FIXED INCOME COMMENTARY

January 8, 2019

KEY TAKEAWAYS

The risk off move in equities in December led most fixed income sectors to positive returns. The exception was high yield, which was hit hard by the flight to quality. Federal Reserve Chairman Jay Powell's recent dovish tone has expectations for rate increases in 2019 down to only one, from the 3 originally expected.

Key Rates (%)	Dec 31 2018	Nov 30 2018	Dec 31 2017
Treasury Yields			
2 Year	2.49	2.79	1.88
5 Year	2.51	2.81	2.21
10 Year	2.68	2.99	2.41
30 Year	3.01	3.29	2.74
Credit Yields			
BBB Industrial 10 Year	4.35	4.55	3.61
Muni Yields			
AAA 10 Year	2.32	2.55	2.01
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.50	3.86	3.00

DECEMBER IN REVIEW

- The 10-year Treasury yield was down 31 basis points on a month over month basis, finishing December with a yield of 2.68%.
- Treasuries were the best performing sector in December, up 2.15%.
- High yield was hit hard with equities on the month, down 2.14% in December.

Risk On, Risk Off

The "risk off" trade continued in December. Led by Treasuries, bonds generally rallied sharply, as volatile swings in equity prices sparked a move toward safer assets. Lower-rated bonds were the noticeable exceptions to the rally. Non-investment grade bonds were particularly hard hit and posted their worst monthly returns in years.

The rally continued through the month, despite the Federal Reserve raising the reference rates on December 19th. Continued risks (trade tensions, stock market volatility, etc.) in the marketplace have allowed Chairman Jay Powell to suggest monetary policy is now at a neutral position. This is a significant change from his comments in early October, when it was suggested several more rate hikes would be needed to reach the "neutral" target. It is now widely accepted that we will probably see no more than one additional rate hike in 2019. Indeed, many investors are now speculating that rate cuts might even be needed this year.

Longer term bond prices have been adjusting to this point of view and yields have fallen accordingly. However, short term yields are anchored by the Fed funds rate and have therefore barely budged. We now have the flattest Treasury yield curve since 2007. Several segments of the Treasury market are now inverted and the yield differential between the 1-year T-bill and the 10-year Treasury note recently narrowed to just 5 basis points. An inversion between these two segments of the curve has often preceded a recession.

One worrisome trend within the rally is the widening of yield spreads over the comparable risk free rate. Spreads across all segments of the bond market are widening, reflecting the potential increased risk profile of non-government bonds if business conditions begin to slow. Corporate bond spreads are likely to be increasingly sensitive to yield changes, given the wave of corporate bond maturities coming due in the next three years. A rising Federal budget deficit and efforts to unwind the Fed balance sheet will only exacerbate this sensitivity. We expect bonds with weaker balance sheets to have a magnified reaction to these changing conditions.

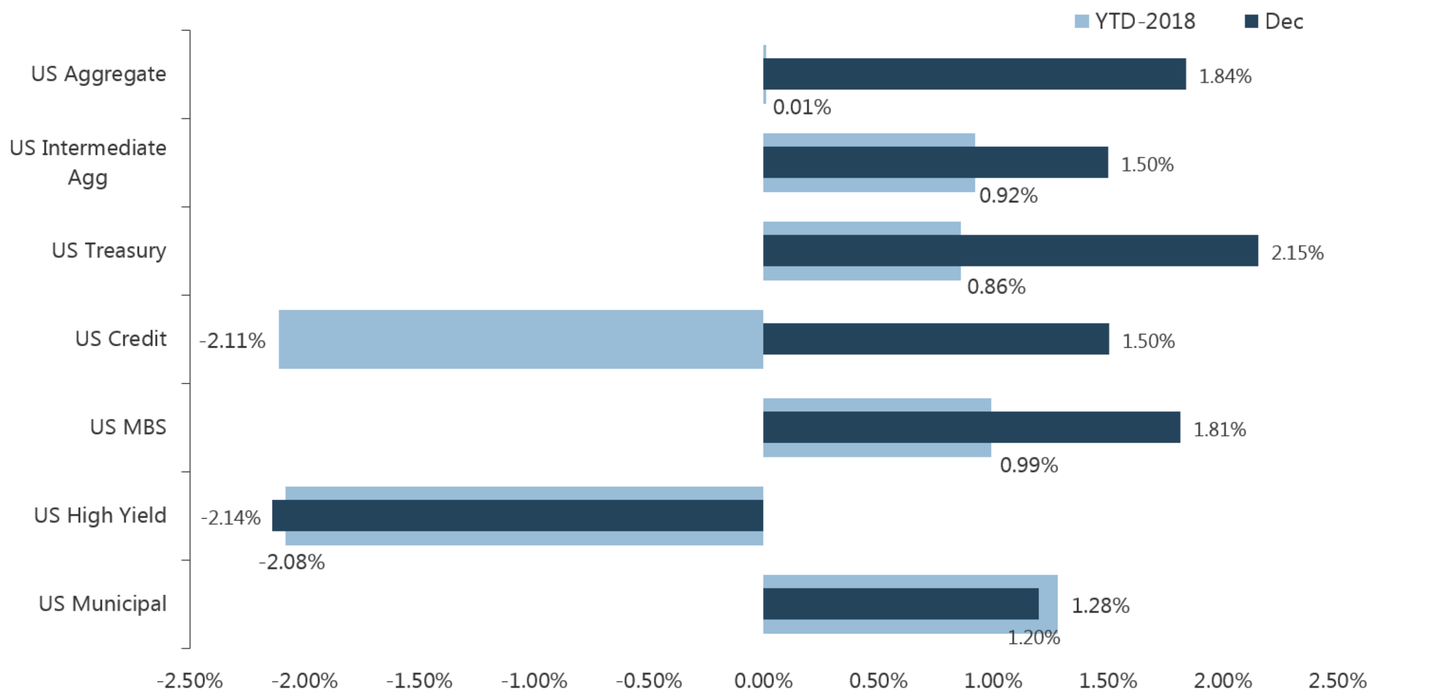
With the sharp run in the bond prices over the past two months, we now see a risk that prices have gone too far. Continued trade tensions or a sharp economic slowdown would certainly suggest current yield levels are appropriate, if not too high. However, crises tend to get resolved, especially when no clear winner can prevail. In trade, for example, both sides are under pressure to compromise. We believe trade tensions will continue for years, but a short term solution to relieve the pressure is likely. Any compromise is likely to push yields higher and bond prices lower.

The strong economic data being released – specifically the employment data released on Friday – suggests there is little room for rates to remain at current levels, even if trade tensions remain high. The domestic economy and the Federal budget deficit are both expanding with ease. At least some of the recent gains will have to be given back if there is any sign of easing trade tensions or the rhetoric behind the government shutdown. We are once again suggesting duration exposure not be extended too aggressively.

Looking forward, higher quality bonds should outperform and boring old Treasury bonds may outperform many sectors of the bond market this year. With a new Congress and a ballooning deficit (i.e. more pressure to raise taxes), municipal bonds should benefit, although issuer specific risks are rising. Bond selection matters more than ever and we are increasingly cautious on many. Mortgages remain fairly priced and offer attractive cash flow attributes for many buyers. Corporate bonds offer higher spreads and steeper yield curves, especially in the BBB-rated sector of the market. However, the risk of further spread widening is very real and we believe current rates do not warrant aggressive buying in the lower end of the sector. We continue to prefer the higher-rated sectors of the bond market and higher-rated issuers within the sectors owned.

The month-to-date and year-to-date sector returns for December and 2018, according to Bloomberg Barclays, are provided in **Exhibit 1**.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

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