Taplin, Canida & Habacht

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Fixed income market update

Taplin, Canida & Habacht, LLC
BMO Global Asset Management
1001 Brickell Bay Drive
Suite 2100
Miami, Florida 33131

p 305-379-2100
f 305-379-4452
tchinc.com

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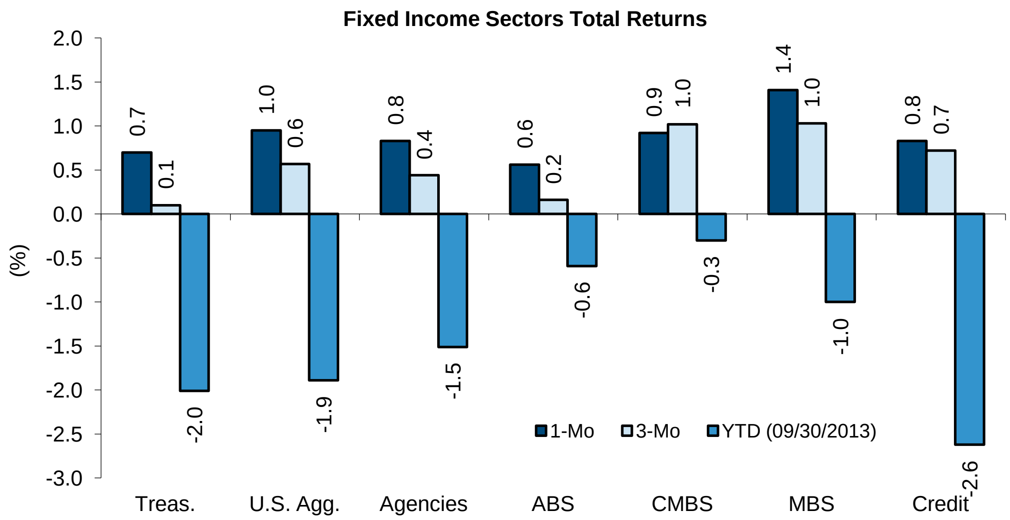
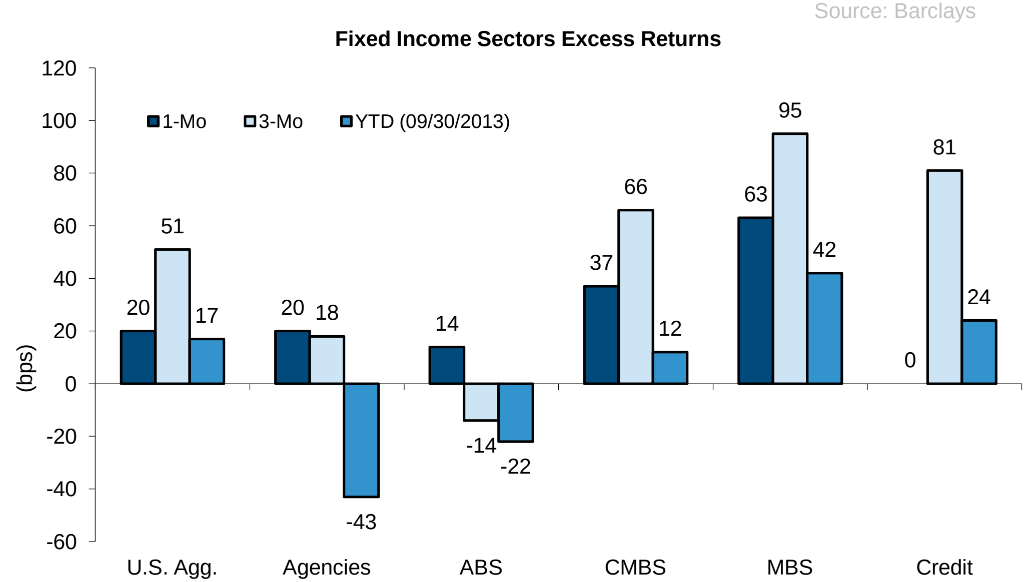
BMO Global Asset Management
A part of BMO Financial Group

Fixed income market update

- For the quarter ended September 30, 2013, the Barclays U.S. Aggregate Bond Index returned 0.57%. Returns were driven by the 0.95% return for September following the Fed's decision not to begin tapering bond purchases.
- U.S. Treasuries realized a positive return for the quarter (+0.10%) and for the month (+0.70%). Intermediate Treasuries (+0.41% quarter, +0.74% month) outperformed long Treasuries (-2.23% quarter, +0.37% month) as the yield curve steepened.
- Mortgage-backed securities outperformed duration-matched Treasuries by 95 basis points for the quarter and 63 basis points for the month.



Source: Barclays



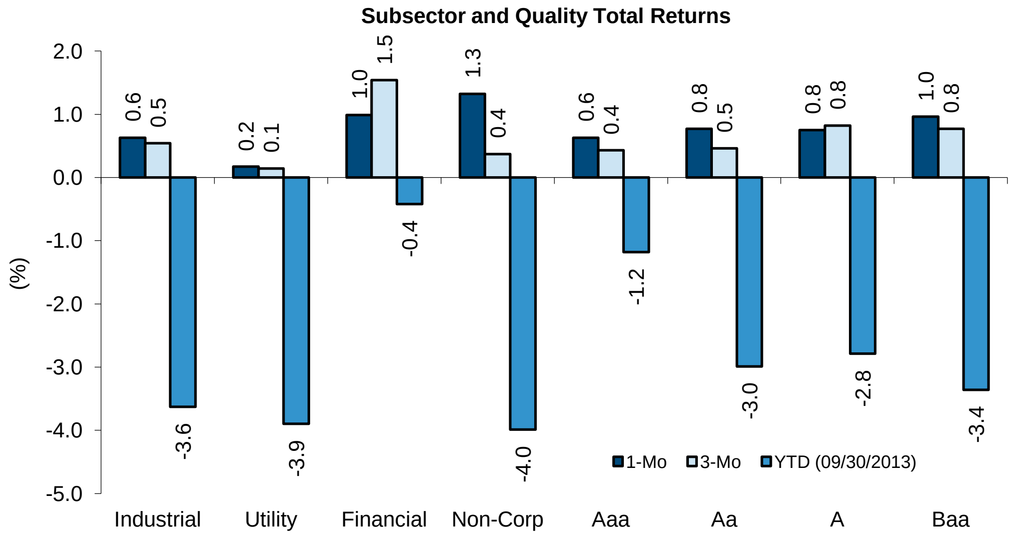
Source: Barclays

Fixed income market update (continued)

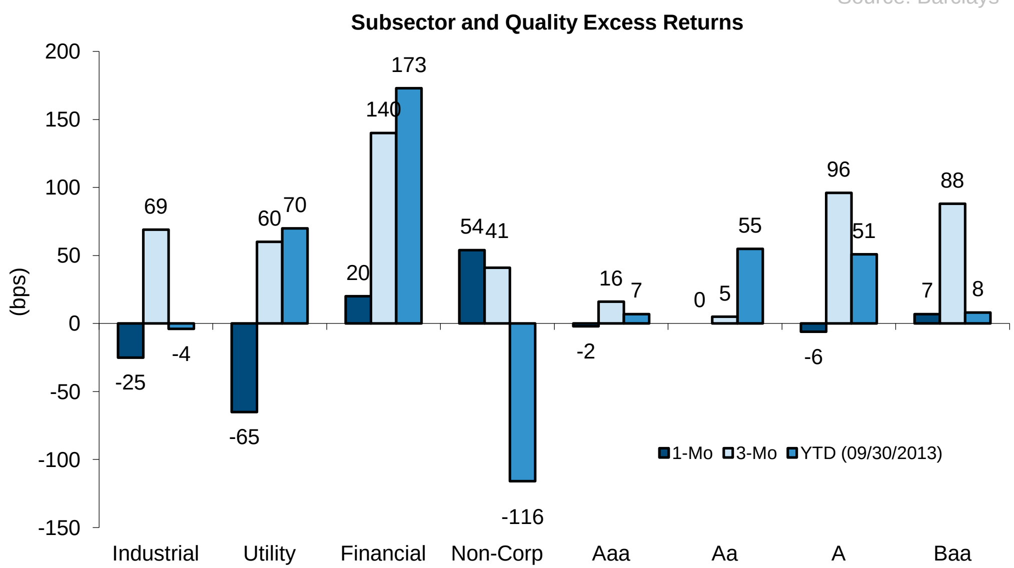
- Credit securities, which returned 0.72% for the quarter, outperformed duration-matched Treasuries by 81 basis points. Long credit (-0.03% quarter) underperformed intermediate credit (+1.01%) on an absolute basis but outperformed by 72 basis points on a duration-adjusted basis.

- Financials (+1.54%) were the best performing credit subsector on a duration-adjusted basis for the quarter with 140 basis points of excess return, outperforming industrials (+0.54%), utilities (+0.14%) and non-corporates (+0.37%) by 71, 80 and 99 basis points of excess return, respectively.

- A rated investment grade securities were the best performing from a quality perspective for the quarter with 96 basis points of excess return, outperforming AAA, AA and BBB rated securities by 80, 91 and 8 basis points, respectively.



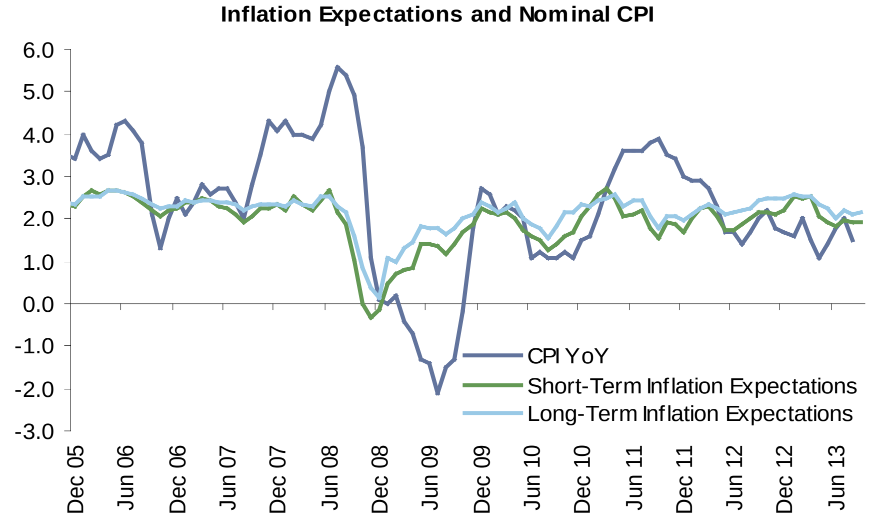
Source: Barclays



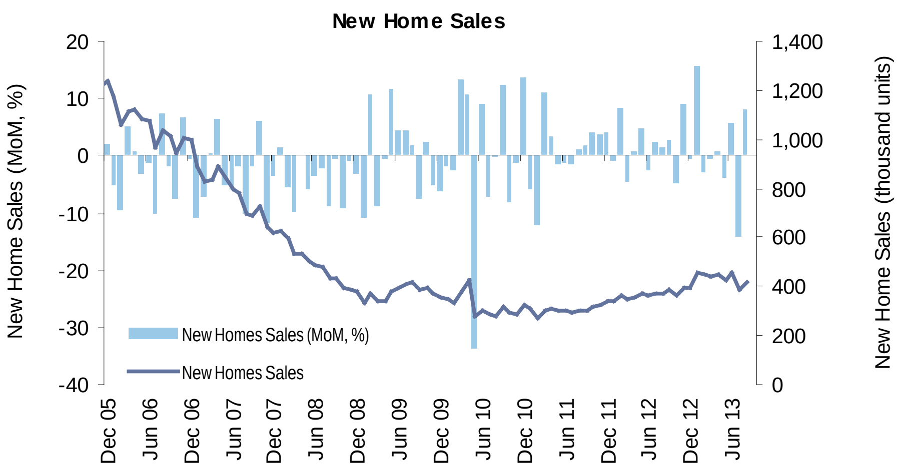
Source: Barclays

Update on the U.S. economy

Both headline and core CPI (which excludes food and energy) rose 0.1% in August, the smallest increase in three months, following a 0.2% gain for headline CPI in July. Inflation figures remain an investor focus as the Fed debates whether economic growth is strong enough to taper bond purchases.



Sources: Bloomberg L.P., BMO Global Asset Management

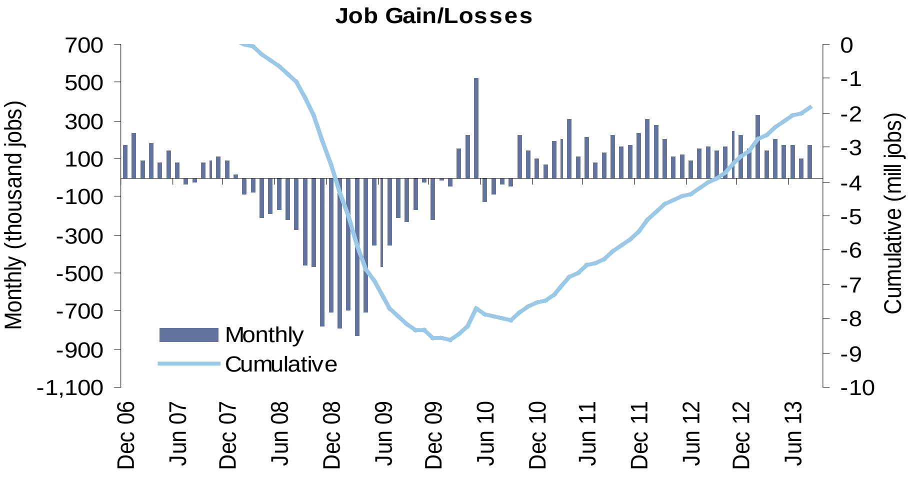


Sources: Bloomberg L.P., BMO Global Asset Management

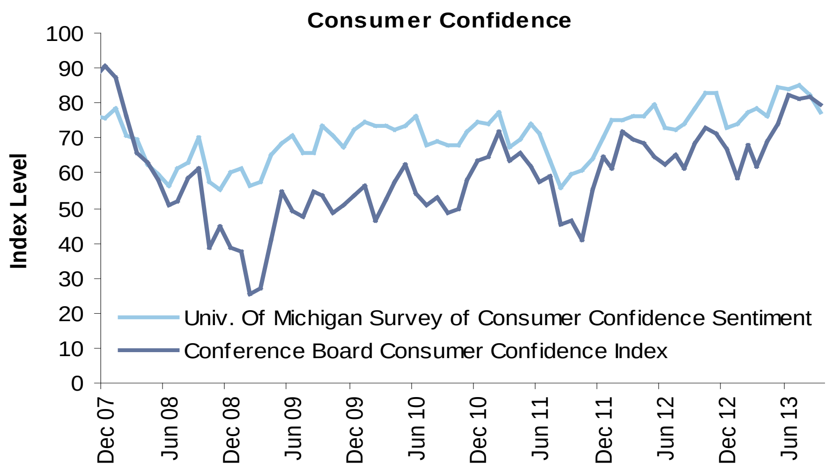
Purchases of new U.S. homes rose 7.9% in August to a 421,000 annualized pace. July and August were the two weakest months of the year for new home sales, demonstrating the impact of higher mortgage rates on the rebound in real estate prices.

Update on the U.S. economy

Total nonfarm payroll employment increased by 169,000 in August, and the unemployment rate fell slightly to 7.3%, its lowest level in four years, driven in part by a civilian participation rate that continues to decline and reached 63.2% in August.



Sources: Bloomberg L.P., BMO Global Asset Management



Sources: Bloomberg L.P., BMO Global Asset Management

The University of Michigan index of consumer sentiment fell to 77.5 in September from 82.1 a month earlier. Consumer confidence hit a five-month low as higher mortgage rates threatened to slow momentum in the housing market.

Economic outlook

- The fourth quarter has begun with a partial shutdown of the United States Government. President Obama notified government agencies that a cessation of services was imminent as several weeks of deliberations within Congress had reached a critical deadline without an agreement.

- At the center of the debate is an attempt by House Republicans to delay the opening of health care insurance exchanges, which are set to open Tuesday. Insurance exchanges match individuals and families with competitively-priced health care insurance plans and were created under the provision of the Affordable Care Act, which mandates that all individuals purchase health insurance.

- The U.S. Government closure will affect non-essential services such as National Parks and passport and drivers license renewals. Economists estimate that the shutdown could cost the economy up to $2 billion dollars as roughly 800,000 U.S. Federal government workers have been put on temporary unpaid leave. Based on these figures, the shutdown may result in a reduction of U.S. quarterly GDP by 0.15% for each week it persists.

- While a partisan standoff over the budget to keep the U.S. Government running is already cause for concern, our greater worry is that such brinkmanship will further complicate the debate surrounding America's borrowing limit. According to U.S. Treasury Secretary Jack Lew, the government will exceed its limit on October 17, but Congressional Republicans are standing firm on the list of concessions they want President Obama to make before they will agree to extend the borrowing limit.

- Markets posted a muted reaction to the news as this is the third time budget negotiations have gone to the wire under the Obama administration. However, one factor that will likely complicate this go-round is a statement released by the commissioner of the Bureau of Labor Statistics stating, "All survey and other program operations will cease, and the public web site will not be updated." This would include the release of the non-farm payrolls data, an ever more critical data point for investors trying to forecast when, or if, the Federal Reserve will begin tapering its purchases of U.S. Treasuries and Agency Mortgage-Backed Securities.

Economic outlook

- The Federal Reserve surprised most investors on September 18th by continuing to purchase $85 billion a month of U.S. Treasuries and MBS. Following Chairman Bernanke's comments in May, and those of several of the FOMC Committee members, the consensus amongst economists, strategists and investors was that the central bank would likely remove a modest amount of stimulus, e.g., a $10 billion reduction in purchases. In fact, as U.S. Treasury yields matriculated higher, it appeared that such action was being "priced in" and justifiably so, as Fed commentary aside, the nation's unemployment rate had declined to 7.3%, very close to the "about 7%" Chairman Bernanke indicated as a critical level at which markets might anticipate the tapering of purchases. Furthermore, the Committee's outlook is for economic growth to increase at a "moderate pace" into 2014. Even after the Fed amended its outlook for growth to "modest," the scorecard still seemed in favor of tapering, so why did the committee unanimously vote to maintain the program, and why did the market score this incorrectly? In our view, there were two predominant areas of confusion -- investor misinterpretation and Fed miscommunication.

- When it has come to assessing and positioning ahead of this Committee's directives, the simpler of two interoperations has consistently led to the better outcomes. Mr. Bernanke did not affirm nor deny that the September 18th meeting would result in a tapering off of purchases. He was in fact, completely neutral. While the Fed's expectations between the future paths of key economic measures remained favorable, the divergence between the actual data and the expected data remained wide. For instance, since early 2008, real personal consumption expenditures, which accounts for approximately 70% of U.S. GDP, has grown at an average annual rate of 1.1%, easily the weakest period of consumer demand since the Great Depression. While the Fed may expect that longer term consumption will approach 2%, will it be able to do so when the majority of the decline in the nation's unemployment rate is coming from a shrinking labor force, the federal government is facing a mandatory shutdown and the Federal Reserve is removing stimulus? In our view, the answer is decidedly "no."

- The second area of contention is the Fed's communication itself. To be sure, a more transparent Federal Reserve can be very effective provided it remains consistent. There is no question that both Chairman Bernanke and the Committee as a whole have qualified their remarks as being subject to the data. However, this recent string of communications shows a lack of consistency. For example, while the Fed has been concerned about the poor mix of the nation's labor market, it has made no such revision as to what that means for the unemployment rate as a policy toggle. Likewise, if the Fed's views of central tendencies are skewed towards more near term outcomes, to what extent is a reduction from "moderate" to "modest" growth material to policy decisions? Ultimately, the Committee may feel that such communications are too transparent, which may be a valid view; however, it is also their responsibility to recognize that the market has been conditioned nonetheless. As we now enter the fourth quarter, a critical factor for both the markets and the U.S. economy will be how the central bank manages expectations on these two separate fronts.

Fixed income returns as of September 30, 2013

Index Returns as of September 30, 2013						
	Total Return (%)			Excess Return (%)		
	One Month	Recent Quarter	Year-to-date	One Month	Recent Quarter	Year-to-date
U.S. Aggregate	0.95	0.57	-1.89	0.20	0.51	0.17
U.S. Treasury	0.70	0.10	-2.01	0.00	0.00	0.00
Intermediate	0.74	0.41	-0.88	0.00	0.00	0.00
Long	0.37	-2.23	-9.88	0.00	0.00	0.00
Agencies	0.83	0.44	-1.51	0.20	0.18	-0.43
U.S. MBS	1.41	1.03	-1.00	0.63	0.95	0.42
U.S. Credit	0.83	0.72	-2.62	0.00	0.81	0.24
Intermediate	0.94	1.01	-0.85	0.08	0.61	0.45
Long	0.51	-0.03	-8.04	-0.21	1.33	-0.25
Industrial	0.63	0.54	-3.63	-0.25	0.69	-0.04
Utility	0.17	0.14	-3.90	-0.65	0.60	0.70
Financial	0.99	1.54	-0.42	0.20	1.40	1.73
Non-Corporate	1.32	0.37	-3.99	0.54	0.41	-1.16
Aaa	0.63	0.43	-1.18	-0.02	0.16	0.07
Aa	0.77	0.46	-2.99	0.00	0.05	0.55
A	0.75	0.82	-2.79	-0.06	0.96	0.51
Baa	0.96	0.77	-3.36	0.07	0.88	0.08

Source: Barclays

Disclosure

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