FIXED INCOME COMMENTARY

February 4, 2019

KEY TAKEAWAYS

The Federal Reserve has opted to take a "patient" approach regarding both rate increases and the pace of balance sheet normalization, as economic data has started to show some weakness. As a result of the change in the Fed's stance, both equity markets and fixed income markets rallied.

Key Rates (%)	Jan 31 2019	Dec 31 2018	Dec 31 2017
Treasury Yields			
2 Year	2.46	2.49	1.88
5 Year	2.44	2.51	2.21
10 Year	2.63	2.68	2.41
30 Year	3.00	3.01	2.74
Credit Yields			
BBB Industrial 10 Year	4.18	4.35	3.61
Muni Yields			
AAA 10 Year	2.19	2.32	2.01
Mortgage Backed Securities			
30 Year FNMA Current Coupon	3.38	3.50	3.00

JANUARY IN REVIEW

- The 10-year Treasury yield was down 5 basis points on a month over month basis, finishing January with a yield of 2.63%.
- High Yield was best performing sector in January, up 4.52%.
- Municipals were positive on the month, up 0.76%

It's Back!!!!

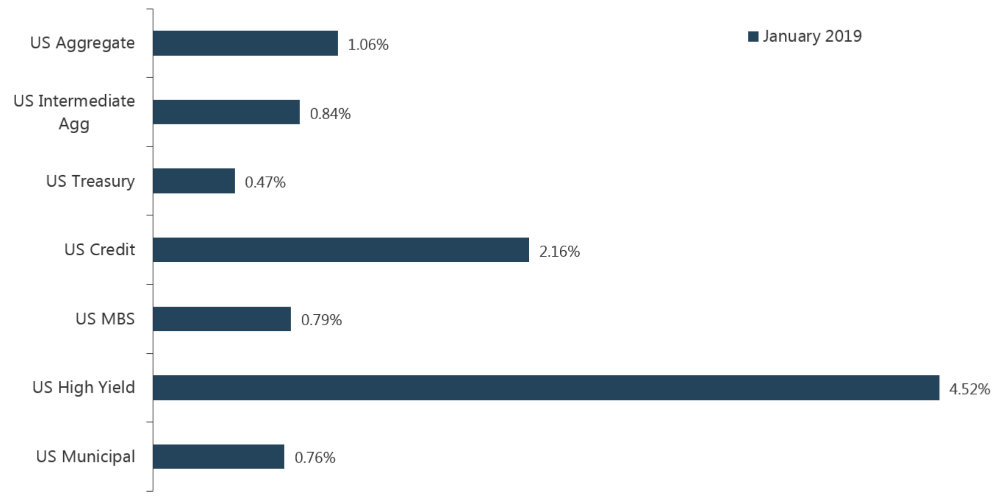
After a deluge of criticism from the Trump Administration and a striking turn in financial conditions during the fourth quarter, the Federal Reserve has opted to take a "patient" approach regarding both rate increases and the pace of balance sheet normalization. In addition to tighter financial conditions which developed during the fourth quarter, economic data has shown some weakness, particularly with respect to housing, durable goods orders, autos, and exports. Global growth has slowed mainly in China and Europe due to the trade war, the strong dollar, and the Brexit quagmire. In addition, reported economic data remain somewhat suspect with the prolonged US Government shutdown and consumer confidence has been falling due in part to the market volatility cited above. On the flip side, employment remains extremely strong and wages have been creeping higher, but inflation (core PCE) has remained steady at about 2%, right in line with the Fed's target. Given the mounting evidence that balance sheet normalization and the collective rate hikes have had a significant impact, the Fed's decision appears prudent and not politically motivated.

The change in the Fed's stance gave both the equity and bond markets reason to rally: both markets have started 2019 with strong rallies. US equity returns on the major indices ranged from 7-10% (just for the month of January) and foreign equities were also up nicely, while bond returns were positive across the board. The credit sectors of the fixed income market posted the strongest returns as the markets embraced a "risk-on" attitude, with the high yield segment performing extremely well. Exhibit 1 highlights January 2019 returns as reported by the Bloomberg Barclays indices.

Strategy

Going forward, even though the Fed seems to have brought back the punchbowl, we still have a "risk-off" mindset for bonds, particularly after the spread tightening witnessed recently. We prefer high quality issues as Corporate America is still laden with debt and the differences between Congress and the Trump Administration continue to grow, implying more shutdowns may be on the way and the weak sentiment seen last quarter could easily resurface as corporate earnings growth decelerates. We continue to prefer the higher-rated sectors of the bond market and higher-rated issuers within the sectors owned: selectivity will be critical at this late stage of the economic cycle.

EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS



Source: Bloomberg Financial L.P. and Barclays Securities

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