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CORE TAXABLE BOND UPDATE

Bond market performance was modestly positive in the 3rd quarter, even as economic results drove interest rates higher across the yield curve. Consumer spending and business fixed investment grew strongly, while labor markets remain tight with a consistently low unemployment rate and strong jobs growth. On the inflation front, wage growth climbed higher with Average Hourly Earnings surprising to the upside on September 7th, and goods and services prices continued to rise with tariffs reportedly pressuring manufacturing costs. The potential effects of Tariffs seemed to influence the market on a daily basis over the course of the 3rd quarter with no consistent impact on sentiment. The Fed raised the Federal Funds target rate, as expected, on September 26th. The policy statement following the meeting removed the term “accommodative” in describing policy and members moved their average expectation for future GDP growth and rate expectations modestly higher. The Fed appears to be determined to move the target rate closer to “neutral” while economic data supports it and they have the tailwind of the Tax Cut and Jobs Act fueling growth. Given the esoteric nature of the “neutral rate”, the Fed is not able to communicate what it is or when they reach it with precision. Rather, it can only be known in hindsight. Despite their inability to communicate the neutral rate, Chairman Powell has increased the overall level of communication and transparency from the Fed by including a press conference after each policy meeting.

Within this environment, Treasury yields moved higher across the yield curve and the curve flattened, slightly. The move higher in yields was primarily a function of real interest rates moving higher as the market discounted higher growth and Fed funds target rate expectations into the future. Inflation expectations increased, as well, but only very modestly at most points across the yield curve.

The corporate bond sector enjoyed significant outperformance relative to Treasury securities and other bond sectors in a profound reversal of the underperformance experienced in the 2nd quarter. The decrease in investor demand for high grade corporate bonds experienced earlier in the year seemed to abate in the 3rd quarter, providing technical support to relative performance. This was evidenced by mutual funds reporting healthy net inflows into high grade corporate bond funds over the course of the quarter. Reduced new issue supply and strong execution metrics, including orderbook oversubscriptions, deal spread tightening, and new issue yield concessions, also provided technical support to corporate outperformance. From a fundamental perspective, high grade corporate issuers reported very strong sales and earnings growth figures during the quarter. This translated into relative outperformance moving progressively down the quality tiers of the investment grade ratings spectrum. Corporate balance sheets remain healthy with leverage metrics virtually unchanged.

It may be challenging to sustain the robust financial performance reported by high grade corporate issuers last quarter, but we believe there is a high likelihood for more growth ahead in the U.S. economy. Consequently, we will continue to maintain our bias to investing in high quality corporate bonds to best position our client portfolios to benefit from that growth. We are watchful for signs of change in the health of the economy and corporate issuers, and mindful of likely being in the latter stage(s) of the growth cycle. Our goal continues to be the maximization of income for a high level of quality and reasonably low level of interest rate risk.

Source: Bloomberg, Barclays