

## REVIEW OF FOURTH QUARTER 2015



### ABOUT THE BOUTIQUE SEIX INVESTMENT ADVISORS LLC



Seix Investment Advisors LLC (Seix) is a fundamental, credit-driven fixed income boutique specializing in both investment grade bond and high yield bond/leveraged loan management. Seix has applied its bottom-up, research-oriented approach to fixed income management for more than 20 years. The firm's success can be attributed to a deep and talented group of veteran investment professionals, a clearly defined investment approach and a performance-oriented culture that is focused on delivering superior, risk-adjusted investment performance for our clients.



**JAMES F. KEEGAN**  
Chairman and  
Chief Investment Officer

Jim is Chairman and Chief Investment Officer of Seix. Prior to joining the firm in 2008, Jim was Head of Investment Grade Corporate & High Yield Bond Management for American Century Investments. Jim's Investment Grade team subadvises several of the RidgeWorth Funds. He has appeared on CNBC and Bloomberg television, and has been quoted in a range of national publications. Jim has more than 30 years of investment management experience.



**PERRY TROISI**  
Senior Portfolio Manager  
U.S. Government/Securitized

Perry is a seasoned Senior Portfolio Manager focused on the Government-Related and Securitized asset classes and a member of the Seix Investment Policy Group. Before joining Seix in 1999, he was a Portfolio Manager at GRE Insurance Group, where he was responsible for all North American fixed income assets within the group. Perry has more than 25 years of experience in the investment management industry.

## POLICY ERROR(S) — TAKE YOUR PICK

The fourth quarter delivered a respite from the risk off environment that permeated most of the third quarter. The major event of the quarter was the commencement of the first tightening cycle in over a decade and rates rising modestly. The front end predictably underperformed in this environment as the two-year Treasury yield increased by 42 basis points (bps) while the longer end of the yield curve rose somewhat less than the short end of the yield curve. The 10-year Treasury yield ended the year at 2.27%, an increase of 23 bps over the quarter but only a 10 bps rise for the full year, well below the oft-cited draconian forecasts for higher long-term rates that have permeated the investment landscape since the financial crisis. Modestly higher rates obviously pressured nominal returns into negative territory for the quarter and the Barclays Aggregate Bond Index (Agg) total return came in at -0.57%. The full year total return for the Agg remained positive at 0.55%. The improved tone for risk assets over the quarter allowed the primary spread sectors to enjoy positive excess returns following a difficult third quarter. Residential mortgage-backed securities (RMBS) led the way with 61 bps of excess return, while the Corporate Bond sector delivered 45 bps of excess return. Commercial mortgage-backed securities (CMBS) were the underperformers, with -28 bps of excess as the sector remained challenged by the cross currents of a healthy new issue calendar and bid lists that kept the paper well offered through year end. Asset-backed securities (ABS) were essentially flat with only -7 bps of excess return. Beyond the investment grade universe, high yield bonds and loans remained under pressure as capital continued to flee the sector amidst another quarter of weak commodity prices and a continued flight-to-quality within the non-investment grade sectors. The Barclays High Yield Bond Index total return was -2.07% for the quarter and -4.47% for the year. The Barclays Bank Loan Index total return was -2.23% for the quarter and -0.82% for the year. The aforementioned weakness in commodities was relentless and the oil complex remains at the epicenter of the pain. West Texas Intermediate crude suffered another -17.9% quarter to bring the full year decline to -30.5%. The broader commodity complex, as represented by the Thomson Reuters/CRB Commodity Index, declined -9.0% for the quarter and -23.3% for the year. There are days when all things risk related seem to be trading solely with oil and this was a recurring theme on and off throughout the second half of 2015. Exhibit 1 below has the detailed total and excess returns for the quarter and full year for the broader domestic bond market as well as the S&P 500 stock market index.

### EXHIBIT 1: LOWER QUALITY SUFFERS AGAIN IN Q4

	Q4 TOTAL RETURN	Q4 EXCESS RETURN	2015 TOTAL RETURN	2015 EXCESS RETURN*
Aggregate	-0.57	0.32	0.55	-0.53
Treasury	-0.94	n/a	0.84	n/a
Agency	-0.75	-0.04	-0.36	-1.33
RMBS	-0.10	0.61	1.51	-0.05
ABS	-0.57	-0.07	1.25	0.44
CMBS	-1.24	-0.28	0.97	-0.28
Corporate	-0.58	0.45	-0.68	-1.61
High Yield	-2.07	-1.19	-4.47	-5.77
HY - Ba/B	-1.02	-0.11	-2.79	-4.13
HY - Ba	-0.15	0.78	-1.00	-2.37
HY - B	-1.99	-1.12	-4.72	-6.05
HY - Caa	-7.51	-6.77	-12.11	-13.26
HY - Ca-D	-22.13	-21.57	-56.15	-57.21
HY - Loans	-2.23	n/a	-0.82	n/a
S&P 500 Index	7.03	n/a	1.37	n/a

\*As of 12/31/2015

Source: Barclays, Bloomberg, data pulled 1/4/2016

**Past performance is not indicative of future results.**

Despite the positive narrative surrounding the domestic economy's performance, concerns about global growth persist amidst ongoing uncertainty about the growth slowdown in China and by extension, similar economic concerns for its primary Asian and emerging market trading partners. After the surprise mini currency devaluation (1.9%) over the summer, Chinese authorities have continued to intervene in the currency and stock markets to provide the illusion of stability, but the results have been decidedly mixed and the overall volatility in the Chinese markets remains high. This has continued to result in significant spillover effects into most other global markets and the impact on our own capital markets on any given day can be disproportionately dictated by the flow and performance of the overnight Chinese trading session. We are monitoring import/export data throughout Asia in order to gain a clearer picture of the Chinese growth trajectory.

### SOME OF THE SURPRISES OF 2015

- Switzerland Started 2015 by Abandoning its Currency Peg vs. the Euro
- Oil/Commodity Prices Continued to Fall but Failed to Translate into Strong Consumption Growth
- U.S. 10-Year Treasury Rate Stayed Range Bound Below 2.50%
- China Stock Market Crash Culminating in a 1.9% Devaluation of the Renminbi
- Stock and High Quality Bond Returns Essentially Flat as a Stealth Bear Market in U.S. Equities Followed the End of QE3

### MARKET CONSENSUS FOR 2016

- Central Bank Policy Divergence Favors U.S. Dollar vs. Euro and Yen
- Oil Prices Bottom in 1H 2016 and Rise in 2H 2016
- China Engineers a Soft Landing/No Major Devaluation
- Service Economy Immune to Manufacturing/Industrial Slowdown/Recession
- Low U.S. Growth Means Recovery Will Last Longer
- Benign Default Cycle in High Yield Market
- Negative Interest Rate Policy (NIRP) Should Not Alarm Investors, It's Just Another Tool in the Central Bankers' Toolbox

### PROMINENT ISSUES FOR 2016

- \$6-7 Trillion of Sovereign Debt Trading with Negative Yields
- Petrodollar/Sovereign Wealth Repatriation
- Refugee Crisis in Europe/Middle East
- Credit Market Leads Equity Market and Economy
- Does an Inverted Yield Curve Precede the Next Recession?
- The Central Banks' Narrative Portrays Domestic Strength (questionable)/Global Weakness
- China Capital Outflow Risk
- Default Cycle Depth and Breadth
- U.S. Presidential Election Wildcard(s)
- Central Bank Omnipotence Questioned

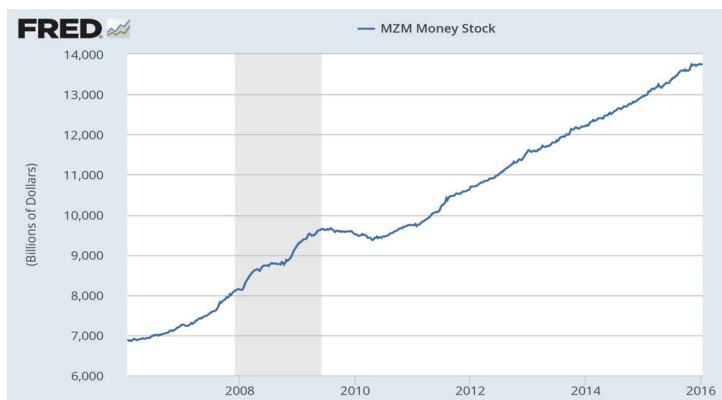
### RATES ARE RISING, RATES ARE RISING (Not Really)

Seven years to the day, and seven years of a zero interest rate policy (ZIRP) ended quietly on December 16th, an unprecedented period where savers were "asked" to subsidize the over-levered for the greater good of the financial rather than the real economy. Well, "asked" might be a bit of a stretch, since the Federal Reserve Bank's (Fed) Open Market Committee (FOMC) essentially mandated ZIRP back in 2008 as it stared into an abyss that was the global financial crisis and once again provided excessive liquidity in another misguided attempt to solve a debt crisis with yet more debt. Now everyone seems to forgive the FOMC for its rash actions; in fact, the counterfactual question "but how bad would it have been had the Fed done nothing?" is an overused excuse for everything the Central Bank ultimately did over the last seven-plus years. Since the Fed actually dragged its feet in its capacity as a regulator in the lead up to the financial crisis, and then was forced to react hastily at the height of the crisis and ensuing recovery, we will never really know answers to simple questions such as: "was zero the right setting for rates?? and, "if so, for how long?" The FOMC would probably answer no to the first question, since its theoretical models said the appropriate setting for rates was deeply negative for a time and then only slightly negative for an even longer time. So the zero-bound was an unfortunate constraint on optimal model-based monetary policy. Regardless, zero proved to be great for a banking system that essentially choked itself on leverage and then got bailed out by a central bank afraid to let the system find clearing prices for assets the banks bought with borrowed money. Clearly the banking lobby has a lot more influence in this country than the AARP, whose constituency suffered the most with savings accounts offering 0.1% or thereabouts for a very long time. But for the greater good, as the story is told by Ben Bernanke and company, as he joins the club of retired central bankers actively engaged in legacy preservation with memoirs like "The Courage to Act: A Memoir of a Crisis and Its Aftermath" (<http://www.amazon.com/The-Courage-Act-Memoir-Aftermath/dp/039324721X>).

That the FOMC acted on its tightening threat in December was in itself a bit of a miracle, given that it delayed as long as it could in the calendar year before finally hiking. Early in the year, the guidance or central bank narrative for its policy intentions was for a rate hike by mid-year. However, by mid-year the timing had shifted to the fall; by the fall, it still wasn't time. That left only December for a rate move, and after telegraphing hiking intentions for over a year, the FOMC decided it needed to finally follow through. Credibility, at least in our estimation, was its primary motive at that point, even though it's hard to believe the FOMC has any reservoir of credibility to salvage. Consider this, if you didn't know that rates were still at zero and given the macroeconomic backdrop of late 2015, would you guess the next move by the central bank was going to be a tightening or an easing? The narrative around liftoff was one of a strengthening economy rather than ZIRP having left the Fed with little to no ammunition in the monetary policy arsenal. Fast forward to early 2016 and the drum beat for "policy error" is already starting to reverberate. Call us crazy, but the policy error was made years ago, with an adherence to ZIRP that long since lost any economic effectiveness beyond starving savers of critical interest income.

The St. Louis Fed publishes a series called "money of zero maturity" (MZM) and is what we would describe as a proxy for low-risk savings. MZM is essentially an aggregation of the cash and cash-like deposits in the banking system, but its technical definition is the monetary aggregate M2 less small time deposits plus institutional money funds. MZM has continued to grow throughout most of the crisis and recovery period, except for a brief period in 2010 when it declined slightly before returning to its upward trajectory. Despite the FOMC rate repression regime via ZIRP over the last seven years, MZM ended 2015 at just over \$13.7 trillion, growing at about a 7% annualized pace over the past five years. From the Fed's perspective, that's an unintended consequence, whereby many savers refused to respond to the policy and take more risk. In fact, the annualized growth rate over this five-year period essentially matched the growth rate seen over the prior five-year period when the Fed's target rate averaged 2.5% rather than zero. That's called the paradox of thrift, as savers were forced to save more in an environment where the risk free rate offered no return on their savings. What if the FOMC had even modestly normalized rates after the crisis of late 2008 and early 2009? Rates could have slowly been normalized to a still very accommodative 2% by the end of 2010 and then spent the next five years at 2% rather than at zero. From 2011 to 2015, MZM averaged just over \$11.8 trillion in annual income or nearly \$1.2 trillion cumulatively over the full five years. That would have been significant stimulus to the economy, given that so many savers would have spent that interest income on the staples of everyday life. Defenders of the Fed have often fallen back on the mantra that monetary policy was the only avenue for stimulus given Washington's inability to craft any credible fiscal policy stimulus. But the Fed opted for stimulus directed at the banking and financial system rather than mom and pop savers, hence the sub-par outcome ZIRP produced over the life of its implementation. Exhibit 2 below illustrates the nearly unimpeded growth of MZM over the last decade.

### EXHIBIT 2: SAVINGS GROWS DESPITE ZIRP



Source: St. Louis Federal Reserve Bank, data pulled 2/1/2016

## SURREAL MARKET CONDITIONS PERSIST

Capital markets continue to behave in ways that defy logic and convention and no matter how often the central banking community tries to convince us that new rules and policies apply to finance in the 21st century, we focus more on the consequences of these new rules and policies in our analysis. The idea that rates were driven to zero and kept there for seven years went far beyond the lender of last resort and banking doctrine, but now the adoption of negative interest rate policies is reaching proportions that are starting to seriously concern us. This subject was touched upon in our last quarter's perspective, but in the ensuing brief period since then the ground beneath us has been radically altered. The European Central Bank (ECB) moved further into negative territory in the fourth quarter, again in the name of stimulating inflation to reach the ECB's mandated inflation target. While still not as negative as the deposit rate settings in Switzerland, Denmark and Sweden, the ECB has made it clear that it will take deposit rates further into negative territory should its 2% inflation target remain elusive. In a much bigger surprise, on the final day of January, the Bank of Japan (BoJ) instituted NIRP amidst a backdrop of continued frustration with "Abenomics" where the narrative still claims success absent any significant empirical data supporting such claims. While additional action from the BoJ was part of our internal forecast, the timing of the move surprised everyone, and the fact that it was a move to NIRP versus an expansion of their ongoing quantitative easing (QE) program is another indication of the lack of efficacy of QE as well as the false narrative that surrounds such extraordinary policy measures.

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When Japan's Prime Minister Abe and the Kuroda-led BoJ embarked on another unprecedented wave of QE in 2014 the magnitude of the announced program was interpreted as the final litmus test of such unconventional monetary policy. Advocates of QE

led by Paul Krugman and Brad DeLong, among many others, have long argued that the policy had never been employed in sufficient quantity to elicit the true economic benefits economic models forecasted. The advent of "Abenomics" and a QE initiative done in a quantity its proponents argued the policy required for success was going to be the final litmus test for the true efficacy of QE. Approaching nearly two years of this massive QE initiative and there is a veritable cacophony of silence surrounding the results, or lack thereof to date. Before a full accounting can be done which ultimately discredits QE (particularly as practiced this cycle) as little more than a policy for creating asset inflation/bubbles and weakening one's currency, policymakers are shifting the emphasis and narrative over to NIRP as the next great policy in an evolution of unconventional policy failure. Nobel prizes are not likely to be awarded for the work analyzing QE's lack of efficacy.

Our Shadow Investment Policy Group recently studied the existing NIRP regimes already deployed in Europe and our findings were interesting. First and foremost, the programs do differ in that the degree of negative rates varies, with rates considerably more negative in Sweden, Switzerland and Denmark while less negative in the Eurozone. More consistent, however, is that deposit rates for the majority of households and corporations have remained positive, meaning that a broad swath of the deposit base has not yet been subjected to a negative rate. In fact, only small segments of bank reserves, essentially excess reserves sloshing around the respective banking systems, have been subjected to negative rates. Given the limited application thus far, some of the more predictable outcomes from such a policy have yet to materialize. Demand for cash has not really increased amidst these NIRP experiments. Given the very limited scope of application, money market yields have not moved into negative territory, and as such, some of the more unnerving consequences that could have created destabilizing conditions in the money market remain absent.

The obvious question is why is NIRP being instituted in such a "half measure" manner? If the intent is to further discourage (punish) savings and encourage (force) consumption and investment, then why limit its application as to render the policy a failure at its inception? Our guess is that the central banking community is very fearful of the money market and banking system disintermediation that would follow a more stringent application of NIRP. Inflict a real penalty rate on savers and the likely outcome would be a flight to cash, as in the physical kind, not a money market fund. Under the mattress and into the safe would go a significant amount

of the cash currently sidelined in the worlds' banking system. The half measures in place are seemingly more about the perception of central banks engaging in additional monetary policy accommodation and marketing unconventional policies like ZIRP, QE and NIRP as successful experiments that enhance and broaden the central banker tool kit. Empirically, the evidence fails to support the oft repeated claims of fundamental economic stimulus from these unconventional policies, yet seven-plus years after the financial crisis, policymakers and the media alike are still comfortable pretending that monetary policy can solve the structural problems faced by the global economy. At times it feels almost "Ponzi" like, a sad game of confidence building that assumes the use of such sleight of hand policies can convince the masses to return to a borrow-and-spend mentality so the economy can grow like the good old days. Sadly, that ship has sailed and as much as the central banking community tries, they are slowly learning that you can't put Humpty Dumpty back together again. ([Click here to read the Q214 Boutique Perspective "Humpty Dumpty"](#))

## POLICY ERROR(S)

Barely two months into the new calendar year and the revisions are already coming fast and furious, as an ongoing deleveraging in risk impresses on many the relatively fragile foundation capital markets have been built upon. Remember the market dichotomy of an FOMC forecast via the "dot charts" of four rate hikes in 2016 versus the market pricing of only two hikes? By the middle of February, the market probability of no rate hikes this year was approaching 70%! The growth optimism for 2016 was all about the service economy, given that the smaller manufacturing base had already fallen into near recessionary conditions despite another robust year of automobile production. The inevitable convergence between the Institute for Supply Management® (ISM) surveys via a lower non-manufacturing reading rather than a higher manufacturing reading progressed in January, but it has surprised many despite what prior periods of similar divergence would have implied. Inflation remains contained, exhibiting a similar dichotomy in that services inflation is running at a fairly healthy clip while goods inflation remains depressed. Fourth quarter growth was only 0.7% according to the preliminary gross domestic product (GDP) estimate (two revisions pending) leaving year-over-year GDP at 1.8%. Labor market indicators remain robust with strong employment growth and a 5% unemployment rate, not that anyone really believes that this statistic is an accurate depiction of the strength of the labor markets given the considerable assist from the declining participation rate in driving unemployment down so much. An early estimate for sure, but most first quarter GDP tracking models in mid-February are gravitating around 2%, hardly the robust bounce most economists would forecast following such a weak prior quarter and relatively mild winter.

This fundamental backdrop is the basis for what seems to be a growing narrative that the Fed's rate hike last December was in fact a policy error.

Unbelievable you say? Seven years of ZIRP, then finally a 25 bps hike and barely six weeks elapses before the commentary shifts to characterizing this hike as a policy error. You can't make this stuff up. The policy error was made five-plus years ago as the Fed opted to leave emergency monetary policy settings in place long after the emergency had ended. The actual policy setting of zero was sadly ignored throughout the entirety of the debate about the first rate hike. Over a year's worth of "should they or shouldn't they" was played over and over again in the media, but seemingly lost on everyone was that the target rate remained on an emergency setting nearly seven years after the "crisis" had ended. Earlier, we focused on just how brutally ZIRP punished savers over that time frame, but the negative consequences hardly end there. In fact, the ramifications from the massive misallocation of capital that took place during this unprecedented period are only beginning to manifest themselves (see energy, CCC and lower credits, and emerging market corporate debt).

The most obvious ramification at hand is the flight of capital from the high yield market. A near-zero risk-free rate pushed investors of all stripes to seek yield and take on high-risk investments in order to generate income that used to be generated in their bank and money market accounts. This cut across both the institutional and retail investor landscape, where allocations to higher yielding sectors of the bond market as well as new-fangled alternative strategies became

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an accepted norm over the seven years of ZIRP. With an under-appreciation for the added volatility that naturally comes with higher return potential, many investors are finding out the hard way (once again) that there is no free lunch. What once worked suddenly no longer works, and when combined with a central bank rate hike, higher risk allocations that were a one-way bet for many years are suddenly reversing direction and the impact is wreaking havoc across the capital markets and investor portfolios. The cries of policy error grow louder and louder with each decline in the stock market. The central bank “put”, or said another way, the “wink and nod” from the Fed that it has everyone’s back should markets wobble, is being tested yet again as the Fed answered prior market sell-offs with the increase in QE1, then QE2, then Operation Twist, then the extension of Twist and finally QE3. Data dependency is the oft referenced stance the Fed claims will drive policy decisions going forward, but the history indicates that the data that seemed to matter most this cycle has been the stock market. Watch the anxiety the Fed exhibits when the market sells off and its dependency on an ever rising stock market becomes apparent. Should stocks trade off five to 10 percent, it’s a near certainty a talking head from the Fed will be on television talking about returning policy to a more accommodative stance. Jim Bullard, President of the Federal Reserve Bank of St. Louis, is the most likely candidate, as he has historically

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exhibited this reflexive response when markets swoon. His first line of defense seems to kick in when stocks decline more than 7%, so pay attention to CNBC so you don’t miss a Bullard rally.

The catch phrase the Fed will rely on is financial conditions. We will hear a lot about “tighter” financial conditions

as we approach the next Fed meeting in March. The degree of “tighter” will even be presented in terms of rate hike equivalence. Don’t be misled by the jargon as the tighter financial conditions are just a reference to lower stock prices (primarily), wider credit spreads and a stronger dollar (secondarily). Despite all the energy wasted presenting the unconventional measures as precise policy science, never mind the unintended consequences and their associated cost over the long run, in the short run the Fed is still engaged in nothing more than a hope trade tied to higher stock prices and the still elusive wealth effect. Hope is never a sound strategy...

## OUTLOOK & PORTFOLIO POSITIONING

Global trade (Baltic Dry Index is at a record low) is at its weakest since 2009, global growth is slowing with the global manufacturing sector likely already in recession and the odds of a global recession increasing (our view is 50% probability of sub 3% global GDP growth). The U.S. manufacturing sector looks increasingly like it is in recession (industrial production, ISM-manufacturing and capital goods orders) and the odds of a recession in the U.S. are rising (33% probability in our view). China’s economy is slowing as it attempts to transition to a more consumption-driven service-based economy. China’s slowdown/rebalancing will be a key driver of the global economy and commodity prices and by extension global financial markets as its currency adjusts with related capital flows being closely monitored by global investors.

The credit cycle has peaked and rolled over so security selection will be critically important going forward. Within the investment grade sector, fallen angel risk (investment grade rated companies getting downgraded to non-investment grade) has increased. In the non-investment grade sector, the distressed ratio, a leading indicator of defaults, is approaching 30% of the high yield market, pointing to the potential of above average defaults with risk spreading beyond the commodity related sectors and the risk that recoveries will be lower than the historical averages as ZIRP/QE postponed the default and bankruptcy cycle. ZIRP/QE allowed marginal credits to survive until either the next economic downturn and/or to that point in the future where the wall of maturities could not be refinanced.

2016 is off to an atypical “risk off” start as global equities came under broad selling pressure, high yield experienced a negative return (no January effect), long U.S. Treasuries gained more than 5% during January, while the Yen and the Euro appreciated against the dollar despite the Fed tightening while the ECB and BoJ both ease policy further. The stealth bear market has broadened into sectors that outperformed last year, the so-called FANG stocks (Facebook, Amazon, Netflix, Google), financials and technology are leading the way down in 2016.

Central banks are not likely to stand by and allow financial conditions to tighten (lower stock prices, wider credit spreads and a strengthening dollar) much further before stepping in to try to support financial markets. The questions one must ask are:

*How effective are further unconventional policies likely to be (remember each iteration of QE in the U.S. had diminishing returns)?*

*What are the costs and negative consequences (intended and unintended) of further unconventional policies?*

As we have stated previously, it is our measured opinion that this tightening cycle would be the easiest in the Fed’s history, as it waited too long in our view before removing emergency settings (ZIRP/QE) and in waiting too long valuations became more and more stretched. The Fed will likely wait before reversing policy as it would be loath to acknowledge a policy error and any reversal will be driven by financial conditions. The Fed has limited options should a recession occur in the U.S. with rates already so low. The options in the playbook are:

- Reversing the December 2015 hike
- Reverting to forward guidance (calendar-based commitment to ultra-low rates)
- QE4
- NIRP
- Helicopter Money

Our base case after the Fed raised rates in December saw the Fed likely back to ZIRP and possibly NIRP before the Fed target rate even reached 1% to 1.5% and for the 10-year Treasury to trade below the July 2012 low yield of 1.38%. NIRP is the next unconventional measure that major central banks are putting into their toolbox. NIRP is a tacit acknowledgement that ZIRP and QE did not work, in addition to being a sign of desperation by central banks globally where a new unconventional policy with significant and potentially negative consequences is employed in the name of meeting the inflation target and/or a dual mandate in the U.S.

The issues that culminated in the Great Financial Crisis were never solved and it has been a rolling crisis in nature manifesting itself first in the U.S. (2008-2010), then working its way to Europe (2010-2012) with the most recent wave in China/ Emerging Markets (2014- present). Much ink has been spilled, and time taken in the financial media, to convince people that this is not 2008. While we agree that it is not 2008 — it is 2016 — market participants must acknowledge that while banks have raised significant amounts of capital over the intervening years, many other issues from the Great Financial Crisis remain. Global debt has risen significantly, the global economy is more leveraged now than it was in 2008, big banks are bigger than they were in 2008, major central bank balance sheets are larger and policy rates are close to zero or below zero with central banks essentially out of ammunition should the economy go into recession and/or the next phase of the Great Financial Crisis emerge.

It should be obvious to policymakers and investors by now that you cannot solve a debt crisis with more debt, and while liquidity buys time for policymakers to deal with problems and find solutions, too much liquidity for too long not only postpones the day of reckoning, but it compounds existing problems. Excessive debt undoubtedly slows growth below potential and is a problem that can only be solved by debt restructurings, haircuts and write-offs. As we have witnessed over the years the longer policymakers wait to deal with problems, the more difficult and painful the outcome and therefore, the more reticent they are to deal with directly. In the years to come when the history books are written, several policy errors will be recorded — increasing debt to solve a debt problem, liquidity (buys time), if not temporary it becomes the problem rather than the solution, and the boom resulting from excessive liquidity on top of excessive liquidity creates asset bubbles, misallocation of capital and mal-investment that lead ultimately to bigger busts. Is 2016 the year that the chickens finally come home to roost? Only time will tell. As for the policy errors this cycle — take your pick.

Portfolio sector weightings were little changed in the fourth quarter with exposure to the primary spread sectors (RMBS and corporate bonds) not far from their respective index weightings. Corporate bond spreads actually tightened a token 4 bps to close the quarter at 165, but spreads were still 34 bps wider over the full year. Despite several extended spells of high volatility and a dormant new issue calendar during both the third and fourth quarters, investment grade corporate bond supply set another record in 2015 with \$1.33 trillion in issuance, easily surpassing 2014’s record by a healthy 16%. It has been four years now that



investment grade corporate new issuance has surpassed the \$1 trillion threshold, a testament to the demand for high quality income producing assets since the global financial crisis. Valuations are clearly more compelling relative to one year ago, but headwinds from both a fundamental and technical perspective warrant discipline when allocating capital to the sector. The global growth slowdown underway will likely elicit even higher volatility in 2016 and with it opportunity to deploy capital to the corporate bond sector at more attractive levels. In a world clamoring for greater liquidity, we prefer to be in a position to offer it when other investors are forced to sell or unable to provide liquidity. Within the Corporate sector valuations are most compelling in transportation, technology and energy while electric utilities, consumer non-cyclicals and insurance offer the least value in our opinion.

The securitized sectors (residential, commercial and asset backed) experienced a mixed performance in the fourth quarter with the residential sector outperforming both the commercial and asset-backed sectors by a fair margin. New issue supply as well as considerable secondary supply hitting the street over the quarter was the primary drag to the commercial sector. Investors were particularly hesitant to put any capital to work in December, so spread levels naturally widened in commercial mortgage-backed risk and in asset-backed risk to a lesser extent. Our residential mortgage strategy still relies on exposure to agency commercial mortgage risk held in lieu of current coupon pass-through holdings. This offers a convexity advantage over the mortgage index that we prefer amidst heightened volatility. We remain modestly overweight in private CMBS and ABS, a continuation

of our safe income at a reasonable price strategy in the short to intermediate parts of the yield curve. A government related sector underweight persists as the spread offered on a significant portion of this sector fails to compensate for the underlying risk.

Our core plus portfolios remain void of any strategic non-investment grade exposure. Our sale of a 5% allocation to bank loans back in the first quarter looks prescient after seeing the full 2015 performance calendar unfold and our small exposure to the high yield sector since then has been through selective crossover risk that are specific upgrade/credit stories rather than a strategic allocation to the sector. Capital continues to flee the high yield sector so the technical backdrop remains tenuous as we begin 2016. Valuations have moved considerably over the past year and are very cheap over one- and three-year time frames. However, over a 10-year time frame, valuations register as only fair as that time period encapsulates a full market spread cycle. With this improved risk/reward profile, we are clearly closer to a strategic allocation to the sector and will look for longer term valuation measures to turn cheap as well to offer an even better opportunity to redeploy capital to the sector for our core plus clients. While we never endeavor to market time such strategic high yield allocations for the absolute widest spread level, given the exceptionally negative technical backdrop as well as softer economic fundamentals globally, we believe patience is warranted before beginning to scale into the sector again.

## SPECIAL ADDENDUM: DO YOU THINK THE NEXT FIVE YEARS WILL BE LIKE THE LAST FIVE YEARS?

During the second half of 2015, one of the key questions that we posed to the marketplace and believe to be critical for investors, plan sponsors, pension funds, endowments and consultants to be asking was, "do you expect the next five years to be like the last five years?"

In order to answer this question one needs to consider the factors and forces that drove financial markets, asset prices and the global economy since the Great Recession. Central banks, led by the Fed, experimented with unprecedented, unconventional policies (ZIRP and QE) in an effort to generate a wealth effect that was supposed to translate into stronger economic growth and higher inflation. The Fed lowered rates to zero and held them there for seven years while the various QE programs led to the Fed's balance sheet being increased by a factor of five. Other major central banks, including the Bank of England, the Bank of Japan and the European Central Bank, followed the Fed's lead and employed similar unconventional policies to varying degrees.

Consider just three simple statistics to put this global central bank stimulus into perspective since 2008:

- 637 interest rate cuts since Bear Stearns
- \$12.3 trillion in asset purchases globally by central banks
- \$57 trillion of debt added globally between 2008 and the second quarter of 2014 (McKinsey Global Institute report)

When examining the effects of this unprecedented stimulus one can see that asset prices, particularly equities and credit-related instruments, were reflatated/inflated with the highest beta, lowest quality parts of the capital markets outperforming their lower beta, higher quality counterparts. As a matter of fact, there was an extremely high positive correlation between the size of the Fed's balance sheet and the S&P 500, and while correlation is not necessarily causation there is an obvious linkage that should not be dismissed.

In our view ZIRP and QE were very successful in creating asset inflation, but were less than successful when it came to stimulating the economy as the anticipated wealth effect never did materialize. The Fed openly stated that one of the purposes of these unconventional policies was to push investors to take more risk. Investors did take more risk, but we believe that this only served to pull performance and return forward, while also pushing downgrades, defaults and bankruptcies out thereby extending the credit/default cycle. So it should not come as a surprise that riskier asset prices have come under pressure led by the lower quality, higher beta parts of the market since the Fed ended QE3. Risk asset prices are mean reverting with credit leading the way as it typically does at inflection points in market cycles. Not only did QE3 end in the fourth quarter of 2014, but the Fed started what we believe will end up being the easiest tightening cycle in Fed history in December 2015.

In a world without ZIRP or QE (at least for the time being), it would seem that earnings and dividends will be the primary drivers of equity returns. As for the credit sectors, seven years of ZIRP and QE pushed investors and savers into riskier assets (corporate and high yield bonds, leveraged loans, emerging market corporate debt, and even master limited partnership equities) in search of income as their savings earned nothing in savings accounts and money market funds. This demand for income and yield in a ZIRP world served as an extremely favorable technical backdrop for the credit markets that allowed many companies to issue debt for the following purposes:

- Share buybacks (investment grade corporate bonds)
- Refinance upcoming/future maturities (high yield and leveraged loans)
- Offer marginal companies another lease on life to try to survive (CCC and lower rated credits)
- Allow foreign companies in developing markets to access low cost debt in the dollar markets (emerging market corporates)

This very positive technical condition has now started to turn into a headwind, which was a concern of ours coming in to 2015 (high yield exposure in our core plus accounts was taken to zero in the first quarter of 2015) as much of the capital that flowed into riskier parts of the credit market during ZIRP/QE was provided

by investors that needed income but did not possess the risk appetite or financial wherewithal to be putting savings they need to live on at risk. That incredibly favorable technical tailwind reversed turning into a headwind in 2015.

The other major force that drove the global economy since the Great Recession was China. China enacted a massive stimulus coming out of the Great Recession as it continued to expand its investment and export capacity which caused its debt to increase from \$7-8 trillion to upwards of \$30 trillion during that period. China effectively served not only as the primary engine of the global economy (emerging markets benefitted as suppliers of commodities), but also as the global economic shock absorber since the Great Recession. The August 11, 2015 mini devaluation (1.9%) of the Chinese Yuan marked a turning point in our view where China was signaling that it was no longer able and/or willing to serve as the global economic shock absorber to the world economy. The ramifications and reverberations are obvious when viewed through the lens of commodity prices, commodity producers and export driven commodity economies. You probably have read the story about China pouring more cement in three years than the United States poured in the last 100 years, putting the magnitude of China's use of commodities in context during this period.

*The other major force that drove the global economy since the Great Recession was China.*

China needs to devalue its currency, but at the same time is concerned about the impact devaluation would have on global risk sentiment and asset prices given the crash in the Chinese equity market and the selloff in global risk markets that occurred back in August. Yuan devaluation on the order of 15-20% would be a market shock no doubt, but it would reset the markets rather than having this cat and mouse game between China and the market over the currency's value. Chinese locals continue to move money out of China concerned about a devaluation, which has led to unprecedented capital outflows. As a result of these capital outflows, and in order to tame speculators looking to profit from currency devaluation, China has used significant amounts of its foreign exchange reserves to manage the value of its currency.

China is also in the midst of rebalancing its economy away from investment and exports to more of a consumption and services based economic model. This

rebalancing combined with the massive increase in debt/leverage as well as its overvalued currency paint a picture that China will not be to the global economy over the next five years what it was to the global economy since the Great Recession. The ultimate question is, which countries have the capacity going forward to be the new engine of growth, similar to what China and the emerging markets were to the global economy over the last five to seven years?

No matter what levers were being pulled by policymakers in this over levered global economy, the structural problems consistently overwhelmed these cyclical responses, but little evidence to date can be found that a better path from policymakers is at hand. So will the next five years be like the last five years? While possible, it is not likely in our view and investors should plan accordingly.

**Asset-Backed Security (ABS)** is a financial security backed by a loan, lease or receivables against assets other than real estate and mortgage-backed securities. For investors, asset-backed securities are an alternative to investing in corporate debt.

**A Basis Point** is equal to 0.01%.

**Beta** is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

**Barclays U.S. Aggregate Bond Index** is a widely recognized index of securities that are SEC-registered, taxable, and dollar denominated. The Index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

**Barclays U.S. Corporate High Yield Index** is an unmanaged market value-weighted index that covers the universe of fixed rate, non-investment grade debt.

**Baltic Dry Index (BDI)** is an economic indicator issued daily by the London-based Baltic Exchange. The Index provides an assessment of the price of moving major raw materials by sea.

**Credit Suisse Leveraged Loan Index** is a market-weighted index that tracks the performance of institutional leveraged loans.

**Commercial Mortgage-Backed Securities (CMBS)** are a type of mortgage-backed security that is secured by the loan on a commercial property. A CMBS can provide liquidity to real estate investors and to commercial lenders.

**Convexity** is a measure of the curvature in the relationship between bond prices and bond yields that demonstrates how the duration of a bond changes as the interest rate changes.

**Coupon** is the interest rate stated on a bond when it's issued.

**Credit Ratings** noted herein are calculated based on S&P, Moody's and Fitch ratings. Generally, ratings range from AAA, the highest quality rating, to D, the lowest, with BBB and above being called investment grade securities. BB and below are considered below investment grade securities. If the ratings from all three agencies are available, securities will be assigned the median rating based on the numerical equivalents. If the ratings are available from only two of the agencies, the more conservative of the ratings will be assigned to the security. If the rating is available from only one agency, then that rating will be used. Ratings do not apply to a fund or to a fund's shares. Ratings are subject to change.

**Credit Spreads** are the difference between the yields of sector types and/or maturity ranges.

**Federal Open Market Committee (FOMC)** is the Federal Reserve Board that determines the direction of monetary policy.

**Gross Domestic Product (GDP)** refers to the market value of all final goods and services produced within a country in a given period. GDP per capita is often considered an indicator of a country's standard of living.

**Negative Interest Rate Policy (NIRP)** is an unconventional monetary policy tool whereby nominal target interest rates are set with a negative value, below the theoretical lower bound of zero percent.

**Quantitative Easing (QE)** is an unconventional monetary policy used by some central banks to stimulate their economies when conventional monetary policy has become ineffective.

**Residential Mortgage-Backed Security (RMBS)** is a type of security whose cash flows come from residential debt such as mortgages, home-equity loans and subprime mortgages. This is a type of mortgage-backed security that focuses on residential instead of commercial debt.

**Standard & Poor's 500 Index** is an unmanaged index of 500 selected common large capitalization stocks (most of which are listed on the New York Stock Exchange) that is often used as a measure of the U.S. stock market.

**The Thomson Reuters/CoreCommodity CRB Index** is a commodity futures price index.

**Yield Curve** is a curve that shows the relationship between yields and maturity dates for a set of similar bonds, usually Treasuries, at any given point in time.

**Zero Interest-Rate Policy (ZIRP)** is a method of stimulating growth while keeping interest rates close to zero.

Investors cannot invest directly in an index.

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