Fixed Income Commentary
Spring 2018

Interest rates moved higher again this quarter with ten-year Treasury yields approaching 3% for the first time since 2013. The ten-year Treasury bond finished last year yielding 2.4%. The increase in yields coincides with a strengthening economy, a rising inflation rate, and an increasing federal funds rate. With respect to the latter, Jerome Powell replaced Janet Yellen at the helm of the Federal Reserve Bank ("Fed") this quarter. The change appears to be more cosmetic than material as Powell's commentary and policy has been largely in line with his predecessor. As such, the Fed hiked the federal funds rate another 0.25% to 1.75% in March and expects two more rate hikes this year. Additionally, Powell does not intend to change the plan laid out last year to reduce the Fed's $4 trillion of bond holdings over time. Both measures indirectly restrict employment and inflation growth to prevent the economy from overheating, and of direct importance to bond investors, they create an upward pressure on interest rates.

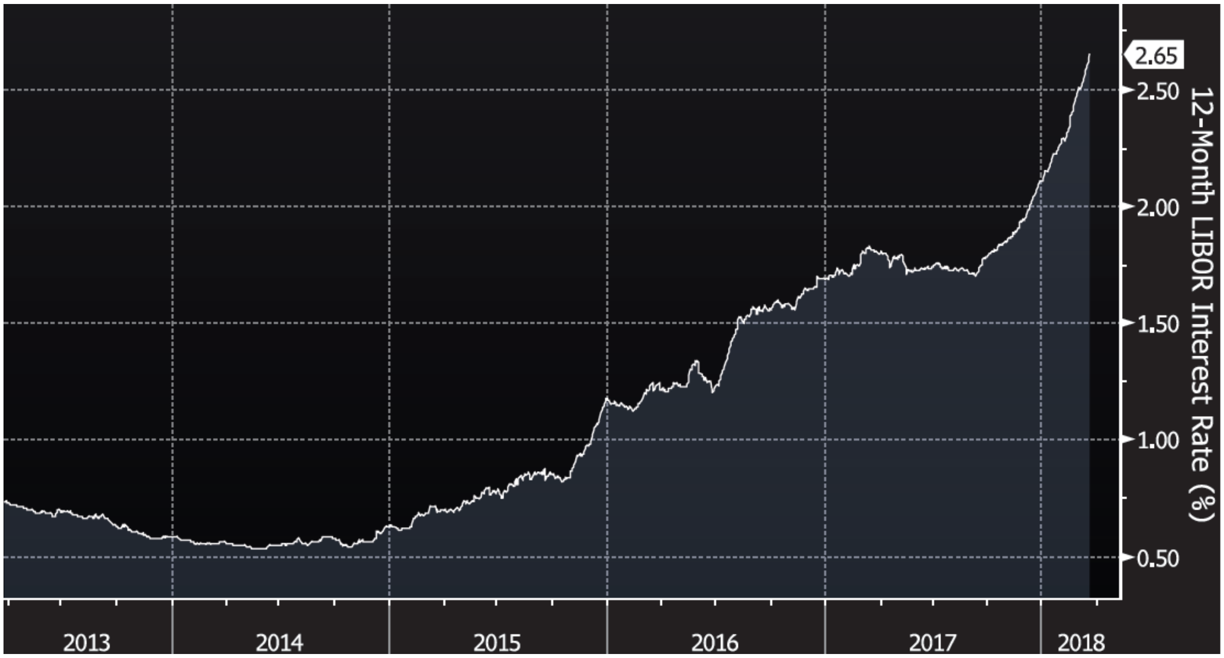
In the short-run, rising interest rates can be painful for bond investors. Rates and bond prices move in opposite directions – as rates increase, bond prices fall. The risk that rate movements will impair a bond's value is known as interest rate risk. There are two primary ways to minimize interest rate risk, both of which we employ in clients' bond portfolios:

1. **Buy bonds with limited time to maturity.** Since bonds are redeemed at a set "par" value and approach that value as time to maturity decreases, price deviations on short-term bonds are minimized.
2. **Buy floating-rate bonds.** Instead of being locked into fixed coupon payments, the coupons on floating-rate bonds reset to prevailing market interest rate levels. Since the coupons adjust for rate changes, the bond's price can remain relatively constant.

We moderate maturities by capping our clients' bond ladders at a maximum eight-years to maturity. While this structure is designed to protect principal better than longer-term maturities in a rising rate environment, it's the floating-rate bonds we have purchased for our clients that are showing the most immediate benefits.

Most of our non-agency mortgage-backed securities ("CMOs") are collateralized with adjustable-rate mortgage loans, and the coupons on these bonds have been ratcheting up along with other short-term rates. We originally started buying CMOs near the depths of the Financial Crisis in 2008. At the time, the bonds were trading at "fire sale" prices, and the success of the investments relied on home prices stabilizing and homeowners staying afloat. Every mortgage payment is delivered to investors at 100 cents on the dollar, so when bonds are purchased at large discounts, each payment realizes sizable gains for investors. Today, homeowners are on solid footing, and the CMO market is no longer plagued with the same risks from a decade ago. With credit no longer a major concern, bond prices are more rational, and total return relies heavily on coupon payments. Fortunately, coupon payments have been soaring over the last three years.

Short-Term Rates Are Soaring



The coupon rates for many floating-rate bonds are pegged to twelve-month LIBOR, including many non-agency mortgage-backed securities ("CMOs").

Adjustable-rate mortgages – much more popular before the Financial Crisis than today – are home loans with interest rates that change periodically based on movements in an underlying index, typically one-year Treasury yields or LIBOR rates[4]. For example, a borrower could be charged 2%, plus the twelve-month LIBOR rate. This borrower benefited from a low 2.5% mortgage interest payment in 2014, but that rate has climbed to over 4.5% today. If the Fed continues with their rate hike plan, the borrower's rate should continue to grow. Unless the borrower can pay off the loan or opts to refinance to a fixed-rate mortgage, those adjusted rates will keep flowing through to CMO holders in the form of higher coupons. Our primary goal as bond investors is to enhance client returns without accepting high levels of interest rate or credit risk, and CMOs play an important role in our clients' bond portfolios of doing just that.

[4] *The London Interbank Offered Rate ("LIBOR") is the rate which most large international banks are charging each other for short-term loans and is a widely-used benchmark for short-term interest rates.*

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