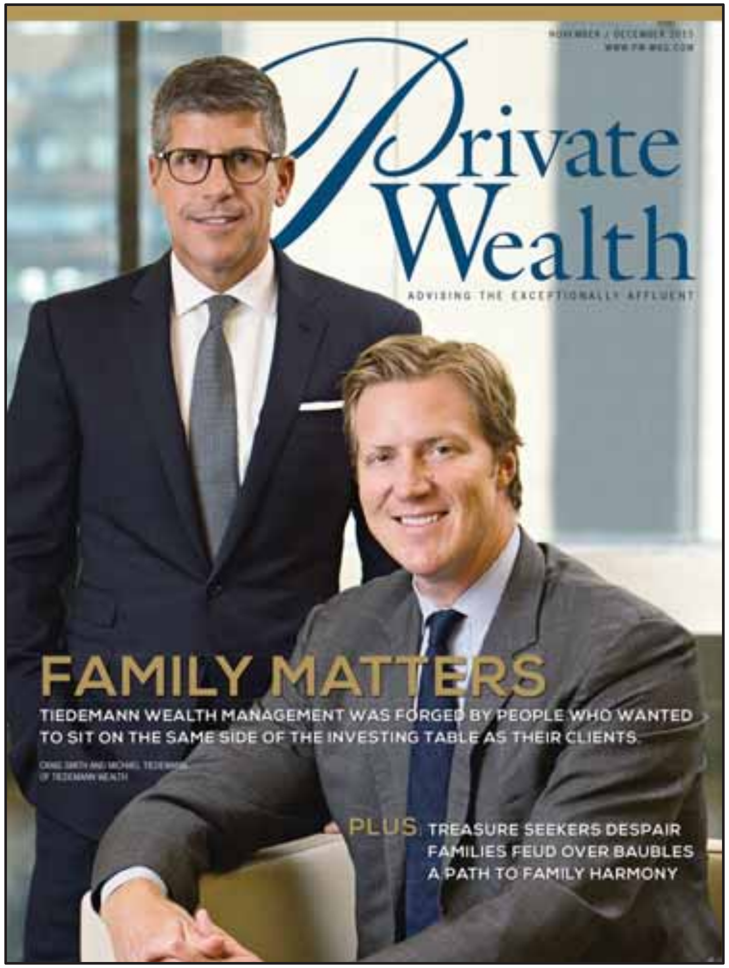

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FINANCIAL ADVISOR FA Private Wealth

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The Outlook For Actively Managed Fixed Income In An Era Of Rising Rates

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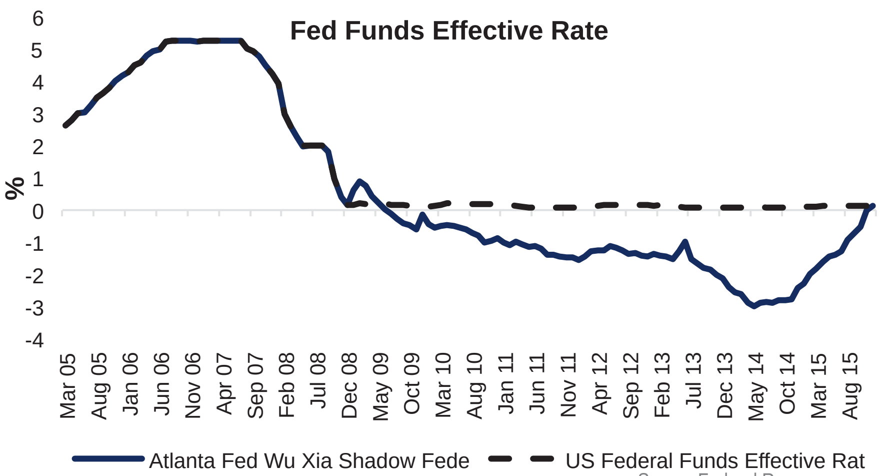
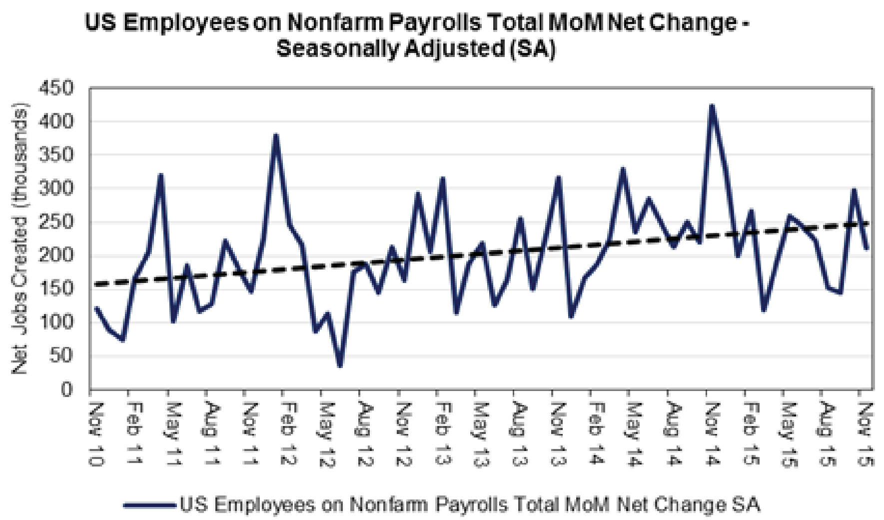
TCH perspective: Exploring rising rates



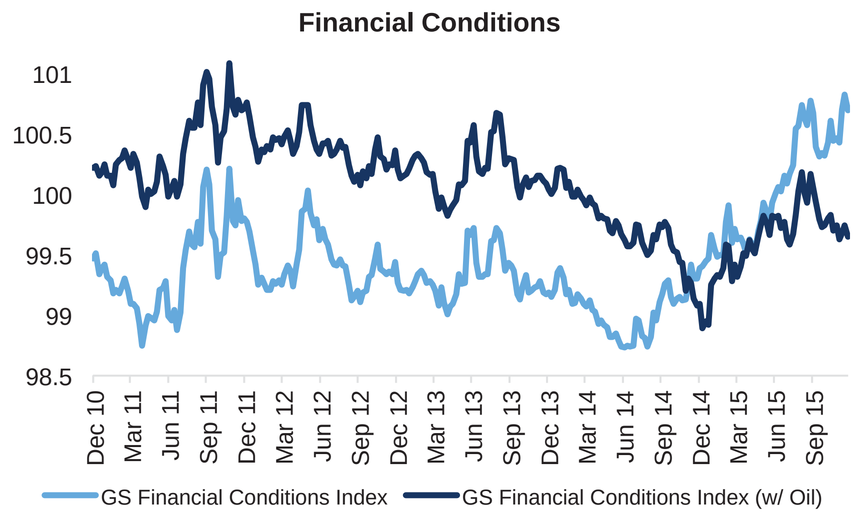
Source Federal Reserve

•The first rate hike in the US in nearly a decade offset some stimulus provided by non-traditional policies, as policy remains highly accommodative; and the tightening path is likely to remain measured, continuing to undershoot FOMC projections.

•The hike resulted in higher Treasury rates for certain maturities, but as we have expected, to date the yield curve has flattened as longer interest rates have declined.



Sources: Bloomberg L.P., TCH, LLC



Source Goldman Sachs, Bloomberg

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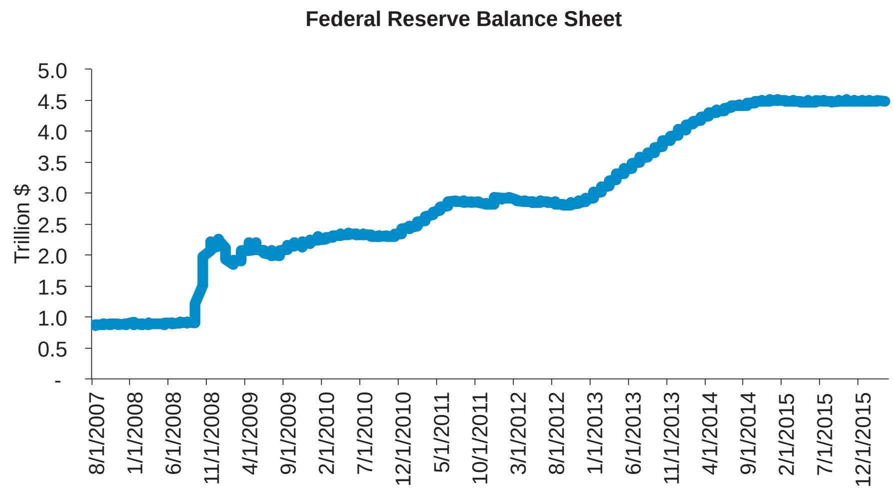
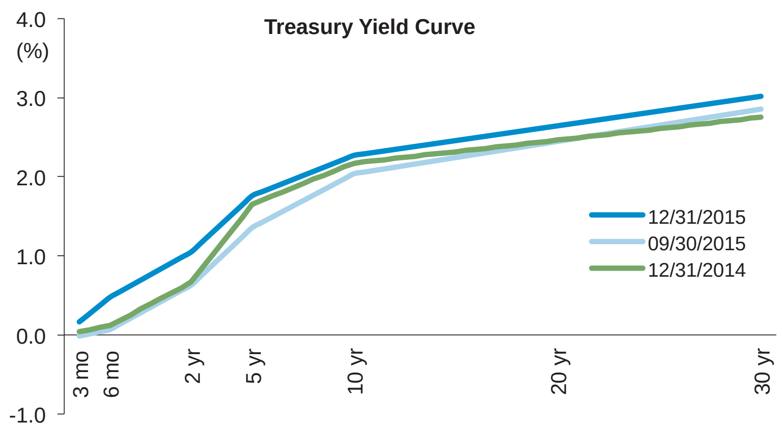
BMO Global Asset Management

TCH perspective: Reversion to the mean ain't what it used to be

- The Fed's balance sheet remains significantly enlarged since the crisis, with limited expectation to decline near term and a stated purpose of supporting long interest rates and maintaining an accommodative monetary policy.
  - Over the intermediate term, the Fed will likely maintain its balance sheet as a means to ease the policy transition and continue support for both financial and housing markets
- While periods of higher interest rates persist in the collective memory, the long term trend suggests current rates are not as much below the mean as might be imagined
- Fed policy isn't the only factor constraining rates



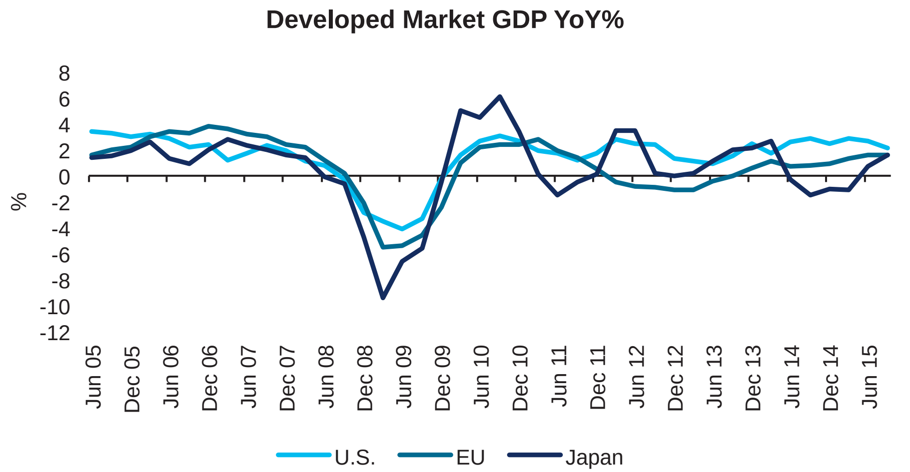
Source: Federal Reserve



Sources: Bloomberg L.P., BMO Global Asset Management

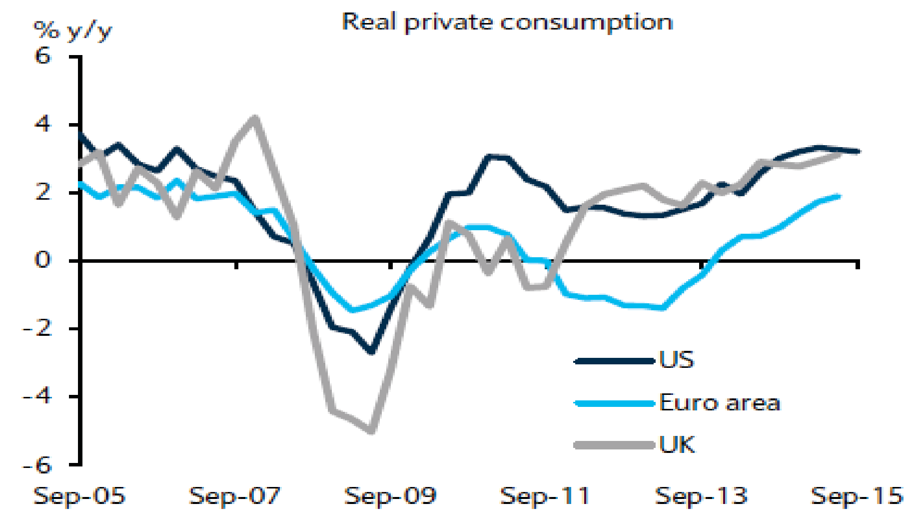
Source: Bloomberg

TCH perspective: Policy divergence, developed market growth



Sources: Bloomberg L.P., TCH, LLC

- Global policy divergence will remain an important theme in 2016, with the ECB and BOJ furthering their QE programs; low inflation will likely support a easier Fed, despite the first shift in gears.
- Developed market global consumption remains an anchor for growth with energy prices as a tailwind
- EM slowdown fears belie still significant growth, with bottoming out expected to emerge in more stressed geographies



Source: Haver Analytics, Barclays Research

Source: Bloomberg

TCH perspective: Commodities and the big repricing

- Global volatility, led by geopolitical instability and a slowdown in China's growth have caused much gnashing of teeth across all market participants.

- The commodity-level imbalances are unlikely to change over the near-term as disappointing data from China continues to weigh on global growth expectations. OPEC effectively abandoning price controls make forming a trough in oil prices painfully slow.

- The relative decline in oil prices roughly equals the worst crisis in 40 years. Given the severity of price declines, another severe leg down has become less probable for most commodities.

- While the decline in commodity prices have stirred up significant concerns for global growth, there is evidence that conditions within the U.S. remain favorable for further expansion and consumption

- More importantly, credit valuations have outstripped the severity of the fundamental backdrop as spread differentials/multiples are now wider than at any other time including 2008

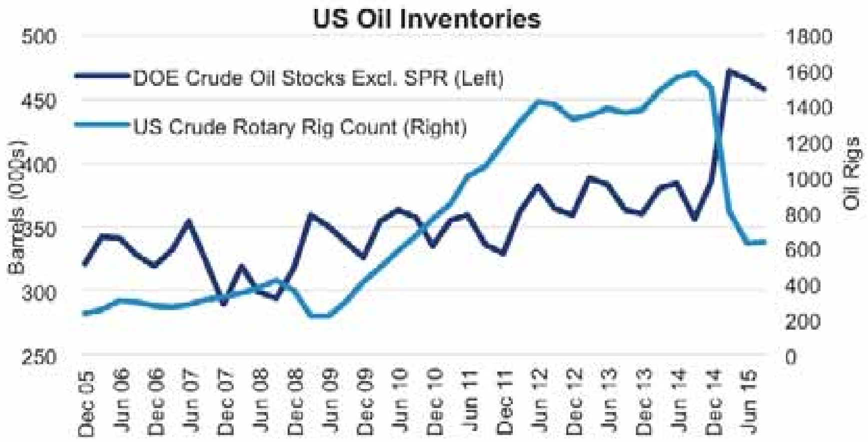
Source Barclays

Comparison of current commodity price levels with previous crisis lows

Low point (relative to 5-year rolling avg. price)

	Jan-16	Avg. Low previous crises	2008 financial crisis	1997 Asian financial crisis	1980s economic slowdown
Copper	-38%	-36%	-44%	-39%	-26%
Oil	-61%	-45%	-35%	-40%	-59%
Gold	-21%	-27%	-35%	-25%	-32%
BBG index	-41%	-32%	-35%	-27%	n.a.

Source: Bloomberg, TCH, Barclays



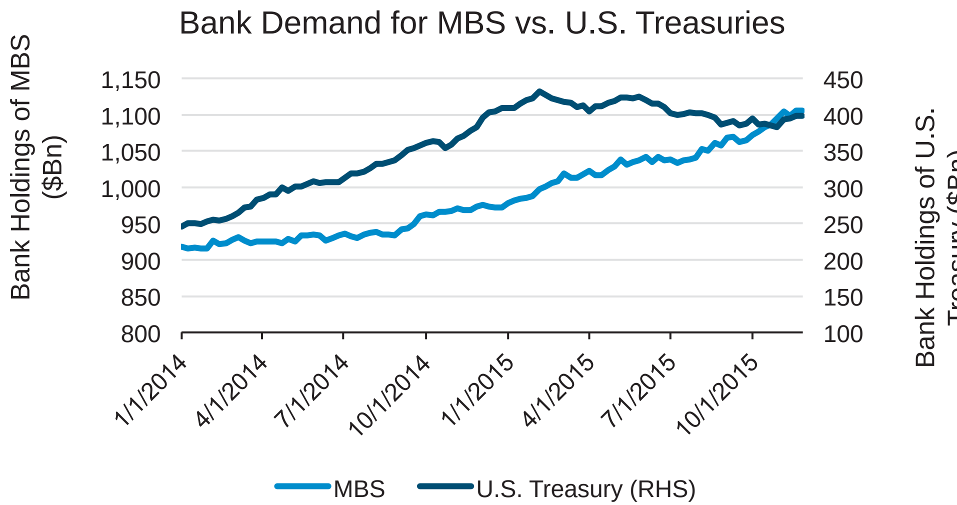
Source: Baker Hughes, US Department of Energy

TCH Perspective: MBS basis well-supported in 2016

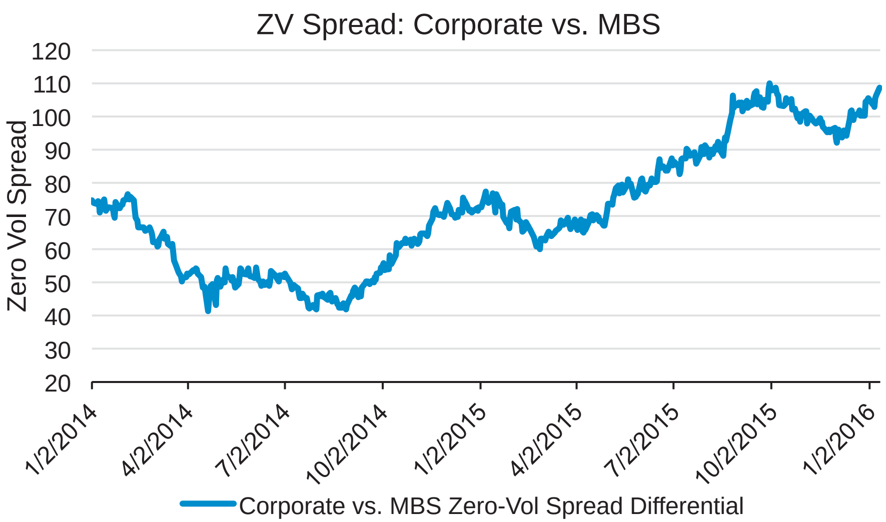
•The Fed's continued reinvestment of U.S. agency MBS cash flows, in conjunction with investor demand, will likely continue absorbing the bulk net supply.

•Bank demand is likely to remain strong with higher yielding MBS preferred over Treasuries. Money manager demand should be spurred by periodic bouts of credit risk aversion.

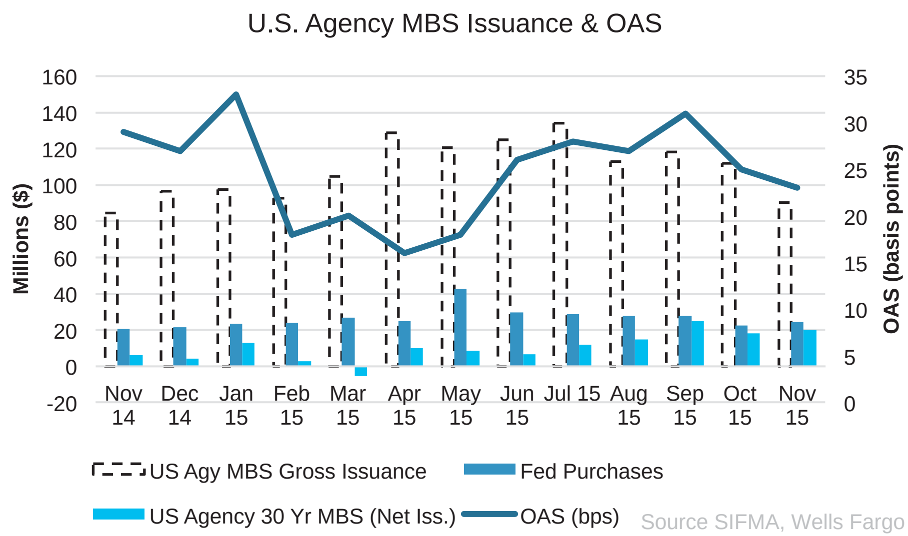
•On a relative basis, U.S. agency MBS presents a limited opportunity for significant excess returns, but the securities remain a highly liquid, safe haven as concerns for global growth and turbulent financial markets have increased risk premiums



Source: Bloomberg



Source Barclays

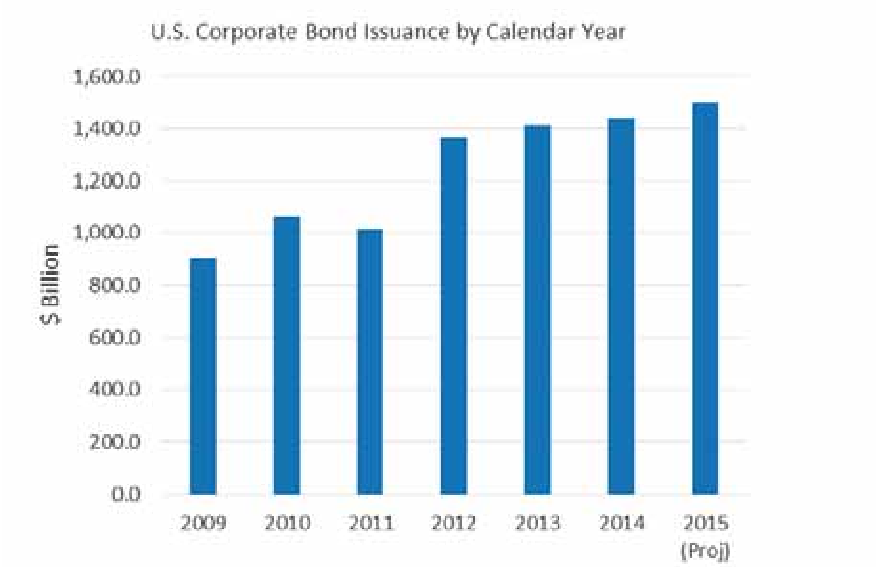


Source SIFMA, Wells Fargo

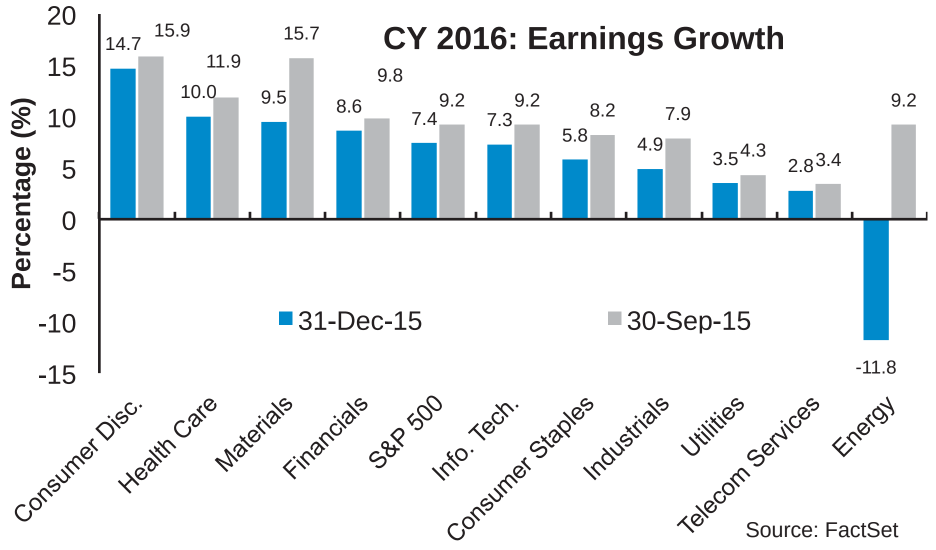
TCH perspective: Credit internals stable, despite mature cycle

- A monetary policy transition and increasing M&A activity suggest a mature credit cycle; however leverage generally remains consistent with historical averages
- Valuations are at the widest levels for any start of a tightening cycle in recent history (1994, 1999, 2004) mitigating some policy tail risk
- Earnings estimates remain solid despite commodity weakness skewing aggregate results
- Valuations are unlikely to retest recent tights, but solid macroeconomic underpinnings against the backdrop of historically wide valuations suggest some tightening, if not stabilization is warranted

Source: MSCI



Source: SIFMA

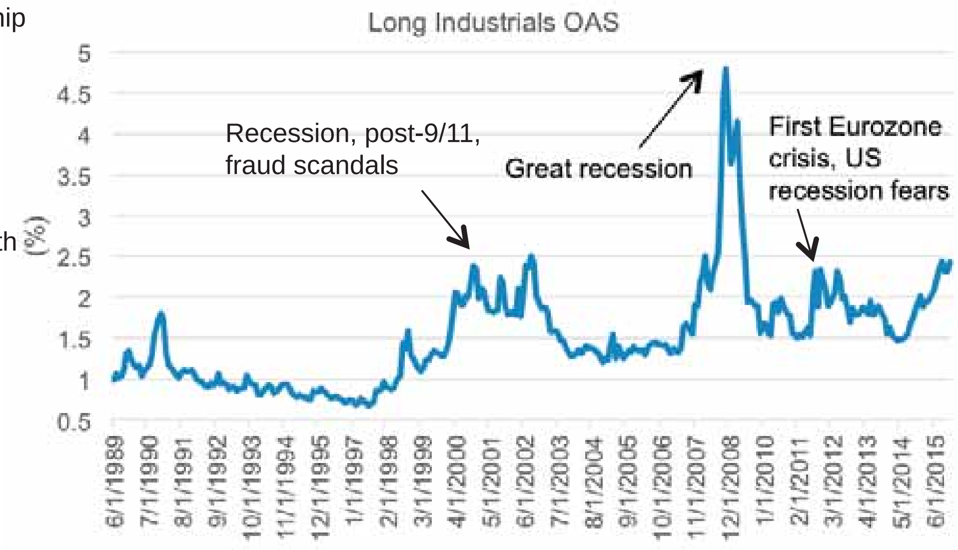


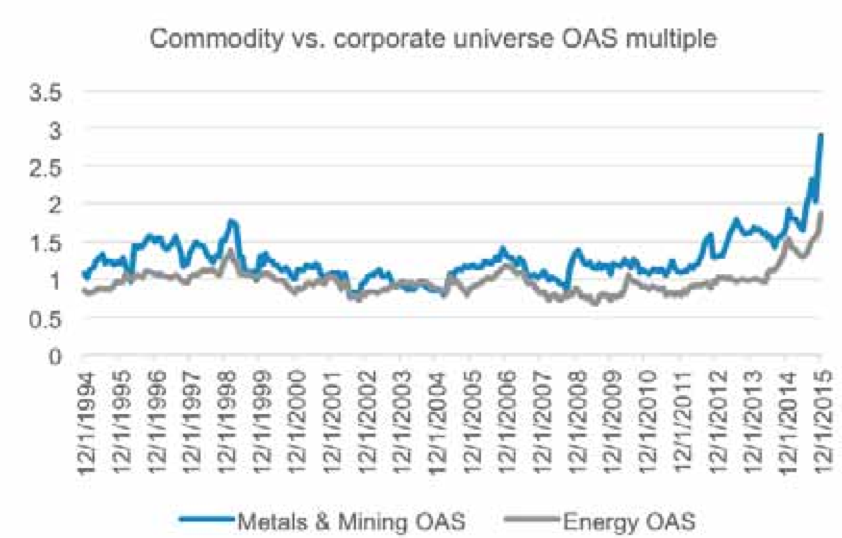
Source: FactSet

TCH Perspective: How wide is too wide for spreads?

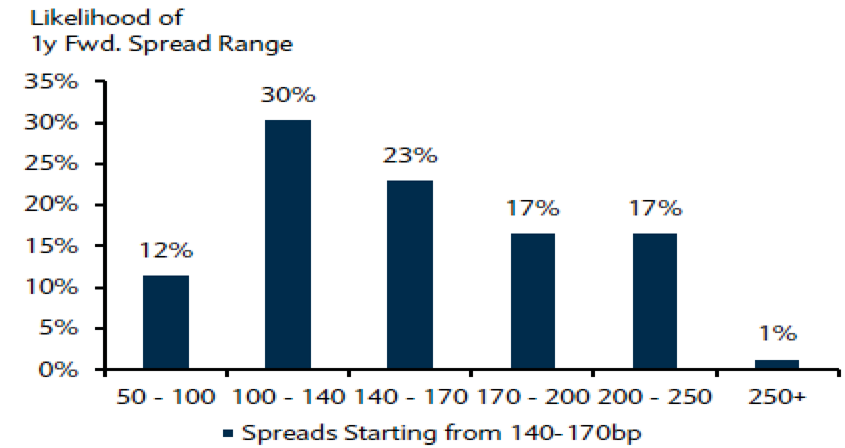
- Risk of a disorderly slowdown in China and geopolitical brinkmanship (OPEC) remain key sentiment drivers in financial and commodities markets. Oil declined nearly 20% to new lows in the fourth quarter and the market distress was exacerbated at the start of 2016.

- Credit spreads have reached valuations only seen in much more severe environments, with segments like long industrials and BBBs surpassing all but the 2008-09 crisis, despite stable if modest growth in the US, improvements in Europe and stabilization in many EMs. While commodities may take time to bottom out, credit spreads are pricing in very severe outcomes. Even neutral or modestly positive developments for many segments could result in positive excess returns for 2016.





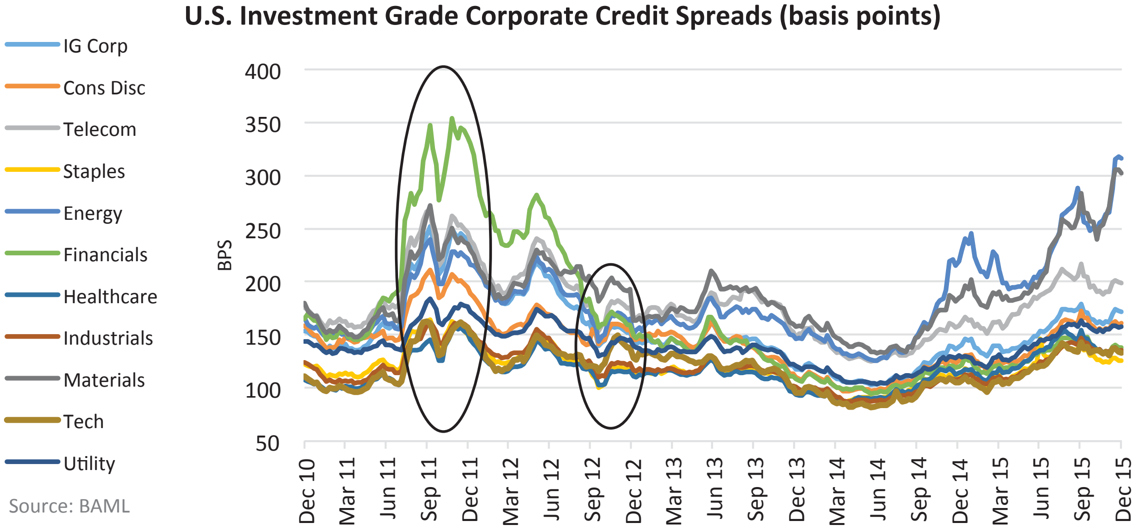
Spreads starting in the current range are more likely to tighten than widen



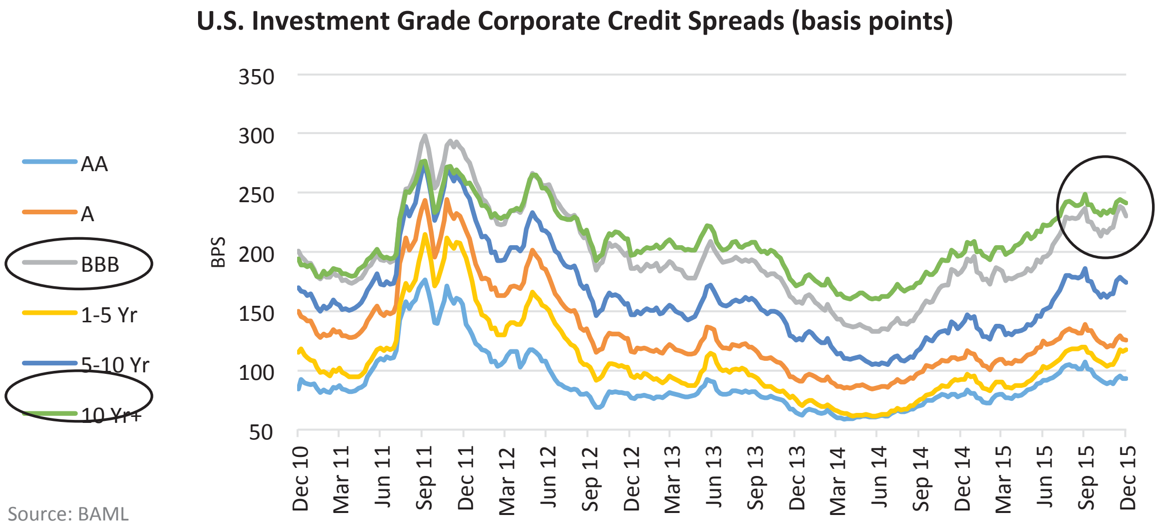
Source: Moody's, Barclays Research

TCH perspective: Relative value opportunities abound

- Within investment grade, widening credit spreads have been the most pronounced in longer-dated, BBB rated securities
- IG credit spreads have decompressed, but with significant bifurcation, presenting a tactical opportunity
- Sectors such as metals & mining and energy have seen pressure with little differentiation between issuers, furthering the near-term opportunity
- Normalization expected: Near-term between issuers, followed by cross-sector over the intermediate term



Source: BAML



Source: BAML

TCH outlook and investment strategy

Positioning and Rationale

YIELD CURVE ANALYSIS

- U.S. growth outlook for 2016 likely in the range of 2.5% consensus, but inflationary outlook likely to remain subdued
- U.S. growth to lead developed markets in 2016 as Fed policy normalization continues, patiently. The ECB and BOJ remain highly accommodative
- Commodity & energy prices have muddied inflation expectations; however, positive U.S. jobs and wage data may provide some stability
- Fed outlook: Continue structuring for trajectory rather than timing; After a brief mention, the Fed has moved past global volatility, refocusing on the US economy
- U.S. Treasury futures imply a slow ascension to a historically flatter term structure and lower point of neutrality, consistent with Fed language
- Duration construction: Neutral, with bias towards barbell as opportunities within Treasury and credit term structures are created; Global volatility and yield spreads both supportive of U.S. rates

SECTOR OUTLOOK

- Investment Grade Credit: Global growth concerns have led to a *decompression* in credit spreads, widening and steepening OAS curves with little differentiation; however, continued outperformance from the U.S. economy will likely lead the period of *normalization* which typically follows; U.S. IG will likely recognize further support from global yield *substitution effect*
- Securitized: U.S. agency MBS to realize continued support from low supply and Fed reinvestment; While the total return potential appears limited relative to cross-sector opportunities, they remain a safe haven during periods of uncertainty
- “Beta” Sectors: Market volatility has created bottom-up opportunities in the wake of macro concerns; Should the “tightening” of U.S. monetary policy transmit to the credit markets U.S. high yield should be better positioned for normalization vs. EMD

QUALITY DECISIONS

- The ratings migration within U.S. credit continues to trend downward; however, the compensation for “down in quality” trade within investment grade has increased significantly; Wider, steeper OAS curves and bifurcated quality buckets offer relative value opportunities

SECURITY SELECTION

- Favor nominal Treasuries over TIPS given interest rate and global macro outlook
- Credit: Utilize steeper OAS curves for compelling relative value cases and dislocations
  - Significant primary market supply should create additional opportunities in secondary
  - Industrials- Broad selloff lacks differentiation, opportunities in issuers benefiting from lower commodities
  - Financials- ECB policies supportive of European banks; U.S. sub-debt structurally attractive
- U.S. Agency MBS: Favor large cohort FN/FG 3.0% and 3.5% w/ low pay-up to establish basis

Disclosures

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