Fixed Income Commentary

July 5, 2018

KEY TAKEAWAYS

The combination of strong economic data and higher inflation trends with increasing trade tension rhetoric has produced the flattest yield curve in nearly 11 years. While there could be short term winners in a trade war, trade wars never end well and global GDP will suffer in the long term. Looking forward, investors will begin to look for cracks in the U.S. economic expansion as trade war tensions potentially continue to increase.

Key Rates (%)	Jun 30 2018	May 31 2018	Dec 31 2017
Treasury Yields			
2 Year	2.53	2.43	1.88
5 Year	2.74	2.70	2.21
10 Year	2.86	2.86	2.41
30 Year	2.99	3.03	2.74
Credit Yields			
BBB Industrial 10 Year	4.34	4.24	3.61
Muni Yields			
AAA 10 Year	2.47	2.43	2.01
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.60	3.58	3.00

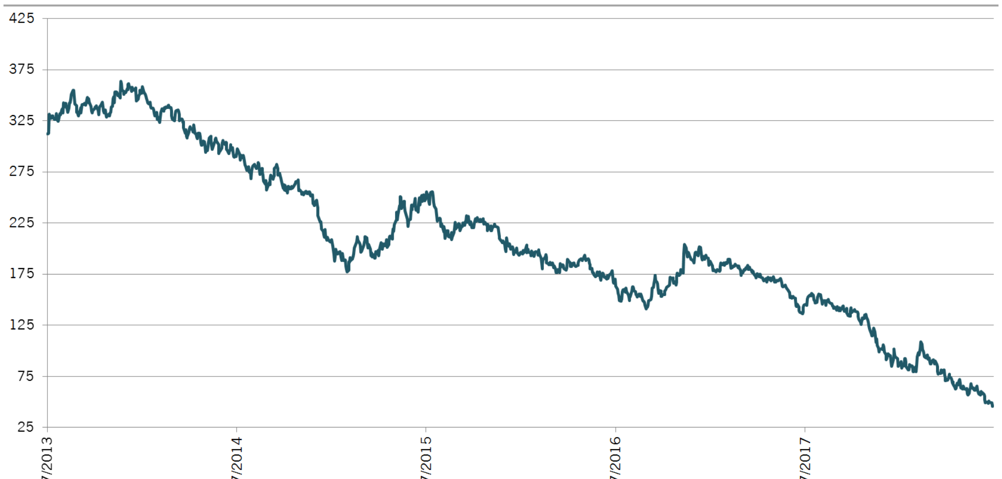
JUNE IN REVIEW

- The 10- year Treasury yield was unchanged, month over month.
- High yield was the strongest performer in June and is the strongest performer on the year, up .40% in June and up .02% on the year.
- Municipals continued their strong performance from May, up .09% in June.

Trade Wars, Who Wins?

Despite a Federal Reserve rate hike, strong economic data and numerous signs of higher inflation trends, increasing trade tensions kept interest rates steady in June. The mounting discourse between the U.S. and its key trading partners has worried investors and raised questions about the continued viability of the global expansion. Front-end rates are set by the Federal Reserve, but longer term maturity yields reflect investor demand. The combination of monetary policy pushing the front-end of the curve higher and "risk off" bond buying supporting prices on the longer end has produced the flattest yield curve in nearly 11 years. The chart in **Exhibit 1** shows the steady narrowing of the spread between 2-year and 30-year U.S. Treasuries over the past five years.

EXHIBIT 1: 2-YEAR VS. 30-YEAR U.S. TREASURY SPREAD



Source: Bloomberg Financial L.P.

It is a widely accepted fact that trade wars are detrimental to global economic growth. While certain countries may gain from such actions in the short run, the long-term pain eventually hits all countries and global GDP suffers. As the U.S. continues to impose new tariffs on foreign countries, whether friend or foe, these countries are responding with retaliatory tariffs on U.S. goods. The President's withdrawal from the Trans-Pacific Partnership (TPP), on his first day in office set the stage for a new level of protectionism for the United States. On the docket is a re-negotiation of the North American Free Trade Agreement (NAFTA) which many Americans view as eliminating thousands of U.S. jobs in favor of cheaper foreign labor. President Trump is even threatening to leave the World Trade Organization (WTO), an organization which regulates international trade.

While the U.S. economy is currently on a strong trajectory, these policies and reciprocal tariffs will likely be a detriment to future U.S. growth rates, resulting in job losses, higher inflation rates and slower growth abroad. The global economy's free-trade driven growth over the last two decades is now facing the risk of the party coming to an abrupt end. The consequences could be severe.

This is not just a bond market view. Interest rates have held relatively steady in the face of two rate hikes and strong economic data this year. This should have been a positive for stock prices, but U.S. equity markets are showing numerous signs of strain. One particularly worrisome sign for stock investors is the risk the U.S. Treasury yield curve moves from flattening toward an outright inversion, which has historically meant a recession is imminent.

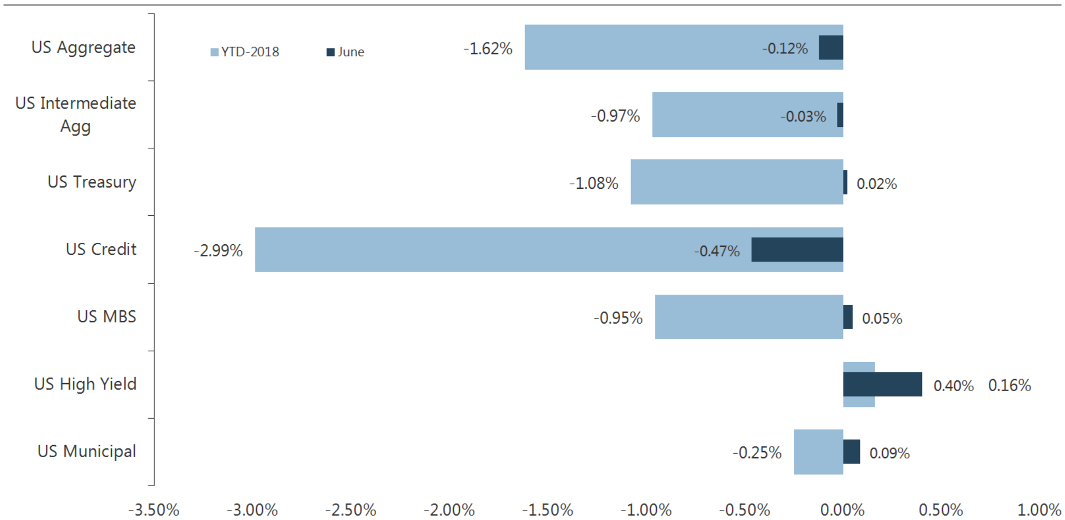
The pain has been worse for foreign stock markets, with most in negative territory for the year and some in full-blown bear markets. The dollar has gained against the currencies of many countries, causing effective interest rates in those nations to rise.

Interest rates rose during the quarter, albeit modestly. The Fed hiked rates 25 basis points in June and short-term bonds reflected the move. However, the rest of the yield curve did not. For example, the 10-yr. Treasury note rose 12 basis points, to 2.86%, while the 30-year Treasury bond was only up 2 basis points, to 2.99%. We continue to believe the yield curve is moving toward a "bowed" shape and may possibly be on its way to inverting.

Returns were generally modest in the quarter, with the exceptions being high yield and municipal bonds. Investment-grade corporate bonds posted negative returns - another indication of the risk the U.S. economy will soften. The chart in **Exhibit 2** reports the total returns of the various fixed-income sectors according to the Bloomberg Barclays Indices.

Looking ahead, we are growing increasingly concerned about the vibrancy of the U.S. economic expansion. As previously mentioned, the current U.S. trade policies will inevitably lead to long-term growth problems. Slowing economic growth would lead the Federal Reserve to be more accommodative under normal conditions. However, the U.S. is at or near full-employment, and wage pressures are mounting. Inhibiting low cost imports will also lead to higher prices in the U.S. This combination of slower economic growth and higher inflation calls to mind a term not used since the 1970's: *stagflation*.

EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

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