Bond Market Update

As of December 31, 2015 / Volume 4, Issue 4 / FFTAM.COM

The fourth quarter of 2015 for the fixed income market turned out to be very eventful. Total returns were mixed as the Federal Reserve (the Fed) raised the short term Fed Funds rate for the first time in 9 years! The US economy continued its slow growth trajectory as GDP forecast for the 4th quarter come in at 2.10%. Both AAA taxable and tax-exempt yield curves flattened.

Total returns for taxable investments where negative and tax-exempt investments where positive. For the 4th quarter, the Barclays Aggregate Bond Index recorded a total return of -0.57% and the Barclays Muni Index recorded a total return of 0.79%. YTD returns are 0.55% and 2.45%, respectively. As mentioned above, the economy continued its slow growth trajectory as 3rd quarter GDP came in with a final reading of 2.0%. ISM Manufacturing broke its trend of prints above 50 as both November and December produced readings below 50. ISM Nonmanufacturing continued their readings above 50 (a reading above 50 indicates expansion). The unemployment rate is projected to drop to 5.0% from 5.1%.

The biggest event in the 4th quarter was the Fed raising the short term Fed Funds rate to a range of 0.25% to 0.50%. It only took 9 years, but liftoff was widely expected by the market. In reviewing the much scrutinized dot plot, the Fed guided expectations to four 0.25% increases for 2016. Since there are eight meetings in 2016, the assumption is for the 0.25% rate increase to happen at every other meeting.

Below to the left is the US Treasury Yield curve as of 12/31/14 and 12/31/15. As you will see, the yield curve has flattened as short rates have moved up more than intermediate rates. Below to the right is the AAA Municipal Yield curve as of 12/31/14 and 12/31/15. It also experienced a flattener, however, short rates moved up and intermediate rates came down.

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For the quarter, investment grade credit spreads were marginally tighter (12bps) and high yield credit spreads widened moderately (44bps) versus the risk free rate. YTD, investment grade credit spreads widened by 32bps and high yield credit spreads widened by 203bps. This significant widening (tightening of credit) in the high yield market will have big implications going forward as the cost of credit just increased 203 basis points versus the prior year.

Looking forward, we do expect pressure on the short part of the yield curve as the Fed has started the process of normalization. This process as communicated by the Fed will be gradual. Figuring out the definition of gradual will be key. 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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