Transition

2015 US Interest Rate Forecast *from* Cardea Partners

It's Definitely Better…Now What?

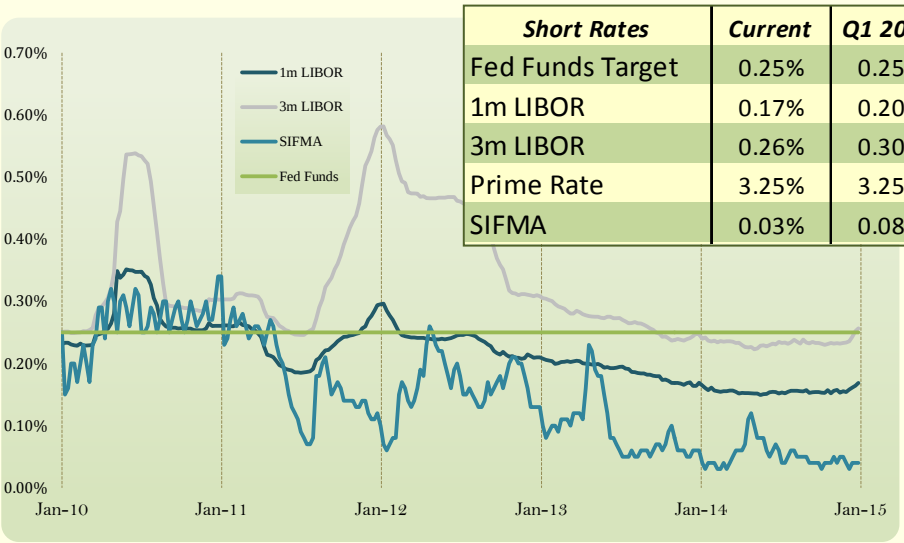
"The time to repair the roof is when the sun is shining."

-John F. Kennedy

Despite predicting the year-end level of the S&P 500 within 0.5% in 2014, our focus is the bond market, where like 99.5% of prognosticators last year, we failed to foresee an expected first half drop in long rates broaden throughout the year. Our shorter maturity predictions were more respectable, and fortunately, the magnitude of our long-end incorrectness was better than most—our 35 bps predicted rise YoY for the 10-year US Treasury yield ended up being about 1.15% higher than reality, but many on the Street were calling for 4%+ yields. Certainly no one expected a sub-3% yield on the 30-year maturity. The theme in rates in 2014 was the compression around a central range of 1.5 - 2.5% for much of the yield curve, right near long run inflation, and we expect this trend to continue and intensify in 2015. The US dollar's 12%+ rise and uber-low EU/Japanese yields made Treasuries that much more desirable in 2014. The handoff from Bernanke to Yellen as Chair of the Federal Reserve was smooth enough, with data providing ample room for tightening, led by the culmination of the QE asset purchases (Tapering), to continue in 2015, starting in June. Unemployment fell faster than expected to 5.8%, GDP rallied after a crushing winter to a decade-high 5% QoQ annualized Q4 growth, and headline and core inflation failed to clear 2% thanks to imported Eurozone deflationary pressures and supply-driven price declines in the energy and ag complexes. Welcome news!

While the government failed to accomplish much policy in 2014, markets do have some certainty that shutdowns and economically-stifling actions are off the table this year with a fully Republican Congress and President Obama looking to improve the outlook on his legacy. For the first year in five, the government could actually add to GDP. The FOMC voting members will shuffle to a slightly more dovish cohort in 2015 as Fed Governors Fisher and Plosser retire, but **the Committee still needs to act while markets can handle the tightening**. With employment poised to expand, we expect the Fed to raise its target rate range by 25 bps at each of the final four meetings of the year, taking it to 1.25% by year end. All short rates (T- bills, LIBORs, SIFMA, and the Prime Rate) will rise in concert.

Historical Short Term Rates and 2015 Forecasted Levels



Short Rates	Current	Q1 2015	Q2 2015	Q3 2015	Q4 2015
Fed Funds Target	0.25%	0.25%	0.25%	0.75%	1.25%
1m LIBOR	0.17%	0.20%	0.30%	0.90%	1.38%
3m LIBOR	0.26%	0.30%	0.34%	0.93%	1.42%
Prime Rate	3.25%	3.25%	3.25%	3.75%	4.25%
SIFMA	0.03%	0.08%	0.14%	0.40%	0.65%

Historical Data Source: Bloomberg

2015 is the year that LIBOR will once again move and affect the cost of borrower debt in a negative way. The Fed's dot plot projects their target rate at 1.125% at year end, a consensus of economists see it at 1%, and the swap market projects 3-Month LIBOR at 0.75%.

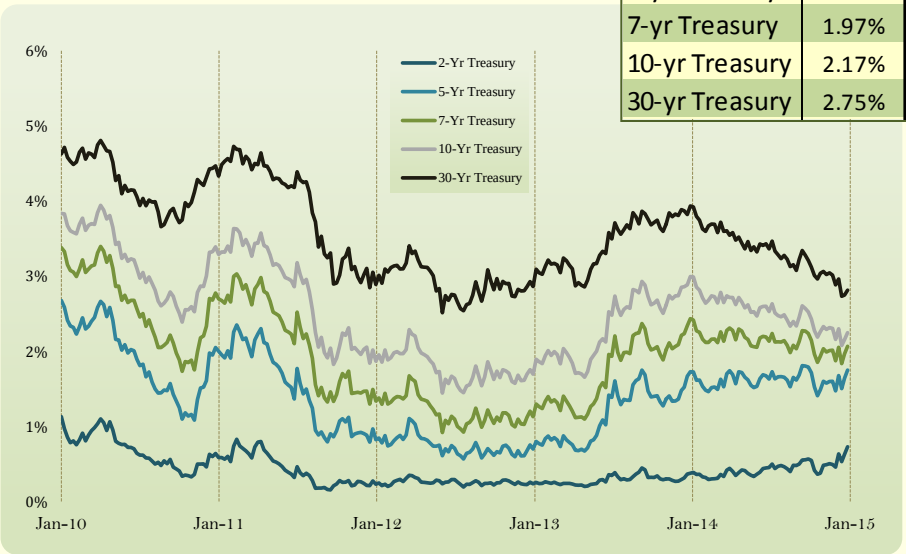
Short Yields Will Rise, Long Yields Won't in 2015

One final bear-crushing rally for the long bond in 2014? A 20%+ move for 'risk-free' bonds in a single calendar year is amazing, and we think the bond market will get back to supply and demand in 2015. Frankly, the supply is declining with the deficit, despite our record national debt, and global demand will continue to grow in our minds, particularly as the German bund and Japanese government bond yields languish at 50 bps or less and belly maturities in Germany and Switzerland go negative. The bond math and arbitrage of market instruments will drive our T-bill and 2-year note yields higher relative to a rising Fed funds target rate in the coming year, but demand will keep surprising pressure on the longer end of the curve, and we actually think the yield curve could invert in 2015. While this is often a harbinger of recession, we think the global impact on rates that could come from jitters in emerging markets (Russian and Venezuelan defaults?) won't necessarily portend the worst for the US economy, even if the curve flattens near zero or inverts from 2- to 10-year maturities. The currency strength should continue, but with only 10% of our economy built on exports, the United States is well insulated from missteps abroad. The European Central Bank will be executing asset purchases throughout the year to re-inflate itself, as ECB President Draghi will do 'whatever it takes.'

Congress might get something passed in 2015 with House and Senate majorities for Republicans wanting to show some effectiveness as they hope to reclaim the White House in 2016. We may see Greece step out of the Eurozone if its upcoming election goes to the nationalist party. Energy prices could default a number of producers domestically and countries abroad, but will broadly embolden the citizens to reduce household debts and consume. And persistent low rates could easily rekindle the soft housing markets, particularly as many millennials face record rents and free-falling costs of home ownership. Financial institutions will have a mixed year as yield margins compress but enhanced credit quality and price volatility could drive transaction and loan volume after a slow 2014.

Historical US Treasury Yields and 2015 Forecasted Levels

Treasury Yields	*Current*	*Q1 2015*	*Q2 2015*	*Q3 2015*	*Q4 2015*
2-yr Treasury	0.67%	0.75%	1.00%	1.50%	1.75%
5-yr Treasury	1.65%	1.50%	1.65%	1.75%	1.85%
7-yr Treasury	1.97%	1.85%	1.95%	2.05%	2.15%
10-yr Treasury	2.17%	2.00%	2.15%	2.20%	2.25%
30-yr Treasury	2.75%	2.75%	3.00%	2.85%	2.90%



Historical Data Source: Bloomberg

After a 100 basis point drop in the spread from 2s to 10s in 2014, the flattening of the yield curve should continue in 2015, and the spread could go negative (invert). Federal Reserve voting members shouldn't worry about this inversion when the curve is so low relative to historical norms—1.5% could be the converging yield for government rates in the year to come.

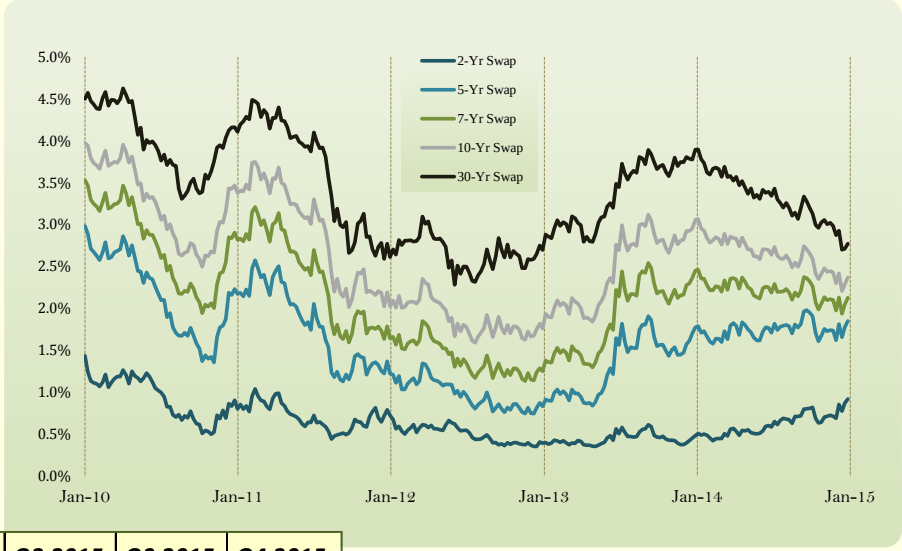
Flattening, Rising Spreads for Swaps

While we think interest rates will compress towards the long run inflation rate here in the United States, and while our Treasury yield forecast increase is muted, we think there will be moments of rapid rate increases and decreases. With those moves, we think the rate premium built around swaps relative to Treasuries should exist and will continue to be priced into swaps. Long term spreads were steady in 2014, while shorter spreads widened from remarkably tight levels. We think the reverse could play out this coming year, with more premium for duration trades and much of the movement in the short end of the curve being absorbed in base Treasury yields. The net effect could be an even flatter term structure for swap spreads in the 20-30 bp range. The long run expectation for LIBOR will remain constrained by the Federal Reserve's so-called dot plot that emanates from quarterly FOMC meetings and shows central tendencies for the target rate at year-end. The expectation for 2018 and beyond has come down to 3.75% since the polling began two years ago from well above 4% initially.

With tradable markets currently underestimating relative to the Fed's rate policy and our forecasts, it would seem an opportune time to hedge shorter duration exposures that most market participants have become so happy to float. Beyond seven years, there may be another opportunity to hedge exposures at cheaper levels in 2015. At the end of the day, interest rate cap and swap pricing should benefit from low absolute levels in rates, but we could see increased trading costs due to volatility spikes and regulatory pressures and costs borne by some counterparties filtering through into quotes.

Historical 3m LIBOR Swap Rates and 2015 Forecasted Levels

Swaps exchange fixed or floating payments for one another, and most commercial end users mitigate risk using swaps to hedge variable cash flows, asset prices, net investments, or debt portfolio valuations. Large commercial banks make revenue by adding spreads to these structures. Please confirm with us that your contemplated structures are in fact appropriate for the risk profile of your organization and that your pricing is reasonable for the risk that your bank is accepting.



Swap Rates	*Current*	*Q1 2015*	*Q2 2015*	*Q3 2015*	*Q4 2015*
2-yr LIBOR Swap	0.89%	1.00%	1.20%	1.50%	1.95%
5-yr LIBOR Swap	1.77%	1.70%	1.90%	2.00%	2.10%
7-yr LIBOR Swap	2.04%	2.00%	2.15%	2.25%	2.40%
10-yr LIBOR Swap	2.28%	2.15%	2.35%	2.40%	2.50%
30-yr LIBOR Swap	2.70%	2.80%	3.10%	3.00%	3.10%

Historical Data Source: Bloomberg

Hedging Dos and Don'ts

Get Ahead of It Then Be Patient

You have the chance to control your destiny in the hedging process for your portfolio exposures. You need to identify and quantify your risks and tolerances, firstly, then you need to know your options and the appropriate price for each option. While your team of trusted advisors is undoubtedly well versed in many aspects of law, tax, and finance, we believe that having a hedging advisor for derivative transactions is crucial to positive outcomes, and in our experience, much, much cheaper in the long run for borrowers. Dodd-Frank legislation set up monitoring and rules for swap dealers for a reason, and mandated borrowers to have appropriate sophistication or representation in the municipal space. So please don't assume that these transactions are straightforward and obvious, and please don't do exactly what your bank tells you to do on these trades. Trust us, there is always room to improve your position, and with trades being on the books for a long time, getting it right the first time is pivotal.

So do call us, and don't feel like you will be wasting our time with small deals—every dollar matters, and small can be tricky too. Do allow us to answer all your questions and educate your team, and don't think you will offend anyone by going outside the organization or by pushing back on the bank. Do appreciate that if you hedge, how much you hedge, and when you hedge should all be up to you, and don't think there isn't enough time to get the transaction right in a limited time prior to a closing.

Six years removed from the depths of despair for the economy and markets, we think that short term rate movements are coming this year. It's going to be a year of transition, but the economy will still be in expansion mode. Knowing the cost of your exposures in present value terms and over the life of your deals adds an invaluable perspective to your decision making process. We are here for our clients with the market data and tools to help them make smart decisions in 2015 and beyond. Please call us to discuss your portfolio or your current deal any time, and have a joyful New Year!

Don't hedge without us!

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Other Movers	*Current*	*Q1 2015*	*Q2 2015*	*Q3 2015*	*Q4 2015*
Dow	17,823	17,000	18,500	19,000	20,000
S&P 500 Index	2059	2000	2150	2300	2400
GDP QoQ (ann)	5.0%	3.0%	3.1%	3.2%	3.5%
EURUSD	1.218	1.20	1.18	1.16	1.14
VIX	19%	17%	15%	13%	15%
Gold ($/oz)	1200	1175	1150	1100	1000

Historical Data Source: Bloomberg

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