ACROPOLIS®
INVESTMENT MANAGEMENT

ALM INSIGHTS

Volume 4, Issue 3 // Editors: Cliff Reynolds, CFA and Ryan Craft, CFA

In this Issue:

2 | **We Have Liftoff!**
By: Ryan Craft, CFA

4 | **But I Thought Rates Went Up?**
By: Cliff Reynolds, CFA

5 | **Is The Canary Still Singing?**
By: Ryan Craft, CFA

Contact us:

P | (888) 882-0072 (Toll Free)
| (636) 449-4900 (St. Louis)
F | (888) 453-1266 (Toll Free)
| (636) 449-4923 (St. Louis)
E | info@acrinv.com
A | 14755 North Outer Forty, Suite 100, St. Louis, MO 63017

Acropolis was born from a simple idea:

In an industry where high quality, objective advice is hard to come by, we make a difference by putting the client's interests above our own.

Key Rates:

Fed Funds Target	0.50%
Discount Rate	1.00%
Prime Rate	3.50%
3-mo LIBOR	0.61%
2-yr Treasury	0..98%
3-yr Treasury	1.25%
5-yr Treasury	1.65%

10-yr Treasury	2.18%
2-yr Swap	1.09%
5-yr Swap	1.61%
10-yr Swap	2.08%
5-yr A Corp Yield	2.58%
5-yr A BQ Muni Yield*	2.10%
* Tax Equivalent Yield	

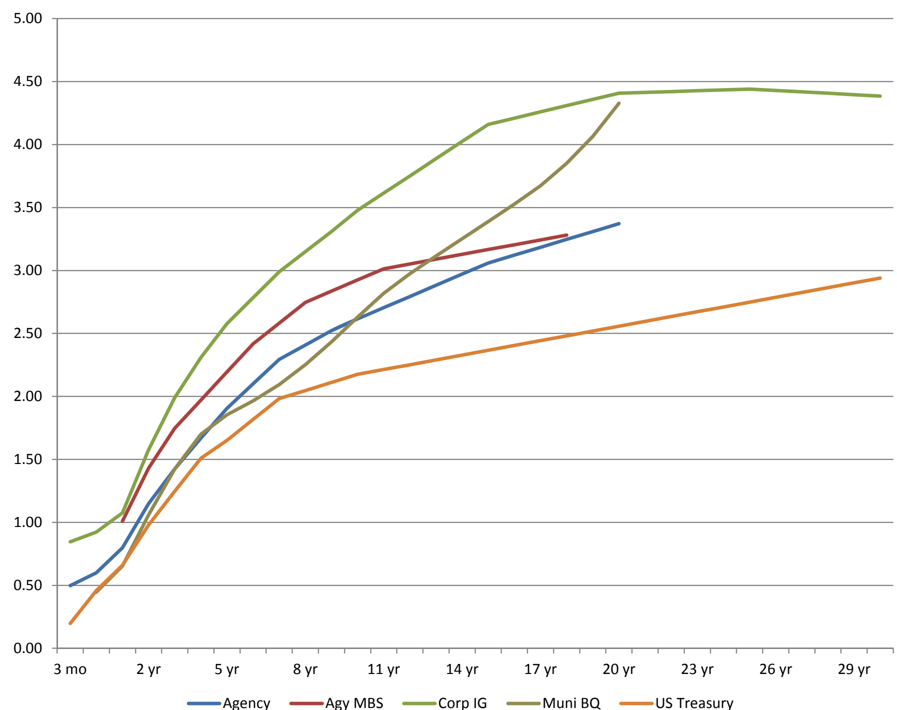
Economic Data:

Q3 GDP Growth	2.0%
November CPI YoY	0.5%
Unemployment Rate	5.0%

Upcoming Events:

Next FOMC Meeting	Jan 27

Yield Curve *All data as of 1/6/2015*

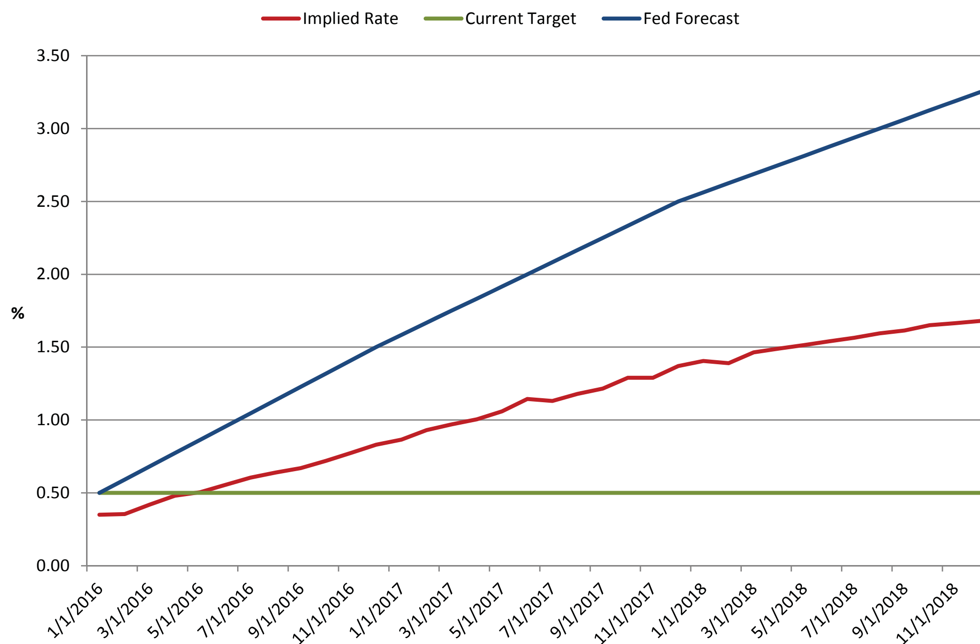


We Have Liftoff!

By Ryan Craft, CFA

After seven years of zero interest rates, the Fed has finally begun to raise its overnight benchmark rate. At its December meeting, the FOMC voted to raise the Fed Funds target rate by 25 bps. The Fed has been telling the market all year that it would begin the removal of emergency accommodation in 2015, so this move did not surprise the credit markets. Coming out of the December meeting, the primary concern for market participants is the path of future rate hikes.

If all goes as planned, the market can anticipate Fed Funds following the path outlined by the Fed (shown by the blue line in the chart nearby), which means a 25bps hike roughly every other meeting. The FOMC has clearly stated that any future actions will remain data dependent. Therefore, for rates to follow their forecast, GDP growth will have to average ~2.5%, Unemployment will remain steady or fall slightly, and Inflation will remain on a slow march towards the Fed's 2% target. This is the Goldilocks scenario – where the Fed can slowly wean the economy off of monetary stimulus without much disruption.



If the Fed deems the porridge too hot or cold, they will most likely deviate from the plan. The Fed is comfortable to let the economy overshoot to the positive for a while, so a large inflationary shock is the only plausible scenario that would cause the Fed to raise rates more aggressively than outlined in their forecast. The too hot scenario is the least likely to happen given the global economic outlook for 2016.

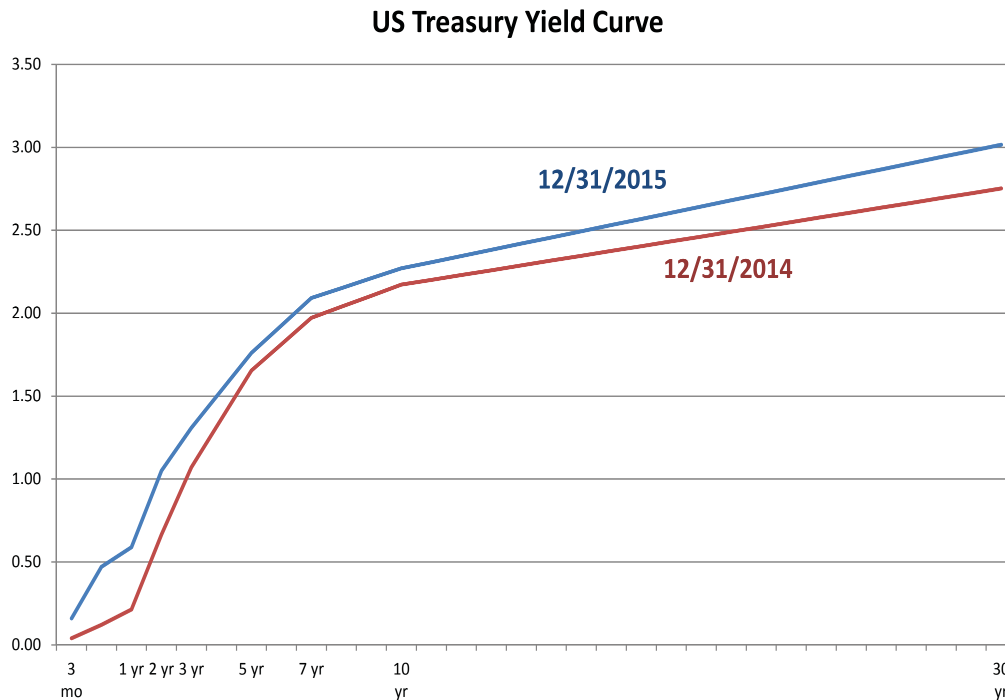
What could cause the Fed to undershoot their forecast? Well, a lot. First, the Fed's forecasted path for Fed Funds assumes that inflation increases, credit markets normalize, and economic growth remains steady. Current market-based inflation expectations are much lower than the Fed's forecast. The US dollar continues to strengthen as China, Japan and the ECB continue to weaken their currencies. With the Fed tightening monetary policy while the rest of the world is adding monetary stimulus, the dollar may be in

continued on page 3...

...continued from page 2

for further strength which would keep inflation low as higher US interest rates relative to the other major economies typically result in dollar appreciation.

Additionally, any external shock to the economy (geopolitical, oil, etc) or a contagion from the junk bond or equity markets spreading to other sectors of the economy could give the Fed pause in continuing to drain liquidity from the system. This is why the market's forecast is much lower than the Fed's. The Fed Funds Futures market implies a much slower rise in the Fed Funds rate as seen in the nearby chart.



This year is looking to be a difficult year for bonds as the Fed is likely to raise rates multiple times during the year. However, it is important to remember that not all bonds will be effected the same way. As rates rise, the yield curve will likely change shape, meaning that different maturities may have very different performance. This has already happened at the end of 2015. As the market anticipated the Fed raising rates, short maturities began to rise as the short part of the yield curve is most influence by Fed policy. Little impact was felt in longer maturities as yields further out the curve are more influenced by long term expectations of inflation. As the Fed raises rates, we anticipate the biggest change in yield on the short end of the curve, resulting in a much flatter yield curve.

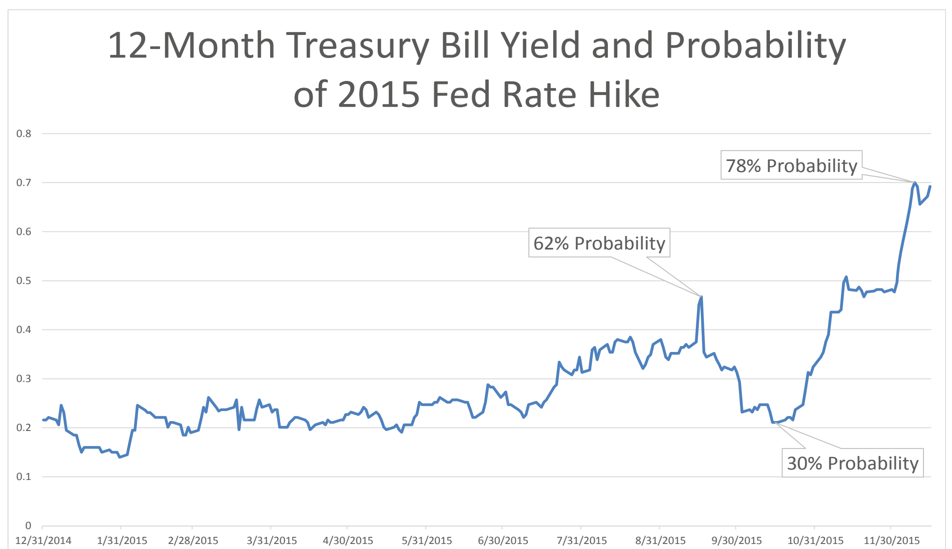
But I Thought Rates Went Up?

By Cliff Reynolds, CFA

Given how effective the market is at adjusting securities prices to reflect new information, it shouldn't be a huge surprise to see interest rates rise before the Fed actually took action. That's not to say that using market prices as a guide to the future is mistake free. If that were true then asset bubbles and stock market crashes would never happen. Because the new information is always becoming available, securities prices are always changing and the market's projection for the future is changing along with prices.

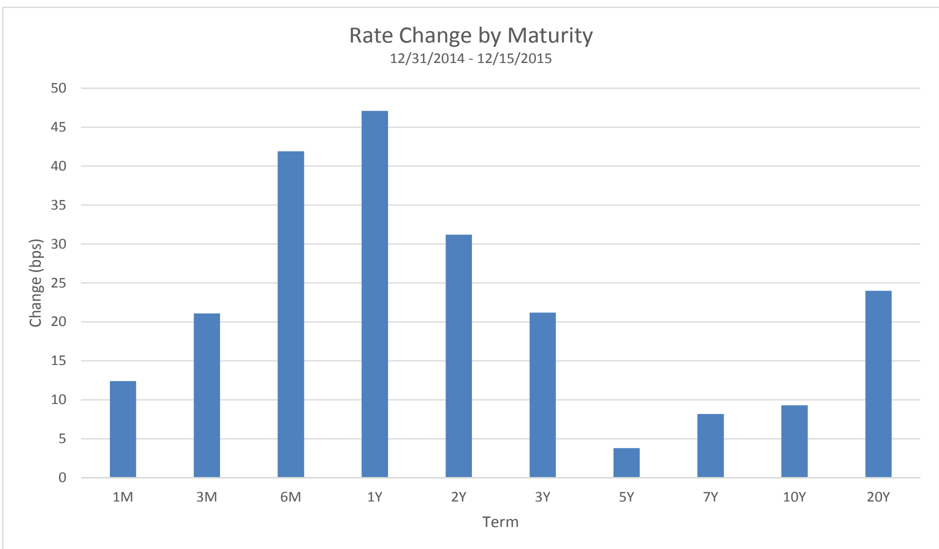
Short-term interest rates over the course of 2015 are a good example of this in action. Expectations for a Fed rate hike in 2015 changed a lot over the year, especially in the third and fourth quarters.

As economic data and comments from FOMC members flowed through the bond market, in the form of changing interest rates, implied probability of a hike in the target for Fed Funds also changed. (Rising to a 62% probability in mid-September, before falling to 30% in October and finally rising to 78% on the eve of the December 16th announcement)



For fixed income investors it may be useful to look at which interest rates were most effected by the changing expectations for a rate hike in 2015.

Looking at the graph below, you can see that while rates across all maturities rose since the beginning of this year, they all didn't rise the same amount. Because dynamic twists in the yield curve are difficult to model, it's easy to fall into the expectation that when rates rise they will all rise together. Because a true parallel rate shift really never happens, designing a bond portfolio expecting rates to change as if they were all linked can be dangerous.

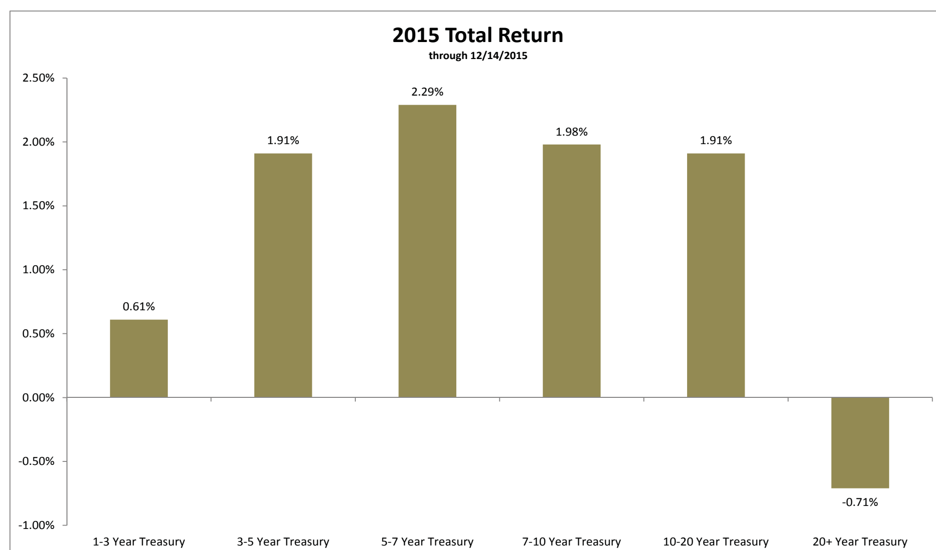


While the factors that influence short-term rates have been volatile, factors that influence intermediate and long-term rates remain fairly steady. A simple rule of thumb is that monetary policy has more influence on the short-end of the curve. (Less than two-years for example) While inflation and economic growth rates have more influence on the longer-end, it's reasonable to expect

continued on page 5...

...continued from page 4

the intermediate part of the curve to be influenced by a combination of both factors. By no means is there a clear line marking where investors quit paying attention to the Fed and when they only care about the economy. This is very much an inexact science.



Nonetheless if you can concede that longer-term interest rates are more effected by economic factors, then the scenario that has played out recently shouldn't be that much of a surprise.

Even considering that most of rate changes have been concentrated in shorter maturities, it may still be surprising to see how bonds from different parts of the yield curve have performed.

We have written about the possibility of a flattening of the curve before. It's not a stretch to expect rates to move this during a tightening campaign by the fed – looking at history it's actually most common path for rates. But the results clash with the "hurry up and get short ahead of the Fed" strategy that many bond investors have implemented over the past few years.

Like I said, using the market as a guide to the future is not mistake free. While it is the best indication of value today given all available information, there will be new information tomorrow that will cause prices to change further.

Is The Canary Still Singing?

By Ryan Craft, CFA

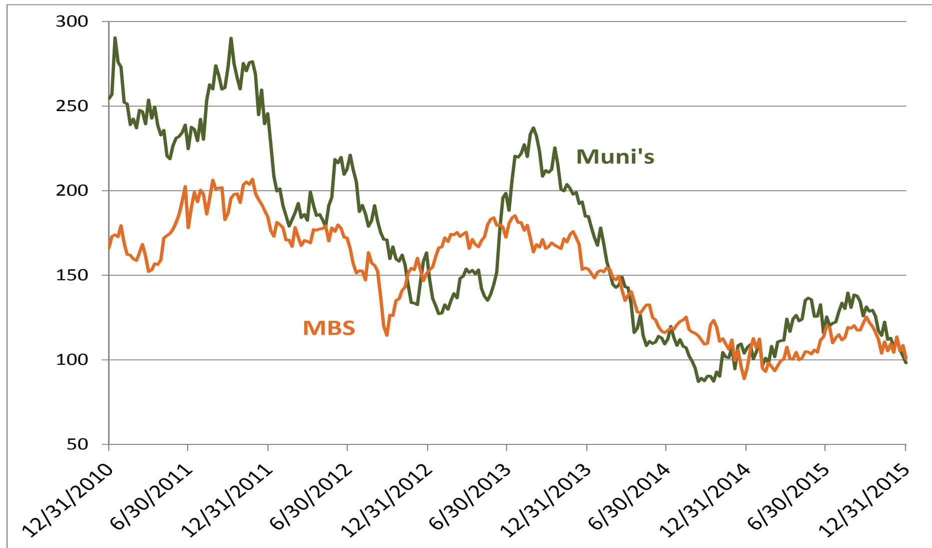
Something peculiar is happening in the bond markets. As the market has priced in the start of the Fed's tightening campaign, risk assets are already feeling the pain.

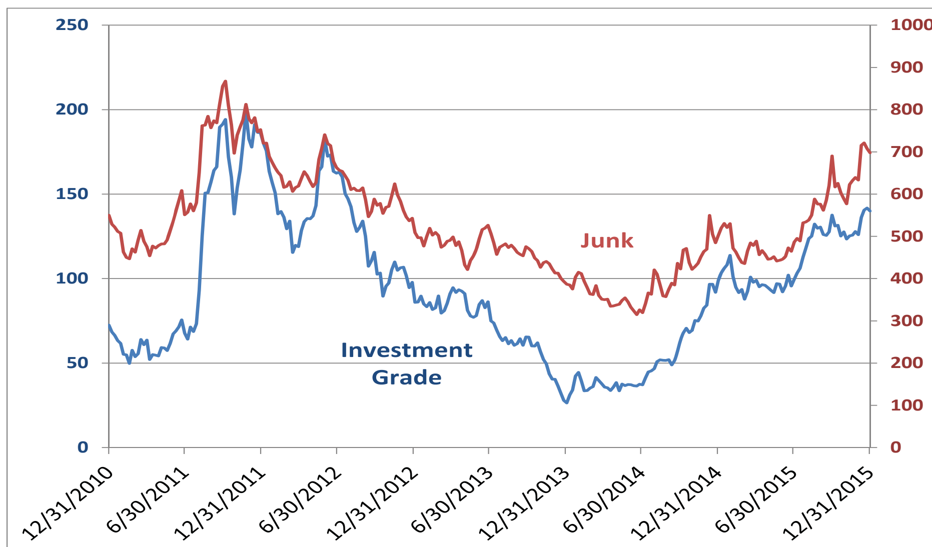
One way to gauge the market's appetite for risk is to look at spreads, or the difference in yield between risky bonds and safe bonds (typically Treasuries). This spread is the premium an investor demands to assume the risk of a bond versus holding the risk-free bond. If a bond's risk is perceived to be low, the spread is low. Conversely, investors will demand a higher yield premium to hold bonds with more risks.

One of the primary effects of the Fed's zero interest rate policy and QE programs has been diminishing credit spreads across all sectors. As the Fed pushed yields down on safe bonds, it incentivized investors to move out the risk spectrum in search of higher returns. The result has been lower yields in everything from Treasuries to Junk bonds to higher equity prices. The decline in spreads is illustrated in the nearby charts.

continued on page 6...

...continued from page 5





Agency MBS spreads have been holding fairly steady at multi-year lows over the past year. Municipal bond spreads have been a bit more volatile as market perceptions of muni credit risk have fluctuated over the past few years. Over the second half of 2015, muni spreads have approached the lows of the current cycle (shown on a taxable-equivalent basis). The behavior of spreads show investors perceive little risk in these sectors.

The corporate bond market tells a completely different story. During the financial crisis, corporate bonds were hit hard, especially non-investment grade, or junk, bonds. Since then, junk bonds have been a star performer as investors continued to buy them in search of yield. However, alarm bells have begun to ring over the junk bond market for the past few months. Spreads on junk bonds have increased nearly 200 basis points in 2015. Much of this rise has been attributed to falling oil prices effecting the creditworthiness of the oil and gas sector. Credit risk in that sector has certainly worsened along with the declining price of oil, but that sector only accounts for 7% of the high yield bond market.

While most of the press has been focused on the high yield market, risk in investment grade corporate bonds has been increasing as well, with spreads widening by nearly 100 basis points throughout 2015. The fact is that investors are demanding such a steep premium from high quality corporate bonds while MBS and municipal bond spreads have been unchanged over the same period. Historically, this has not been a positive sign for the markets and economy.

On December 10th, a high yield mutual fund managed by Third Avenue Management closed its doors and barred investors from selling shares in the fund. Poor performance triggered an investor exodus from the fund. The fund was unable to raise cash in a timely manner to meet redemptions without selling bonds at fire sale prices. This episode highlights the risk associated with owning thinly traded securities and the cost of liquidity. It also shows how the credit markets have changed since the introduction of Dodd-Frank as many banks are no longer in the business of making a market in corporate bonds, thereby reducing liquidity in the market. However, this is not just a liquidity story. Liquidity became a problem because of the poor performance and perceived credit risk of its holdings.

continued on page 7...

...continued from page 6

Is this just short term volatility or a harbinger of things to come? Credit markets tend to be the canary in the coalmine for the economy in general. The 2008 credit crisis began with a widening of credit spreads and the failing of a Bear Stearns hedge fund in the summer of 2007. Or, this could be like the spike in 2011 that saw spreads quickly reverse course. A big difference between today and 2011 is monetary policy. The volatile markets of 2011 were countered by aggressive Quantitative Easing from the Federal Reserve. This time, markets are contending with a Fed that is just beginning to tighten policy. Widening spreads in credit markets could simply be the market repricing risk in the absence of Fed intervention or it could be pointing to danger on the horizon. This will be one of the key metrics to watch over the new year and could influence how aggressive the Fed raises rates.

THE ACROPOLIS VALUE PROPOSITION

Independent Voice – Acropolis provides independent insight to the Asset Liability Management of financial organizations through effective portfolio management in the context of the entire balance sheet and liquidity needs.

Unbiased – Advice on portfolio management is completely unbiased without influence from outside factors such as trading commissions or dealer inventory. As a fee-only advisor, we are solely beholden to our clients' best interests.

Best Execution – Acropolis offers years of Fixed Income trading expertise and an expansive network of dealers from which to execute trades. This results in buying and selling the most appropriate bonds at the best prices, with no mark-up to our clients.

Specialized Reporting – Our proprietary securities portfolio reports provide detailed data on individual positions with scenario analysis and allocation breakdown.

Fiduciary Duty – As a Registered Investment Advisor, Acropolis is bound to puts its clients' interests first. Acropolis takes pride in serving as a fiduciary and took deliberate efforts to become one of fewer than 100 investment advisory firms in the country that are certified as fiduciaries by the Centre for Fiduciary Excellence (CEFEX) *(http://www.cefex.org)*.

Notice to Clients

Please remember to contact ACROPOLIS® Investment Management, LLC if there are any material changes to your financial situation or investment objectives or if you wish to impose, add or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement as set forth on Part 2 of Form ADV continues to remain available for your review upon request.

Legal Disclaimer

This publication is provided as a service to clients and friends of ACROPOLIS® Investment Management, LLC solely for their own use and information. The information in this publication is not intended to constitute individual investment advice and is not designed to meet your particular financial situation. You should contact an investment professional before deciding to buy, sell, hold or otherwise consider a particular security or investment strategy based on this publication. Information in this publication has been obtained from sources believed to be reliable, but the accuracy, completeness and interpretation are not guaranteed and have not been independently verified. The information in this publication may become outdated and we are not obligated to update any information or opinions contained in this publication.

© ACROPOLIS® Investment Management, LLC 2015. All rights reserved.