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CORE TAXABLE BOND UPDATE

The high grade bond market sustained a substantial increase in volatility, but enjoyed positive performance in the 4th quarter. It began with Federal Reserve Chairman Powell's now famous quote from an October 3rd PBS interview when he suggested monetary policy is "a long way from neutral." We ended the quarter with a reduction in future rate expectations provided by the Fed's Summary of Economic Projections (SEP) published after their December 19 meeting. The volatility experienced between these 2 divergent events is best illustrated in the performance of the Merrill Option Volatility Estimate (MOVE) index. It measures the price volatility on U.S. Treasury security options, and it produced a 44% increase in the 4th quarter. The source of the increase in volatility may have originated with Fed rhetoric, but the U.S. trade war with China, Brexit negotiation impasse, turnover in Congress, and slowing economies in Europe and China all added to market anxiety. U.S. economic data generally moderated over the course of the quarter, but continued to demonstrate positive results indicating the economy is on solid footing, but perhaps not growing at the pace enjoyed in the 2nd and 3rd quarters. Consumer spending was steady in the 4th quarter and the consumer remains in a very strong position supported by a strong labor market, rising wages and disposable income, and elevated home values and savings balances. The health and confidence of the consumer is always critical in judging future upside for the U.S. economy, but it is now exponentially more important due to the negative impact low oil prices and trade policy are having on corporate capital spending plans. On the inflation front, prices rose modestly in the 4th quarter with input costs generally outpacing final goods prices, and tariff-induced cost increases have begun to spread beyond the manufacturing and construction sectors to restaurants and retailers.

Within this environment, interest rates declined significantly across the 2 to 30 year maturity spectrum in the 4th quarter and the 2 to 10 year Treasury yield curve flattened 5 basis points. Rates were higher for the year, however, and the curve flattened 0.33% as 2 and 10 year yields rose 61 and 28 basis points, respectively. Decreased inflation expectations proved to be a significant drag in pulling nominal interest rates lower across the curve in 2018, particularly in the 4th quarter. Real yields moved higher for the quarter and year, however, and overwhelmed lower inflation expectations as the market discounted higher future Fed funds and economic growth rates.

The economic and political uncertainty which pushed interest rates lower in the 4th quarter as investors moved assets to the safety of bonds also had the effect of pushing yield spreads (compensation for credit risk) wider. High grade corporate bond spreads widened 21 basis points in the 4th quarter and ended the year wider by 0.55%. It is remarkable to think corporate spreads had reached their tightest level in a decade last February. The higher quality bands of the corporate investment grade spectrum outperformed lower quality bands in 2018 as the market rewarded stronger credits given the increasing uncertainty surrounding politics and the economy. Taxable Municipal bonds were also rewarded with relative outperformance compared to other "spread" sectors due to the high quality nature of issuers within the sector. New issue supply for the 4th quarter and the year proved to be supportive of corporate bond performance with issuance levels down 32% and 18%, respectively. This reduction in supply is largely attributed to higher overall borrowing costs, overseas cash repatriation as a result of the Tax Cut and Jobs Act, escalating trade war rhetoric, and volatile equity market swings. Fundamentally, corporate financial statement performance through the 3rd quarter was supportive as leverage and coverage ratios in high grade bond issuers were virtually unchanged. Sales and earnings results for S&P 500 companies reported for the 3rd quarter were very strong with increases of 8.06% and 26.12%, respectively.

We continue to believe the current growth cycle of the U.S. economy has the ability to extend given the strength of the consumer and job market, relatively low interest rates, and benign inflation. We are pleased with our taxable bond strategy performance for the 4th quarter and 2018, and continue to believe high quality will be rewarded on a relative basis as we move into the unknown of 2019 and late stages of the economic cycle. Our management focus continues to be income driven while maintaining a high level of quality. We remain watchful for opportunities to extend our strategies to "lock-in" higher yielding positions prior to a downturn in the economy and rate cycle.

Source: Bloomberg, Barclays