CORE TAXABLE FIXED INCOME UPDATE

Bond market performance over the 2nd quarter of 2018 proved to be a battle between data indicating continued positive momentum in the U.S. economy versus fears over trade policy and geopolitics. Recent U.S. labor market data confirmed continued strength and acceleration in domestic employment with job openings in the manufacturing sector at a 20 year high. The May retail sales report suggests consumer spending has rebounded in the 2nd quarter after a sluggish 1st quarter. Inflation readings have continued to grind higher with the Core PCE Deflator finally reaching the Fed's 2% objective in the May reading. The Fed raised the Federal Funds Target Rate on June 13th for the second time this year, and it is widely anticipated it will raise the target 2 more times this year. Minutes from the Fed meeting suggest members believe stimulative fiscal policy and spending pose upside risks to their outlook. This resulted in the Fed Summary of Economic Projections (SEP) being revised to include a reduced unemployment projection, an increased inflation projection, and an increased Fed Funds Rate projection. The nature of the increased rate projection was meaningful due to it being the median expectation for rates which moved higher to a total of 4 increases in 2018 and for an overall increase in rates of 0.25% for 2018 and 2019. This median increase suggests a generally higher level of conviction among Fed policy makers. On the other hand, the Fed also made mention of the potentially negative impact of trade tensions on business sentiment and investment. Immigration and trade policy dominated the headlines in the 2nd quarter in addition to growing concerns over the desynchronization of global economic growth, specifically between U.S. and other major world economies. Higher U.S. interest rates, the increased value of the U.S. Dollar, and oil price increases have become problematic for emerging market economies. This, in addition to uncertainties surrounding the political environments in Italy and Turkey, combined to foster a difficult market environment where investors seemed more intent to focus on the timing of the next recession rather than the strength of the domestic economy and potential for future inflation.

Within the context of this environment, U.S. Treasury security yields moved higher across the yield curve in the 2nd quarter, with the exception of 30 year Bond yields which finished the quarter unchanged. Yield movement was more pronounced in short-term securities which reflected the Fed funds target rate increase in June and the expectation for further increases. For the first half of 2018, yields have moved higher on Treasury securities with maturities 5 years and longer due to increases in real interest rates and inflation expectations. Real rate increases account for approximately 2/3rds of the move higher in yields indicating the market believes future fed funds rates and the expected return on invested capital outweigh inflation expectations. In other words, the outlook for U.S. economic growth is good. The yield curve (difference in rates between the 30 year and 2 year Treasury) flattened in the 2nd quarter to a level last seen in 2007. Year-to-date the curve has flattened 0.39%, most of which happened in the 2nd quarter when the curve flattened 0.25%. The implications for the curve flattening we have experienced and the potential for further movement toward an inverted curve have conjured a significant level of anxiety in the market as inverted yield curves are considered a precursor to recession.

The relative performance of the corporate bond sector is best illustrated by changes in yield spread (the difference in yield between a corporate bond and a comparable maturity Treasury security). Yield spreads are influenced by technical (supply and demand), sector, and company specific factors. The relative performance of the corporate sector suffered in the 2nd quarter as exemplified by the 14 basis point widening of the Bloomberg Barclays U.S. Corporate bond index. Fundamentally, quality has remained high as S&P 500 issuers posted strong sales and earnings growth in the 1st quarter of 8.20% and 23.70%, respectively. While high grade leverage ratios moved modestly higher in the 1st quarter, the longer trend of decreasing leverage remains intact. Specific sectors, like consumer non-cyclicals, which have experienced more robust merger and acquisition activity, are better positioned to support higher leverage ratios due to increased cash flow from tax reform. Technical influences, however, had a negative impact on corporate bond performance in the 2nd quarter as weaker investor demand forced yield spreads wider despite support from a lower level of new bond issuance year-to-date relative to the same period in 2017. Reduced demand from the European Central Bank due to it moving toward policy normalization, and the flatter U.S. yield curve and high U.S. Dollar value decreased the attractiveness of corporate bonds on a currency adjusted basis. Overall, the relative performance of high grade corporate bonds seems incongruous with the fundamental economic and corporate growth backdrop. However, the 2nd quarter outperformance of higher quality issues within the investment grade rating spectrum does support the "flight-to-quality" thesis as stronger balance sheets were rewarded. Intermediate taxable municipal bonds performed well, in comparison, supported by investor movement toward higher quality, relatively low new issuance in the municipal bond market, and the increased demand for a post-tax cut alternative to traditional municipal bonds for some institutional investors.

Moving forward, we are committed to carefully monitoring the hawkishness of the Fed and the potential unintended consequences of its policy to stave off inflation, further desynchronization in global economic growth momentum, and the potential long-term consequences of a global trade war. While we expect heightened merger and acquisition activity in the second half of the year, we look for corporate yield spread relationships to normalize based on our anticipation for issuers to maintain strong fundamentals and continued economic growth. There are signs indicating we have entered into the latter part of the economic cycle. We maintain our belief in the continued growth capability of the U.S. economy and lengthening of this cycle based on the support of relatively low interest rates, relatively low inflation, a healthy labor market, and no apparent excesses (bubbles) within the economy. We will continue to maintain our bias to high quality and position our bond portfolios based on our outlook.

Source: Bloomberg, Barclays