Fed Rate Hike: Uncharted Territory

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INVESTMENT TALKS

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The Time is Right

The Federal Reserve Board has taken an historic, widely broadcast step in raising the target Federal Funds rate by the expected 25 basis points. This move ends the zero interest rate policy that prevailed for the past seven years following the 2008 financial crisis, and ushers in another phase of this unprecedented, uncharted experiment in monetary policy of a very gradual increase in rates.

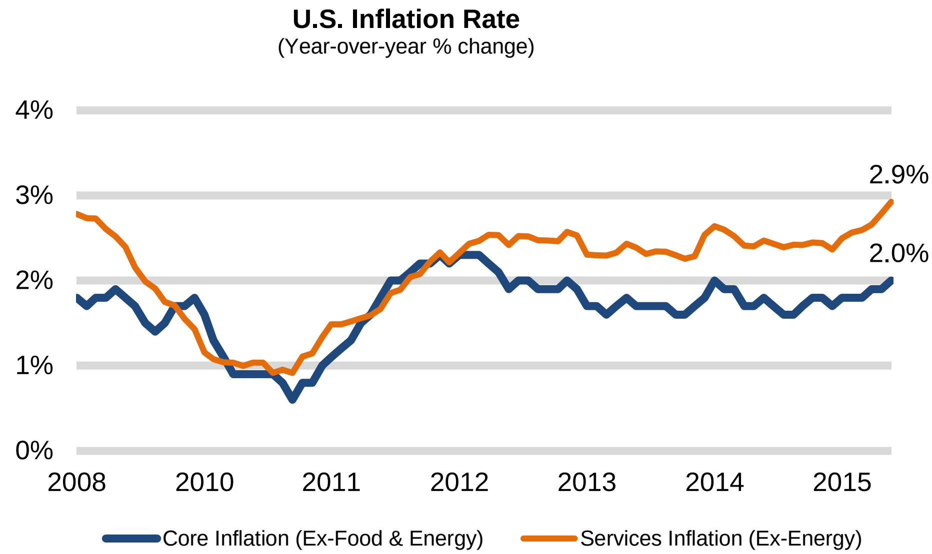
The decision to begin raising rates is appropriate in light of an unemployment rate of 5%, which is very close to a level of full employment, rising core inflation and steady economic growth. Beyond economic reasons for rising rates, the Federal Reserve has also previously noted its desire to normalize monetary policy to avoid financial market excesses, and to regain an important monetary policy tool that can help address future economic or market downturns.

Steady U.S. Growth

We have believed for some time that the Federal Reserve should raise rates in 2015. U.S. GDP growth continues to be steady, and should lead growth among developed nations at approximately 2.25% - 2.50% in 2016. Strong employment is supporting consumption, as indicated by a ten-year high in auto sales and a seven-year high in housing starts. Government spending should also contribute to growth. While the strong U.S. Dollar (USD), along with weak energy and commodity prices, may continue to depress the manufacturing and export sectors, these sectors each only represent approximately 12% of U.S. GDP. This trend should lessen, moreover, as any additional USD appreciation should be modest, relative to its record appreciation over the past 1.5 years.

Equally important to the Federal Reserve's decision has been increasing inflation. While headline Consumer Price Index (CPI) has been well below their target 2% rate, the Fed looks beyond transitory effects of energy and food prices. The core CPI Index has established an emerging trend of increasing inflation, reaching 2% in November. The CPI Services ex-Energy Index, which focuses on consumer-focused sectors, indicates a nearly 3% inflation rate.

The Federal Reserve has refocused on U.S. growth, employment and inflation, rather than on the impact of rate increases on global economic growth. We believe that global growth may have bottomed, and that the Fed's protracted approach to further rate increases could reduce the negative impact of rising rates, particularly in light of easy global monetary policies that should support economic growth and markets.



Source: Bloomberg. Last data point November 30, 2015.

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Observations on the Fed Statement and the Yellen Press Conference

On the whole, the Fed statement did not contain any significant surprises. The statement highlighted strong economic activity in consumption, business fixed investment (ex-energy), housing, and declining unemployment. In addition, a considerable portion of the statement focused on inflation and the Fed's conviction that, despite current low levels, it could recover to their target 2% level.

Future Rate Hikes: Fed vs. Market = Volatility

The Federal Reserve has indicated that it will raise rates much more gradually than in the past. We believe this approach should help ensure that they will not undermine economic growth. At the same time, because their decision-making is data-dependent, investor uncertainty may continue, resulting in higher market volatility.

The divergence in views between the market and the Federal Open Market Committee (FOMC) regarding rate increases may contribute to this volatility. The market continues to price in only two rate increases, compared to the four increases reconfirmed in the December FOMC forecast. Relative to its September forecast, the FOMC did shift its bias downward. While the 2016 median remained the same, the dots shifted downward, compared to September. In 2017, the FOMC removed one rate increase. ("Dots" refers to data in the chart on the following page indicating the number of FOMC members favoring future Fed Funds rate increases.)

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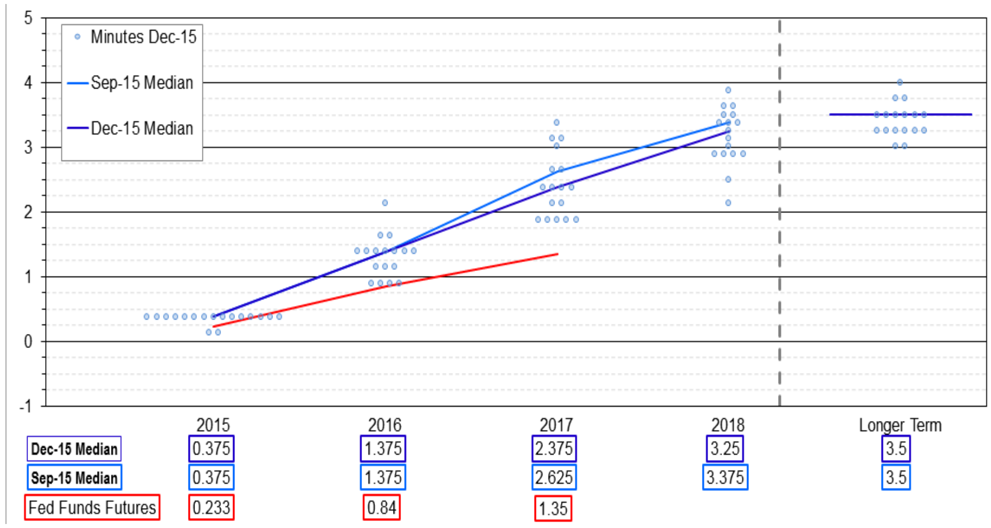
FOMC vs Fed Funds Futures:
Divergence in Views of Future Fed Rate Hikes



Source: Bloomberg. Data as of December 16, 2015.

Investment Outlook

Our overall outlook for fixed income markets is fundamentally unchanged. We have seen corporate credit spreads widen despite the fact that U.S. economic activity is recovering, and we are seeing some recovery in Europe as well. So, wider credit spreads may represent a good opportunity. While we remain cautious on energy, the recent sell-off in the high yield and bank loan markets has created select buying opportunities in many sectors. We believe bank loans offer particular value as floating rate, senior-secured assets. The bank loan market also has significantly less energy exposure than the high yield market. We also find Treasury Inflation Protected Securities (TIPS) attractive relative to nominal Treasuries, because we believe inflation may surprise to the upside. We continue to favor portfolios that are broadly diversified by sector because many sectors have above average spreads on a historical basis.

Emerging markets (EM) have suffered in the wake of lower growth in China and lower commodities prices. Higher rates will hurt those countries with significant external USD-denominated debt. In emerging markets, we enter 2016 on a cautious note, as some economies are relatively more vulnerable to a Fed tightening. Based on our proprietary Vulnerability Index, Asia is the least vulnerable EM region, with China, India and Philippines showing the most resilience.

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Important Information

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