Congress Asset Management Company

Fixed Income Outlook

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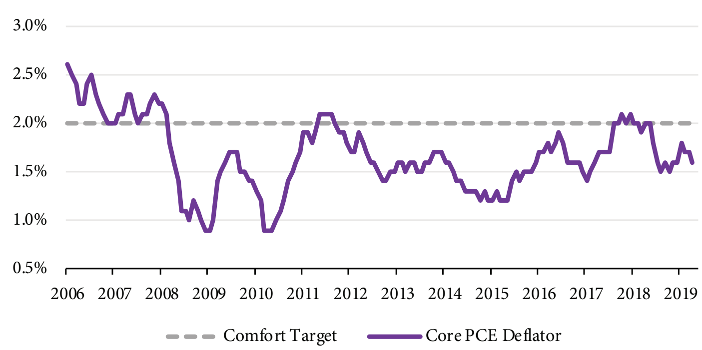
In this edition of the outlook we look back at the calendar year gone by and reflect on major market movers, persistent trends, as well as performance drivers within the marketplace. 2019 witnessed domestic market uncertainty, continued global economic malaise, falling U.S. interest rates, narrowing credit spreads, and a strong performance by the fixed income markets. It was not always a smooth ride in 2019, but by the conclusion of the year markets stabilized to a more normal environment, pleasing market makers and investors alike.

The FOMC spent most of 2019 retracing its steps from 2018. The Fed cut rates three times over the course of the year, effectively undoing the four rate hikes it implemented in the previous year. In doing so, the Fed has openly admitted to making a policy mistake when it hiked rates prematurely. This mistake most certainly hampered economic growth in 2019. More recent messaging from the Fed shows a greater propensity to wait for economic data to dictate future rates moves rather than taking proactive actions. Inflation, as measured by the Core PCE deflator (which ignores volatile food and fuel prices), remains steadfastly below the Fed's comfort target. This metric should continue to be the most watched gauge of inflation.

Figure 1 **Core PCE Deflator & FOMC Comfort Zone (2006 - 2019)**

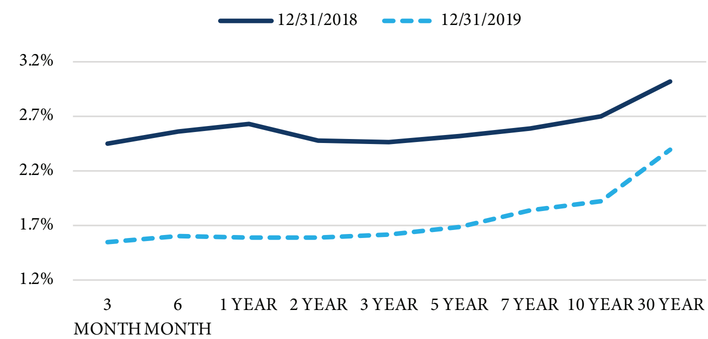


Source: FactSet

Globally, economic weakness in Europe and Japan remained a constant narrative throughout the year. Despite maintaining aggressive monetary policies to spur growth, both the eurozone and Japan are mired in low to zero growth environments. Massive infusions of stimulus in the form of negative interest rates as well as extraordinary quantitative easing measures have so far failed to push these economies out of their doldrums. We expect these monetary policies to remain in place until their respective economies begin to rally.

Trade tensions with China spurred more headlines than we thought possible as the rhetoric from both sides rose and fell throughout the year. The Huawei product ban, put in place in May, was just the start of more heated discussions, punctuated by on-again, off-again trade negotiations. By the end of 2019, the U.S. had applied tariffs of over $350 billion on Chinese goods and China responded with tariffs of over $100 billion on goods from the United States. We see these tariffs as distractions for businesses, markets, and investors. Ultimately, these disputes surely contributed to slower growth in 2019 as they dampened sentiment and hindered capital investment.

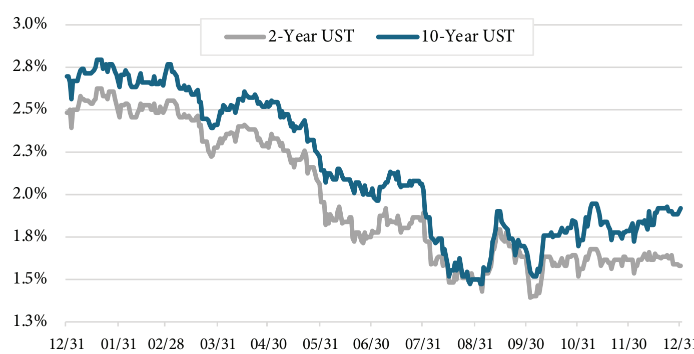
Figure 2 **US Treasury Yield Curve at the End of 2018 & 2019**



Source: FactSet

Interest rates fell in 2019, yet looking solely at the beginning and ending yields obscures a picture of volatility, especially in the second half of the year. This change in the second half coincided with the ramping up of tariff negotiations with China as well as the beginning of the Fed's interest rate cut cycle that began in July. The yield curve became extremely flat in the third quarter, reflecting investor fears over the potential for recession. But by the end of the fourth quarter, these fears were lessened by the three FOMC rate cuts and the yield curve regained its normal upward sloping shape.

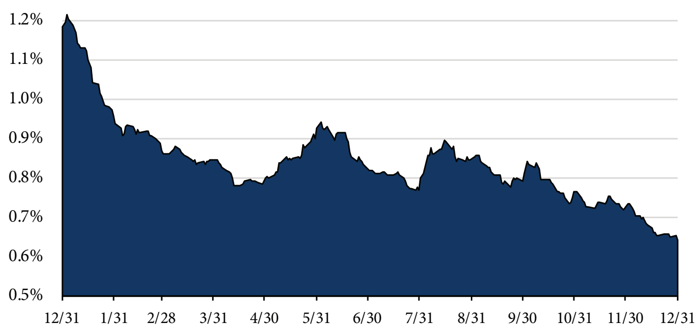
Figure 3 **US Treasury 2-Year and 10-Year Notes, Daily Yields 2019**



Source: FactSet

Turning to fixed income performance, the theme of lower quality corporate issues prevailing over other securities stood firm throughout the year. In each quarter of 2019, lower quality credit issues strongly outperformed higher quality issues. For the full year this translated into BBB-rated corporate bonds outperforming AAA-rated corporate bonds by a 2-to-1 margin. Given this overwhelming performance, it should not be a surprise that credit spreads, the additional yield investors require to compensate for default risk, shrank over the course of the year. US Treasuries and US Agency issues predictably underperformed Corporate bonds but still posted very respectable returns for the year.

Figure 4 **Intermediate Credit Spreads, 2019 Daily Obervations**



Source: FactSet

More closely examining those shrinking intermediate maturity credit spreads, 2019 saw spreads hit notable post-1999 milestones, reviewed here by ratings cohort. AAA-rated corporate spreads hit a low of 7 bps in September and AA-rated corporate spreads saw a low of 31 bps in December. A-rated corporate spreads ended the year at 52 bps, just one basis point wide of post year-end 1999 low set in February 2005. Finally, BBB-rated corporate spreads finished 2019 at 94 bps, about 7 bps wide of the low of 87 bps set in January of 2018.

Looking forward, we believe that over the near-term interest rates and credit spreads will maintain their current levels. Likewise, economic growth is set to begin the year at very modest single-digit levels. As we move through the year and forward through the election cycle, future paths are much less clear. We of course are searching for bubbles or looming events that may shock or spook markets, but these are typically difficult to spot far out into the future. As such we will continue to re-evaluate our current balance of corporate bonds versus US Treasury bonds held in our clients' portfolios as we progress through 2020.

Lastly, we are pleased with our strategy's performance in 2019. Our aim is to maintain a duration neutral portfolio with high quality standards, managed in a conservative, long-term strategy. We see no reason to deviate from this strategy based on 2019's results or our 2020 outlook. Tactical shifts in our portfolios are dictated by changes to market structure, economic developments, and valuations. Our committee-based approach ensures that such changes are not haphazardly implemented and are instead made with deep deliberation and consensus approval.

We wish you a safe, happy, and prosperous 2020.

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