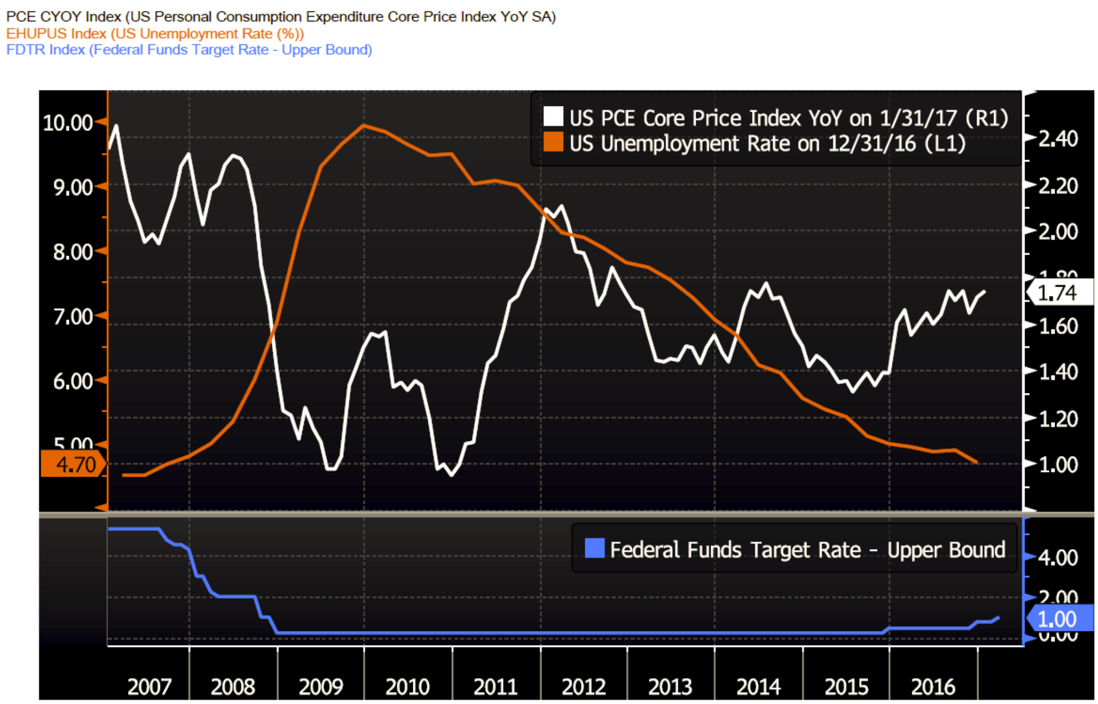
KOVITZ INVESTMENT GROUP
*Intrinsic Values®*

# Fixed Income Commentary
## Spring 2017

Bond yields ended the quarter roughly in-line with their level at year-end 2016. However, one area of the fixed income market that experienced significant change was short-term government bonds maturing in one year or less. Three-month Treasury bill yields increased 49% from 0.51% to 0.76%, and the one-year Treasury yield surpassed 1% for the first time since 2008. These increases were a direct result of the widely expected Federal Reserve ("Fed") decision to increase the federal fund's target rate, the interest rate at which banks lend to each other, from 0.75% to 1%. The Fed anticipates two more rate hikes this year, and the financial markets seem to agree.

The Fed adjusts the federal funds rate to tighten (raise rates) or loosen (lower rates) bank lending policies and, in turn, influence the amount of leverage and growth in the economy. This monetary tool helps the Fed fulfill their so-called "dual mandate" to maximize employment and moderate inflation. The Federal Reserve is currently targeting 2% for long-run annual inflation rates and estimating 4.7% as the normal rate of unemployment. Exhibit 1 shows how inflation and unemployment rates have changed over the last ten years. The unemployment rate is currently at the Fed's long-run goal of 4.7%. The inflation rate is 1.7%, which is below, but trending towards, the 2% inflation target. As long as employment holds steady, the inflation rate's future path should dictate how much, or how little, the Fed considers raising rates from this point forward.

Exhibit 1

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In the short-run, the increases in the federal funds rate will continue to increase short-term bond yields and, therefore, have a negative impact on bond prices. That being said, we believe long-term bond investors should embrace rate hikes.  Further normalization of interest rates will increase the yields at which we can purchase bonds in the future and should also have a moderating effect on inflation, which is one of the largest risks to a fixed income investor.

To illustrate inflation risk, Treasury bonds maturing in 30 years are currently yielding roughly 3%. After taking into account an assumed tax rate of 35%, an investment in one of these bonds would return close to 2%. If future inflation rates surpass the Fed's inflation target of 2%, inflation would wipe out this after-tax return and leave the investor with the choice of being locked into negative real returns for the remaining 30 years until maturity, or selling the bond at a price well below the purchase price. As Ronald Reagan once said, "Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man." Any investor in 30-year Treasuries today would think the same should the double-digit inflation that plagued the economy during Reagan's early years in office ever return.

At Kovitz, we believe our bond strategy is well positioned to handle the current monetary environment. Our municipal and corporate bond portfolios are currently capped at eight year maturities, meaning roughly half of all clients' bond portfolios can be redeployed into potentially higher rates within the next four years should rate hikes continue. We are also assuming minimal inflation risk by avoiding long-term maturities.  We also believe our clients' non-agency mortgaged-backed portfolios are arguably even better positioned. The majority of these bonds are adjustable-rate with their coupons pegged to various short-term rates – meaning, future rate hikes will lead to higher interest income for these investors.

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