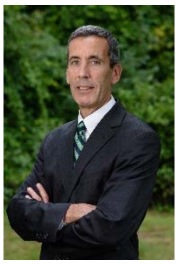
Fixed Income Market Commentary
January 2017



Breakout: Bond Yields Move Higher

Since the presidential election, bond yields have begun to break out from the low interest-rate environment that has frustrated fixed-income investors for years.

And the moves have been decisive. Bond prices have dropped and yields have risen, with longer-maturity bonds feeling a much greater sting than their shorter-maturity kin. These moves serve as an excellent reminder of the risks associated with "reaching for yield" in long bonds. All seemed fine as yields fell and prices rose, but the speed with which the tide turned has surprised those who took on more risk than they bargained for.

Though it's impossible to call either the top or the bottom of the interest rate cycle, I have been anticipating a period of rising interest rates for some time and have constructed our bond portfolios accordingly, keeping average duration on the low side. It's been my belief that we sacrificed little in yield compared to the potential for capital losses, and the recent market action has borne that out.

Though I expected rising interest rates to be driven by a combination of an improving economy and Federal Reserve policy adjustments, that's not exactly how it's played out just yet. Rather, bond investors have seemingly responded to the election outcome and the incoming president's stated view that infrastructure spending should rise and taxes should fall more than anything else. The concern among some bond investors is that this vision may result in higher levels of inflation and increased deficits—neither of which is bond-market friendly. The unknown, of course, is the degree to which words can be translated into policy, and policy into accelerated economic growth.

Market sentiment has shifted from "lower for longer" to a more uncertain read on future interest-rate policy. It's therefore not surprising that many bond investors began to rethink their positioning and to move away from perceived risks. This was evident in the outflows that many bond funds experienced over the final weeks of the year following the election.

But no matter how we got here, bond investors should welcome the higher yields that are now available in the market. You and I have been waiting patiently, and our patience is about to be rewarded. Because I have kept maturities short, many of the bonds in our portfolios are maturing into this higher-yield environment, giving us the ability to reinvest and lock in higher rates without paying a premium to do so or extending out as far into longer-maturity bonds as we would have had to just a month or two ago.

Investing in bonds when interest rates are rising benefits disciplined fixed-income investors. We may not see an immediate reward, but over time, when maturing principal and interest are reinvested in additional bonds or shares of bond funds, we will effectively be buying in at lower prices and higher yields that, more often than not, will generate more current income.

I am positive that some investors will equate rising interest rates with rising risks for the bond market. However, I would make a different argument—that ultra-low yields (and ultra-high prices) represented some of the greatest risks bond investors have ever encountered. As rates rise, those risks actually abate somewhat.

Finally, I'd like to make a distinction between risk in the investment-grade-rated bond market and risk in other investment assets. November's bond market loss (measured by the Bloomberg Barclays Aggregate Bond Index) of 2.4% marked its worst month in more than eight years. Yet this setback is nothing compared to some of the worst months for the S&P 500 stock index, or even the average of all the index's losing months. (Over the past 37 years, the S&P 500 lost an average 3.3% during down months.) This is not to make light of the decline in the bond market, but rather to put it into perspective.

Bond investors have endured low interest rates for years. Now that rates are beginning to rise, it would be folly, not to mention poor timing, to step away from the bond market. We need merely avoid the riskiest parts of the market. I've often said that bond investors don't have to invest in the whole market, and we won't. I will continue to avoid large swaths of it, such as long-maturity bonds or those with less-than-stellar credit quality. Together we will find the area that suits your individual needs and concentrate there. Today's rising bond yields are exactly what you and I have been waiting for.

Christopher Keith
Senior Vice President
Fixed Income Manager

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