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Fixed Income Market Comments

Finally, after a year of talking about it, the Federal Reserve raised rates by 0.25 percentage points, the first rate hike since 2006. The new range for the federal funds rate is 0.25% to 0.5%. The Fed unanimously agreed the economy was strong enough to warrant an increase: they noted as positives “ongoing job gains” and “declining unemployment.” Even with this change, monetary policy remains extremely accommodative from a historical standpoint. However, in a somewhat overzealous fashion, the Fed went on to predict four more rate hikes in 2016 and another four in 2017 (25 basis points each). That seems a little extreme considering it took all of 2015 to just get one increase. Currently, the market is only predicting two rate hikes next year; possibly less if market volatility continues. January has already been taken off the table and March is looking very unlikely. Focusing on December’s increase, however, the consensus seems to be that it was long overdue. The unemployment rate is already very close to the Fed’s long-term projection of 4.9% and nominal GDP growth is up at a 3.9% annual rate in the past two years. But while unemployment may be where the Fed wants it, inflation is another story. The freefall in oil prices has put downward pressure on inflation and has yet to stabilize. The dollar continues to strengthen against other currencies, pushing inflation lower as well. Historically, the dollar has weakened after liftoff in a tightening cycle. This counterintuitive reaction occurs because the market often prices in the effects before the liftoff actually occurs. However, international central banks are moving in the opposite direction as the Fed, providing monetary easing instead of tightening.

In a perfect world, low oil prices and a strong dollar would increase consumer income and we would see an increase in spending. Unfortunately, the savings rate continues to tick up and the windfall the market was expecting from the consumer has been disappointing. There are two ways to interpret higher savings: first, a lot of people who were unemployed or underemployed were spending everything they had and are now replenishing those savings. This is the optimistic view. The pessimistic view is that individuals tend to save when they are less certain about future prospects and confidence erodes. The erosion of confidence would mark a drop in expected future demand and potential future deflation. If the Fed has been guilty of anything, it’s been to ignore the drop in long-term inflation expectations. As the effects of a strong dollar and weak oil, as well as global instability become clear, it is unlikely the Fed’s current inflation projections will hold.

The second half of 2015 was a volatile one and unfortunately that volatility does not seem to be subsiding in the first quarter of 2016. Investors have a number of headwinds to face: Will China continue to unnerve an already jittery market? Can oil prices find a sustainable bottom without a major corporate or financial catastrophe? If the Fed continues to raise rates, will the headwind that has been the strength in the dollar slow down? And, finally, what changes will the 2016 elections bring in the US as well as abroad?

Taxable Fixed Income Performance Composite

In a world of volatility, high quality investments continue to pay off. Highly rated bonds, especially municipals, have performed very well. The TCVA taxable fixed income composite outperformed its benchmark for the quarter and for the year. The composite continues to retain an average weighted maturity and duration shorter than the benchmark, as well as higher credit quality. In the current interest environment and market volatility, we believe that a fixed income portfolio with short to intermediate durations invested in high quality municipals or corporate bonds remains the best strategy.

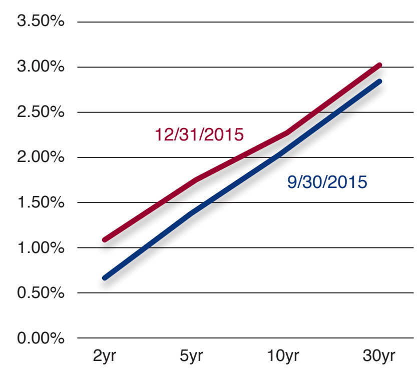
Portfolio Characteristics:

Average Maturity	3.8 yrs
Average Duration	3.4 yrs
Average Yield to Maturity	2.63%
Average Coupon	4.30%
Average Quality	AA-

Credit Quality:

AAA	12%
AA	49%
A	30%
BBB	9%

Treasury Yield Curve



Fixed Income Sector Breakdown