2Q 2019

CORE TAXABLE BOND UPDATE

The high grade bond market logged another strong performance result for the second quarter of 2019 on the heels of very strong performance in the 1st quarter. Trade tensions were the dominant theme driving bond market activity over the course of the 2nd quarter. Those tensions have had a definitive impact on the Fed in terms of how risks to the economic outlook are being perceived and their consequent willingness to consider easier monetary policy. In addition to trade tension, the continued softening of economic data around the world (particularly cyclically sensitive manufacturing data) and declining inflation and inflation expectations have markets positioned for a cut in the Fed Funds Target Rate at its July 31st meeting. Recent congressional testimony given by Chairman Powell validated the market's belief in the likelihood for a future cut, however, expectations for aggressive cutting (50 basis points) have diminished with very strong June payroll and CPI reports.

This has been a very confounding market to understand for most investors as traditional relationships between risky and credit risk-free assets have behaved opposite of what would be expected given the economic and political circumstances being experienced. While the bond market is exhibiting signs normally associated with a coming recession (inverted yield curve between the 3-month Treasury Bill and 10-year Treasury Note), stocks and corporate bond spreads (compensation for credit risk) have continued to rally as though the economy is on solid footing and good times lie ahead. Normally, when risk assets (stocks and corporate bonds) are rallying, it is indicative of growth and potential inflation, which pulls bond prices down (pushes yields up). A plausible explanation suggested for this recent market incongruity is the possibility that the Neutral Fed Funds Rate (the rate which neither stimulates nor slows economic activity) is actually lower than what has been assumed. If true, the Fed may have inadvertently moved the rate to a restrictive level, and the next logical action would be to cut the rate back to ensure it is not preventing economic growth. When coupled with the uncertainties surrounding global economic slowing and trade policy risks, a cut in the target rate appears to be forthcoming. Market behavior has certainly demonstrated that a cut is a forgone conclusion.

Within this environment, U.S Treasury security yields fell across the 2-year to 30-year maturity spectrum, with the more dramatic declines experienced in shorter-term securities, resulting in a steepening of the curve between 2-year and 30-year bonds. This performance was largely driven by the anticipation for a cut in the Fed Funds Target Rate as mentioned above. Nominal treasury yields are comprised of two primary components: real yield and inflation compensation. Both real yields and inflation expectations fell over the course of the second quarter. Real yields fell based on lower expectations for future growth and Fed Funds yield levels. Inflation expectations fell as worldwide output and inflation metrics diminished. If the Fed does, in fact, reduce the Fed Funds rate going forward, inflation expectations will reverse, somewhat, with the possibility the Fed may have stoked inflation by lengthening the business cycle.

The high-grade corporate and taxable municipal bond sectors enjoyed another quarter of solid total return performance as yield spreads compressed modestly and bond prices moved higher across the curve. Corporate bond performance was supported by continued strong demand and a year-over-year decrease in new issue supply of approximately 12%. Moving into quarter-end, new issue corporate bond deals were three times over-subscribed, with initial price talk narrowing an average of 20 basis points by final pricing and very modest yield concessions relative to outstanding bonds. Retail investors continued to support bond prices by adding $6.4 Billion to high-grade corporate bond mutual funds during the quarter.

The length of the current U.S. economic growth cycle is now officially the longest in recorded history. We continue to believe the 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 do not regard the recent decline in yields as indication of a coming recession. Rather, relatively benign inflation, foreign economic weakness, trade war concerns, and $14 Trillion in negative foreign government bond yields are exerting downward pressure on U.S. bond yields. Even a modest reversal in the momentum of these influences could provide support for higher U.S. bond yields.

Source: Bloomberg, Barclays