Fixed Income Update

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Treasury rates moved significantly higher immediately following the surprise election results on November 8, 2016 with the intermediate to long end exhibiting the greatest rise as the market repriced inflation and growth expectations under a Trump administration and a Republican Congress.

While the timing and scope of tax reform and infrastructure spending are highly unknown, they are being interpreted as stimulative to both economic growth and inflation. It is important to consider that in addition to the "Trump effect", economic data has been mostly positive over the last month, which is also supportive of higher interest rates. Given the election impacts and encouraging economic data coupled with a less dovish Federal Reserve and potential for pullback in global quantitative easing, real rates have risen substantially. The 10-year real rate went from 9 basis points (bps) on October 31, 2016 to 42 bps on November 30, 2016, so 33 bps of the 55.4 bps rise in the nominal 10-year yield was due to real rates rather than to inflation expectations.

Tenor	Yield to Maturity U.S. Treasury Curve 11/30/16 Yield (%)	Yield To Maturity U.S. Treasury Curve 11/01/16 Yield (%)	Yield to Maturity (change) 11/30/16-11/01/16 Yield (%)
30Y	3.038	2.580	45.8
10Y	2.386	1.827	55.9
7Y	2.192	1.611	58.1
5Y	1.842	1.294	54.8
3Y	1.393	0.987	40.6
2Y	1.115	0.833	28.2
1Y	0.779	0.648	13.1
6M	0.613	0.511	10.2
3M	0.485	0.359	12.6
1M	0.370	0.198	17.2

Source: FactSet

The steepening of the Treasury curve has been dramatic post-election as well. After flattening steadily in 2016 and bottoming out in early July, the 2- to 10-year U.S. Treasury curve has risen 54 bps since July 8, 2016 and now stands at 129 bps (as of December 5, 2016). Given the current macro-political uncertainties, our strategies continue to have a neutral stance (1% to 3% short) regarding duration and curve positioning. Impact on portfolios for the month of November will be broadly neutral relative to the portfolio's benchmarks.

The steepening of the yield curve now offers greater compensation to invest further out with the yield-to-worst indices moving significantly higher on the month.

	Yield to Worst 10/31/16 (%)	Yield to Worst 11/30/16 (%)	One-Month Change (%)
1-3 Yr Gov/Credit	1.12	1.40	0.28
Intermediate U.S. Gov/Credit	1.63	2.06	0.43
U.S. Aggregate	2.12	2.57	0.45

Source: FactSet, Bloomberg Barclays Indices

Spreads have responded positively by tightening modestly over the course of November. In particular those sectors and industries viewed as benefiting from the incoming administration's policies have performed the best: banks (steeper curve, less regulation), energy and coal (more favorable energy policy), and pharmaceuticals (less scrutiny on drug pricing). Credit curves have flattened with longer-dated spreads rallying in response to the move higher in U.S. Treasury rates. Given our constructive fundamental, valuation tactics outlook, we have added to the corporate contribution to duration across styles by tactically adding credit in both the new-issue and secondary markets. Financials continue to be an overweight across strategies given positive fundamentals and valuations that remain attractive despite recent tightening.

	Option-Adjusted Spread 10/31/16 (%)	Option-Adjusted Spread 11/30/16 (%)	Change (%)
U.S. Credit	1.25	1.23	(.02)
U.S. Corporate: Investment Grade	1.32	1.29	(.03)
U.S. Corporate: High Yield	4.77	4.55	(.22)
Investment Grade: Industrial	1.35	1.32	(.03)
Investment Grade: Utility	1.25	1.22	(.03)
Investment Grade: Financial Institutions	1.29	1.24	(.05)

Source: FactSet, Bloomberg Barclays Indices

The dramatic move higher in rates led to agency mortgage-backed securities' excess returns of negative 47 bps on the month. Due to the negative convexity inherent in mortgage-backed securities, the index extended more than a year to roughly 4.5 years. Across the coupon stack, lower coupons performed the worst as they are most impacted by the extension of the index. Looking forward, prepayments are likely to fall over the coming months creating better fundamentals for the sector as a whole. Therefore we remain neutrally positioned in our mortgage-backed securities allocation.

Definitions:

Basis point: One basis point is equal to 0.01% or 1/100th of a percent.

Tenor: The length of time left for repayment of a loan or the expiration of a financial contract.

Yield to maturity: A bond's total return if it is held until its maturity date.

Yield to worst: The lowest yield that can be received on a bond short of the bond issuer defaulting.

Option-adjusted spread: The spread between a fixed-income security, adjusted for embedded options, compared to the risk-free rate of return.

An investment a fixed income security is subject to interest rate risk, which is the possibility that an investments yield will decline due to falling interest rates and the potential for bond prices to fall as interest rates rise. High yielding, non investment grade bonds present a greater risk of loss to principal and interest than investment grade securities. The value of debt securities may be affected by the ability of issuers to make principal and interest payments and even the possibility that the issuer will default completely. Obligations issued by some U.S. government agencies and instrumentalities are backed by the U.S. Treasury. Obligations issued by other agencies (such as the Federal National Mortgage Association, the Federal Home Loan Mortgage Association and the Federal Home Loan Bank) are backed solely by the ability of the agency to borrow from the U.S. Treasury or by the agency's own resources.

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