

Bond Market Update

As of March 31, 2016 / Volume 5, Issue 1 / FFTAM.COM



The first quarter of 2016 for the fixed income market turned out to be very eventful. Total returns were positive as the Federal Reserve (the Fed) changed its communication to gradualism. The U.S. economy continued its slow growth trajectory with GDP forecast for the 1st quarter coming in at 0.40%. Both AAA taxable and tax-exempt yield curves flattened.

Total returns for taxable and tax-exempt investments were positive. For the 1st quarter, the Barclays Aggregate Bond Index recorded a total return of 3.03% and the Barclays Muni Index recorded a total return of 1.24%. As mentioned above, the economy continued its slow growth trajectory as 4th quarter GDP came in with a final reading of 1.4%. ISM Manufacturing saw its first print above 50 since August 2015. ISM Nonmanufacturing continued their readings above 50, although slower than previous quarters (a reading above 50 indicates expansion). The unemployment rate ticked up slightly in a positive manner to 5.0% from 4.9% as the participation rate increased.

Multiple Fed events occurred in the 1st quarter. At the beginning of the year, several members of the FOMC spoke about raising rates four times in 2016. Markets reacted very negatively and forced the FED to reevaluate their stance on monetary policy. At the March meeting, Chairwoman Yellen elected not to raise rates and forecasted a stance of gradualism. This reevaluation of Fed expectations can be seen in the much scrutinized dot plot as the Fed guided expectations down to two rate rises for 2016. Current expectations in the market are for only one rate rise.

Below to the left is the U.S. Treasury Yield curve as of 12/31/15 and 03/31/16. As you will see, the yield curve has flattened substantially as intermediate to long rates have moved down. Below to the right is the AAA Municipal Yield curve as of 12/31/15 and 03/31/16. It also experienced a flattener, however, short rates moved up slightly and intermediate and long rates came down.

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For the quarter, investment grade credit spreads were marginally wider (4bps) and high yield credit spreads were marginally tighter (7bps) versus the risk free rate. With the Fed communicating a pause to very gradual rise in rates going forward, this should be a positive for credit. Probabilities for a recession have been pushed down and out with the Fed's current stance. However, probabilities still have the chance to rise again as external factors outside the U.S. continue to put downward pressure on growth, hence, the reason for the Fed's about face.

Looking forward, we do expect pressure on the short part of the yield curve as the Fed has communicated the desire to attempt to raise the cash rate. The desire to raise cash rates as communicated by the Fed will be very gradual. In short, we remain committed to a very high credit quality portfolio with a bias towards a flatter yield curve. As opportunities present themselves in the risk free curve, we may selectively increase our duration to take advantage of the higher interest rates.

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