# Fixed Income Commentary

March 4, 2019

## KEY TAKEAWAYS

The slowing pace of growth now being observed in economic reports lends support to the Fed's decision to pause its rate hike policy. Weakness is most acute in the manufacturing sector, but services are also slowing as seen in the slide in the ISM non-manufacturing survey.

| Key Rates (%) | Feb 28 2019 | Jan 31 2019 | Dec 31 2018 |
|---|---|---|---|
| **Treasury Yields** | | | |
| 2 Year | 2.51 | 2.46 | 2.49 |
| 5 Year | 2.51 | 2.44 | 2.51 |
| 10 Year | 2.72 | 2.63 | 2.68 |
| 30 Year | 3.08 | 3.00 | 3.01 |
| **Credit Yields** | | | |
| BBB Industrial 10 Year | 4.17 | 4.18 | 4.35 |
| **Muni Yields** | | | |
| AAA 10 Year | 2.14 | 2.19 | 2.32 |
| **Mortgage Backed Securities** | | | |
| 30 Year FNMA Current Coupon | 3.48 | 3.38 | 3.50 |

## FEBRUARY IN REVIEW

- The 10-year Treasury yield was up by 9 basis points on a month over month basis, finishing February with a yield of 2.72%.
- High Yield was best performing sector in February, up 1.66%.
- Municipals were positive on the month, up 0.54%.

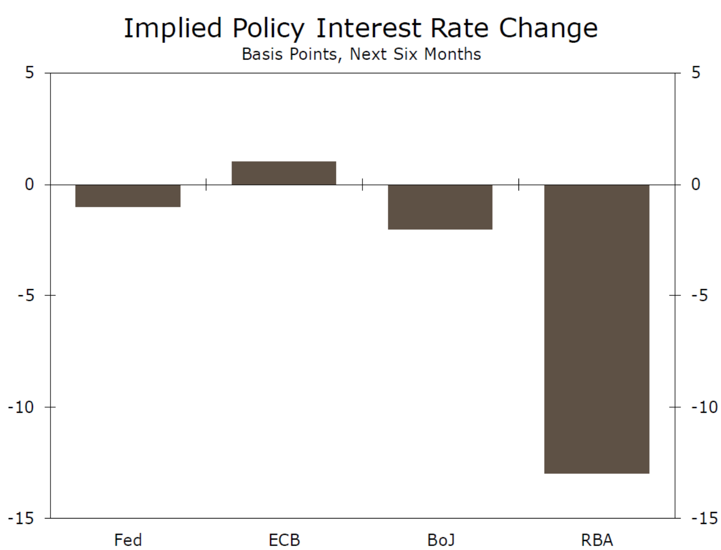
## The Pause That Refreshes

As we indicated last month, the Fed has paused its campaign of raising rates each quarter after a plethora of negative developments in financial markets late last year caused financial conditions to tighten. This pause is refreshing for those who feared this Fed was going to repeat the mistakes of the past and go too far by bringing the growth cycle to an end.

Treasury yields rose modestly in February but remain in a tight trading range: the 10-year Treasury stayed in the tightest monthly range since 1979. Meanwhile, corporate yield spreads tightened further from January as investors embraced risk-taking, likely on the theory that the Fed's pause will serve to elongate the economic cycle much like last year's tax cut. Spreads on corporate bonds are now back to mid-November levels and are once again compressed across industries and rating categories.

Economic reports on domestic activity have revealed a slowing pace of growth and stable inflation, but overseas activity is decidedly softer. The trade war is partially to blame, but many other factors are also playing a role and it has become clear that a higher rate environment is simply not tolerable for most of the debt-heavy economies across the pond.

As shown in the chart on the right, prevailing interest rates across developed markets are indicating the next policy move is toward rate cuts rather than further rate hikes. The RBA, which is Australia's central bank, is the one most affected by China's slowdown and therefore it makes sense to see it is priced most aggressively for a rate cut.




Source: Wells Fargo

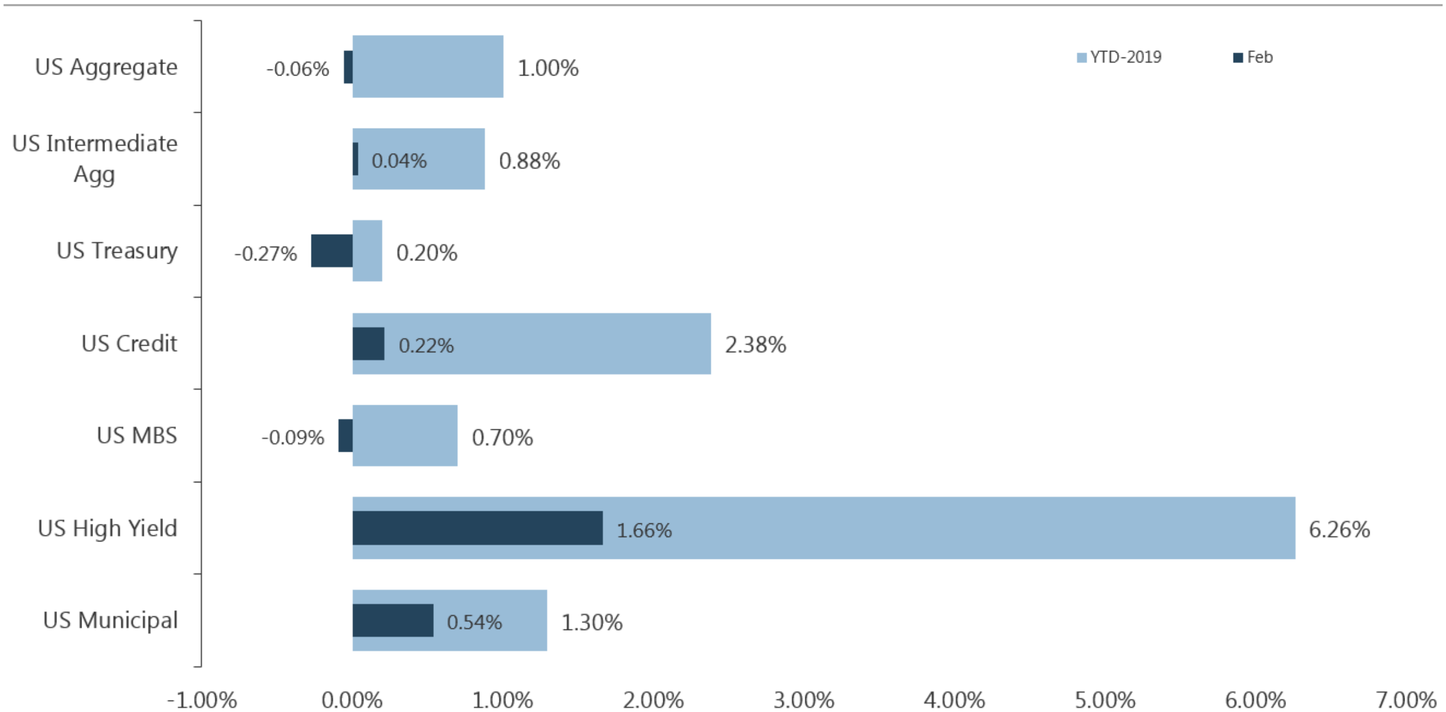
### Strategy

Since year end, spreads have been moving in one direction, but we would expect more volatility to emerge as companies begin to experience choppier results and the market sifts through the winners and losers. At the risk of repeating ourselves, we believe the economic cycle is "late stage" and therefore we advocate for an up-in-quality stance since compensation for taking risk is low while downside risks are mounting. Furthermore, supply of corporate bonds is lower compared to last year at this time but that may change as large M&A deals come to market for funding in the months ahead.

### Final Word

Bond yields reflect investor enthusiasm both for a soft landing on the economy and a continuation of corporate profit growth. Absolute yields in the front end of the yield curve are certainly attractive relative to the last few years, but taking additional risk does not bring much additional yield. Therefore, now is not the time to let complacency take hold and we prefer to position portfolios with an up-in-quality bias.

**EXHIBIT 1: FIXED INCOME MARKET TOTAL RETURNS**




Source: Bloomberg Financial L.P. and Barclays Securities

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