

FIXED INCOME: FROM SUMMER WIND TO AUTUMN LEAVES

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With the calendar turning to October, investors are entering the final lap of 2016. Certainly, there was a lot to digest in the third quarter, as the money and bond markets were faced with the potential fallout of the [Brexit](#) vote to begin the three-month period and concluded it with a heavy dose of central bank policy decisions. Before embarking on the homestretch, let's take one last look at how Q3 panned out in the fixed income arena. While we are going to focus our comparison on a quarter-versus-quarter perspective, it should be noted that there was definitely [volatility](#) squeezed in between the end of June and the end of September that did not necessarily get captured in the final quarter-end results.

Key Fixed Income Gauges

	6/30/2016	9/30/2016	Change
2-Year U.S. Treasury Note	0.58%	0.76%	18bps
10-Year U.S. Treasury Note	1.47%	1.59%	12bps
10-Year German Bund	-0.13%	-0.12%	1bps
10-Year JGB	-0.22%	-0.09%	13bps
Investment Grade Corporate Spread ¹	156	138	(-18)bps
Investment Grade Corporate Yield ²	2.88%	2.84%	(-4)bps
High-Yield Corporate Spread ³	594	480	(-114)bps
High-Yield Corporate Yield ⁴	7.27%	6.17%	(-110)bps

Source: Bloomberg, as of 10/01/2016. Past performance is not indicative of future results. You cannot invest directly in an index.

¹Represented by Bloomberg Barclays US Aggregate Corporate OAS Spread;

²Represented by Bloomberg Barclays US Aggregate Corporate Yield to Worst;

³Represented by Bloomberg Barclays US Corporate High Yield OAS Spread;

⁴Represented by Bloomberg Barclays US Corporate High Yield Yield to Worst.

Overseas in the [sovereign debt](#) market, [10-Year German](#) and [Japanese yields](#) remained in negative territory, although for a brief post-European Central Bank meeting trade in September, bunds did cross over the zero threshold back to the positive side of the ledger. As the data in the table clearly reveals, the 10-Year bund yield ultimately ended up little changed. In Japan, the 10-Year Japanese government bond yield also moved closer to zero in September before finishing the quarter back in the negative area, registering a quarter-on-quarter increase of 13 [basis points \(bps\)](#). The action in Japan's sovereign debt market reflected the Bank of Japan's decision to try to steepen the [yield curve](#) by shortening the duration of its [quantitative easing \(QE\)](#) program. In the [U.S. Treasury \(UST\)](#) market, the post-Brexit flight to quality trade was of paramount importance to begin Q3 as the 2-Year yield dropped to a low of 0.55% in early July and the 10-Year yield posted a new all-time low of 1.36%. As domestic economic data continued to come in, revealing visible improvement from earlier in the year, and the worst-case scenarios post-Brexit failed to

materialize, [safe-haven](#) demand gave way to the fundamentals. In the process, [Federal Reserve \(Fed\)](#) policy expectations were recalibrated (i.e., a [rate hike](#) is back on the table). As a result, the UST 2- and 10-Year yields reversed course and rose roughly 30 bps and 40 bps, respectively, from their aforementioned lows. Ultimately, the quarter-on-quarter changes amounted to +18 bps and +12 bps, respectively. In the credit-sensitive sector, both [investment-grade \(IG\)](#) and [high yield \(HY\) spreads](#) flattened to their lowest readings since mid-2015. The most notable narrowing occurred in HY, where spreads contracted by 114 bps. It is interesting to note that despite the increase in UST yields in Q3, IG corporate yields actually fell 4 bps due to the narrowing in spreads being more than the increase in Treasury yields. **Conclusion** Here in Q4, besides the usual economic forces, investors will once again be confronted with potential [monetary policy](#) actions, and throw in a U.S. presidential election for good measure. As we saw in the waning days of September, the risk-off trade can come back at any unannounced moment, as concerns about Europe's banks once again came to the fore. Barring any further negative headlines on this front, economic data looks to be moving to the front of the line for the fixed income arena. However, it would be prudent for investors to expect the potential for a near-term reaction to the outcome of the U.S. presidential election as well. With the Fed putting the markets on notice that the case for a rate hike has strengthened, we would expect to see volatility return to the UST market, as investors respond to incoming data with a "will they or won't they?" mindset.

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DEFINITIONS

Brexit: an abbreviation of “British exit” that mirrors the term Grexit. It refers to the possibility that Britain will withdraw from the European Union.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Sovereign Debt: Bonds issued by a national government in a foreign currency, in order to finance the issuing country’s growth.

German 10-year bund: a debt instrument issued by the German government with an original maturity of 10 years.

Japanese Government Bond (JGB): A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Yield: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Basis point: 1/100th of 1 percent.

Yield curve: Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Quantitative Easing (QE): A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Treasury: Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Safe-haven: Characterized by being a potentially desirable focal point of investment flows during periods of increased volatility and market risk. Safe-haven is not synonymous with risk-free.

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Investment grade: An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

High Yield: Sometimes referred to as “junk bonds,” these securities have a higher risk of default than investment-grade securities.

Spread: Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Monetary policy: Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.