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2015 Review and Outlook for 2016

2015 was a year of transition for the fixed-income markets. After eight years of unprecedented monetary policy stimulus, the Fed took a first small step toward a more normal interest rate policy. Bond investors began the year impatiently awaiting the first change in Fed policy since the Financial Crisis, which was finally delivered in December. While markets remained calm during the first half of 2015, volatility increased during the second half due to uncertainty over Fed timing, persistent weakness in commodity prices, and growing pressure on high-yield securities.

Weakness in emerging markets and sharp drops in prices of energy and other commodities triggered a rise in the number of rating downgrades and bankruptcies during 2015. As a result, the second half of the year saw substantial downward pressure on energy-related high-yield bonds and fixed-income investments such as MLPs. In October, once the market became convinced that the Fed would begin raising rates at its December meeting, strong selling brought higher yields in virtually all U.S. fixed-income sectors, with the worst damage done in less liquid, lower quality markets such as leveraged loans and junk bonds. By early December, selling pressure had mounted to such a degree that some high-yield fixed-income mutual funds and hedge funds froze redemptions completely. When funds resort to “gating,” investors lose access to their money for an unspecified period of time. The objective of the funds is to prevent forced selling at deeply distressed prices in order to raise the cash needed to cover redemptions.

While high-yield investors were re-learning painful lessons about liquidity and the dangers of chasing yield, investors in U.S. government debt and high-grade corporate and municipal bonds faced much calmer markets. Expectations of Fed tightening caused yields to rise on the short end of the curve, but yields moved only modestly five years and out, remaining well below mid-year highs. The most disruptive force affecting high-grade credit in 2015 was the robust new issuance used to fund corporate mergers and stock buy-backs, not the Fed. U.S. corporate M&A activity and corporate debt issuance reached record levels in 2015 by a number of measures.

In municipal markets, investor demand remained strong despite the year-long drama surrounding Puerto Rico and its impending default. Even when the first Puerto Rico agency bonds failed pay interest in August, the general market impact was negligible. Although municipal mutual funds and ETFs have been hurt by sharp drops in the prices of their Puerto Rico holdings, generally strong credit quality and high demand for tax-exempt income has continued to support relatively stable performance in municipal bonds throughout the year.

Looking ahead to 2016, we expect many of the same themes to continue to drive fixed-income markets' performance. Now that the Fed has initiated a tightening cycle, the market will try to judge how fast and how far the Fed will go. We expect the Fed will move slowly on additional rate hikes and continue to telegraph any changes. If there is any significant disconnect between market expectations and Fed actions, though, we could see a high level of volatility in all bond markets.

An additional driver of 2016 bond market performance will be developments in commodities markets. If weakness persists, especially in the energy sector, we would expect default rates to continue to rise and junk bonds to remain under pressure. There is potential for a domino effect if high-yield and alternative funds continue gating redemptions and liquidating their portfolios. Should more funds follow suit, or if the affected funds are high-profile hedge funds or mutual fund companies, there could be potential spillover effects in other segments of the bond markets, as well as in stocks.

Municipals face more high profile credit concerns in 2016. There is a chance that Puerto Rico or its agencies will default on multiple bond issues on January 1st, though we believe the Commonwealth is likely to negotiate a grace period with its largest creditors. However, our view is that even a payment default is unlikely to have dire consequences for the broader market. The highest risk is to individual investors holding uninsured Puerto Rico general obligation (G.O.) and agency bonds as well as to those invested in municipal mutual bond funds, ETFs or hedge funds that have significant positions in Puerto Rico debt. Of greater concern for the broad market may be the situations in Pennsylvania and Illinois, where the states still haven't passed a budget halfway through their fiscal years. In particular, we are closely watching developments in Chicago. Pressure is mounting on the city, and Chicago schools face financial difficulties so severe that they could be forced to consider default or debt restructuring in the near term.

Though we now face a rising rate environment for the first time in nearly a decade, Ascent's fundamental approach to fixed-income investing will not change. We continue to focus on credit selection and structuring portfolios that best balance risk versus return in changing market environments. Our buy-and-hold approach allows us to look for value in high-credit-quality names in out-of-favor sectors (such as miners, oil and gas, electric utilities, etc.). By ensuring we invest in issues that will pay in full as scheduled, market declines over the short term do not create any pressure to sell bonds that have declined in value, but instead may present buying opportunities. Likewise, laddered portfolios of high-grade bonds mean a constant stream of interest and maturing principal to reinvest, averaging in higher yields as rates rise without trying to time the market.



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