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The Week That Was

Author:
Sean Fallon, CFA
Senior VP

Mr. Fallon joined Stephens in July of 2012 to Head the Municipal Taxable efforts and to trade CMBS, Agency CMBS, and ABS. He has 19 years of experience managing and trading fixed income assets. Mr. Fallon holds a Bachelor of Arts in Political Science from St. Mary's College and both an MS in International Management and MBA from University of Maryland. He also holds the Charter Financial Analyst and Chartered Market Technician designations.

sean.fallon@stephens.com

Stephens Inc.
111 Center Street
Little Rock, AR 72201

501.377.3466
800.643.9691

www.stephens.com

Member NYSE, SIPC

The idiom "we are all in the same boat" is meant to relay the message that one is experiencing the same condition as someone else. Its genesis dates back to ancient Greece when the expression was first used to describe the shared risks of all passengers on a small boat. Over the course of time this expression has expanded beyond its nautical origins to include all people in similar, unpleasant circumstances on land, sea, or in the air.

In looking at the markets this week I was struck by the similarities of the issues facing investors across the globe. The common themes would appear to be excessive levels of debt (and in some cases pension liabilities) and lack of economic growth. In fact, in some cases it would appear that these issues have actually begun to curb growth. Why? Because as more and more money is used for debt/pension service it is being diverted away from more productive uses—such as creating growth.

The most obvious example of a country plagued by these issues would be Greece, where the debt-to GDP-ratio is 177% and climbing. Worse yet, Greece is finding itself in a dangerous, perverse cycle of borrowing to cover not only operating expenses but also to make payments on its debt. Under more typical circumstances countries can increase taxes and curb spending to help alleviate its debt. However, with the Greek economy continuing to contract (down -0.20% for Q1 2015), and the massive amount of austerity that has already been implemented, Greece's only option to avoid default is to continue borrowing.

However, the types of issues facing Greece are much more wide-spread than most investors realize. Japan actually has the globe's highest debt-to-GDP ratio, at 227%, and if you begin looking at state and local governments the numbers are just as bad. Puerto Rico has $73 billion in debt (70% debt-to-GDP ratio) and a shrinking population that currently translates to roughly $21 thousand in debt per person. On the mainland, both Chicago and the state of Illinois have massive budget deficits and have unfunded pension liabilities that continue to balloon.

This week the city of Chicago issued $668 million of general obligation debt for the first time since being downgraded to junk status by Moody's. Yields on the 10-year bonds were priced at 286 basis points above the Municipal Market Data scale for a yield of 5.18%.What struck me was the fact that Chicago was not much different from Greece: Both are lacking cash and have a massive amount of debt. Additionally, there is no easy fix to their problems, and I am hard pressed to see how these issues get resolved without an eventual bankruptcy. In the short term, the lack of a viable solution to Chicago's issues will likely increase the volatility in their credits. Longer term, we will likely see some form of debt and pension restructuring.

In trading, the European markets were under pressure as the terms tied to the next Greek bailout had yet to be reached as of writing. Greece is out of cash and needs an infusion to facilitate a scheduled June 5th payment to the International Monetary Fund. And while most market participants believe that an agreement will be reached, there was still an increase in the level of volatility tied to the uncertainty. As a result, European equities were under pressure for most of the week as most indexes fell by 2-3%. In fixed income there was a resumption of the push into negative yields as German 5-year debt

went negative (-0.01%) again for the first time since April.

In U.S. trading, equities were under pressure (falling by 1-1.25%) as a slate of weaker economic data raised concerns about the strength of the economy. The final revised numbers for first-quarter GDP showed that the economy contracted by 0.70%, raising fears that the recovery is not as robust as had been believed. Corporate debt spreads were slightly wider as high-grade names widened by 1 to 2 basis points while high-yield spreads were largely unchanged.

In fixed income, Treasuries benefited from both the flight to quality tied to the Greek situation and weaker U.S. data. The long end of the yield curve was the best performer on the week as 30-year rates fell by 13 basis points. Longer-duration assets benefited from investors' need for duration as many accounts had reduced their exposure to long-dated assets during the recent sell-off. The activity on the front of the curve was more muted as rates ended the week little changed. With the outperformance of the long end, the yield curve flattened on the week as the spread between 2-year and 10-year Treasuries finished the week 10 basis points narrower, at 160.

Technically, the market breached the 2.17% level on 10-year Treasuries—a level we had highlighted last week which would signal that the bulls had taken control. With the strength of this week's move our target of 2.00% could come into play over the next several weeks. Big picture: The overall range continues to remain the same at 2.00% to 2.30%, and I would expect this range to remain in place until later this year.

As we close the week, the issues of too much debt and too little growth continue to weigh on the markets. With the first quarter behind us there are major questions being raised about second quarter growth. I continue to question whether the markets, and for that matter many issuers, can really handle higher rates should the Fed being to tighten. And as a result I would expect little to change over the next few months as both investors and the monetary authorities come to the same conclusion that I have: We are all in the same boat.