Fixed Income

Quarterly Market Commentary — Third Quarter 2015

The U.S. economy expanded at a 2.3% annual rate in the first half of 2015 after final revisions showed modest growth in the first quarter. Goods consumption remained healthy and housing activity supported further advances in residential fixed investment. While the underlying strength of the domestic economy remains evident, growth expectations for the second half of 2015 are moderating due to the influences of a strengthened dollar and global macro concerns.

The Federal Reserve's September policy statement and its decidedly more pessimistic narrative drove yields across the U.S. Treasury curve lower during the quarter; longer rates fell significantly while the Treasury yield curve (2s/10s and 2s/30s) flattened. A disappointing September jobs report brought average payroll growth below 200,000 on a three- and six-month basis and heightened concerns that "lift-off" may now be pushed out into 2016 (one in three chance of a move by the end of 2015 based on Fed fund futures).

Commodity prices dropped considerably in the third quarter as concerns about China's growth contributed to a broader equity market correction. The CBOE Volatility Index (VIX) spiked in mid-August and remains elevated relative to the low levels, which have persisted for much of the last 18 months. Credit spreads across both investment-grade and high-yield bonds moved broadly wider during the quarter, compounded by the acute challenges across the commodity and energy sectors.

We will discuss in greater detail below the four major factors that we analyze when formulating our strategy for our clients' portfolios:

- Monetary Policy
- Fiscal Policy
- Inflation Expectations
- Volatility

Monetary Policy

Chairman Yellen's late-July speeches and Congressional testimony suggested the Fed was on a course to begin policy normalization as early as September. However, higher volatility in financial markets, increasing concerns about falling commodity prices, and slowing global growth temporarily drove U.S. Treasury yields lower. By mid-September, world market stabilization allowed Treasury yields to retrace much of the decline over the course of the quarter. In particular, the 2-year Treasury note (which should be most impacted by a change in Fed funds) rose to a four-year high of more than 80 basis points (bps).

In September, the Federal Open Market Committee (FOMC) decided to not raise the fed funds rate, lowered near-term inflation expectations and downgraded its forecasts for economic growth. The Committee further expanded on the discussion of global financial markets illustrated in the minutes of the July meeting. Many market participants were surprised by an explicit reference to "monitoring developments abroad" as a qualifier to the Committee's risk assessment as it is not part of the Fed's dual mandate.

Expectations for an initial increase in the fed funds rate during 2015 diminished and the December contract now yields less than 20bps. Based on the FOMC's September "dot plot" forecast, the majority of participants indicate the Committee will begin increasing the target rate this year. More importantly, market-based yields for the evolution of the fed funds rate over the course of 2016 remain well below the Committee's indicated pace.

Fiscal Policy

Fiscal policy has not been a significant source of volatility for more than a year. However, the resignation of Speaker Boehner and clarity around who may take up the gavel for the Republican conference could introduce added uncertainty around upcoming negotiations on the debt ceiling ("extraordinary measures" expire in early November) and the federal budget (December 11, 2015). These could introduce additional risk factors for Federal Reserve policymakers to consider when discussing the appropriate timing of "lift-off." We expect a timely resolution of these negotiations and continue to believe fiscal policy will have a limited impact on economic activity (either positive or negative).

Inflation Expectations

Market-based measures of inflation and inflation expectations declined significantly during the third quarter as commodity prices fell. The U.S. dollar rose 5% against a broad currency basket during the quarter, continuing the trend of the last twelve months (15% appreciation). The breakeven inflation rate on 10-year TIPS dropped almost 50bps and reached new lows in this commodity correction cycle. The average price at the pump tracked oil prices lower over the course of the third quarter and they are down over $1 to $2.33 year-over-year. The Fed continues to emphasize the transitory effects of both global commodity prices and the U.S. dollar, and instead focus on relatively stable survey-based measures. The Dallas Fed's trimmed mean PCE inflation rate has been relatively stable around 1.7% and the median 12-month inflation expectation from the University of Michigan's consumer survey has eased modestly to 2.8%. We believe a stronger domestic economy and the improved labor market will act as a counterbalance to global disinflationary pressures.

Volatility

We had previously noted a divergence between Credit spreads and stock-market volatility for much of this year. The August stock-market correction drove the VIX index briefly into the 50's and has confirmed the widening of spreads evident since late summer of 2014. While up notably during the quarter, the St. Louis Fed's stress index still indicates a relatively low level of financial market stress.

The Barclays Credit Index OAS pushed to +160bps by quarter-end, an increase of 23bps and now almost 70bps higher than the lows of last year. Lower-quality BBB-rated issuers underperformed their higher-quality counterparts as commodity pressures led to significant widening in Metals and Mining. Similar dynamics impacted the High Yield market, as lower-quality and commodity-exposed issuers pushed spreads to almost 650bps, resulting in a yield above 8%. Our strategies were negatively impacted by the decline in commodity markets and re-pricing of risk across impacted sectors. We continue to believe the scale and liquidity profiles for many of these companies present attractive longer-term risk/return opportunities despite near-term pressure from an extended period of weakened profitability.

Outlook

While domestic economic fundamentals continue to firm, growth has not generated sufficient momentum to accelerate beyond the 2% to 3% area. The U.S. consumer continues to support domestic activity and the housing market is strengthening. However, global conditions are weaker and will likely be a near-term drag on potential growth. As labor markets improved, the gap between headline unemployment (U-3) and the broader U-6 measure narrowed, but remains above mid-2000 levels.

The evolution of the Fed's policy narrative introduces uncertainty for the Board's commitment to rate normalization and has led some to question its credibility. While markets are discounting the potential for a rate increase in 2015, we believe the Federal Reserve will likely raise the target rate at the December meeting. We believe the Fed's indecisiveness contributes to market volatility associated with global macro concerns and we acknowledge this volatility may continue. In late August, we increased the target duration profile of Intermediate and Core strategies to 90% of the relevant benchmark by neutralizing positions in longer-dated securities (10 years and beyond). We continue to believe our defensive duration position in the short end of the yield curve (maturities of 5 years and lower) is warranted. At current yields, we believe the asymmetry of returns favors maintaining this position in the near-term.

Finally, we modestly lowered our Credit exposure in August due to concerns that market volatility could persist for an extended period. However, we remain overweight Corporate securities (concentrated in Financials and BBB-rated Industrials) and believe based on current valuations this positioning will be additive to relative performance over the intermediate term.
