Janney Fixed Income Strategy & Research
April 2014

Janney Macro Themes 2014

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Janney Macro & Fixed Income Outlook 2014 – Market Strategy

- ***What is normal, anyway?*** **Five years after the Global Financial Crisis, economic growth continues to unfold sluggishly and interest rates remain stubbornly low**
- **Once again, *the* key driver of markets in 2014 is likely to be Fed policy, and with the transition to Yellen, expect less QE, more guidance, and an effort to keep short term rates lower for longer**
- **For "go anywhere" investors, fixed income markets have shifted from a source of portfolio return to a source of protection against declines in equity markets**
- **We recommend staying well shorter in duration than the overall markets, and concentrating new purchases in the 5yr and under durations**
- **For investors with an exclusive need for current period income, the tradeoff for shorter duration is much less obvious**

Segment		2014 Position	Comments
GDP Growth	–	Neutral	Speed limits mean growth remains stable
Inflation	–	Neutral	Fed may try to spur, but won't hit til '15
Treasuries	↓	Underweight	5YR should show stable returns
Agencies	–	Neutral	5YR/1YR callables have great carry
Agency MBS	↓	Underweight	Sensitive to Fed taper decision
IG Credit	–	Neutral	Spreads tight, likely slightly better than Tsys
HY Credit	↑	Overweight	Only "absolute return" asset left in fixed income
Municipals	↑	Overweight	Tax benefit provides return "subsidy"

Source: Janney FISR

Janney Fixed Income Outlook 2014 – Sector Takeaways

- **Interest Rates:** We expect longer term interest rates to rise in 2014 as the Fed begins slowing bond buys; short term rates should remain anchored

  Overall, we recommend keeping durations significantly shorter than normal, as rate risk is the primary risk within the fixed income markets—and it's easily avoidable, though there is an income give-up.

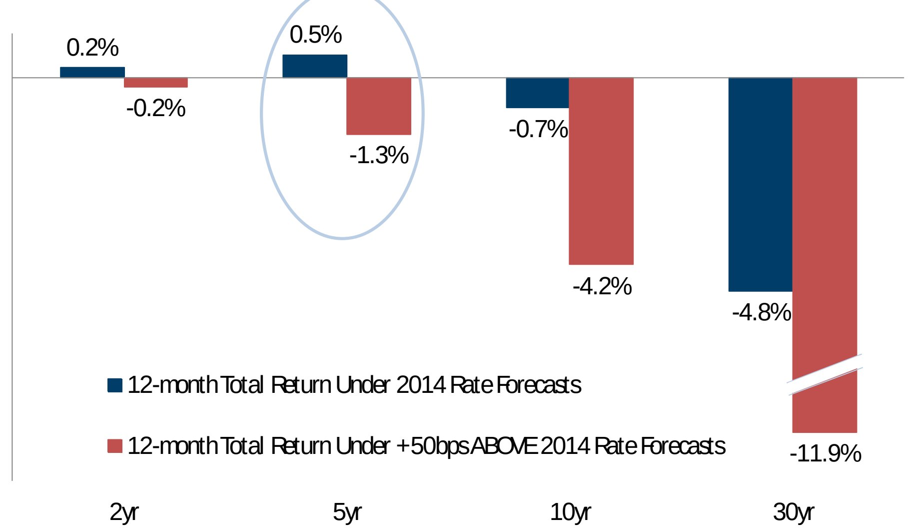
  The 5yr area of the yield curve is the most attractive, and best accessed via callable agencies, HY credit, and munis.

- **Corporate Credit:** In investment grade, credit spreads are near recent tights, implying limited cushion against interest rate risk, particularly for higher-rated credits; high yield spreads will likely benefit from the continual hunt for yield, but the potential for a correction in the equity markets poses a risk

- **Municipals:** While higher rates on the long end will negatively impact the muni markets, the relatively higher income generated by the tax-exemption along with higher tax rates means that munis are looking like the strongest income

Source: Janney FISR

Total Returns Based On Janney Rate Forecasts Recommend 5yr Part of Yield Curve



Taxable Equivalent Yields Allow Apples to Apples Yield Comparison

Federal Bracket	28.0%	33.0%	35.0%	39.6%
Total with Medicare	28.0%	36.8%	38.8%	43.4%
Tax Free Yields	Taxable Equivalent Yields			
2.00%	2.78%	3.16%	3.27%	3.53%
3.00%	4.17%	4.75%	4.90%	5.30%
4.00%	5.56%	6.33%	6.54%	7.07%
5.00%	6.94%	7.91%	8.17%	8.83%
6.00%	8.33%	9.49%	9.80%	10.60%
7.00%	9.72%	11.08%	11.44%	12.37%

Assumes Medicare Tax is applied to investment income in federal brackets of 33% and above. Certain investors in the 33% bracket may not be subject to all or any of the Medicare tax.

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Economics

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Current Economic Outlook

1. **We're calling for steady economic growth in 2014 vs 2013, with GDP expansion of 2.1% – 2.5%, which is about as rapid a growth as we can expect based on the secular economic backdrop; note that these numbers are essentially unchanged from our December estimates.**

2. **Jobs growth has accelerated and should sustain at a 180 – 200K monthly pace, which would push the unemployment rate to 6.5% by year end, though the usefulness of the "raw" unemployment rate is limited by changes in the composition of the job markets and falling participation**

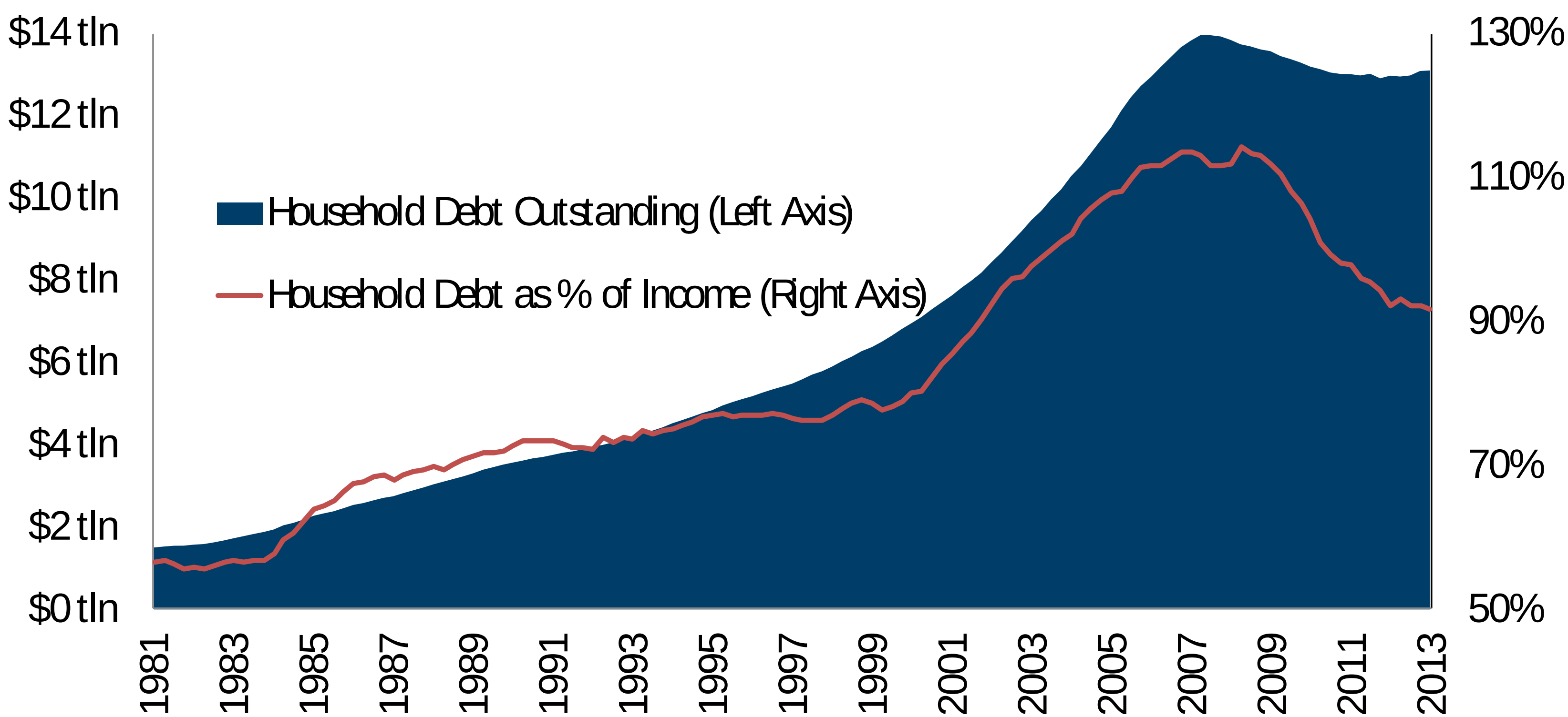
3. **Disinflation continues to loom, despite five years of expansionary monetary policy; we believe the Fed will set itself up to tolerate significantly higher rates of inflation, but that inflation will remain constrained in 2014, falling in the 1.5% – 1.7% (core CPI) / 1.1% – 1.3% (core PCE) range, only accelerating in 2H 2015**

4. **Fiscal policy will continue to be contractionary, though recent agreements with the Murray-Ryan budget deal indicate that rationality is beginning to hold sway on Capitol Hill**

5. **Longer term, the lack of real economic innovation is very troubling, and will serve to constrain economic growth, as well as inflation and interest rates, below its post-World War II average**

Monetary Policy & Economic Outlook

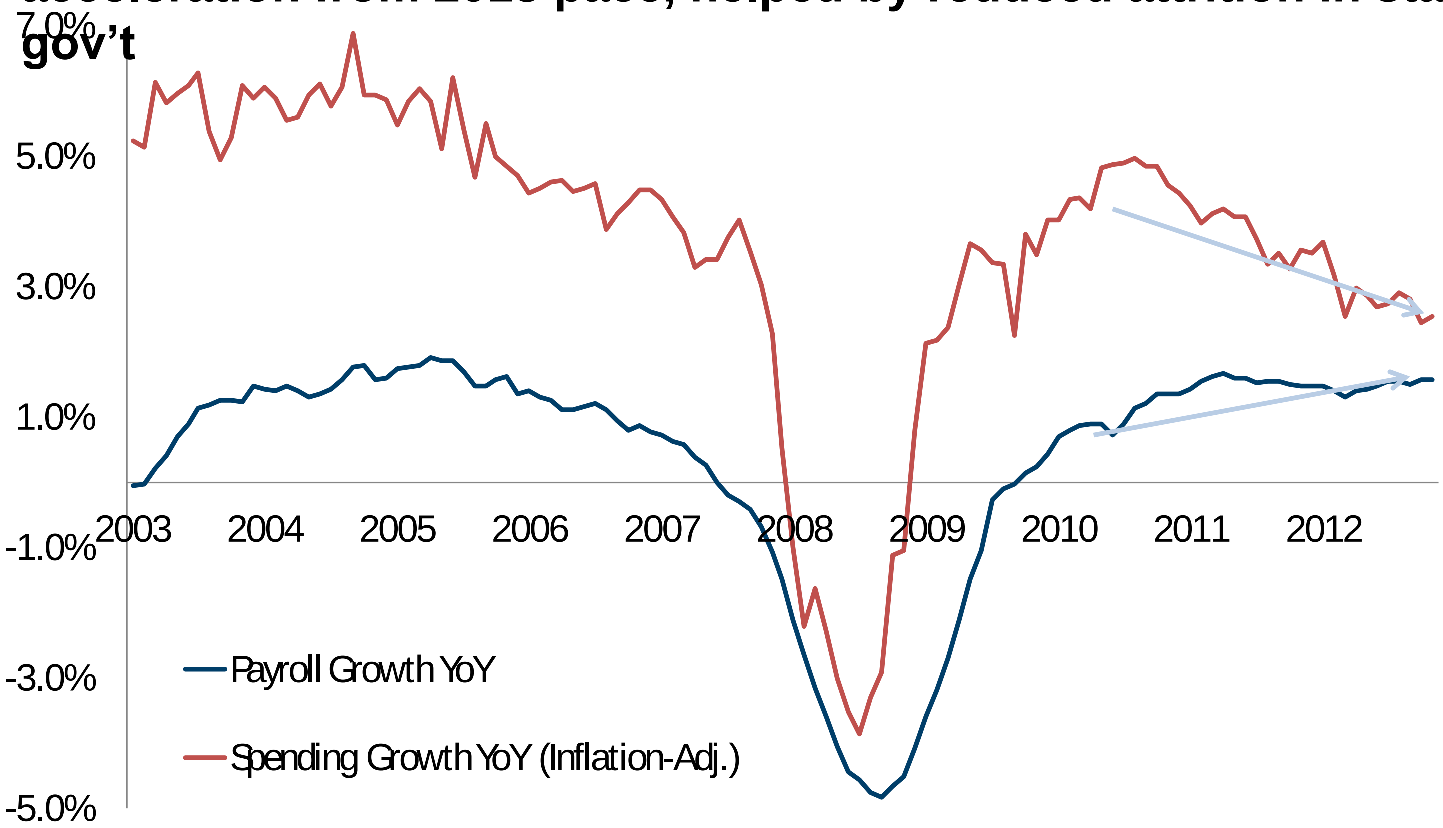
- **Fed bond buying supports economy in three ways:**
  1. **Consumer preferences**
  2. **Borrowing demand**
  3. **Portfolio Balance Channel**



Source: Janney FISR; Federal Reserve Board

Consumer Balance Sheets Repaired; All About the Jobs

- **With wage inflation low, income growth will need to come from job creation**
- **We're projecting 180K – 200K monthly job growth for 2014, slight acceleration from 2013 pace, helped by reduced attrition in state and local gov't**

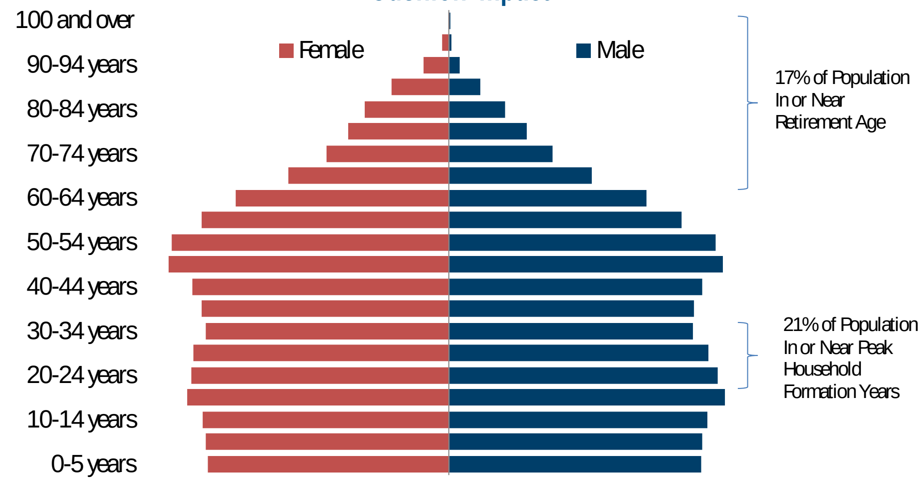


Source: Janney FISR; Federal Reserve Board; Commerce Department; Labor Dept.

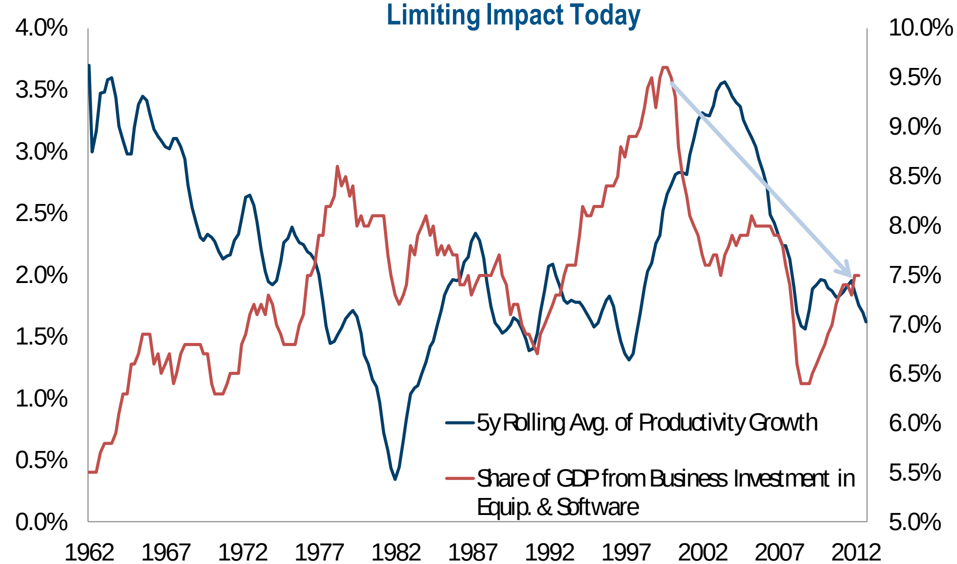
Speed Limits

- **Significant longer term problems suggest growth won't return to its pre-2008 average**
- **Demographic trends are not particularly favorable**
- **More problematic is the lack of economic innovation that drove growth in the 1990s (tech innovation) and 2000s (financial innovation)**
- **Lower levels of real investment in the 2000s and today restrict future innovation and act as a speed limit for long term economic growth**

Demographic Profile Poses Challenges, but Millennials Cushion Impact



Decline in Real Investment Beginning in 2002 is Having Productivity-Limiting Impact Today

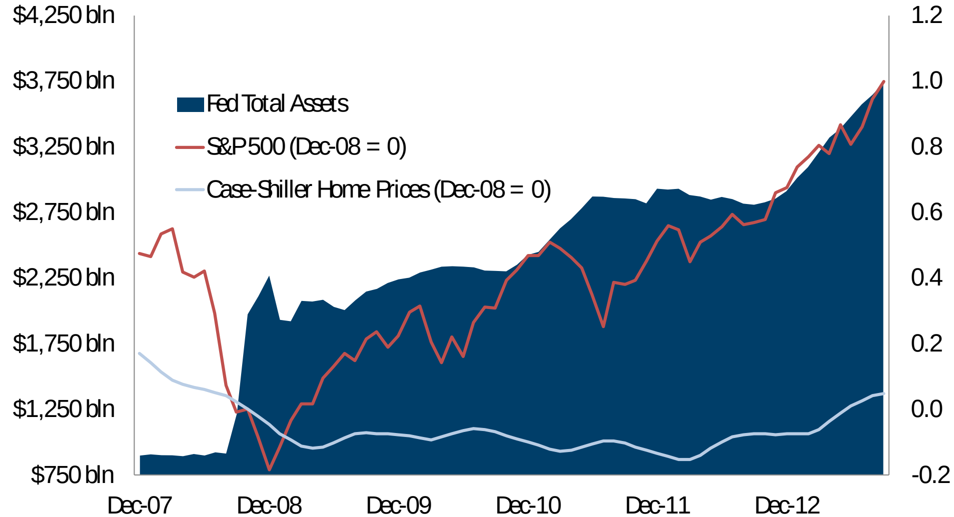


Source: Janney FISR; Census Bureau; Commerce Dept.

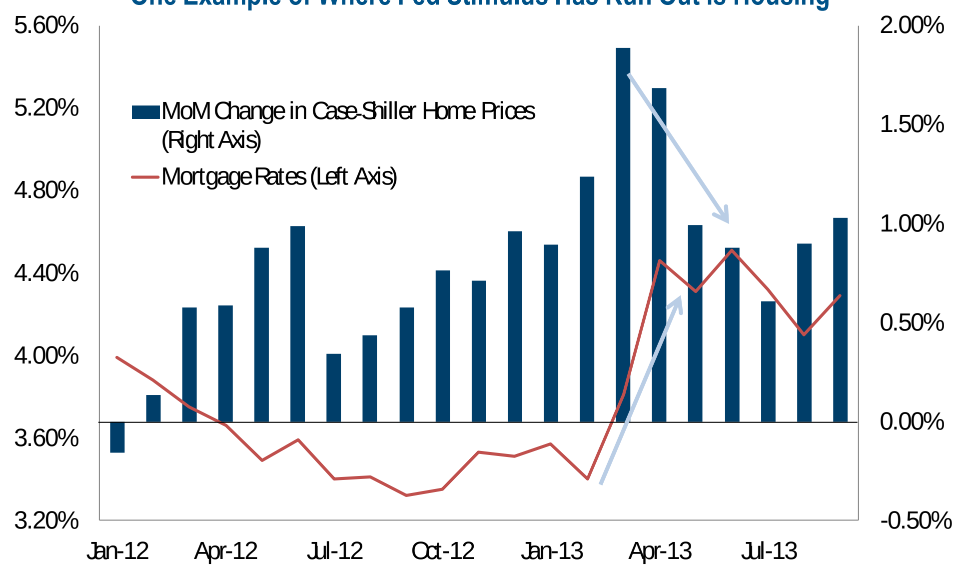
Limits of Monetary Policy

- The biggest economic debate of the coming few years will be one about the effectiveness of monetary policy
- Recent partial successes in Japan are an encouraging test case
- But if sluggishness is constrained by "speed limits," all the Fed is doing by keeping rates low is forcing the economy up against its ceiling, which will cause other problems (inflation, asset bubbles)
- One thing we do know: Fed policy is causing investors to take more risk, and thereby artificially inflating asset prices in the US

Fed Balance Sheet Expansion Pushed Up Value of Liquid Assets



One Example of Where Fed Stimulus Has Run Out is Housing



Source: Janney FISR; Federal Reserve Board; S&P/Case-Shiller; Freddie Mac

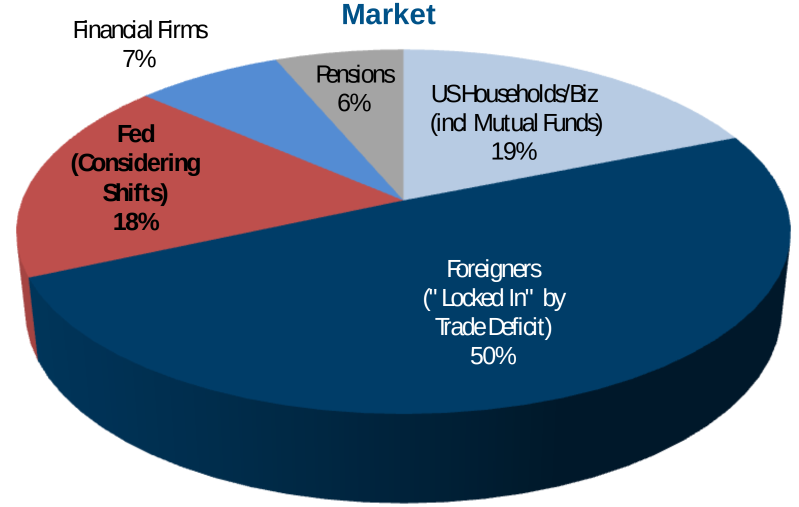
The Only Thing That Really Matters for Bonds: The Fed

- **Fed's response to incoming data has been virtually flat for the last five years: no matter the numbers, the Fed just kept easing**

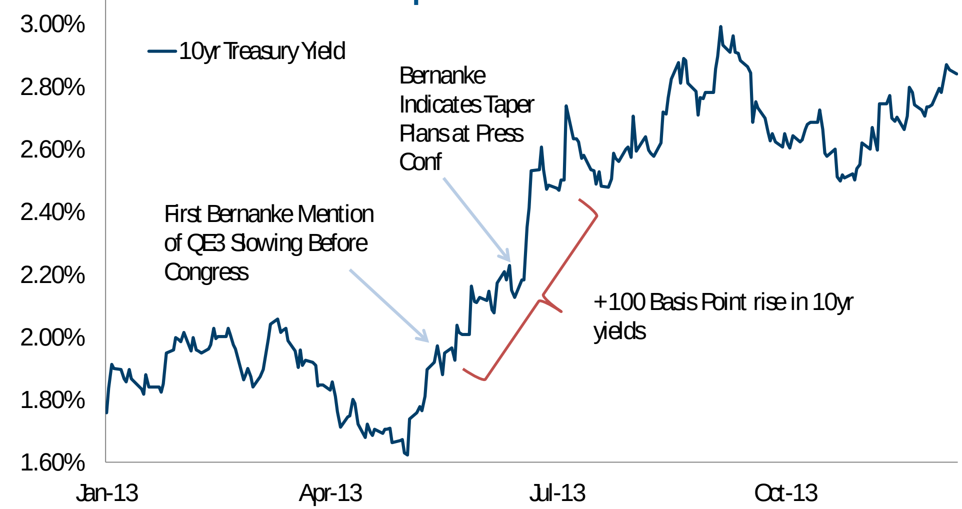
- **We think good portion of the taper was priced in by the June/July rise in rates from 1.60% – 2.75% ten year yields**

- **Now, the focus is on where the Fed will STOP hiking rates, not when they'll start**

Fed Has Grown To Hold Almost One-Fifth of the US Treasury Market



June/July Spike in 10YR Rates Indicates Some Portion of Taper is Priced-In

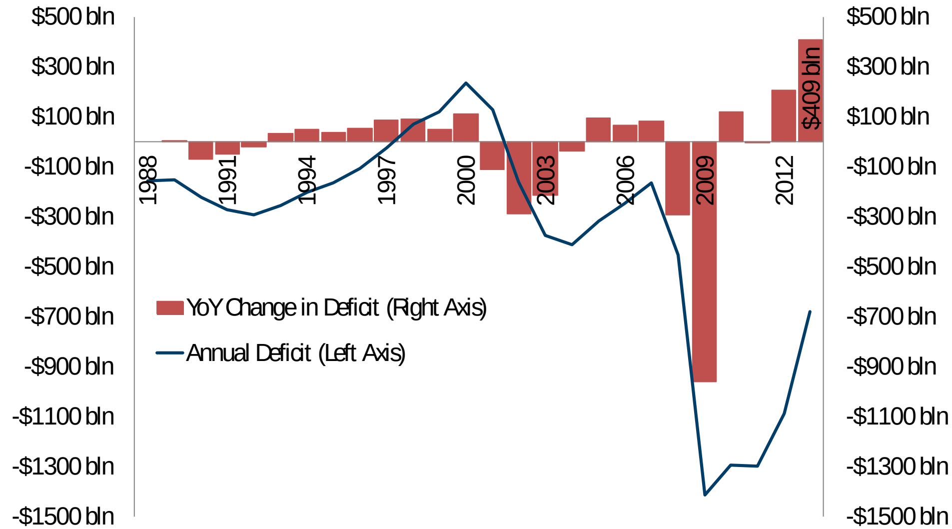


Source: Janney FISR; Federal Reserve Board

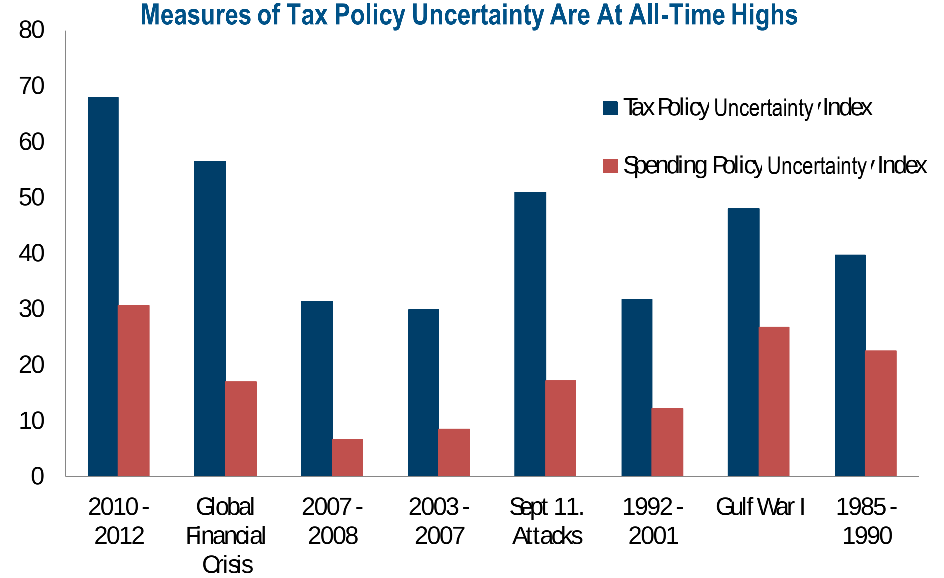
Fiscal Impacts

- Real issue isn't slower spending, it's uncertainty created by fiscal debates, as that reduces businesses' and households' willingness to invest over the long term
- This lack of investment is and will continue to be one of the biggest long term problems for the US economy, as productivity growth will prove harder to come by in future years and decades

Deficit Fell $409bln in FY2013, Indicative of Less-Stimulative Fiscal Policy



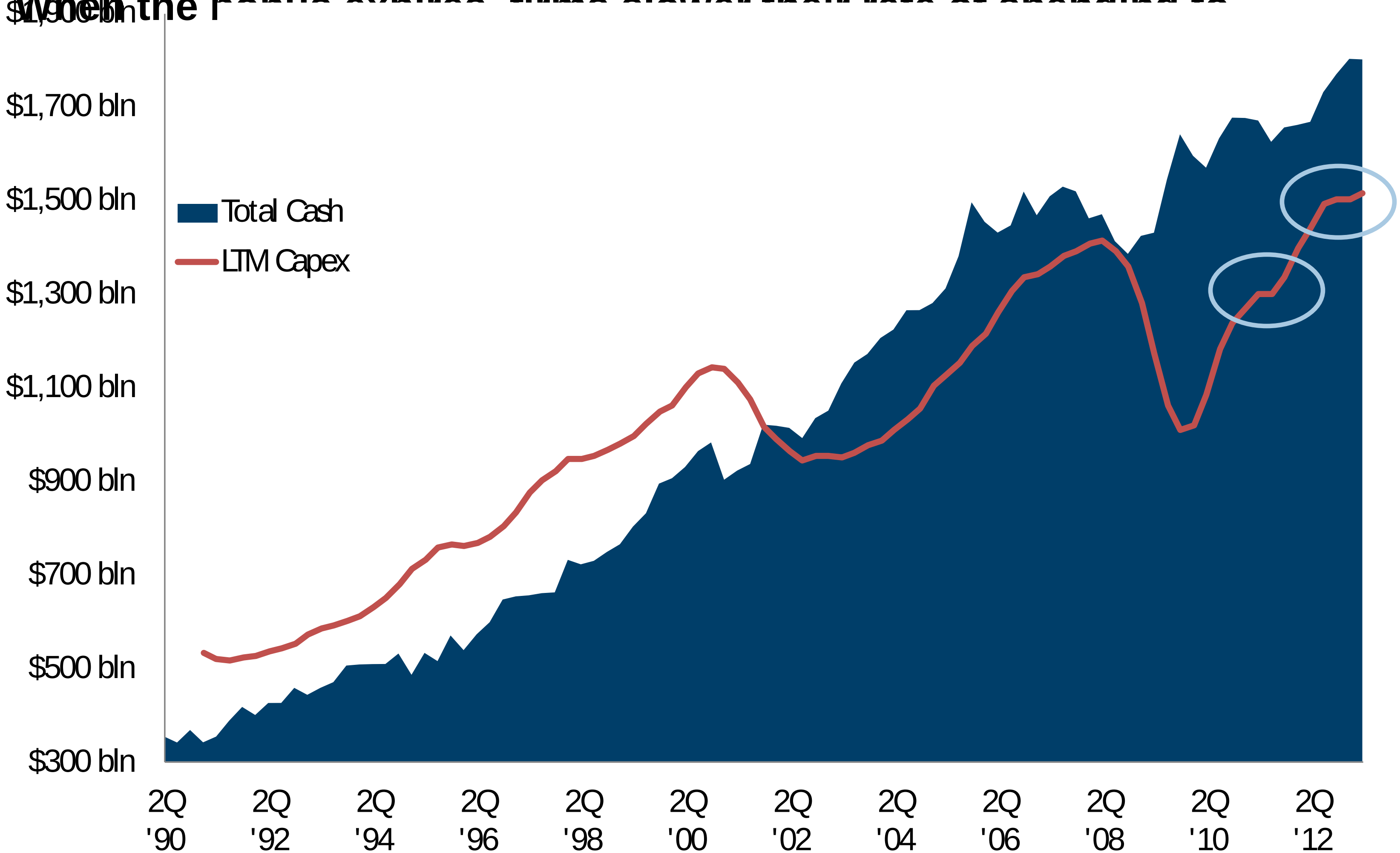
Measures of Tax Policy Uncertainty Are At All-Time Highs



Source: Janney FISR; Treasury Dept.; Access World Newsbank Policy Uncertainty Index

The Question of Business Investment (or Lack Thereof)

- **Another key area of fiscal intervention has been the “double depreciation” tax break**
- **When the**



Source: Janney FISR; Federal Reserve Board

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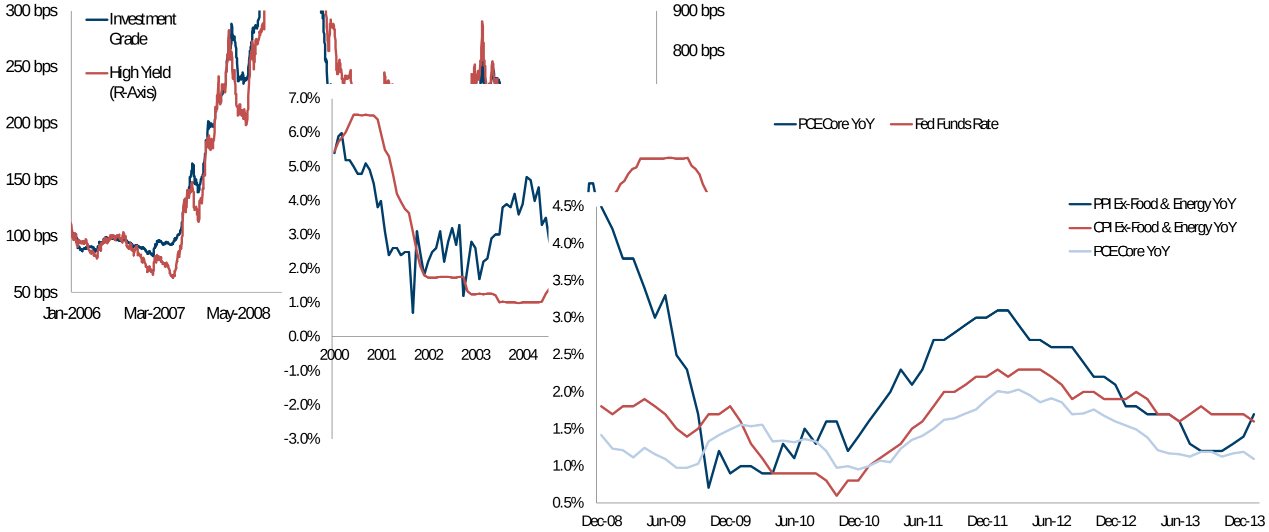
Value of Economic Models



$$(1)\quad Y^*_{ij} = \gamma_Y{}'X_{ij} + \delta_Y{}'Z_j + \alpha_Y PR^*_{ij} + \beta_Y AL^*_{ij} + \varepsilon_{Yij}$$

$$(2)\quad Y_{ij} = 1 \text{ if } Y^*_{ij} > 0 \text{ and } Y_{ij} = 0 \text{ if } Y^*_{ij} \leq 0$$

$$(3)\quad PR^*_{ij} = \gamma_{PR}{}'X_{ij} + \delta_{PR}{}'Z_j + \mu_{PR} RPR_j + \mu_{PR} RPR_j^2 + \varepsilon_{PRij}$$

$$(4)\quad PR_{ij} = 1 \text{ if } PR^*_{ij} > 0 \text{ and } PR_{ij} = 0 \text{ if } PR^*_{ij} \leq 0$$

$$(5)\quad AL^*_{ij} = \gamma_{AL}{}'X_{ij} + \delta_{AL}{}'Z_j + \mu_{AL} RAL_j + \mu_{AL} RAL_j^2 + \varepsilon_{ALij}$$

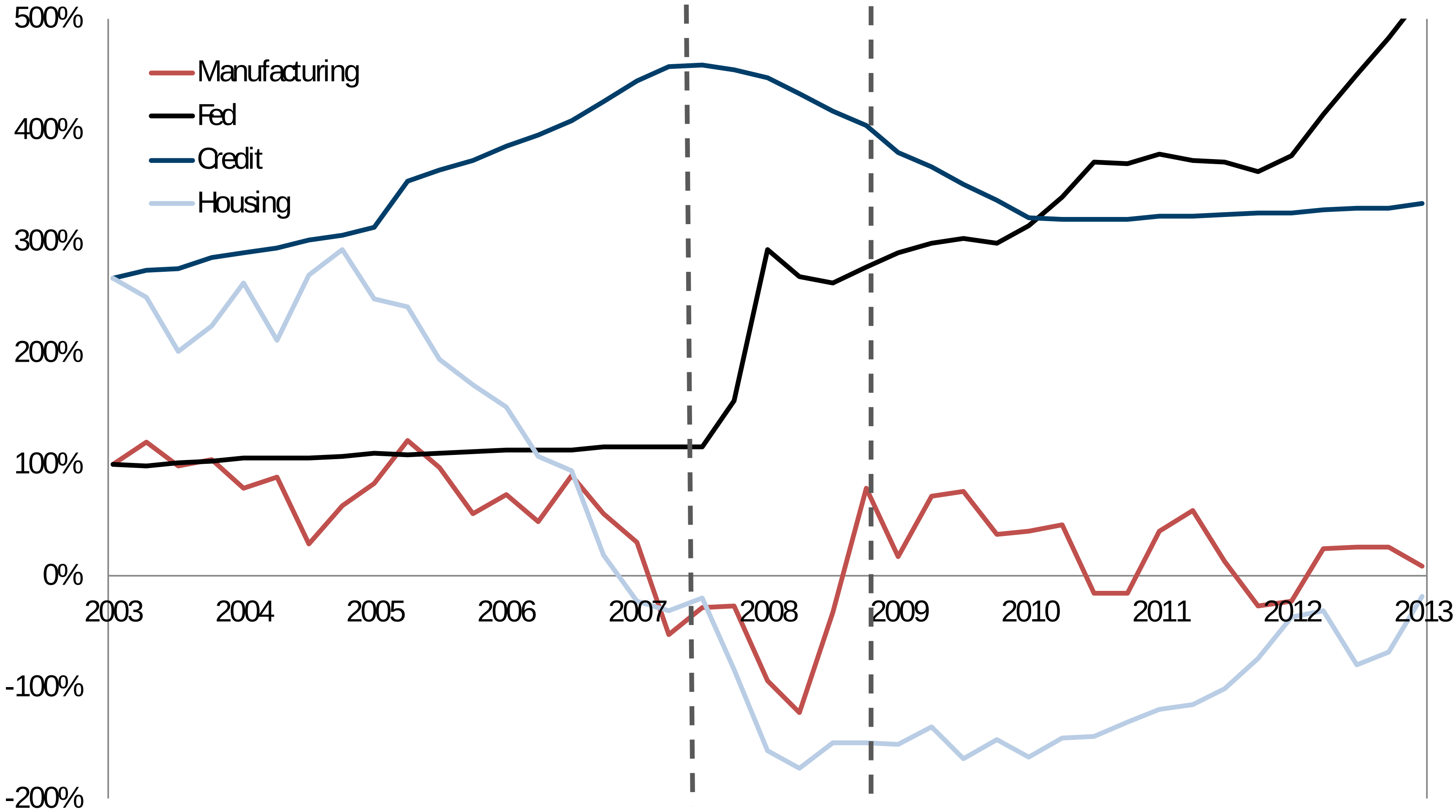
$$(6)\quad AL_{ij} = 1 \text{ if } AL^*_{ij} > 0 \text{ and } AL_{ij} = 0 \text{ if } AL^*_{ij} \leq 0$$

- **Complex models of the economy thrive on data**
- **The more data, the better defined the relationships**

Source: Janney FISR

Limits of Economic Models

- **That data models thrive on? The relationships it produces may no longer hold.**

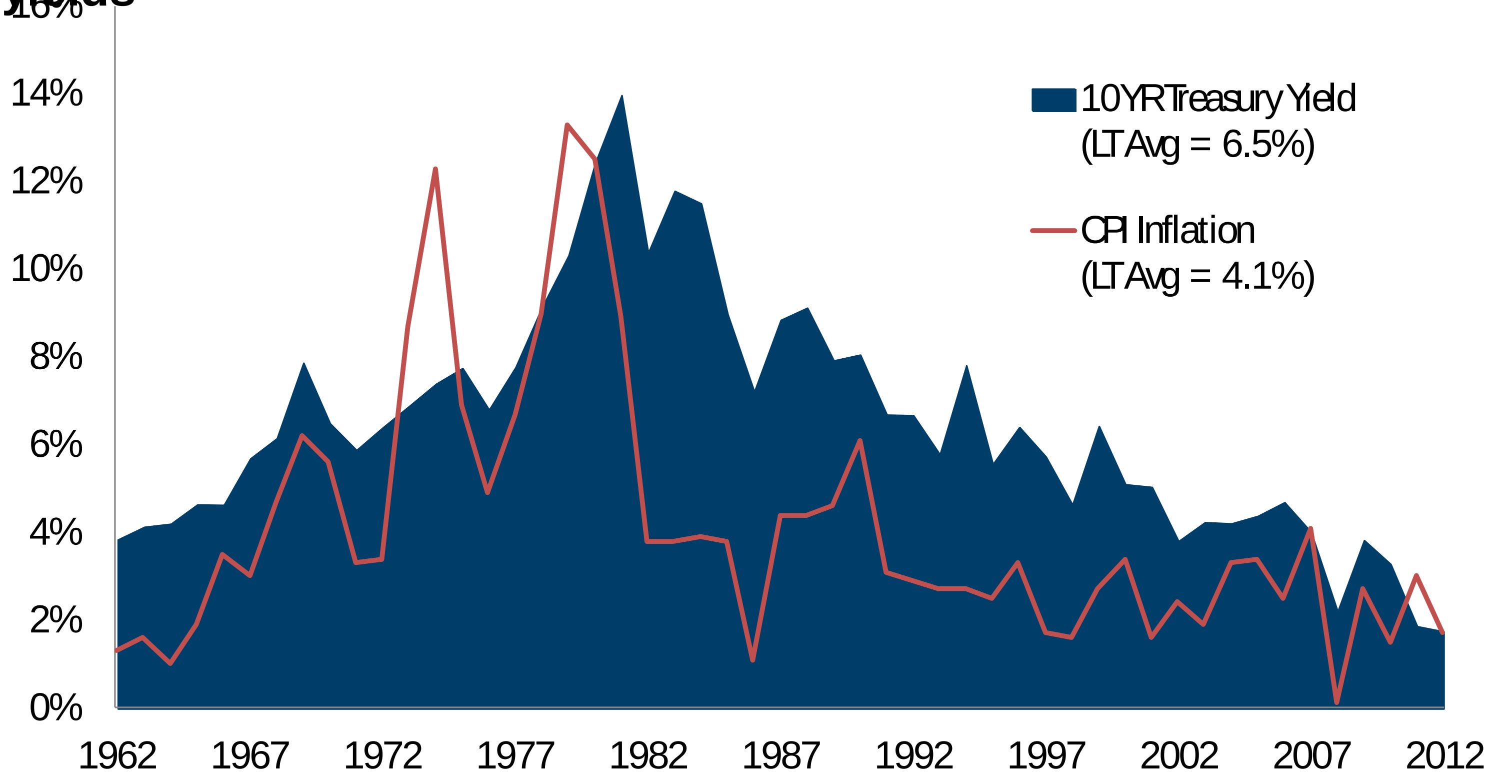


Source: Janney FISR; Federal Reserve Board; Census Bureau; Federal Reserve Bank of NY

A Return to the Long Run "Normal"

- **Longer run, speed limits of economic growth and very benign inflation suggests that the long run level of interest rates is much lower than post-War average**

- **We would peg 4.00 – 4.25% as the new settling area for 10yr Treasury yields**



Source: Janney FISR; Labor Dept.

Outlook 2014 Rate Forecasts

- **Short Rates:** The Fed is likely to strengthen its low rate pledge along with reductions in longer term bond purchases, thereby largely anchoring the curve. Our forecast for the first fed funds hike isn't until 1Q 2016.
- **Intermediate Duration:** The curve is very steep between 2/5yr points, and the roll down for 5yr bonds makes them very attractive. Interest rates have to rise 45bps/yr to turn total return on 5yr note negative, and carry is much better than in the 2-3yr area.
- **Long End:** The long end of the curve faces further increases in interest rates once the Fed sponsorship wanes. Long term economic speed limits mean that rates are unlikely to return to long term averages, but 3.50% 10yr by 4Q 2014 implies total return on 10yr note of -0.7%.

Interest Rate Strategy: Forecast Detail

Central Bank Rates	Current	2Q 2014	4Q 2014	4Q 2015	4Q 2016
Fed Funds O/N	0.13%	0.13%	0.13%	0.13%	1.25%
Treasury Curve	**Current**	**2Q 2014**	**4Q 2014**	**4Q 2015**	**4Q 2016**
3m Bill	0.01%	0.06%	0.09%	0.91%	1.51%
2yr Note	0.45%	0.55%	0.84%	1.74%	2.04%
5yr Note	1.79%	1.87%	1.93%	2.37%	2.65%
10yr Note	2.79%	2.88%	3.30%	3.64%	3.68%
30yr Bond	3.62%	3.61%	3.92%	4.00%	4.03%
2s/10s	234 bps	233 bps	246 bps	189 bps	164 bps
10s/30s	83 bps	74 bps	62 bps	37 bps	36 bps

Source: Janney FISR

Municipals

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Tax Free Interest Rates

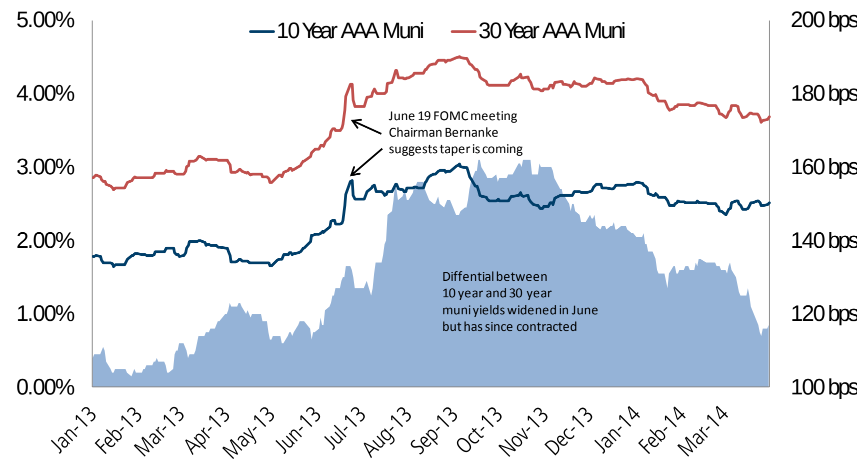
- **Long end of muni yield curve has flattened since June 2013 market downdraft.**

- **We believe munis should outperform Treasuries in 2014. Muni to Treasury ratios will decline.**
  - **April 2, 2014 – 91%**
  - **2013 average – 98%**
  - **2010-2013 average – 96%**
  - **2000-2009 average – 88%**

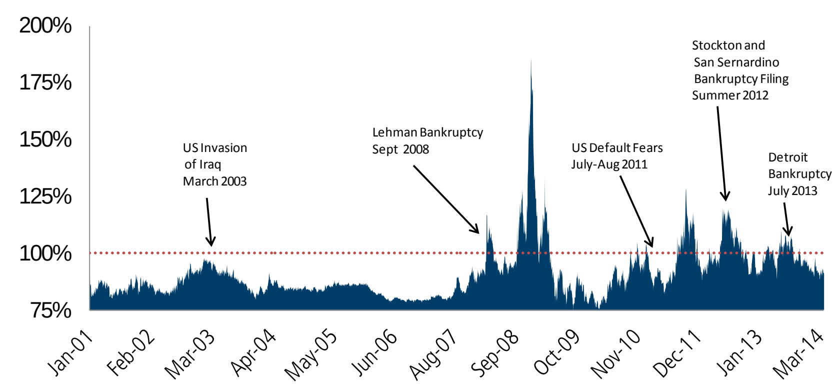
- **Including 3.8% Medicare tax on investment income, tax brackets are highest since 1981, making tax exempt income increasingly valuable**

- **With credit concerns receding, the threat to tax exemption is the remaining driver of elevated ratios.**

Rates Have Been Relatively Stable Since June Crash



Muni to Treasury Ratios Are Above Historical Averages



Source: Janney Fixed Income Strategy, Thomson Reuters MMD

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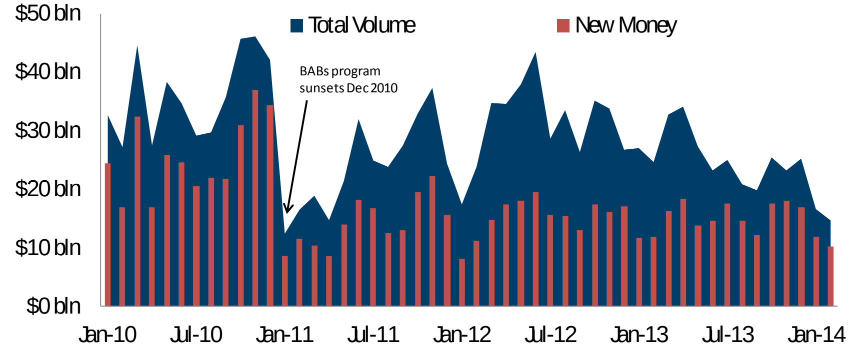
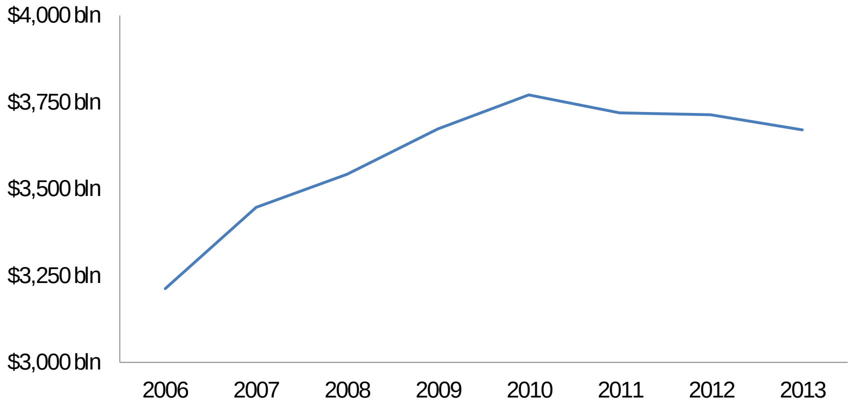
New Issue Pace Has Slowed. Fewer Municipal Bonds Outstanding

- **Since Build America Bond program ended in December 2010, municipal bond new issue volume has contracted.**
- **Refinancing of higher coupon debt drove much of borrowing in recent years**
  - **50% in 2012**
  - **40% in 2013**
- **Federal Reserve data shows the amount of municipal bonds outstanding is contracting**
  - **$3.7 trillion outstanding**
  - **44% held by households (shrinking)**
  - **28% held by mutual funds (shrinking)**
  - **24% held by banks and insurance companies (growing)**

New Money Issuance Slowed Sharply With Sunset of Build America Bond Program Sunset



Federal Reserve Data Indicates Amount of Muni Debt Outstanding is Contracting



Source: Janney Fixed Income Strategy, Bond Buyer, Federal Reserve

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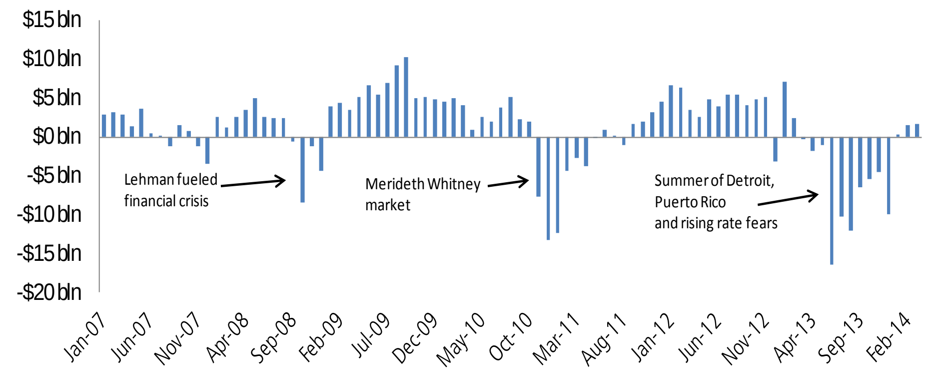
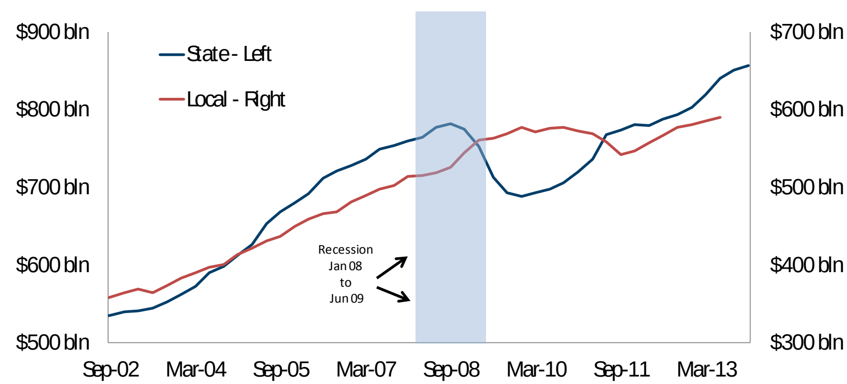
Demand for Muni Bonds Fell in 2013 even as Credit Conditions Improved

- **Detroit bankruptcy filing (July 2013) and concerns about Puerto Rico ($70 billion in debt) fueled municipal credit concerns and municipal mutual fund outflows**
- **State sales and income tax revenue, which fell sharply during and after the recession, has recovered to exceed pre-recession levels. The pace of recovery has not been consistent in all locations.**
- **Property taxes, which underlie about 75% of local government tax revenue, have been slower to recover and more spotty than sales and income taxes, but stability is gradually returning.**
- **The challenge of managing expenses and balancing budgets during recent difficult times, have prepared municipalities and states to manage finances in future slower growth economy.**

Weekly Mutual Fund Flows are Proxy for Demand



State and Local Tax Revenue has Recovered to Pre-Recession Levels But Some Areas are Lagging



Source: Janney Fixed Income Strategy, Investment Company Institute, US Census Bureau

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Marketweight: *Janney FIS expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return*
Underweight: *Janney FIS expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return*

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Asset Classes: *Janney FIS ratings for domestic fixed income asset classes including Treasuries, Agencies, Mortgages, Investment Grade Credit, High Yield Credit, and Municipals employ the "Barclay's U.S. Aggregate Bond Market Index" as a benchmark.*
Treasuries: *Janney FIS ratings employ the "Barclay's U.S. Treasury Index" as a benchmark.*
Agencies: *Janney FIS ratings employ the "Barclay's U.S. Agency Index" as a benchmark.*
Mortgages: *Janney FIS ratings employ the "Barclay's U.S. MBS Index" as a benchmark.*
Investment Grade Credit: *Janney FIS ratings employ the "Barclay's U.S. Credit Index" as a benchmark.*
High Yield Credit: *Janney FIS ratings for employ "Barclay's U.S. Corporate High Yield Index" as a benchmark.*
Municipals: *Janney FIS ratings employ the "Barclay's Municipal Bond Index" as a benchmark.*

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