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FIXED INCOME Q&A

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Where do you think we are in the current interest rate cycle?

As we approach mid-year, the odds of a rate increase later this year (Sept-Dec) have fallen to just over 50/50. Our view is that we will see at least one increase this year of 25 basis points, assuming that GDP remains above a 2% annualized growth rate. We also continue to believe that barring a significant increase in GDP or inflation, increases in short rates will occur slowly over time with less than 100 basis points of increases in 2016 regardless of what happens later this year.

How do you put today's low interest rates into perspective?

With continued slow payroll increases, a large percentage of underemployed and low labor force participation rates, the FED continues to seek out avenues to improve economic growth in the current slow growth, low inflation environment in which we are living. With rates already so low and limited alternative growth stimulating programs available to the FED, maintaining a low rate environment to encourage borrowing seems like one of the few avenues available to improve economic growth.

What factors will influence the timing of the FED's decision on interest rates?

Besides the obvious projections of economic activity (GDP) and inflationary trends (the FED likes to look at the personal consumption expenditure (PCE) numbers), the FED also factors in underemployment, wage growth, and possibly the labor force participation rate when judging potential economic growth. While the mantra of FED policy is supposed to be limited to "promoting economic growth while maintaining a low inflationary environment", in recent years both the FED Chairmen and FED Governors have indicated their periodic concerns with valuations in the securities markets, potential bubbles in various markets, etc. While these later points may be of concern from time to time, we believe the FED should stick to the primary goal discussed above and not attempt to manage FED policy in regards to all risks of the economy and the various capital markets.

How and why do interest rates go negative?

Historically negative interest rates have occurred, although very infrequently. In general most investors believe accommodative FED policy is limited to dropping rates close to or near zero in an effort to maintain a low rate, growth oriented environment across the yield curve. However, in an extremely accommodative environment with massive amounts of buying by central bankers, supply/demand can result in short rates actually going negative. In other words, investors are actually paying a penalty to hold short-term deposits.

What impact, in your opinion, do historically low interest rates have on asset allocation decisions?

Asset allocation is and always will be a tradeoff between potential growth opportunities in certain asset classes (stocks, real estate, commodities, etc.) and income producing asset classes (bonds, income producing real estate, MLPs, etc.). In many sectors, valuations rely on income potential to assign acceptable valuations. Therefore, with historically low interest rates and very low credit spreads in recent years it has been difficult to allocate funds to many fixed income sectors. One of the problems for investors is that after nearly seven years of low interest rates, many formerly risk adverse investors have found themselves with minimal fixed income exposure for the reasons mentioned above. In some of these cases the investors' risk profiles and current asset allocation may have become imbalanced. We frequently attempt to remind clients that their risk profiles need to remain in line with their existing asset allocation regardless of how attractive the valuations in certain sectors may or may not be. While moving one's allocation to the low end of a targeted range may be very applicable in certain markets, eliminating an allocation to a sector because it appears overvalued hints of market timing and should be avoided unless the client's risk profile truly changes.

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