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CORE TAXABLE BOND UPDATE

The high grade bond market enjoyed strong performance for the 1st quarter of 2019. The primary influence on performance originated from Fed policy, specifically the reversal of Fed policy since mid-December. The market is clearly not accustomed to having a Fed Chair state we are “nowhere near neutral” policy in early October, raise the target rate 2 months later (while guiding 1 rate lower for the coming year), and then remove all previously expected increases in 2019 from the “Dot Plot” in March. Additionally, the FOMC elected to end the balance sheet runoff program in September, at which point it will resume the full reinvestment of maturing securities. The net effect of the policy evolution over the past several months has been very bullish for risk assets. By reducing the expected number of future rate hikes, the Fed has provided the market a measure of confidence in the potential for extending the current economic growth cycle. It is somewhat heartening to know the Fed can adapt its policy in short order to changing economic conditions, but it is also somewhat unsettling as a sign the Fed is no longer as strongly convicted about the growth trajectory of the U.S. economy. In its most recent meeting minutes, the Fed recognized the slowing of economic activity in the U.S. and abroad, including the slowing of household and business fixed investment spending. While overall inflation declined somewhat in the 1st quarter, core inflation has remained near their 2% objective, and they continue to regard the labor market as strong.

Within this environment, U.S. Treasury security yields fell across the 2 to 30 year maturity spectrum, and most areas of the curve flattened modestly as most longer-term yields declined more than shorter-term yields. The exception to this performance was the 30 year Treasury bond which declined in yield, but not as dramatically as shorter maturities. This caused a modest steepening in the relationship between 30 year bonds and shorter securities. Nominal treasury yields are comprised of 2 primary components: real yield and inflation compensation. Looking back on the 1st quarter, we witnessed a significant reversal in the behavior of those 2 components relative to the way they behaved over the course of 2018. Specifically, the real yield component, which measures the expectation for both future economic growth and the Federal Funds Rate, declined significantly across the maturity spectrum, while the inflation compensation component moved high across the maturity spectrum. The motivation for the significant change in the behavior of these yield components is based on the change in Fed policy. With the Fed quickly moving away from the semiautomatic rate increases of the prior 2 years and further signaling their intent to maintain the current rate level for an extended period, the market began pricing-in higher inflation expectations and lower growth expectations.

Given the accommodative nature of the Fed policy reversal in the 1st quarter and lower interest rates around the world, risk assets had a firm base to rebound from December losses. The high grade corporate bond sector enjoyed the best quarter of total return performance in 15 years. Yield spreads (compensation for credit risk) tightened approximately 34 basis points (most of which was accounted for in reduced default risk expectations) indicating investors’ confidence in the ability of the business cycle to extend based on Fed policy, and lower interest rates boosted total returns. The strong conviction in the market regarding the ability of the cycle to lengthen was also demonstrated by the relative outperformance of the lower quality band of the investment grade spectrum. This marked a reversal in the reward securities with higher credit ratings received over lower ratings in 2018. Foreign demand was a key driver for high grade corporate bond relative performance as hedging costs dropped significantly with lower LIBOR rates, and the steepness of the longer end of the yield curve in U.S. Treasury securities attracted foreign assets. Very low broker-dealer inventory levels and significant flows into Corporate bond funds illustrates the breadth of strong demand and conviction across retail and institutional investors. Corporate bonds were also supported by solid 4th quarter financial performance results, an 18% increase in trading volume (relative to the 4th quarter of 2018), an 8% decrease in new issue supply (year-over-year), and gradually declining volatility over the course of the 1st quarter.

We continue to believe the current U.S. economic growth cycle can persist for some time based on relatively low interest rate and inflation levels, strong consumer balance sheets, and a strong labor market. We believe we are late in the cycle based on indicators including cycle length, yield curve shape, and Fed monetary policy progress. While yields in the marketplace have moved lower, we remain watchful for opportunities to improve portfolio yield and lengthen duration as we grind closer to the end of the cycle.

Source: Bloomberg, Barclays