

Fixed Income Rally Continued; Global Risks Drove Treasury Yields Lower



WEEKLY FIXED INCOME UPDATE

AUGUST 11, 2014

Last week's geopolitical uncertainty appeared to cause investors to seek the safety of U.S. Treasuries. Strong demand pushed rates lower across the curve with the sharpest drops occurring Wednesday and Thursday. The 10- and 30-year Treasury yields reached year-to-date lows on Thursday at 2.41% and 3.22%, respectively. These are the lowest levels since May/June 2013. The trend reversed on Friday as all maturities saw increasing yields, but the modest movement did not offset the previous declines.¹



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High Yield Taxable Sector Bounced Back

WE BELIEVE STABLE GROWTH AND SUBDUED INFLATION WILL ALLOW THE FEDERAL RESERVE TO CEASE ASSET PURCHASES this year and begin raising rates in mid-2015. As this occurs, interest rates will likely be volatile but increase only modestly. Near term, the yield curve could steepen with long yields moving higher. Longer term, we expect 2- to 5-year maturities to underperform.

MARKET UNCERTAINTY GENERALLY CAUSED INVESTORS TO SHUN NON-TREASURY SECTORS. Falling yields supported positive total returns, but almost all of the sectors underperformed Treasuries.² The single exception was high yield, which staged a recovery. The sector underperformed in previous weeks, dragged down by investor outflows.² The outflows continued at a record pace last week,³ but investor support appeared later in the week when valuations looked more attractive. Overall, longer sectors posted higher total returns due to the larger decline in long maturity yields.² Despite positive returns, these sectors could not keep pace with the long Treasury rally.

LAST WEEK'S PERFORMANCE ILLUSTRATED THE VOLATILITY THAT TECHNICAL FORCES CAN CREATE. Over shorter time periods these factors can overwhelm fundamentals. It is important to be respectful of technical issues and manage risk with this in mind, but we believe longer-term positioning should emphasize fundamental analysis. For example, recent high yield performance has been volatile, but the sector's fundamental factors (default rates, balance sheet health, etc.) have not changed significantly. This leads us to believe that – with continued low defaults and a meaningful yield advantage – high yield remains a relatively attractive sector. ■

High Grade Municipals Outperformed High Yield

FIXED INCOME IN GENERAL CONTINUED TO RALLY THIS PAST WEEK, WITH MUNICIPALS OUTPERFORMING GOVERNMENT BONDS.² This was partly due to lasting global unrest, as the U.S. economy is actually continuing to improve. Municipals have been cheap relative to U.S. Treasuries, and last week cross over buyers capitalized on this inefficiency.³ Municipal ratios are now in the fair value range versus Treasuries. Municipal bond funds experienced inflows of \$16.5 million.⁴ The new issue calendar remains manageable, with this week's supply totaling \$6.8 billion.³

HIGH YIELD MUNICIPAL FUNDS NET FLOWS REMAINED POSITIVE LAST WEEK AT \$60 MILLION.⁴ This brings year-to-date flows to \$5.3 billion.⁵ Absolute yields decreased but spreads widened as high yield municipals failed to keep pace with the more aggressive high grade bond rally. The more volatile sectors of Puerto Rico and tobacco were stable for the week.² The yield ratio of high yield municipals to high yield corporates retreated to historical highs as high yield corporates rebounded after a large sell-off during the prior week. ■

¹ Source: Bloomberg. ² Barclays Live. ³ *The Bond Buyer*, August 8, 2014. ⁴ Source: Lipper Fund Flows. ⁵ Investment Company Institute.

U.S. Treasury Market

Maturity	Yield	% Change		
		Week	Month-to-Date	Year-to-Date
2-year	0.45	-0.03	-0.08	0.06
5-year	1.62	-0.04	-0.13	-0.12
10-year	2.42	-0.07	-0.14	-0.61
30-year	3.23	-0.05	-0.09	-0.74

Source: Bloomberg. As of August 8, 2014. **Past performance is no guarantee of future results.**

Municipal Market

Maturity	Yield to Worst	% Change		
		Week	Month-to-Date	Year-to-Date
2-year	0.32	0.00	0.01	-0.01
5-year	1.18	-0.06	-0.04	-0.06
10-year	2.15	-0.12	-0.11	-0.62
30-year	3.20	-0.10	-0.10	-0.99

Source: Municipal Market Data. As of August 8, 2014. Yields are for AAA-rated general obligation bonds. **Past performance is no guarantee of future results.**

Characteristics and Returns

Index	Yield to Worst (%)	Spread (bps)	Effective Duration (years)	Returns (%)		
				Week	Month-to-Date	Year-to-Date
Municipal	2.28	--	7.05	0.46	0.47	6.68
High Yield Municipal	6.80	385 ¹	10.39	0.12	0.13	8.34
Short Duration High Yield Municipal ²	6.30	465	4.38	0.37	0.40	6.89
U.S. Aggregate Bond	2.26	43 ³	5.66	0.28	0.52	4.20
U.S. Treasury	1.40	--	5.40	0.34	0.61	3.18
U.S. Government Related	2.10	61 ³	5.42	0.16	0.30	4.64
U.S. Corporate Investment Grade	2.93	103 ³	7.14	0.34	0.50	6.15
U.S. Securitized	2.78	39 ³	4.94	0.19	0.48	3.83
BofA Merrill Lynch Preferred Stock Fixed Rate	4.83	231 ³	6.47	0.32	-0.15	11.58
High Yield 2% Issuer Capped	5.73	405 ³	4.26	0.48	-0.06	3.99
Global Aggregate (unhedged)	1.77	43 ³	6.45	0.32	0.58	4.60

¹ Yield difference between the Barclays High Yield Municipal Index and the 20-year AAA MMD scale. ² Data is a subset of the S&P Short Duration Municipal Yield Index that is below investment grade/nonrated. Spread is the yield difference between this subset and the subset rated AAA. ³ Option-adjusted spread to Treasuries.

Source: Morningstar Direct; Barclays Live; Bloomberg. As of August 8, 2014. **Past performance is no guarantee of future results.** Unless otherwise noted, the index is Barclays. All index returns are shown in U.S. dollars. **Yield to worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting. **Effective duration** (expressed in years) measures the price sensitivity of a fixed-income investment to a change in interest rates, considering that expected cash flows will fluctuate as interest rates change. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indices are unmanaged and unavailable for direct investment.

Yield Ratios

	Ratio (%)
10-year AAA Municipal vs Treasury	88
30-year AAA Municipal vs Treasury	99
High Yield Municipal vs High Yield Corporate	119

Source: Bloomberg, Barclays Live, Thompson Reuters. As of August 8, 2014. AAA municipals represented by the MMD scale. The high yield ratio equals the yield-to-worst for the Barclays High Yield Municipal Index divided by the yield-to-worst for the Barclays High Yield Corporate Index. **Past performance is no guarantee of future results.**

AUDIO REPLAY

Mid-Year Market Update



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Any reference to municipal credit ratings refers to the highest rating given by one of the following national rating agencies: S&P, Moody's or Fitch. Credit ratings are subject to change. AAA, AA, A and BBB are investment grade ratings; BB, B, CCC, CC, C and D are below-investment grade ratings.

Barclays Municipal Index covers the USD-denominated tax-exempt bond market. **Barclays High Yield Municipal Index** covers the USD-denominated, below investment grade tax-exempt bond market. **S&P Short Duration High Yield Municipal Index** tracks the high yield municipal bond market with maturities from 1 to 12 years. **Barclays U.S. Aggregate Index** covers the U.S. investment grade fixed rate bond market. **Barclays U.S. Treasury Index** includes public obligations of the U.S. Treasury. **Barclays U.S. Government-Related Index** includes debt guaranteed, owned and sponsored by the U.S. government; it does not include debt directly issued by the U.S. government. **Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable corporate bond market. **Barclays U.S. Securitized Index** is a composite of asset-backed securities, collateralized mortgage-backed securities (ERISA-eligible) and fixed rate mortgage-backed securities. **BofA Merrill Lynch Preferred Stock Fixed Rate Index** is designed to replicate the total return of a diversified group of investment-grade preferred securities. **Barclays High Yield 2% Issuer Capped Index** measures the market of USD-denominated, non-investment grade bonds and limits each issue to 2% of the index. **Barclays Global Aggregate Unhedged Index** measures the performance of global bonds. It includes government, securitized and corporate sectors and does not hedge currency.

A WORD ON RISK

Investing involves risk; principal loss is possible. Debt or fixed income securities are subject to market risk, credit risk, interest rate risk, call risk, derivatives risk, dollar roll transaction risk and income risk. As interest rates rise, bond prices fall. Below investment grade or high yield debt securities are subject to liquidity risk and heightened credit risk. Preferred securities are subordinated to bonds and other debt instruments in a company's capital structure and

therefore are subject to greater credit risk. Foreign investments involve additional risks, including currency fluctuation, political and economic instability, lack of liquidity and differing legal and accounting standards. Asset-backed and mortgage-backed securities are subject to additional risks such as prepayment risk, liquidity risk, default risk and adverse economic developments.

Investors should contact a tax advisor regarding the suitability of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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