STONEBRIDGE Capital Advisors

Stonebridge Market Wrap

February 24, 2017

For the week ending February 24, 2017

The 12 day run of new Dow highs has to end sometime, which was almost on Friday. However, the day and the week finished on the upside, continuing the upward march. The talk out of an unnamed alleged source said there maybe no tax deal this year which caused some investors to go on the defensive. Next week look for this bit of “intelligence” to be debunked. A conversation like this is meant to rile up the trading community not investors.

Next week is a bit busier on the economic front now that earnings season is in the rear view mirror. Isn’t it amazing that the market has taken all of the Washington news flow and ignored it? It is almost like we have internalized the disruptive nature of the past few months and are looking forward to the execution of the rest of the agenda like tax cuts, infrastructure plan and health care revision. I think that the pro business tilt to this administration has revved up investors animal spirits and that people see better times ahead due to regulator reform and the rest. At some point there will have to be more legislation on the table, but for now, investors are allowing some room for that to happen. Rightly or wrongly, there seems to be a feeling that we are out of the doldrums.

Dave Eckenrode
Director of Equity Management

Key Economic Releases for the coming week:

Monday, February 27th:
- Durable Goods Orders; 1.6% expected

Tuesday, February 28th:
- 4Q GDP; 2.1% expected
- Consumer Confidence; 111.8 expected

Wednesday, March 1st:
- ISM index; 56.0 expected

Friday, March 3rd:
- ISM services index; 56.5 expected

Index & Price Changes for week ending 2/24/17	
DJIA– 20,821.76	Rose 247.71 points
NASDAQ– 5845.31	Rose 6.73 points
S&P 500– 2367.34	Rose 16.18 points
S&P Small Cap 600– 853.19	Fell 1.91 points
90 Day T Bill– 0.51%	Yield Fell .02%
2 yr TSY– 1.14%	Yield Fell .05%
5 yr TSY– 1.80%	Yield Fell .09%
10 yr TSY– 2.31%	Yield Fell .11%
30 yr TSY– 2.95%	Yield Fell .08%
Oil- $ 54.01*	Rose $.65 per barrel
Gold- $ 1237.10*	Rose $21.80 per oz.
Unleaded Gasoline*-$1.51	Fell $.01 per gallon
Euro- $ 1.0559	Fell .0049 against the $

* Wholesale price for NY Mercantile Exchange traded contract

2550 University Avenue West, Suite 180 South, St. Paul, MN 55114
830 East Front Street, Suite 300 Traverse City, MI 49686
www.stonebridgecap.com

Fax: 651-251-1010 Phone: 651-251-1000
Fax: 231-933-0628 Phone: 231-933-0320
Toll-free: 800-317-1127

Bond Market Update

Since flirting with market highs late last summer, the bond market has experienced a significant selloff in recent months. How has that shift to higher interest rates affected the overall shape of the yield curve? How have we adapted our current fixed income strategy to take advantage of new opportunities? What measures are we using to protect portfolios from further changes in rates, especially in the municipal market, where many of our investors turn to generate tax-free income?

To answer these questions, let's first look back at what has taken place in the market. Overall, along with generally higher rates across the board, we have seen a steepening of the yield curve since August. A steepening of the curve typically indicates the market is expecting inflation will begin to pick up. The difference between short and long rates has widened from 176 basis points to around 211 basis points. The most dramatic movement in yields has been on the short end of the curve. In fact, all of the steepening of the curve has occurred inside of 10 years.

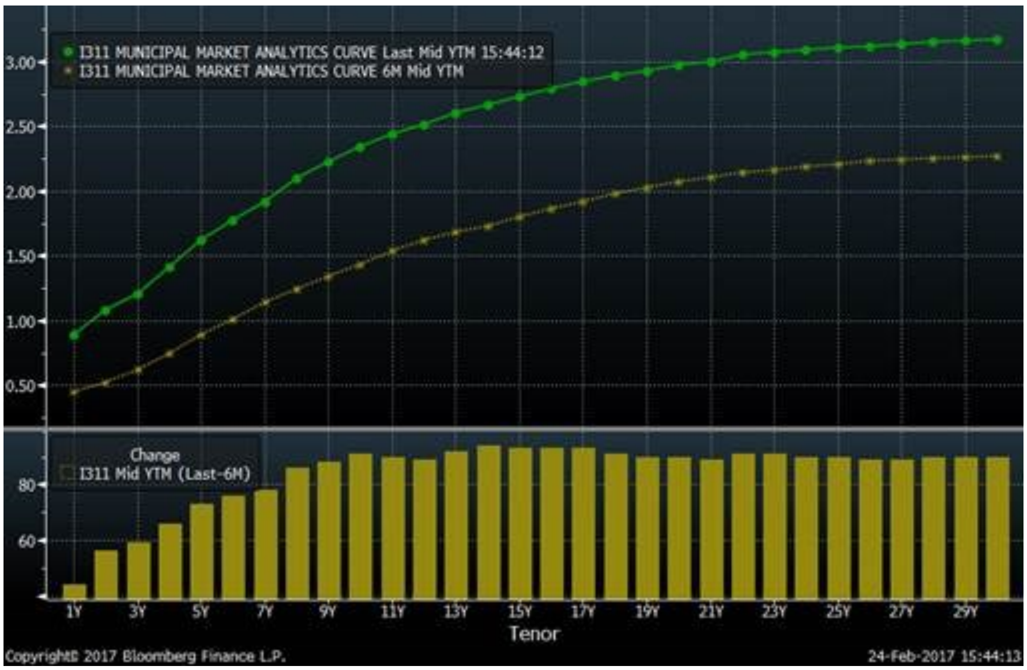
The yield on benchmark one-year AAA GO's has doubled since August. It is now consistently possible to get paid over 1% for an investment made as short as a year. 10 year yields have not quite doubled, but have added almost one percentage point in yield since that time. The long end of the tax -exempt curve (30 years) has moved higher by about 1 percentage point as well to 3.21%. In other words, a parallel shift beyond 10 years.

While the long end offers the highest yield on a nominal basis, from a historical standpoint, it is still not a great return in exchange for locking in the maximum duration. Further to that point, with the 10-year area of the curve currently paying about three quarters of the yield of the long-end, we see the sweet spot right now in the short to intermediate area of the curve. There you are earning the majority of the available yield, while only accepting a fraction of the duration.

Our strategy for this market (modestly higher rates in the coming year) continues to employ some defensive steps like managing duration (reducing price sensitivity) and using premium coupons in structuring bond portfolios. Consistent with those goals, we continue to favor "kicker" or "cushion bonds" in overall portfolio construction and principal reinvestment. We have mentioned them before on several occasions.

Kickers are premium (above market rate) coupon bonds generally with an intermediate dated maturity, but priced with a market yield to a shorter call. The above market coupon coupled with the shorter call feature make for some interesting advantages over simply using either a shorter or an intermediate non-callable maturity with a par coupon. If rates stay relatively stable and the issuer refinances and calls the bonds, your return is comparable to a non-callable bond of the same duration. If rates rise and a refinancing is no longer economical for the issuer, the above market coupon rate then increases the realized yield to maturity over a comparable par coupon bond of the same duration, often by a fairly substantial margin. If that weren't enough, premiums also have another advantage over par coupons in a rising interest rate environment. All else equal, the lower coupon bond tends to decline in price at a faster rate than premiums, therefore cushioning market values.

These shifts in the yield curve have opened up some opportunities for moderately increasing returns in the near term. While we have been taking advantage of this environment to selectively add bonds out in the sweet spot in addition to the short end to improve overall portfolio yield, we are not advocating for dramatic shifts to extend duration right now. As the shape of the yield curve can tell you, just a modest extension in maturity structure right now captures most of the available return.



Source: Bloomberg

Jonathan F. Lynn
Senior Analyst & Portfolio Manager