Loss avoidance is a key to long term investment success. We deem certain risks profitable, to be exploited with sound research, while other risks are inherently unprofitable and should be avoided.

OUR RISK MANAGEMENT TENETS

- A rigorous top-down approach to forecasting liquidity conditions is an essential ingredient in fixed-income risk management
- Active management of interest rate risk within modest limits is a cornerstone of successful fixed income portfolio management
- Extreme variation from benchmark duration is counterproductive
- Yield curve, sector positioning and careful employment of credit risk offer attractive cyclical opportunities to add relative value
- Opportunistic and modest employment of high yield and international debt elements can add significant value to a core investment grade mandate

MONETARY POLICY AND LIQUIDITY CONDITIONS

Paul Teten, CFA
Chief Investment Officer

The Federal Reserve Board’s Federal Open Market Committee (FOMC) has raised the Fed Funds rate three times in the last year, 25 basis points (bp) each, following last December’s rate rise with additional increases in March and June; bringing the rate up to a range of 1.0-1.25% currently with a central tendency around 1.15%. The FOMC reported on September 20 that a substantial majority of members expect to notch the Funds rate 25 bp higher by year-end to a trading range around 1.40%.

The FOMC’s quarterly guidance updated its expectations for the Fed Funds rate at year-end 2018 and 2019 as well, to 2.13% and 2.69%, respectively. The U.S. Treasury 2-yr yield also serves as a Fed Funds projector, and reflects some skepticism that the Fed will be able to deliver on the official forecast. The 2-yr Treasury yield includes an implicit Fed Funds forecast two years out, in that an arbitragable alternative to a 2-yr Treasury is a strip of forward contracts of 90-day T-bills, with the terminal rate closely correlated to the expected Fed Funds rate 2 years out. The 2-yr Treasury yield today at 1.48% implies a terminal T-bill rate of 1.87%, which suggests a 2.0% Fed Funds rate in the fall of 2019. Treasury bond market has priced in roughly 2 more 25 bp increases in the Funds rate through 2019, as opposed to the FOMC projection of 5 more rate rises over that time.

The important point is that the Fed is close to achieving its objective of normalizing monetary policy. Thanks to decelerating core inflation this year, with the Personal Consumption Expenditure (PCE) Deflator, ex food and energy, trailing Y/Y growth slowing to 1.3% through August; when the FOMC raises the Funds rate to 1.40% in December it will have achieved a major objective in raising the inflation-adjusted, or real, Fed Funds rate slightly above zero; the first time that condition has existed since March 2008. Fed Chair Yellen has emphasized the importance of positioning the Fed Funds rate relative to the theoretical equilibrium funds rate, which is a moving target and reflects significant cyclicality, and she has referenced Fed studies estimating the real equilibrium funds rate currently to be approximately zero. The Fed will have raised the real Fed Funds rate from -1.5% to zero in two years since the FOMC embarked on normalization in December 2015. Our expectation is that the FOMC will pause at that point and assess economic and liquidity conditions before moving to raise the Funds rate significantly higher than its estimate of a zero equilibrium real funds rate. Such an expectation is consistent with the 2-yr Treasury yield projection of a 2.0% Funds rate in the fall of 2019. One thing that could lead the Fed to move the Funds rate higher sooner, among other possible developments, primarily including economic
CURRENT RISK ASSESSMENTS

✓ Duration strategies modestly short vs. intermediate benchmarks

ATTRACTIVE SECTORS:
✓ 5-7 Yr Treasuries for optimum roll-down returns
✓ Investment grade Finance credits
✓ Super-senior commercial mortgage-backed securities
✓ High quality Municipals with no pension funding challenges

UNATTRACTIVE SECTORS:
✓ Modestly defensive within Investment Grade credit, tilted to higher quality
✓ Emerging Market credit
✓ Developed Market credit exposure
✓ High Yield corporate bonds

The other major development from a liquidity conditions perspective is the FOMC’s confirmation in September that it will begin to shrink its balance sheet in October. Beginning to unwind the QE that started in 2008 and ran through 2014 sharpens the contrast between the Fed and the other major central banks around the world, which uniformly continue to engage in QE. That divergence is likely to keep the dollar relatively firm. Running down the Fed’s bond portfolio as maturities come due and bonds convert to cash, which is drained from the public markets in the process, is the equivalent of reverse money printing and works to tighten liquidity conditions, as Treasury will refinance the debt from the marginally diminished public liquidity. However, the FOMC guidance is that the unwinding will be very gradual, essentially reversing the massive balance sheet expansion over the next 6-7 years, at roughly the same pace that the Fed increased its Treasury bond holdings.

10-yr Treasury yields rebounded to 3.5-4.0% coming out of the Great Recession in 2009 and it is reasonable to consider the likelihood that the 10-yr yield, 2.33% today, might gravitate back to similar levels over the next several years as the Fed unwinds QE. The major question is how fast that adjustment might occur, and of course other factors will also bear on the course of interest rates. Our view is that the unwinding of QE and associated market rate adjustments will be very gradual. While Chair Yellen indicates that the bond portfolio run off will be measured and essentially on auto pilot, and will proceed on pace regardless of economic and liquidity conditions, we are not persuaded that the FOMC will be insensitive to its impact on market conditions. Rather we are confident that the Fed’s highest priority in the portfolio run off process is to avoid committing a policy error that could be disruptive to the economy’s growth trajectory, absent an inflation problem that needs addressing.

Another very interesting aspect of the FOMC’s September update on their Fed Funds projections is the continuing mark down of the committee’s estimate of the long-term median Funds rate, widely interpreted as a proxy for the long-term nominal equilibrium rate. Initiated by former Chairman Bernanke in 2012 at 4.25%, the long-term estimate has steadily declined over Yellen’s tenure to a new low with the recent update to 2.75%; reflecting the persistence of the low yield, low inflation, low wage growth, weak credit demand environment that has become the new normal. Despite the Fed’s massive balance sheet expansion experiment to stimulate economic growth by unorthodox means, the collapsing gap between the actual Funds rate and the expected long-term equilibrium rate indicates that Fed policy is not as accommodative as the markets and the Fed itself had previously assessed.

We expect the Fed will move cautiously next year, unless and until the economic and/or inflation signals turn a lot stronger. The potential game changer could well be more growth focused fiscal policies and tax reform, the delivery on
election promises from the Administration. However, legislative success has largely eluded the majority coalition so far, and the complexities and costs of tax reform exceed those of healthcare. Nevertheless, the realities of political credibility and sustainability are likely to bring enormous pressure to bear on the governing coalition to deliver something significant on this front. The details will drive the ultimate economic outcome and we will remain close observers of these developments.

**Federal Open Market Committee projections for the long-term median Fed Funds Rate:**

![Graph showing Federal Open Market Committee projections for the long-term median Fed Funds Rate.](image)

*Source: Bloomberg, Federal Reserve, September 20, 2017*

**INTEREST RATE OUTLOOK AND DURATION STRATEGY**

Paul Teten, CFA®
Chief Investment Officer

Our assessment of interest rate direction in the year ahead is cautious and modestly defensive. With the 10-yr Treasury at 2.33% and 10-yr inflation expectations at 2.18%, as reflected in 10-yr inflation swaps, 10-yr Treasuries are unattractive on a valuation basis with essentially zero inflation risk premium. Combined with deteriorating liquidity conditions driven by the Fed’s portfolio run-off, our bias is to expect an upward trajectory in longer-term interest rates over the next couple of years. However, gradual is the key context, and we do not expect an abrupt and disruptive rise in interest rates in the near or intermediate term that cannot be offset by portfolio duration management tactics. We continue to structure intermediate taxable and tax-exempt strategies at 95% duration relative to benchmarks.

The shorter duration segments of the maturity spectrum have incorporated the FOMC’s Fed Funds projections to a significant extent. More importantly, while the Fed’s out-year projections are aggressive, the short end of the Treasury bond market has fully priced in a 2.0% Funds rate over the next two years, in sync with our expectation of the likely outcome. Accordingly, we are positioning short duration strategies at 105% of benchmark duration.
U.S. Treasury rates were mostly unchanged from where they began the 3rd quarter. Nevertheless, there was a fair degree of fluctuation during the period as 10-yr Treasury bonds traded as low as 2.04% before closing at 2.33%. Shorter term rates rose to a greater extent than longer term rates, propelled by expectations for continued gradual Fed Funds rate increases over the next 12 months. Meanwhile, geopolitical tensions grew, highlighted by missile launches by the North Korean military and sharp rhetorical exchanges between the leaders of the two countries. Domestically, the lingering concerns over a government shutdown and the debt ceiling were pushed to the back burner for the time being. President Trump and Congress negotiated a deal that linked Hurricane relief funding with a 3-month stopgap spending measure, and a temporary suspension of the debt ceiling. The issue will likely come to the forefront again late this year or early next year. By then it is possible that tax reform measures will be much more advanced and that a joint budget resolution will be in place to address spending guidelines for the remainder of the fiscal year. Bond investors should be paying attention to the level of discipline Congress and the administration have in achieving tax reform without ballooning budget deficits in future years. All things being equal, rising budget deficits should translate into higher interest rates, and vice versa. Finally, a meaningful, if not immediately market-moving milestone was reached in September, as the Federal Reserve committed to a slow balance sheet reduction process over the coming years. With global interest rates relatively low in comparison with U.S. Treasury rates, we see the Fed’s runoff plan exerting minimal upward force on interest rates. The cap levels for Treasury bond reinvestment are quite small in relation to monthly issuance, so we do not expect a supply/demand disruption to force bond yields higher. Treasury rates should rise slowly over the coming quarters. Fed policy will likely continue to be gradual in nature. Political reforms and pro-growth policy remains an uphill battle for the Administration and Congress, so a sharp increase in growth or a sudden reversal of weak inflation trends is unlikely. The European Central Bank (ECB) is expected to continue the gradual tapering of its bond purchases (QE program) that began early this year. However, they will manage market perceptions closely and are unlikely to tolerate a spike in rates or a further strengthening of the Euro, so we expect the ECB to proceed very cautiously in easing out of QE over the next few years. In a world of uncertainty, low interest rates and unrewarded risk, U.S. Government bonds will remain the safe haven asset of choice. Treasury bonds and U.S. Government securities continue to receive an overweight allocation within our portfolio structures.

CORPORATE BONDS:
INVESTMENT GRADE AND HIGH YIELD
Ronald MacWillie, CFA®
Portfolio Manager

Corporate bond returns once again outpaced the broader market during the 3rd quarter. Unlike recent periods where bonds with lower quality ratings experienced the highest degree of spread compression, corporate spread...
tightening was virtually identical across all quality ratings. As of September 30, month-end spreads were as low as they've been since the financial crisis. Bond issuance in the year-to-date period remained at all-time highs, indicating that issuers continue to have open access to capital markets. Investment grade issuer leverage ticked back up from the prior quarter to near record highs, implying the potential for unprecedented increases in leverage in a recession. All the above factors are evidence of investors’ complacent willingness to accept increasingly lower quality, higher risk bonds at lower yields.

Though there is no reason spreads cannot continue to tighten, we believe the market lacks value and offers a poor risk-return proposition. We continue to have an underweight allocation to investment grade credit within our portfolios, and are employing a variety of quality/duration tactics to create a defensive credit allocation within portfolios.

Spreads tightened through July as an elevated level of coupons and maturities were reinvested into the high yield sector, keeping demand strong. On the flip side, supply of new issues was low. Capital markets were spooked by geopolitical risks in August (North Korea). The VIX (equity volatility index), a useful barometer for risk valuation, rose from 10 to 16 as uncertainty increased. Bond prices fell as investors built in higher discounts for risk. Nonetheless, in a world perverted by quantitative easing, the markets greedily absorbed a wave of new issuance in September. In their gluttony, high yield buyers drove spreads to new lows for the year and to within 10 bps of the July 2014 tights.

Catalysts come and go with no apparent change in investor appetite for high-yield. iHeartCommunications Inc., one of the largest high-yield issuers by par value outstanding, continues discussions with creditors for a restructuring outside of bankruptcy. The gradual reduction in monetary accommodation via 4-25 basis point increases to the Fed Funds rate has so far had no impact on valuations. Unwinding of the Fed’s balance sheet over the next few years may create marginal upward pressure on long rates, but is unlikely to cause a significant technical disruption to the high yield market. There are no evident catalysts for further tightening of spreads either. It would seem that the incremental reach for yield, which might otherwise drive further tightening, now extends below the lowest quality U.S. high yield into emerging markets. With high yield bonds priced to perfection, and a high risk of loss, we have chosen no allocation to high-yield at this time.

**U. S. AGENCY MORTGAGE BACKED SECURITIES (MBS)** Gilbert Braunig, CFA®

Senior Portfolio Manager

The Agency MBS market outperformed Treasuries in the 3rd quarter, finishing on a strong note. MBS spreads have tightened in recent months as demand for the securities remains high and rate volatility has stayed low. A decline in the steepness of the yield curve has also allowed MBS to become optically richer. Both 30-yr and 15-yr mortgage rates have been grinding lower since the start of the year. Overall 15-yr rates relative to 30-yr rates are elevated. Under those
circumstances, refinancing out of a 30-yr loan into a 15-yr loan, makes less sense, which means supply has been less plentiful in the 15-yr space. Despite the lower issuance, 30-yr MBS, which have longer duration, have outperformed 15-yr MBS by a healthy margin this year. Banks can take a good portion of the credit for the strong performance as they have been strong net purchasers. The housing market overall is in a transition period, with new home sales losing momentum, and starts/permits also showing restrained activity. Affordability metrics have taken a hit, even as mortgage rates remain low. The Fed will soon be allowing a portion of the principal and interest payments on its $1.75 Trillion book of Agency MBS to go unreinvested. This move modestly constrains the Fed as an active participant in the market, but the reduction in demand should not be too disruptive given the breadth of support for MBS between banks, asset managers, and foreign investors/central banks. We expect some deterioration in collateral quality to occur, but generally think the market will perform in line.

As spreads move higher from the tight levels seen currently, we will become more interested in this high quality sector. For the time being, however, we are positioning portfolios as neutral-weighted to MBS in accounts with a benchmark mandate. We will be patient before investing in MBS opportunistically (for accounts where the benchmark doesn’t include MBS) given tight spreads. Tactically speaking, we see an opportunity to trade out of “rich” 15-yr 2.5% coupons and into 15-yr 3.0% coupons with shorter duration, more convexity, but added spread in the range of 10 basis points.

MUNICIPAL BONDS

Intermediate municipal rates finished roughly unchanged for the quarter. However, during the quarter, intermediate (3, 5, 7 & 10-yr) municipals reached our full relative and absolute valuation targets so we reduced portfolio interest rate risk (average maturity). Low supply, high demand, record maturities and reduced prospects for lower tax rates all conspired to richen valuations. Year-to-date 2017, intermediate municipals have provided the best risk-adjusted returns in the investment grade fixed income universe (below table).

During the third quarter, high yield and lower quality municipals outperformed as investors chased yield. In the municipal space quality is cheap and credit risk is expensive so we will continue to maintain our high-quality bias. We intend to allow the average maturity of portfolios to decline modestly to further reduce interest rate risk.

Investment Grade Returns: Ranked by Return per Unit of Duration

<table>
<thead>
<tr>
<th>Bond Type</th>
<th>YTD</th>
<th>QTD</th>
<th>1 YR</th>
<th>RPUD</th>
<th>Dur</th>
</tr>
</thead>
<tbody>
<tr>
<td>Muni 1-10 Year</td>
<td>3.31%</td>
<td>0.71%</td>
<td>0.98%</td>
<td>0.92%</td>
<td>3.6</td>
</tr>
<tr>
<td>IG Corp 1-10 Year</td>
<td>3.87%</td>
<td>1.07%</td>
<td>1.91%</td>
<td>0.90%</td>
<td>4.3</td>
</tr>
<tr>
<td>Mortgage Backed</td>
<td>2.30%</td>
<td>0.92%</td>
<td>0.28%</td>
<td>0.52%</td>
<td>4.4</td>
</tr>
<tr>
<td>Treasury 1-10 Year</td>
<td>1.48%</td>
<td>0.34%</td>
<td>-0.66%</td>
<td>0.38%</td>
<td>3.9</td>
</tr>
</tbody>
</table>

Source: Bloomberg & Bank of America Merrill Lynch Indices
A combination of rich municipal valuations (particularly for lower quality issues) that encourage municipal issuance, improved prospects for tax reform, and reduced accommodation by central banks both here and abroad mean that municipal rates are likely to rise modestly during the 4th quarter. Our expectation is that 10-yr Treasury rates (2.33% as of 9/30/17) should finish the 4th quarter somewhere between 2.40% and 2.90%. Our dominant confirmation metric has been employment growth. Specifically, we expect job creation to continue at a rate that should pull people back into the labor force and if this happens the economy should continue to grow at a rate that is sufficient to allow rates to rise modestly. However, in the aftermath of Hurricanes Harvey, Irma and Maria the employment data is likely to be muddied in the near term, so the market will likely focus on central bank policy which is likely to become marginally less accommodative.

Year-to-date our municipal strategy has been focused on 3 to 8-yr municipals, high credit quality names and portfolio durations that are slightly short of benchmark durations. We have reduced short municipal exposure and added to short term corporate bonds. We have been able to add short corporate bonds at yields that are nearly 2 times the yield provided by short term municipal bonds, which is compelling even on an after-tax basis. Overall the strategy has provided near market returns with less credit and interest rate risk than the broader market.

INTERNATIONAL BONDS:
Eric Reynolds
Senior Portfolio Manager

Local currency denominated Developed Market (DM) fixed income experienced solid returns relative to the broad U.S. investment grade fixed income market during the third quarter. Positive year-to-date returns have primarily been driven by currency appreciation relative to the U.S. Dollar. In stark contrast, on a currency-hedged basis developed market fixed income has experienced significant underperformance relative to the broad U.S. investment grade fixed income market (below table).

<table>
<thead>
<tr>
<th>Developed Market Fixed Income:</th>
<th>9/30/17</th>
<th>YTD</th>
<th>QTD</th>
<th>1 YR</th>
<th>RPUD</th>
<th>DUR</th>
<th>YTW</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed Sovereign Bond Index</td>
<td>5.68%</td>
<td>1.54%</td>
<td>-3.59%</td>
<td>0.72%</td>
<td>7.9</td>
<td>1.06</td>
<td></td>
</tr>
<tr>
<td>US Broad Investment Grade</td>
<td>3.14%</td>
<td>0.85%</td>
<td>0.07%</td>
<td>0.53%</td>
<td>6.0</td>
<td>2.56</td>
<td></td>
</tr>
<tr>
<td>Developed Sovereign Bond Index, local</td>
<td>0.75%</td>
<td>0.32%</td>
<td>-2.25%</td>
<td>0.10%</td>
<td>7.9</td>
<td>1.06</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg & Bank of America Merrill Lynch Indices

Going forward the prospects for non-U.S. developed market fixed income is bleak. By way of example, consider that prior to the European Central Bank’s (ECB) direct purchase of government debt in early 2015, 10-yr German Bunds typically maintained yields that were very close to those of U.S. 10-yr Treasuries (below chart).
Today 10-yr German Bunds yield 0.46%, a whopping 1.88% less than a 10-yr U.S. Treasury. If the ECB becomes less accommodative, German Bunds and non-U.S. developed market interest rates will rise significantly more than U.S. interest rates and their bonds will underperform in the process. On the other hand, if the ECB maintains an accommodative posture relative to the U.S. Federal Reserve then its currency will fall significantly relative to the U.S. Dollar. The debt of non-U.S. developed markets offers no value and non-U.S. developed market currencies are vulnerable to a slower than expected removal of ECB accommodation. This being the case, we will be steering clear of non-U.S. developed market fixed income for the foreseeable future.

Emerging Market (EM) Fixed Income has experienced strong year-to-date and third quarter returns. The sources of these returns are primarily attributed to strong credit and currency performance (below table).

<table>
<thead>
<tr>
<th>Emerging Market Fixed Income</th>
<th>9/30/17</th>
<th>QTD</th>
<th>1 YR</th>
<th>YTD</th>
<th>DUR</th>
<th>YTW</th>
</tr>
</thead>
<tbody>
<tr>
<td>EM, Local Currency Govt</td>
<td>12.56%</td>
<td>3.50%</td>
<td>5.10%</td>
<td>2.70%</td>
<td>4.7</td>
<td>5.53</td>
</tr>
<tr>
<td>ISHARES JP MORGAN USD EM</td>
<td>8.96%</td>
<td>3.00%</td>
<td>3.98%</td>
<td>1.30%</td>
<td>6.9</td>
<td>4.49</td>
</tr>
<tr>
<td>US EM External Sov</td>
<td>8.72%</td>
<td>2.46%</td>
<td>3.85%</td>
<td>1.21%</td>
<td>7.2</td>
<td>4.83</td>
</tr>
<tr>
<td>US IG EM External Sov</td>
<td>7.85%</td>
<td>2.13%</td>
<td>1.67%</td>
<td>0.96%</td>
<td>8.2</td>
<td>3.42</td>
</tr>
</tbody>
</table>

Source: Bloomberg & Bank of America Merrill Lynch Indices

While subject to periods of volatility, we expect that emerging market currencies that are supported by higher long term economic growth will appreciate or at least remain stable relative to the dollar over time. In contrast, emerging market corporate credit is expensive relative to emerging market sovereign debt; presently providing a miniscule 0.10% yield advantage relative to EM sovereign debt. The stability of sovereign EM yields (blue line) relative to U.S. high yield (redline) is also attractive (below chart).
Our outlook is that near term the dollar will experience a period of modest strengthening. We have interest in taking a position in local currency sovereign EM fixed in the wake of dollar strength, an event that could realistically present itself around a December Federal Reserve rate hike. Until then, we remain on the sidelines without exposure to EM fixed income.

Current and historical yield and yield spreads across fixed income asset classes.

Source: Citi, Capital One Asset Management

*Percentile ranks based on historical period from 9/30/2007 to 9/30/2017
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