# Fixed Income Outlook

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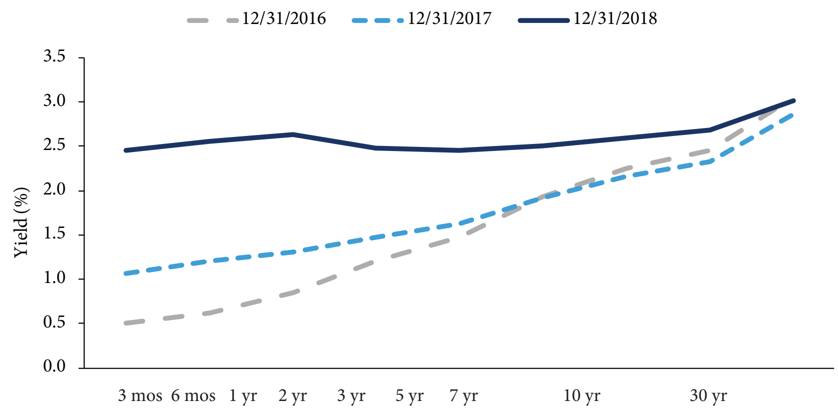
## First Quarter 2019

The fourth quarter of 2018 witnessed a wild ride for both the equity and fixed income markets. Fear and uncertainty were in ample supply and stemmed from many concerns. This long list included the Federal Reserve raising interest rates, intense trade policy negotiations, a looming Federal government shutdown, and swirling foreign policy. Ultimately, fearful investors reacted and injected a dose of volatility to previously pacific markets.

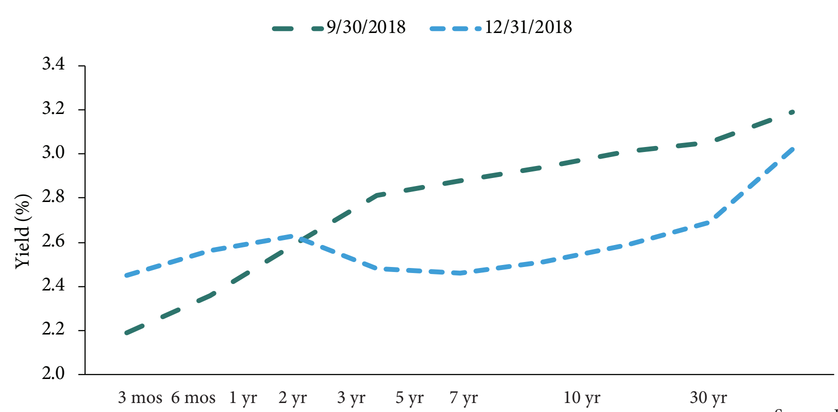
Figure 1 **U.S. Treasury Yield Cure at Year Ends 2016, 2017, and 2018**




Source: FactSet

Stocks hit a rough patch with the S&P 500 recording its worst quarter in a decade, falling 13.5%. Bonds were jostled as well as the year-long cycle of repeated upward shifts in the yield curve was halted with a twist movement. More precisely, the U.S. Treasury 10-year yield dropped 36 basis points, the 1-year yield held steady, and 3-month and 6-month Treasury Bill yields both gained over 20 basis points (see Figure 2). This twist in rates was a firm indication that the character of the marketplace had changed from one based on optimism to one based on skepticism.

Figure 2 **U.S. Treasury Yield Curve at the Beginning & End of Q4 2018**




Source: FactSet

A large focus of the market has been squarely on the actions and forecasts of the Federal Open Market Committee (FOMC). The FOMC hiked short-term rates again in December for a total of four rate hikes in 2018, pushing short-term rates up a cumulative 100 basis points. This was not without controversy as markets reacted strongly following the latest FOMC decision, when stocks slumped and the yield curve twisted into the shape shown in Figure 2 above.

This last rate increase also spooked futures markets. Futures reflect the forward-looking estimates made by market participants of both interest rates and possible FOMC actions. Prior to the December announcement, the futures markets showed a likelihood of two rate hikes in 2019 (contrasting with FOMC expectations of three hikes). After the announcement, the same markets showed expectations of no hikes in 2019 and a rate cut in early 2020.

Our view on this in the past has been apparent. We feel the FOMC has been moving prematurely as there have been few signs of rapidly growing inflation. Now it appears that the rest of the market may agree with us. The Core PCE deflator, the Fed's preferred measure of inflation, fell over the quarter from 2.0% in September to 1.9% in December. The rapid swings in the markets reflect investors' displeasure with the Fed's actions. Clearly, a no-action decision would have been preferable.

Has the FOMC made a policy mistake? The question is front and center in our minds. If this is a policy mistake, the FOMC could dramatically slow an economy that has been growing at only a modest pace. Worse still, these cumulative actions eventually could tip the economy into a recession. While neither of these outcomes are likely to arrive soon, markets are reacting in a manner that suggests that their probabilities have risen. We will be watching future economic data releases for hints of any slowdown.

All told, we do not believe that the latest FOMC action warrants a near-term change to our strategy. This entire scenario will take some time to play out. Meanwhile, we remain attuned to the possible negative consequences. Lest we induce panic, we should note that we are finding ample liquidity in the high-quality, investment-grade market. At the same time, lower-quality issues have suffered in terms of total return, which is unsurprising in times of uncertainty. In short, markets are functioning as they should.

Looking broadly at the fixed income landscape, we observed U.S. Treasury issues outperform by a wide margin over Corporate bonds in the fourth quarter. In fact, the move was so strong that Treasury issues outpaced Corporate bonds for the calendar year. This was a huge reversal from the end of Q3 where Corporate bonds ruled the roost on a year-to-date basis. Credit spreads, or the additional yield investors require to compensate for default risk, increased over the quarter, blunting the returns for Corporate bonds.

The new year of 2019 brings many questions, some of which are holdovers from last year. Prominently, will the FOMC continue to raise rates in the face of data contradicting inflation growth and evident market dissatisfaction? What will fiscal policy look like with a divided Federal legislature? What will come of trade policy negotiations and foreign policy?

While we have no sure answers, we are maintaining an optimistic outlook for the U.S. economy. We are most hopeful that the FOMC will take a breather to re-assess the economy and pause its pattern of interest rate increases. We feel that existing economic data should be enough to warrant such a respite. Bipartisan politics will likely restrain any major fiscal policies from being implemented, as was the case with previously divided sessions of Congress. Trade and foreign policy matters will likely stay unsettled but lower tariffs and fewer overseas conflicts, whether fought in diplomatic or military circles, would be a positive for the economy.

Our strategy, seemingly tailor-made for unpredictable markets, remains unchanged. We favor high-quality, investment-grade bonds for our clients' portfolios. Yields, particularly short-term yields, are higher today than one year ago, increasing the attractiveness of bonds. For investors, high-quality bonds continue to provide excellent downside protection when paired with equity investments. If the volatility of recent equity market moves proves unpalatable, the addition of or an increase to an allocation of investment-grade bonds may help soothe investor fears. Our strategic goal remains the construction of portfolios that provide liquidity, carry high-quality ratings, and favor principal protection.

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