Fixed Income Note

Please refer to Appendix – Important Disclosures

Fixed Income in 2014
Much Better Than Expected

The key to fixed income performance in 2014 was to take duration risk as longer-dated fixed income worked whether it was in the safety of long-dated Treasuries as the 30-year T-bond total return was 29.4% or in lower-rated fixed-rate preferred stocks (where issues can be perpetual in nature) with a 15.4% total return for the year.

Credit risk was not a major factor in determining performance but investors needed to avoid lower-rated high yield as CCC & lower returns were negative 2.6% and single B-rated returns were an anemic 1.3% in 2014. Energy debt issues, which are about 15% of most high yield indices, were hit by the collapse of crude oil and natural gas prices.

The best fixed income performance came from preferred stocks with a 15.4% total return, followed by convertibles at 9.97% and municipal bonds at 9.78%. Weakest performance was in leveraged loans and high yield, at 1.82% and 2.50% respectively.

Fixed Income Comparative Market Returns

	2014	2013	2012	3-yr	5-yr	10-yr
Treasury	6.0%	-3.3%	2.2%	2.1%	3.7%	4.4%
Agency	4.1%	-1.8%	2.5%	1.8%	2.8%	3.9%
IG Corp	7.5%	-1.5%	10.4%	5.4%	6.7%	5.6%
MBS	6.1%	-1.4%	2.6%	2.7%	3.7%	4.8%
Municipal Bonds	9.8%	-2.9%	7.3%	5.4%	5.7%	5.0%
Fixed Rate Preferreds	15.4%	-3.7%	13.6%	7.7%	9.5%	2.8%
High Yield	2.5%	7.4%	15.6%	8.4%	9.8%	7.9%

Source: BofA Merrill Lynch Global Bond Indices

Treasury Market Review

While there is the general opinion that interest rates fell sharply in 2014 it does not apply to the entire curve. Interest rates were stable on the short-end of the curve (one-month-to-six-month maturities), were higher on the one-year to three-year portion of the curve and were lower on maturities five years and out (see the yield curve from Bloomberg for the changes for the year).

Short-term T-bill rates are generally influenced by FOMC policies in regards to where it sets the fed funds target rate. With the Fed leaving its funds target rate at the zero-bound range (0%-to-0.25%) where it has been since December 2008 there was little movement in short-term bill rates last year with rates in the 0.2% - 0.12% range on one-month bills out to six-month bills.

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The one-year T-bill maturity out to the three-year maturity note yields were higher with one-year paper yielding 10 basis points higher at the end of the year (0.21%) while two-year notes were 29 bps higher at 0.67% and three-year notes were 31 bps higher at 1.07%. Yields on this part of the curve rose as enough investors believe that the Fed will raise its target rate during the next six-to-18 months resulting in their demand for higher yields to own this part of the curve.

Long interest rates fell dramatically and the further out on the yield curve the more dramatic the downward move. Five-year note yields fell nine bps to 1.65% while seven-year notes yields fell 48 bps to 1.97%, 10-year note yields fell 86 bps to 2.17% and 30-year bond yields fell 122 bps to 2.75%.

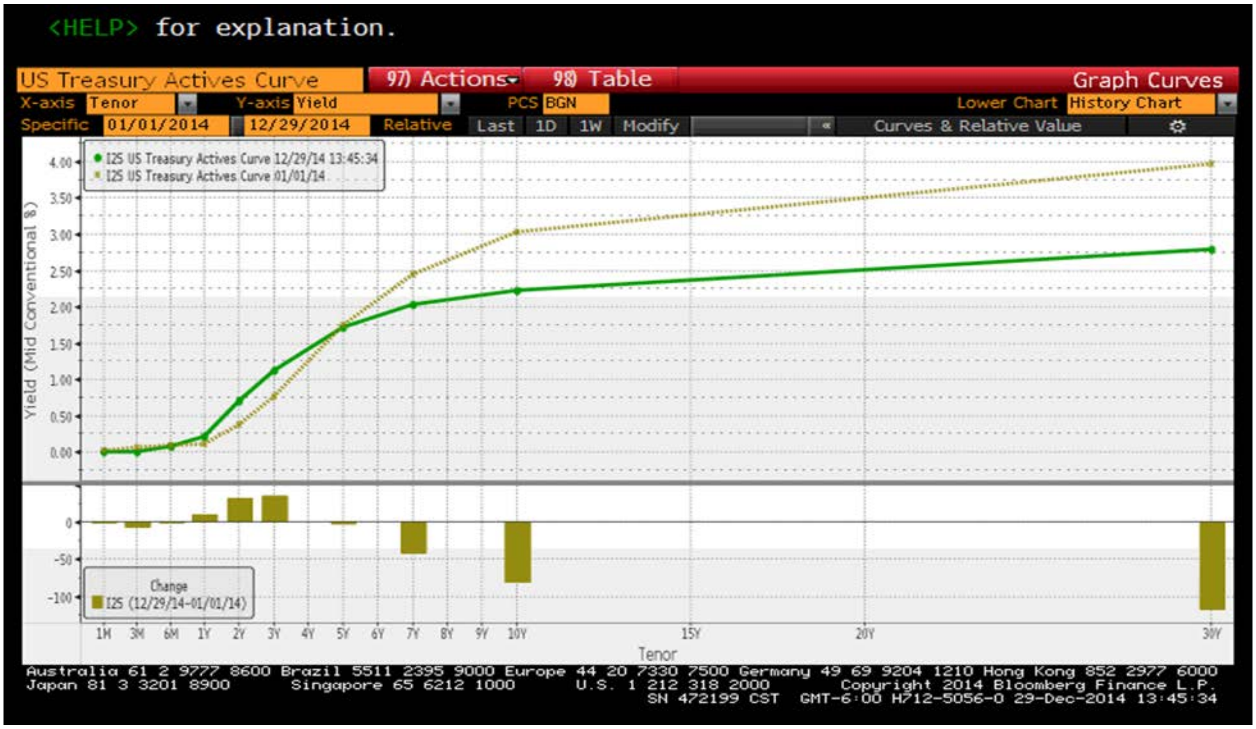
Longer-maturity Treasury yields are greatly influenced by future inflation fears and those fears were not problematic in 2014. While the Fed's favorite inflation measure, the personal consumption expenditure core year-over-year number rose from 1.2% (1.24468%) to 1.4% (1.41250%) inflation remained well below the Fed's 2.0% target rate for inflation.

When we discuss yields we focus on the benchmark 10-year Treasury note. As noted above, the yield on the 10-year ended 2014 at 2.17% (it hit an intra-day low of 1.86% on October 15) which was the opposite of the forecasts of market prognosticators at the beginning of the year. The Bloomberg consensus view among economists and fixed income analysts was that the yield on the 10-year would be 3.44% on December 31. It reminds us of the old proverb that "if one lives by the crystal ball, they must learn to eat ground glass."

Why were forecasters wrong last year? We believed that interest rates would go higher because the Fed would exit Quantitative Easing thus reducing the amount of bond purchases and that U.S. economic growth would be strong enough to generate an inflation rate that would force investors to demand more yield to purchase longer-dated debt.

We were right on both of these accounts (not rocket science on the Quantitative Easing as the Fed had announced in December 2013 that it was going to reduce its purchases in 2014) and economic growth was much stronger than we expected, especially in the second and third quarters when GDP grew by 4.6% and 5.0%, respectively.

However, what we did not expect was the impact of the conflict in the Ukraine with the Russians, the ongoing conflict in the Middle East, the outbreak of EBOLA in Africa and the economic weakness in Europe would create strong demand for American debt pushing down yields. Inflation did not move higher despite the strong American economy as energy pricing collapsed and European economic growth was very weak with the European Central Bank still talking about actions to reduce the possibility of deflation on the continent. Throw in German bund yields (10-year at .054% and 2-year at negative 10 bps) that make U.S. Treasury yields look as if they are junk bonds and the result is much lower long-term Treasury yields at the end of the year.



In case you are curious, last year forecasters were looking for yields to move up 40-45 bps in 2014 when they made their forecasts. The end of year forecast for the 10-year Treasury for 2015 is 3.06%, almost a 100 bps move higher. In addition, the forecast for the fed funds target rate is 0.95% at the end of the year (most likely three interest rate hikes by the Fed during the year).

Sector Performance

Fixed-rate preferred security performance (15.4% total return) was driven by falling longer-term interest rates. These securities with most issues being perpetual in nature (without a final maturity) are subject to price volatility because of the sensitivity to interest rate moves. In 2013 when the yield on the 10-year Treasury note climbed from 1.7% in May to 3.03% by the end of the year, it resulted in a negative 3.7% total return on fixed-rate preferreds. Convertible bond are viewed as equity-like assets thus performance is equity-like. With solid equity market returns in 2014 (S&P 500 total return was 13.68%); there was similar strong performance in converts (9.97%).

Strong municipal bond performance (total return 9.78%) was driven by reduced supply and investor aversion to paying taxes. According to Bloomberg, “the combination of last year’s maturing debt and early redemptions resulted in the municipal bond market shrinking by 4% to $3.5 trillion.” Demand from investors for municipal bonds rose as investors added 4.3% more money into municipal bond mutual funds than in 2013,” according to data from EPFR Global and compiled by BofA Merrill Lynch.

Investment-grade corporate bond total returns were strong while high yield corporate bond returns were weak as investor’s funneled money into quality and avoided riskier high yield paper. Normally, high yield returns are more correlated with equity returns but this was not the case this year. Overall high yield total return was 2.50% with “BB” rated total returns at 5.34%, single “B” rated total returns were 1.32% and “CCC” total returns were negative 2.57%. Leveraged loans had a total return of 1.82% as investors suffered “duration fatigue” tired of the wait on higher interest rates to move the yields higher on loans (leveraged loans are floating rate generally priced off three-month libor) and moving out of the sector.

Investment-grade corporate bond mutual funds had an increased flow of funds of 5.66% in 2014 while high yield mutual funds had a decrease of fund flows of 5.73% and leveraged loans suffered outflows of 13.17% during 2014. It is our understanding that we could have seen negative total returns in leveraged loans if not for CLO's being in the market to take supply.   According to data from JP Morgan, CLO supply hit a record $123.7 billion in 2014.

Sources:
Barclays Indices
BofA Merrill Lynch Indices
BofA Merrill Lynch: The High Yield Flow Report – Outflows to end the year. January 2, 2015.
Bloomberg
CreditSights: U.S. December Credit Market Review: Risk Rebound. January 5, 2015.

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