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Q3 2014 SHORT MATURITY QUARTERLY COMMENTARY

SHORT MATURITY MUNI COMPOSITE CHARACTERISTICS

AS OF: 9/30/2014

Duration: 1.85yrs
Yield-to-Worst: 0.84%
Yield-to-Maturity: 0.87%
Maturity: 1.99yrs

LOW DURATION TAXABLE COMPOSITE CHARACTERISTICS

AS OF: 9/30/2014

Duration: 1.87yrs
Yield-to-Worst: 1.04%
Yield-to-Maturity: 1.04%
Maturity: 1.95yrs

Strategic Overview

Macro: US Treasuries spent Q3 stuck in a narrow range, anxiously awaiting signals from the Federal Reserve. As expected, the Fed continued with winding down its asset purchasing programs. However, rate hike speculation established itself as a key driver of activity in US debt markets. Traders wondered if the strong Q2 GDP print (+4.6%) coupled with declining unemployment numbers (to 6.1%) would give the Fed sufficient confidence to remove its longer-term rate guidance and prepare markets for an accelerated timeline. In the end, that would not be the case – weak inflation and labor participation data overshadowed the Q2 GDP rebound. Still, ahead of the September Fed meeting, 10-year US Treasury yields crept up to 2.62%, a threshold that has proven itself time and again as a significant point of resistance. In the weeks following the Fed's renewal of their dovish status, US Treasury yields tumbled towards the lower regions of their trading channels. A hostile geopolitical picture and slumping economies in Europe and Asia only added to the energized demand for haven assets. Developments in Ukraine, Gaza, Syria, Iraq and Hong Kong demanded close surveillance and still weigh heavily on market tone. Q3 ended with a decisively 'risk-off' bias, suggesting tighter Fed policy likely remains a distant concern.

Market Dynamics: Fed speculation kicked into a higher gear during Q3, and volatility in the front end of the yield curve followed suit. For many FOMC meetings, the Fed has assured participants that they would keep interest rates low for a 'considerable time.' However, traders grew increasingly convinced that the Fed would remove its 'considerable time' guidance in favor of more hawkish word choices, and US Treasury prices in the first five years of the curve suffered from the rate hike concerns. As a result, US Treasury yields experienced a flattening in Q3. From June 30th to September 30th, the spread between 2-year and 30-year debt decreased by 27 basis points. We expect Fed expectations to remain at the forefront of short maturity activity in the coming months.

Caprin Performance Notes: Our overweight to yieldier sectors in both Short Maturity Muni and Low Duration Taxable strategies helped performance versus our benchmarks over the quarter. We avoided US Treasuries altogether in favor of injecting more attractive yields into our Taxable portfolios. Furthermore, we felt short US Treasuries exposed clients to outsized risk given their sensitivity to Fed theories. In the Muni space, buying higher yielding sectors such as hospital, housing and power debt aided those portfolios' total return. We continue to look beyond the highest-rated Munis in the shortest region of the yield curve toward sectors that better compensate investors.

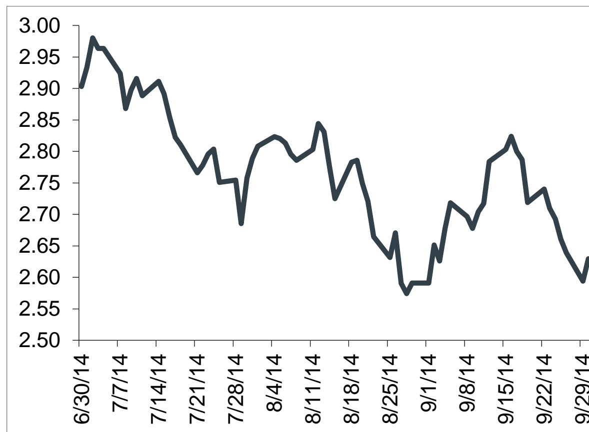

Figure 1: Spread between 2-Yr and 30-Yr US Treasury Yields

Source: Bloomberg

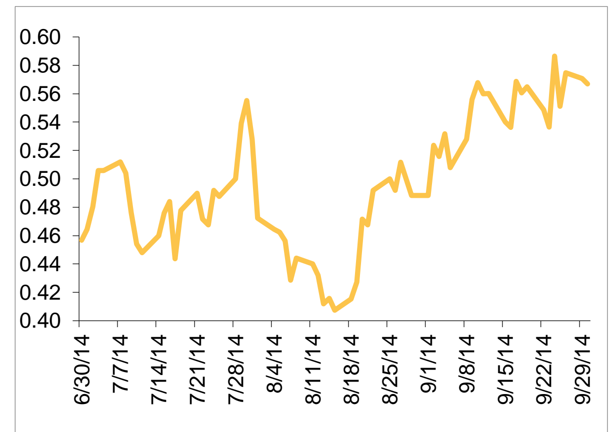

Figure 2: 2-Yr US Treasury Yields

Source: Bloomberg

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