CONGRESS ASSET
MANAGEMENT COMPANY

Fixed Income Outlook

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We are now navigating a course set by Federal Open Market Committee (FOMC) expectations rather than demonstrated economic results. While even the FOMC knows its forecasts are less than perfect, the decision to preemptively slow the economy has been made. Fed Chair Janet Yellen has espoused that future moves will be made gradually and carefully. This signals a definitive end to the long era of "easy money" provided by low short term interest rates.

While the Fed is clear on its stance, the rest of the market is not so sure. The yield on the 10-year US Treasury hovers near 2.3% as of this writing, down a little over 10 basis points since year end. Despite a pledge of higher rates, the longer end of the yield curve has actually dipped lower as a result of investor preference for the safety of Treasury bonds as well as a tacit dismissal of the Fed's expected interest rate hike.

Regrettably, there are still many events that continue to incite fear or even panic among global investors. Recent international and domestic terrorist attacks continue to prompt investors to avoid risky assets and geographic areas and reallocate to Treasuries. Recent saber-rattling by North Korea, missile strikes in Syria, and less-than-friendly relations with Russia have all been clear manifestations of a less-than-perfect world peace. We join others in mourning for victims of senseless violence and in urging less violent solutions to conflict.

We have repeatedly noted our disagreement with the Fed's assessment of the near term risk of inflation. So-called headline measurements of inflation have risen, but only due to resurgent fuel prices and a softening of global food deflation. When viewed without the volatile effects of food and fuel prices, inflation has yet to show any convincing period-over-period momentum.

So where could we be wrong in our assessment? We agree that global investors could find the US markets less attractive as the US Dollar loses strength and international currencies stabilize. This would mean smaller fund flows to Treasuries, ultimately generating higher yields on longer-dated issues. Fiscal policy could accelerate more rapidly, causing the economy to grow faster and thus generate higher inflation. Lastly, the power of the Fed to act should not be taken likely. Continued copious Fed-speak of relentless rate hikes could prompt investors to adopt a more bearish mindset and push longer term rates higher.

In some respects the low overall level of rates could be keeping long term rates in place as short term rates move up. High quality investors have bemoaned the paucity of yield on the short end of the curve and have sought relief by extending the maturity of their investments. Once the Fed moves short term rates high enough to satisfy this hunger for yield, flows will likely reverse to shorter maturity issues and finally entice the curve to steepen.

As we look to the investment-grade marketplace, we continue to find excellent liquidity and execution. Corporate bonds, as in previous periods, have been the market leaders for returns and yield. US Treasury and Agency issues have fared well, but only about half as well as Corporate bonds on a return basis. Lower credit quality Corporate bonds have outperformed higher quality issues while longer-dated issues have outperformed shorter-dated bonds. Looking further afield, below investment grade bonds, or "Junk" bonds, have continued to outperform albeit with an ever-present higher risk of default.

Looking ahead we expect the Fed to continue addressing the markets with a mandate to raise rates at the forefront of its dialog. We do believe the Fed will act carefully and slowly when implementing policy changes. Raising rates too quickly could easily have a deleterious effect on the economy due to the currently modest levels of GDP growth. In the long run we expect to be able to adjust our portfolios over time to capture these higher rates once they arrive.

We, as always, believe that a portfolio of high quality, modest duration bonds are our clients' best option for fixed income investing.