world where it remains uncertain as to when, or if, rates will rise significantly in the near future. Searching for higher yields now? Consider investing in those areas in the investment grade market that are exhibiting wider than normal spreads. Pair this additional spread with the recent rise in Treasury yields, and they pack a powerful one-two-punch resulting in the highest investment grade yields in several years. A larger view of this chart, along with a list of industries/sectors and issuers can be found in Appendix B on page 14. ■

### Plans of Action

**Know What You Own:** Fixed income securities have provided one of the better total returns over the past couple of years; however, don't be sucked into believing this is their primary purpose. Equities, for example, will always carry a much higher potential for price growth and thus greater total return than fixed income securities. Unfortunately, recent history is demonstrating that with greater upward potential also comes greater potential for principal loss. Fixed income securities provide a known cash flow and income stream with a stated maturity and return of face value. This is their strength just as growth is equity's strength. Don't try to substitute one for the other based on a brief moment in time. Think long-term when investing.

**Spread Products Are Delivering:** We are at historically low Treasury interest rate levels. It is hard to be excited about 2.00% yields. This is not always about growing wealth but sometimes about not losing wealth. Spreads have widened on many products, so although Treasury yields seem dismal, corporate bonds, municipal bonds, CDs on the short-end and preferred securities are offering reliable income at levels well above Treasury rates in a market with minimal negative inflation effect.

**Laddered Portfolios:** Simply put, rate predicting is speculating. Don't speculate with the portion of your portfolio which is the foundation of your wealth and retirement. Investing in securities which are going to protect if 'xyz' occurs may prove harmful to one's wealth. Invest the foundation portfolio dollars based on today, not what you think might happen tomorrow. A laddered portfolio may prevent the need for forward projection, possibly provide a higher return and allow continual portfolio roll-off to be reinvested under whatever changing interest rate environment occurs.

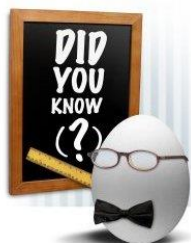
**Don't Stuff Your Money Under the Mattress:** We don't want to guess interest rates but we need to recognize our surroundings. Examine the current environment: All economic powers, with the exception of the U.S., are currently easing monetary policy. The dollar continues to stay strong, thus impeding corporate profits. Inflation remains a "non-factor". Growth in China, the largest commodity consumer, is completely in a downward spiral. Commodity demand is low and therefore prices and commodity companies are getting pummeled. Oil continues to be weak. Equities are already down 7% on the year. Is there any reason to believe interest rates will be significantly higher in the foreseeable future? Of course we don't know. We do know that sitting on the sideline will provide no return. Stay invested, stay the course. Despite the contrary proclamation, duration has actually been an investor's friend over the past several years. ▀



"If you do not change direction, you may end up where you are heading."

– Gautama Buddha





*“Every client with the means to properly diversify, can have a customized bond portfolio that will perform as intended regardless of interest rate moves.”*

- FISG of Raymond James

#### Investments we cover:

- Treasuries/Agencies
- Brokered CDs
- Corporate bonds
- MBS/CMOs
- Tax-exempt municipals bonds
- Taxable municipal bonds
- Preferred securities

### Additional Fixed Income and Strategy Resources

**Doug Drabik** - Sr. Fixed Income Strategist

**Benjamin Streed, CFA** - Fixed Income Strategist

**Drew O’Neil** - Fixed Income Strategist

The Fixed Income Strategy Group provides market commentary, portfolio analysis and strategy to Raymond James advisors for the benefit of their clients. We are part of the larger 13 person Fixed Income Services Group (FISG).

RaymondJames.com is a vast resource for those seeking fixed income market commentaries, strategies, education materials and index/yield data. Please visit our public webpage at <http://raymondjames.com/fixin.htm> for popular resources which include:

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#### From ZIRP to NIRP

By Benjamin Streed, CFA  
February 1, 2016

Much of the developed world has undertaken so-called “zero interest rate policies”, or ZIRP for short, in the aftermath of the great recession to help stoke inflation and ease the balance sheets of the global banking system. As many would argue, this did not work as intended. Instead of targeted inflation near the Fed’s ideal 2% we have the consumer price index (CPI) sitting at a meager 0.70% year-over-year thanks in no small part to the dramatic decline in oil prices. Meanwhile, many gauges of inflation expectations are at multi-year lows with several being at their lowest levels since Ben Bernanke unveiled “QE2” in late 2010. Remember, QE programs were large-scale asset purchases intended to hold down interest rates in hopes of fueling inflation. Finding inflation is the proverbial “needle in the haystack”; the Fed’s preferred measure of forward inflation, the 5y/5y forward swap rate, sits at only 1.89%. This is not only the lowest reading in the post-QE world it is the lowest reading ever. Another measure, 30-year inflation breakeven rates, sit at a mere 1.61%, the lowest since the crisis. In other words, markets are betting we will not see more than 1.61% inflation on average over the next 30 years. Clearly, the markets are concerned with low inflation/growth for a long period of time.

#### 5y/5y Inflation Expectation and the 10yr Treasury Yield (yellow)

(Source: Bloomberg LP, Raymond James)  
[Click here to enlarge](#)

So what is causing such pessimism in the marketplace? Open any newspaper to get a quick feel for what’s causing general unease in the marketplace but one massive move last week took us into uncharted territory. The Bank of Japan (BOJ) voted in favor of implementing a -0.10% rate (or charge) on excess reserves stored by financial institutions at the central bank. More importantly, the BOJ explicitly stated it would be willing to cut the rate further into negative territory if deemed necessary. Cutting



## Appendix A

### 2015 Federal Tax Rates

	Single	Married Joint	Head of Household
<b>10%</b>	Less than 9,225	Less than 18,450	Less than 13,150
<b>15%</b>	9,225 - 37,450	18,450 - 74,900	13,150 - 50,200
<b>25%</b>	37,450 - 90,750	74,900 - 151,200	50,200 - 129,600
<b>28%</b>	90,750 - 189,300	151,200 - 230,450	129,600 - 209,850
<b>33%</b>	189,300 - 411,500	230,450 - 411,500	209,850 - 411,500
<b>35%</b>	411,500 - 413,200	411,500 - 464,850	411,500 - 439,000
<b>39.60%</b>	More than 413,200	More than 464,850	More than 439,000

### Capital Gains Tax Rates

Holding Period	Maximum Rate	Effective Maximum Rate with 3.8% Surtax
Assets Held One Year or Less	39.6%	43.4%*
Assets Held More Than One Year and Sold by Individuals in the 39.6% Tax Bracket or Above	20.0%	23.8%*
Assets Held More Than One Year and Sold by Individuals in the 25% to 35% Tax Brackets	15.0%	18.8%**
Assets Held More than One Year and Sold by Individuals in the 15% Bracket or Below	0.0%	0.00%

\* The additional 3.8% Medicare surtax will apply to these taxpayers.

\*\* The additional 3.8% Medicare surtax may apply to these taxpayers.

### Alternative Minimum Tax (AMT)

Filing Status	AMT Exemption 2015	AMT Exemption Threshold 2015
Married Filing Jointly and Surviving Spouses	\$83,400	\$158,900
Single or Head of Household	\$53,600	\$119,200
Married Filing Separately	\$41,700	\$79,450

Annual Gift Tax Exclusion: \$14,000

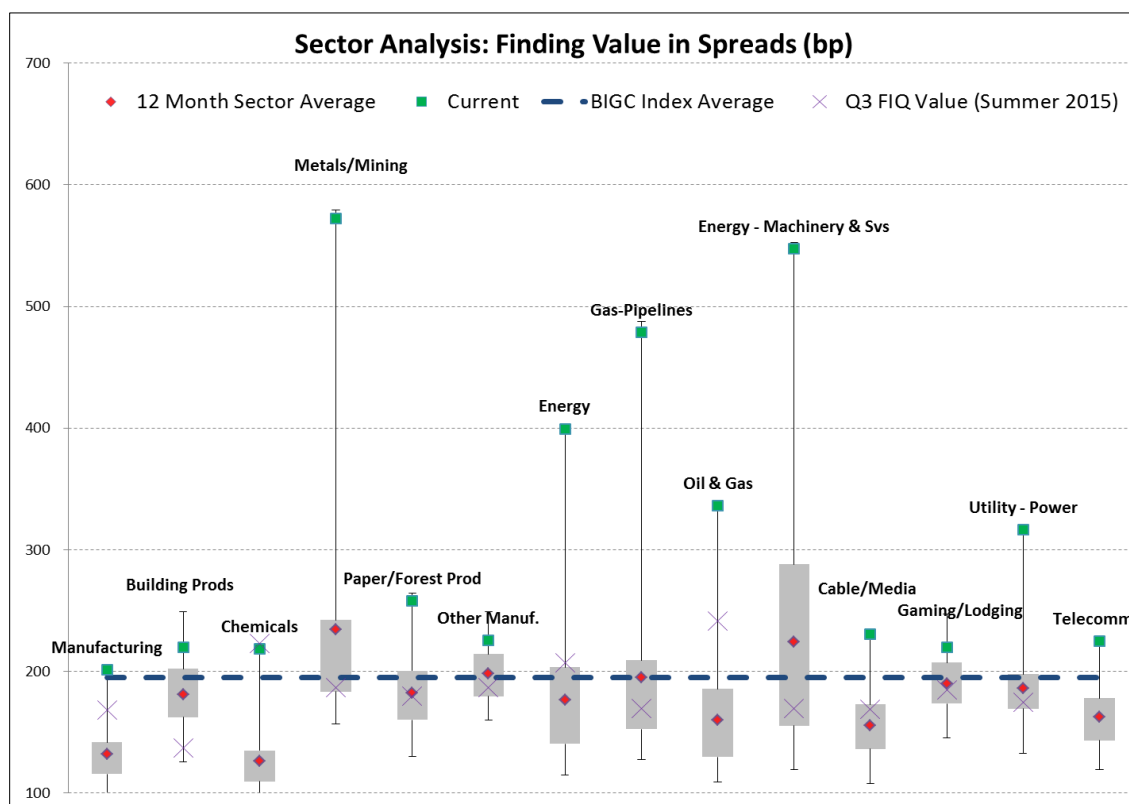
Estate Tax Exclusion: \$5,430,000

Source: Raymond James: ["2015 Tax and Financial Planning Flier"](#)

Consult your professional tax advisor for questions relating to your individual situation.

Appendix B (refer to page 11-12 for corresponding article):

Industry	Sector/Subgroup	Example Issuers
Industrials	Manf.	Building Products    Carlisle, CRH, Mohawk Industries, Stanley Black & Decker
		Chemicals    CF Industries, Cabot, Dow Chemical, DuPont, Eastman Chemical, Monsanto, Mosaic, Sherwin-Williams
		Metals/Mining    Barrick Gold, BHP Billiton, Freeport-McMoran, Goldcorp, Newmont Mining, Rio Tinto, Southern Copper, Teck Resources, Vale
		Paper/Forest Products    Domtar, Georgia-Pacific, International Paper, Packaging Corp of America, Weyerhaeuser
		Other Manufacturing    Eaton, Ford Motor, Johnson Controls, MeadWestvaco, NVR, Rock-Tenn, Sonoco Products, Whirlpool
	Energy	Integrated    BP, Chevron, ConocoPhillips, Exxon Mobil, Statoil
		Pipelines    Kinder Morgan, Oneok, Plains All American, Sunoco Logistics, Williams Partners
		Exploration/Production    Continental Resources, Noble Energy, Murphy Oil, Canadian Natural Resources
		Services/Equipment    Cameron International, Ensco, Nabors, Noble(NE), Weatherford
	Service	Cable/Media    CBS, Comcast, Cox Communications, Discovery Communications, NBC Universal, Time Warner Cable Viacom, Walt Disney Co.
Gaming/Lodging    Carnival Corp, Host Hotels, Hyatt, Marriott, Starwood Hotels, Wyndham		
Utilities	Utility	Utility - Power    Dominion, Entergy, Exelon Generation, Southern Power
		Telecomm    AT&T, Nippon, Qwest, Verizon, Vodafone
		source: Raymond James



The Basis and Spreads associated with this graph are explained in the paragraphs on page 11-12.  
(Source: YieldBook, Raymond James)

The author of this material is a Trader in the Fixed Income Department of Raymond James & Associates (RJA), and is not an Analyst.

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