Taplin, Canida & Habacht

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Fixed income market update

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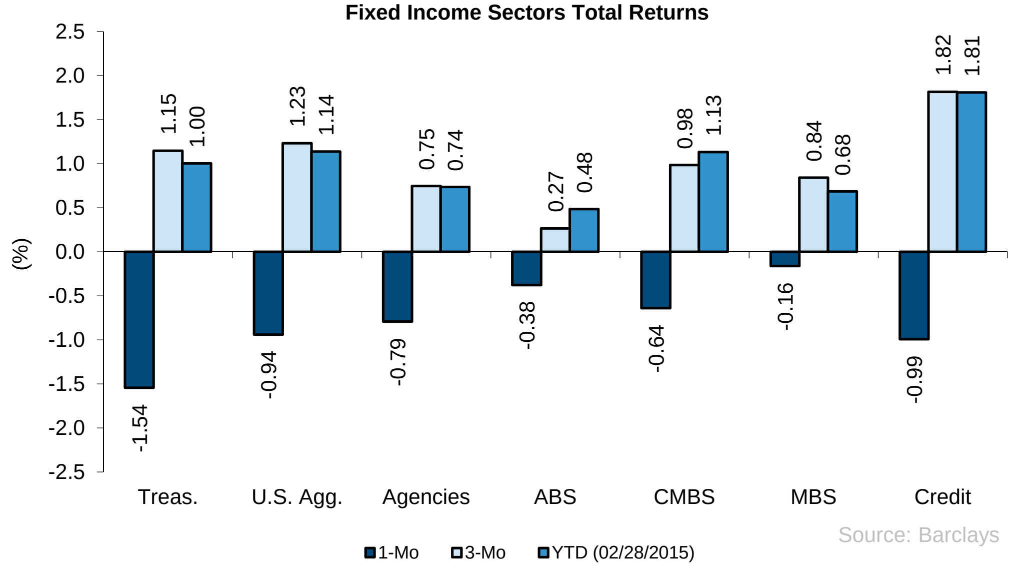
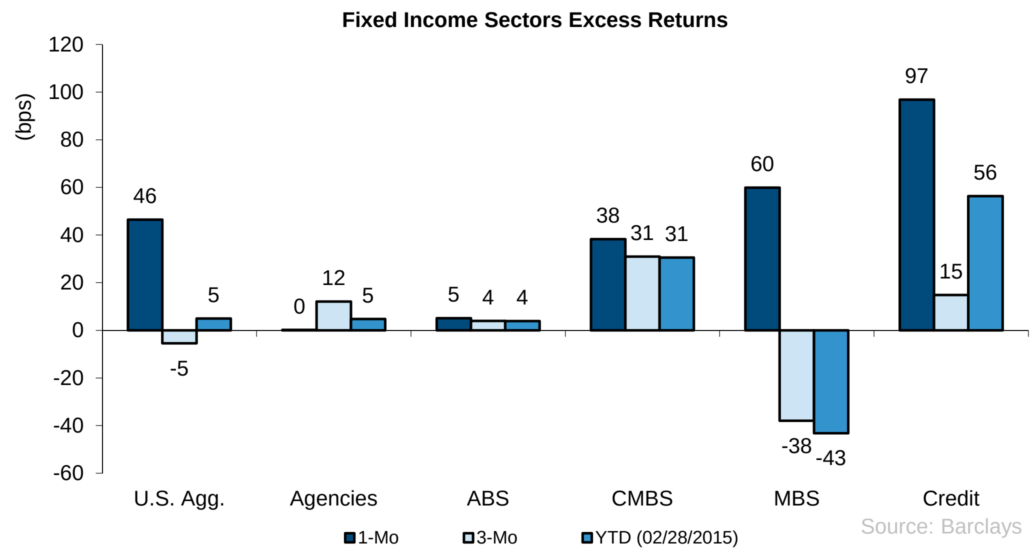
Fixed income market update

- For the month ended February 28, 2015, the Barclays U.S. Aggregate Bond Index (BCAGG) returned -0.94%. Year to date, the index has returned 1.14%.

- U.S. Treasuries returned -1.54% during the month as the yield on the 10-year U.S. Treasury rose to 1.99% from 1.64% at the end of January. For the month, long Treasuries (-5.35%) underperformed intermediate Treasuries (-0.90%) as the yield curve steepened. Despite the meaningful rise in yields in February, rates remain below year-end levels.

- Mortgage-backed securities (MBS) returned -0.16% during the month, outperforming duration-matched Treasuries by 60 basis points. The option adjusted spread (OAS) of the Barclays U.S. Mortgage Index tightened 15 basis points to end the period at 18. The volatile beginning to the year for Treasury yields did not lead to as much prepayment as might have been expected suggesting lower convexity risk moving forward absent prolonged declines in yields.





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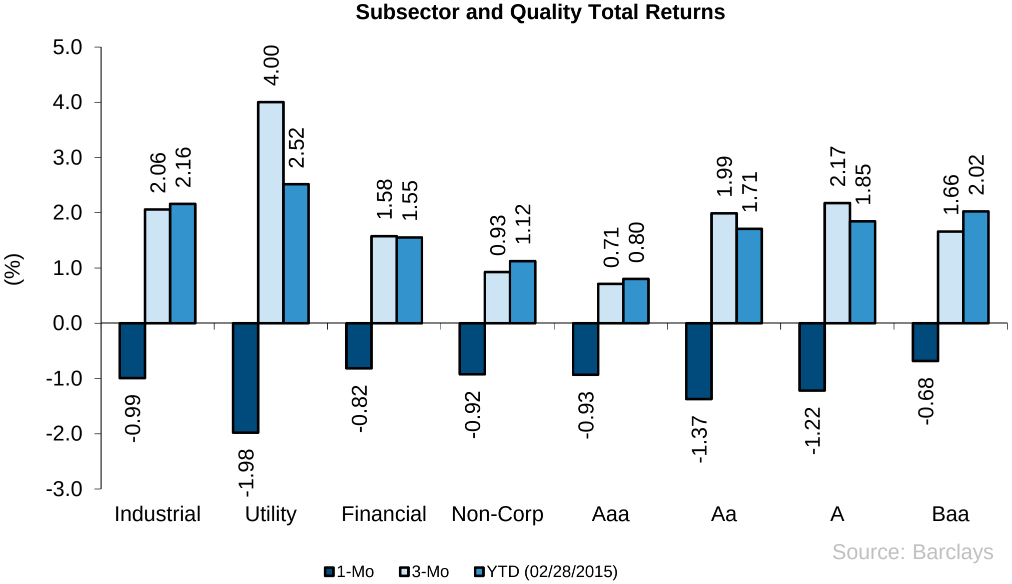
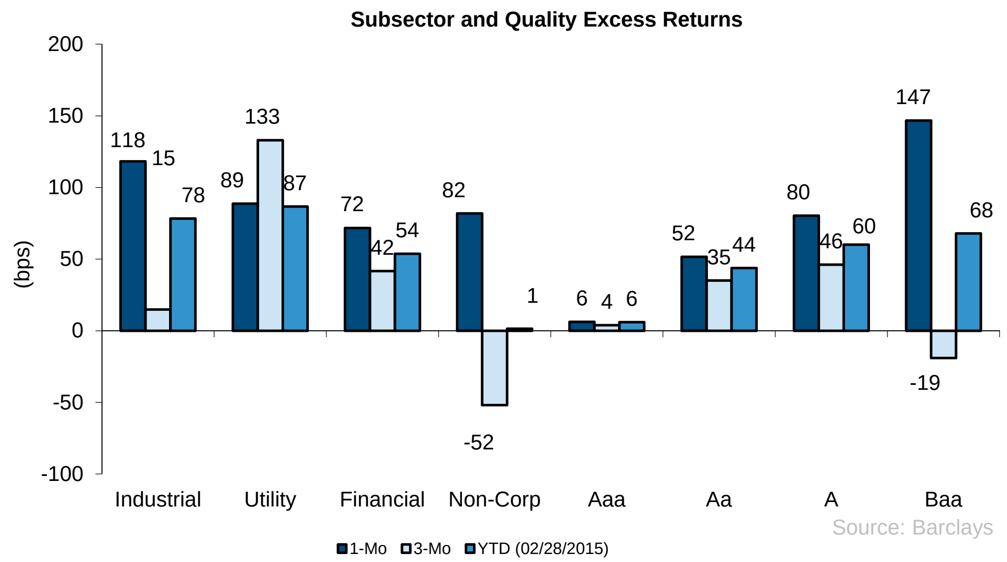
Fixed income market update (continued)

- Credit securities returned -0.99% for the month, outperforming Treasuries by 97 basis points on a duration-adjusted basis. The OAS of the Barclays U.S. Credit Index ended the period at 119 bps, 13 basis points tighter than at the end of January. For the month, long credit (-2.25%) underperformed intermediate credit (-0.42%) on an absolute basis, but outperformed by 121 basis points on a duration-adjusted basis as credit curves flattened.
- For the month, on a duration-adjusted basis, industrials outperformed utilities, non-corporates and financials by 29, 36 and 46 basis points of excess return, respectively. All credit sub-sectors had negative absolute returns, but positive duration-adjusted returns.
- Lower quality investment grade securities outperformed during the month. BBB rated securities outperformed AAA, AA and A rated securities by 141, 95 and 67 basis points of excess return, respectively.





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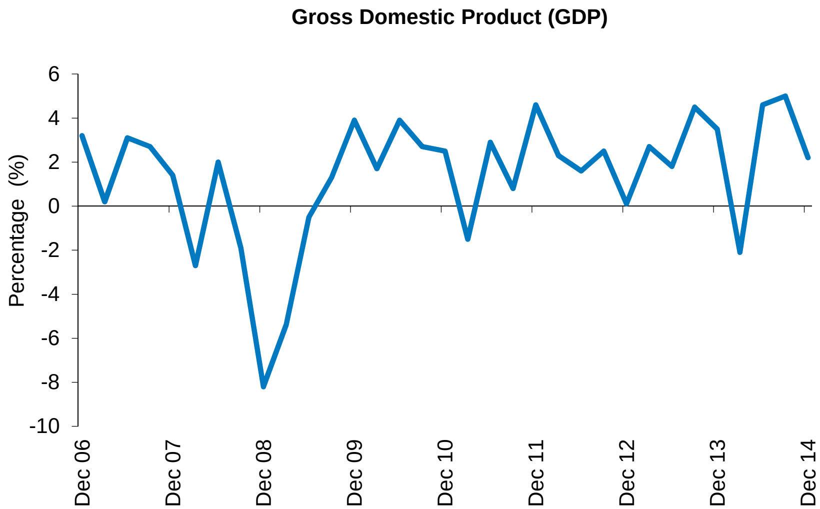
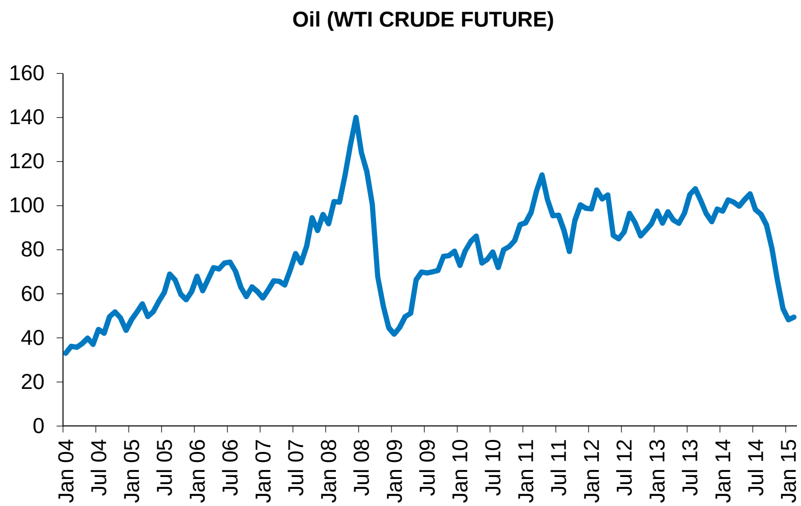
Update on the U.S. economy

Fourth quarter gross domestic product (GDP) was revised down to 2.2% annualized growth from an initial estimate of 2.6%. The largest components of the negative revision were increases in imports and decreases in inventory build-up, both of which are positive signs for future growth. Meanwhile, personal consumption expenditures was revised down only 0.1% and remained a robust 4.2% increase. A difficult winter is likely to detract from first quarter GDP, similar to last year, suggesting the fourth and first quarters are unlikely to match the strong growth in the second and third quarters.



Source: Bureau of Economic Analysis

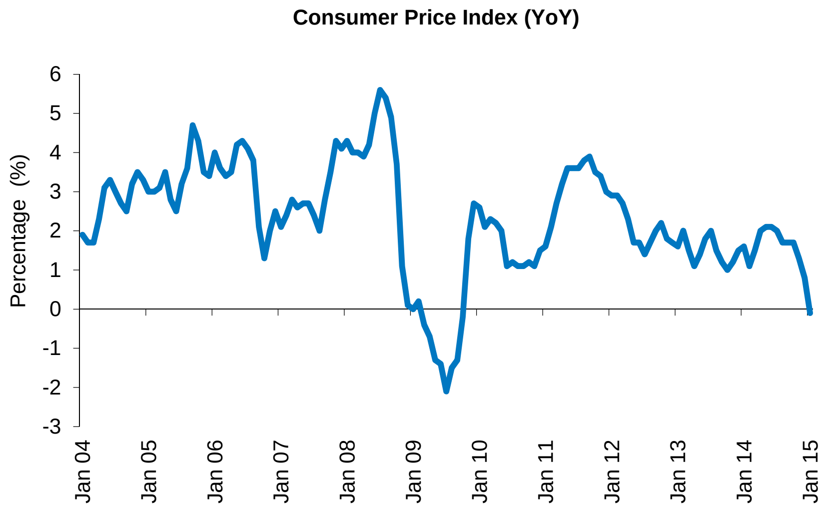


Source: Bloomberg

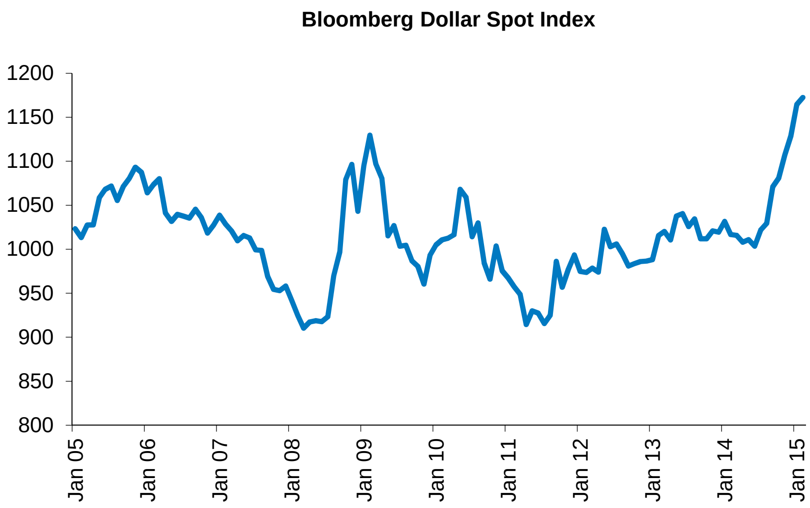
Oil rose slightly to $49 a barrel, in February, halting a seven consecutive month decline in price. As might be expected given the magnitude of the recent fall in price, the number of rigs operating in the U.S. has been reduced along with many layoffs of personnel. While cutting supply on the margin should impact price, this process will take time. Rumors of an emergency Organization of the Petroleum Exporting Countries (OPEC) meeting to reduce supply initially lifted prices. However, many believe OPEC will not limit supply for fear of losing market share in the face of member budget shortfalls.

Update on the U.S. economy

The Consumer Price Index (CPI) declined 0.7% in January, the third consecutive monthly decline and is negative (-0.1%) for the trailing twelve months. Energy prices have been a major source of the fall in inflation as core CPI, which excludes food and energy, was positive (+0.2%) in January. The decline in energy prices has impacted inflation figures globally. The United Kingdom, for example, had its lowest inflation level in almost 15 years in January. The Fed has indicated they believe inflation may decline further before increasing toward target levels.



Source: Bureau of Labor Statistics



Source: Bloomberg

The U.S. dollar strengthened slightly in February, continuing the increase that has sent it to its highest level in over ten years according to the Bloomberg Dollar Spot Index. Dollar strength has been supported by continued low global yields directing cashflow to more attractive U.S. assets and monetary policy easing abroad relative to the U.S. A stronger dollar may be a continued headwind for oil and other commodities priced in dollars as well as having a disinflationary impact on the U.S. as consumers purchase imports at lower dollar prices.

Economic and market perspective

- The Greek bailout program from the Eurozone was set to expire in February. After recent Greek elections where Syriza won on an anti-austerity campaign, there was uncertainty around how Europe and Greece could reach an agreement given member states' insistence on austerity programs. Speculation of a Greek exit from the Eurozone resurfaced, though ultimately a four-month extension of the program was worked out. Without permanent resolution, volatility is expected to persist over the coming months.

- A cease-fire between Ukraine and pro-Russian separatist groups was announced during the month, though tension and fighting persisted. For Russia, which faces European and American sanctions for its actions in Ukraine, low oil prices continue to weigh on the economy. The combination of the these events and the resulting currency weakness led Moody's to downgrade Russian sovereign debt to a below investment grade rating of Ba1.

- Falling inflation globally is creating an environment supportive of further monetary easing. The European Central Bank's (ECB) quantitative easing program is set to begin in March. More quietly in February, the People's Bank of China (PBoC) reduced reserve requirements for banks. The move comes after China's economy grew at its worst pace in 24 years (7.4%) and fears of a slowdown continue. Following the PBoC's rate cut in November, the change in reserve requirements is aimed at creating about $100 billion in additional liquidity. The announcement has led to speculation of further monetary easing in China in the coming months. Easing in China, Japan and Europe illustrate the continuing divergence between global and U.S. monetary policy.

Economic and market perspective

- Minutes of the Federal Open Market Committee (FOMC) meeting from January 27 – 28 were released in February. The minutes highlighted the view within the Committee that when balancing the risks of raising rates too early or too late, many members preferred to err on the side of keeping rates lower for longer. Subsequently, Janet Yellen testified before Congress on February 24 – 25 where she reiterated the Fed would remain patient regarding a potential increase in the Fed Funds rate. Noteworthy was the announcement that the Fed would change the language used in its statements when they begin considering a rate hike before actually implementing a policy change.

- For the trailing twelve months ended December 2014, U.S. home prices increased 4.6% according to the S&P/Case-Shiller Home Price Indices. Despite interest rates declining throughout the year, the home price appreciation in 2014 is the lowest growth rate for a calendar year since 2011 when the index declined for the year.

- In our view, given the global changes in monetary policy, inflation, and energy prices, recent volatility in fixed income markets is not unexpected. This volatility has been seen in the sharp decline in yields in January and subsequent rise in February, though rates still remaining below year end levels. Volatility has been further seen in the reaction of spread product, in both months, credit and mortgage-backed-securities had meaningful differences in duration-adjusted returns versus Treasuries. With many sovereign yields hitting new all-time lows intra-month in February we continue to view U.S. fixed income as attractive in a global context.

Fixed income returns as of February 28, 2015

Index Returns as of February 28, 2015				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to- Date	Month-to-Date	Year-to- Date
U.S. Aggregate	-0.94	1.14	0.46	0.05
U.S. Treasury	-1.54	1.00	-	-
Intermediate	-0.90	0.73	-	-
Long	-5.35	2.75	-	-
TIPS	-1.20	1.91	-	-
Agencies	-0.79	0.74	0.00	0.05
U.S. MBS	-0.16	0.68	0.60	-0.43
U.S. Credit	-0.99	1.81	0.97	0.56
Intermediate	-0.42	1.34	0.59	0.51
Long	-2.25	2.88	1.80	0.70
Industrial	-0.99	2.16	1.18	0.78
Utility	-1.98	2.52	0.89	0.87
Financial	-0.82	1.55	0.72	0.54
Non-Corporate	-0.92	1.12	0.82	0.01
Aaa	-0.93	0.80	0.06	0.06
Aa	-1.37	1.71	0.52	0.44
A	-1.22	1.85	0.80	0.60
Baa	-0.68	2.02	1.47	0.68
High Yield	2.41	3.09	3.44	2.21
Floating Rate Notes	0.15	0.16	0.15	0.15

Source: Barclays

Disclosure

All investments involve risk, including the possible loss of principal.

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