Bond Market Update

As of September 30, 2015 / Volume 4, Issue 3 / FFTAM.COM

The third quarter of 2015 for the fixed income market turned out to be very eventful. Total returns were positive as the US economy slowed slightly from its 2nd quarter 3.9% GDP measurement. The Federal Reserve (the Fed) continued to entertain the idea of raising cash rates before year-end. Both AAA taxable and tax-exempt yield curves flattened. Internationally, China devalued its currency versus its pegged-dollar-rate.

Total returns for taxable and tax-exempt investments where positive. For the 3rd quarter, the Barclays Aggregate Bond Index recorded a total return of 1.24% and the Barclays Muni Index recorded a total return of 1.32%. YTD returns are 1.14% and 1.64%, respectively. As mentioned above, the economy slowed in the 3rd quarter as estimates for GDP now average 2.4%. ISM Manufacturing and ISM Nonmanufacturing continued their readings above 50 (a reading above 50 indicates expansion). The unemployment rate dropped to 5.1% from 5.3%.

The biggest event in the 3rd quarter was China devaluing its currency. Transitioning from an investment/ manufacturing based economy to a consumption based economy is difficult. This devaluation sent shockwaves through the system with emerging economies taking the brunt of it. The appreciation of the US Dollar versus emerging economies is taking a toll on growth. China is slowing. Global growth is slowing. The second biggest event in the 3rd quarter was the Fed not raising interest rates, however, a rise in the fed funds target rate is still a possibility. One major change to the Federal Open Market Committee statement was the inclusion of "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." The inclusion of this language acknowledges the fact that the strong US Dollar is impacting inflation expectations and global growth, therefore, the probability of the Fed raising the cash rate is diminishing but, again, remains a possibility. In addition, any raise in the fed funds target rate should be viewed as a slow and deliberate process with a shallow endpoint, rather than a trend to much higher rates.

Below to the left is the US Treasury Yield curve as of 12/31/14 and 9/30/15. As you will see, the yield curve is slightly lower in the belly (intermediate) and slightly higher on the long end. Below to the right is the AAA Municipal Yield curve as of 12/31/14 and 9/30/15. Its move is very similar with slightly more curve steepening on the long end.

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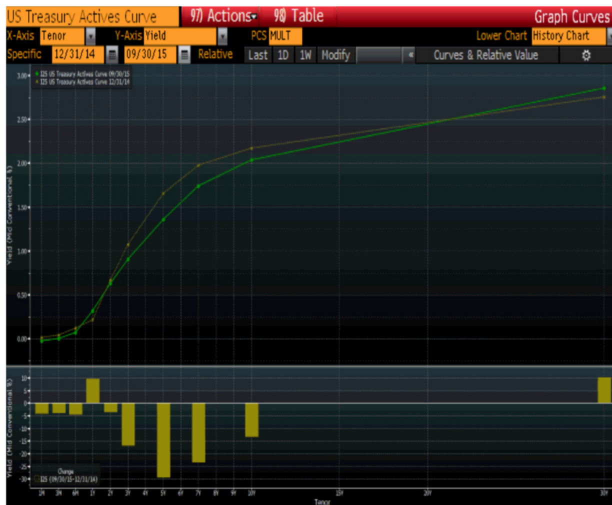

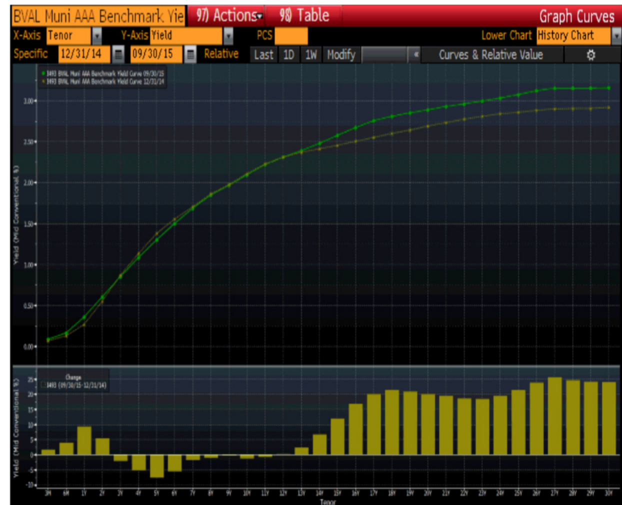

For the quarter, investment grade credit spreads were marginally wider (20bps) and high yield spreads widened significantly (145bps) versus the risk free rate. This significant widening (tightening of credit) in the high yield market will have big implications going forward as the cost of credit just increased 145 basis points versus the prior quarter. Furthermore, if the Fed where to raise the cash rate at the October or December meeting, the probability of these spreads widening further will increase. For the quarter, we did take advantage of some of the spread widening in high grade corporates and started some new positions that offer very attractive risk/reward profiles.

Looking forward, we will continue to deploy the same strategy from the previous quarters. In short, we remain committed to a very high credit quality portfolio with a bias towards interest rates being range bound. As opportunities present themselves in the investment grade corporate market, we may increase our corporate allocations. It is important to note that levels of interest rates around the world are lower than here in the US. That fact in conjunction with a Fed that may come into play, albeit at a very modest pace, is causing us to buy bonds with duration characteristics that result in our bond portfolios being slightly longer than each respective index.

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