# Fixed Income Commentary

May 2, 2019

## KEY TAKEAWAYS

The combination of strong corporate earnings reports and the notion that Fed rate hikes are off the table in the short term helped equity markets continue their 2019 strength and was the impetus for corporate bond spreads to continue to tighten. The most recent economic data seems to suggest that the current economic cycle will be prolonged.

| Key Rates (%) | Apr 30 2019 | Mar 31 2019 | Dec 31 2018 |
|---|---|---|---|
| **Treasury Yields** | | | |
| 2 Year | 2.27 | 2.26 | 2.49 |
| 5 Year | 2.28 | 2.23 | 2.51 |
| 10 Year | 2.50 | 2.41 | 2.68 |
| 30 Year | 2.93 | 2.81 | 3.01 |
| **Credit Yields** | | | |
| BBB Industrial 10 Year | 3.82 | 3.82 | 4.35 |
| **Muni Yields** | | | |
| AAA 10 Year | 1.89 | 1.89 | 2.32 |
| **Mortgage Backed Securities** | | | |
| 30 Year FNMA Current Coupon | 3.27 | 3.11 | 3.50 |

## APRIL IN REVIEW

- The 10- year Treasury yield was up 9 basis points, finishing the month at 2.50%.
- High Yield continues to have a strong year, up 1.42% in April and up 8.78% on the year.
- Both Munis and Credit also posted positive returns on the month, .38% and .49%, respectively.

## Inching Along

Bond yields moved a bit higher during April as economic reports displayed a modestly improved tone and corporate earnings reports for the first quarter generally surprised to the upside. Equity markets rallied during April due in part to these earnings results, but also perhaps due to the relative calm that has returned to the bond market which suggests the economic cycle can be sustained longer now that Fed rate hikes are off the table. Corporate bond spreads continued to tighten, reflecting investors' confidence that growth is likely to continue and credit fundamentals are reasonably sound.

One of the key economic reports was first quarter GDP which came in much stronger than expected at 3.2% (annualized). Two factors drove this figure higher: inventories and net exports. Both are viewed as aberrations and expected to exert a headwind on GDP growth in coming quarters. The other key take-away was the pace of spending by consumers and businesses. This measure was a disappointment at just 1.3%, the slowest rate of growth in this component in nearly six years --- sluggish is an apt description.

### Economic Reports Turning the Corner

The Retail sales in March were much stronger than expected at 1.6%, a welcome relief after the disappointing February report of -0.2% and much more consistent with other data that paint a picture of modest growth and a healthy, albeit somewhat cautious, consumer. Meanwhile, inflation continues to trend lower even though the economy is at full employment: core personal consumption expenditures (PCE) for March, the Fed's preferred inflation measure, was 0.0%. The year-over-year pace was 1.6%, well below the 2% targeted by the Fed and one more reason why the Fed decided to press the pause button on their rate hike campaign earlier this year. Of course, low inflation is not only a U.S. phenomenon. Europe and Japan are also finding it difficult to engineer a pick-up in inflation despite extraordinarily stimulative monetary policies. Demographics and technology are likely culprits in explaining the absence of inflation; some call it the "Amazon effect."

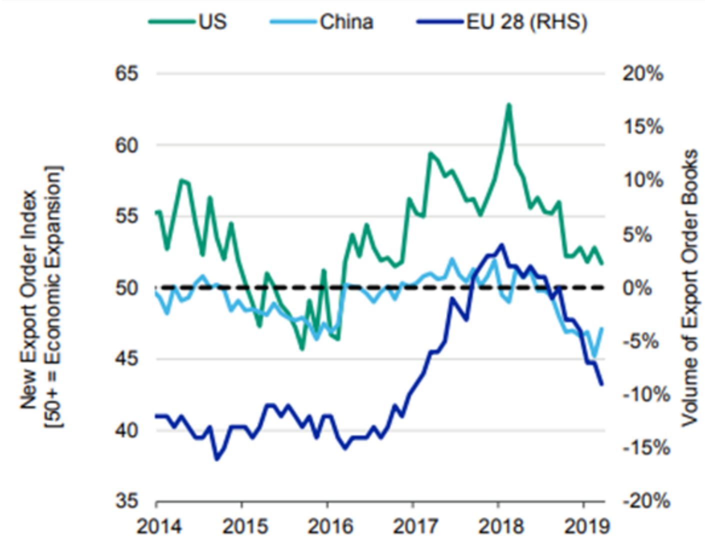
### Will There Be a Trade Deal?

A successful conclusion to the U.S.-China trade negotiations could be the catalyst to propel global growth higher, but an agreement has yet to be reached even though promising comments continue to emanate from Washington. As shown in the chart in **Exhibit 1**, the new export orders have been declining steadily in China and the EU and this is a clear sign that trade uncertainty is having a real impact.

## Here's What We're Doing

Finally, we remain of the opinion that spreads do not offer compelling value given the late stage of the economic cycle, the elevated level of debt on many corporate balance sheets, the much larger size of the "BBB" segment of the corporate market compared to pre-Financial Crisis, and the risks posed by trends like M&A and disruption.  This view leads us to favor up-in-quality and short duration bonds in our investment selection process.  Higher quality does not necessarily mean higher ratings, but rather issuers with a demonstrated record of disciplined financial policies and from industries that have defensive characteristics such as utilities or railroads.  We firmly believe that when conditions change in the market and corporate bonds are out of favor, this positioning will pay dividends in limiting any downside.

**EXHIBIT 1: NEW EXPORT ORDERS**

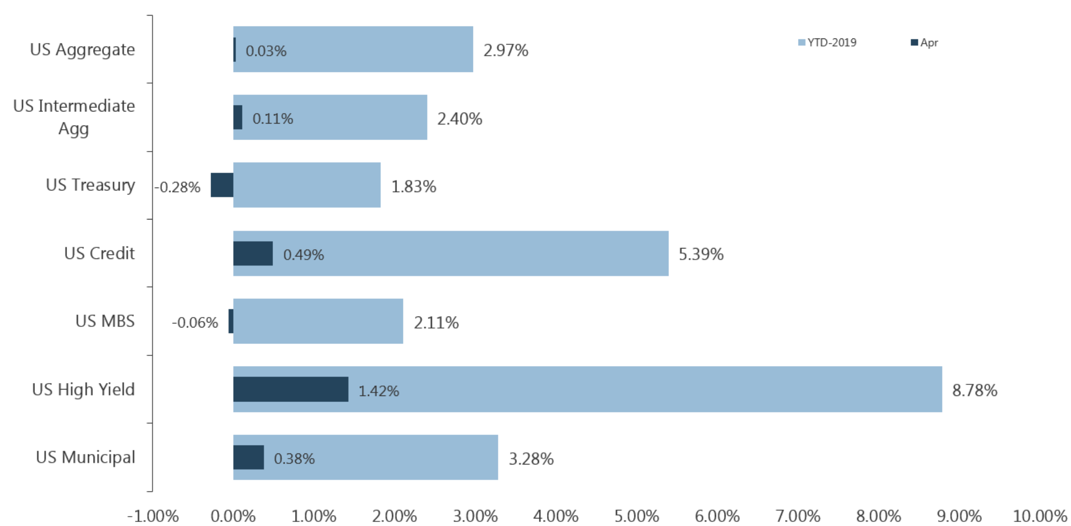



Source: Moody's Investors Service, IATA, Haver Analytics

## Final Thoughts

As we wrote last month, we judge the likelihood of a near-term rate cut as low, particularly if a trade deal is consummated soon.  Therefore, we believe bond yields should move a bit higher as the year unfolds, although negative global yields will likely limit how high U.S. yields can go since this remains the best house on the block.  Corporate bond spreads also seem to have hit a wall and are more likely to widen from here, although the magnitude of widening should be fairly contained unless there's a marked deterioration in earnings.  With slow growth, low inflation, and stable geopolitical conditions, it looks like the financial markets are in for some tranquility for a while.

**EXHIBIT 2: FIXED INCOME MARKET TOTAL RETURNS**




Source: Bloomberg Financial L.P. and Barclays Securities



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