FIXED INCOME COMMENTARY

October 3, 2018

KEY TAKEAWAYS

The Federal Reserve raised interest rates for the third time this year, and is expected to raise rates for a fourth time in December. The U.S. economy continues to perform very well, as the second quarter GDP came in at 4.2%. While there are still concerns about items such as tariffs, and budget deficits, fixed income investors will continue to watch the Federal Reserve.

Key Rates (%)	Sep 30 2018	Aug 31 2018	Dec 31 2017
Treasury Yields			
2 Year	2.82	2.63	1.88
5 Year	2.95	2.74	2.21
10 Year	3.06	2.86	2.41
30 Year	3.21	3.02	2.74
Credit Yields			
BBB Industrial 10 Year	4.40	4.26	3.61
Muni Yields			
AAA 10 Year	2.62	2.47	2.01
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.81	3.62	3.00

SEPTEMBER IN REVIEW

- The 10- year Treasury yield was up 20 basis points on a month over month basis, finishing September with a yield of 3.06%
- High yield was the only positive segment of the fixed income market on the month, up .56%.
- Municipals ended their recent run of four consecutive months with positive returns, finishing September down .65%.

Fed Keeps on Truckin'

The economic data released in September continued to impress. Second quarter GDP came in at 4.2%, jobless claims fell to a level not seen since 1969, and inflation remained relatively subdued. The unemployment rate now stands at 3.9% and may fall to 3.5%, if forecasts are correct. By most measures, the U.S. is experiencing the strongest period of growth in many years.

Against this backdrop, interest rates continued their ascent in September, although this time in a parallel fashion. The yield curve rose approximately 20 basis points across the board during the month. Despite some recent widening, quality spreads within the credit markets remained near five-year narrows as lower quality securities continue to outperform those of higher quality.

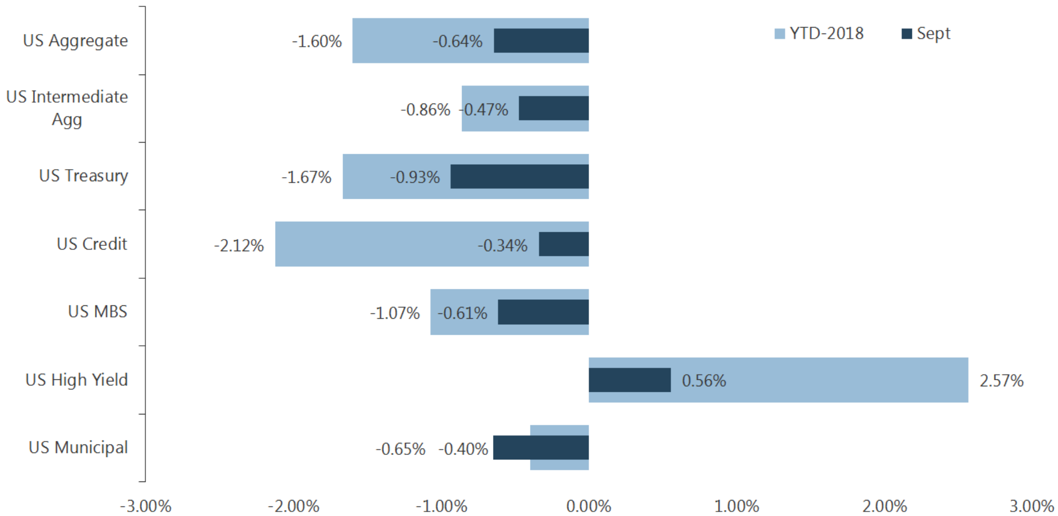
Shorter-duration assets outperformed longer-term assets, as longer dated securities suffered larger price drops for the same basis point change. Higher-grade assets once again lagged lower rated issues. The High Yield Index once again led the way up, with a gain of +0.56% for September. BBB-rated bonds outperformed other investment grade issues with a -0.11% return. By comparison, the return on the U.S. Credit Index was -0.34% and U.S. Treasuries returned -0.93%. The performance of the various sectors of the fixed-income market according to the Bloomberg Barclays Indices are provided in **Exhibit 1** on the following page.

As expected, the Federal Reserve raised interest rates for the third time this year at the September FOMC meeting. The Fed went to great lengths to describe the resiliency of the U.S. economy and Chairman Powell's comments following the release pointed to a resolute position that rate hikes would continue, as needed. However, the press release from the meeting did note that the Fed Governors no longer view monetary policy to be accommodative. Furthermore, the Fed now sees just three rate hikes as likely in 2019.

Following its twin statutory mandates to maximize employment and foster price stability, the Fed believes that future rate hikes will be consistent with sustained economic growth. With labor force participation stuck in the low

60's and inflation hovering below 3%, a gradual approach will be likely unless economic growth stays exceptionally strong. The Fed remains cognizant of the risks of moving too fast. This has happened many times in the past with disappointing results. The fear of an interest rate induced recession or insensitivity to outside events such as trade or political conflict will likely keep them from moving too quickly.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

We continue to favor shorter duration assets in this environment. The math says rates are likely to keep rising in the near term and trading in and out of longer dated securities will have risk. However, we have slowed the move toward emphasizing higher-grade securities for new money. Domestic growth data and debt service numbers suggest more risk can be borne in the near term. Short duration corporate bonds are not glamorous, but there will be few shocks with this approach.

Going forward, we see no reason to fight the Fed. The US economy remains strong, but we still have concerns over tariffs, budget deficits, and the Fed's liquidation of their balance sheet. We continue to believe that short -high quality bonds are the place to be within the fixed-income markets.

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