Congress Asset Management Company

Fixed Income Outlook

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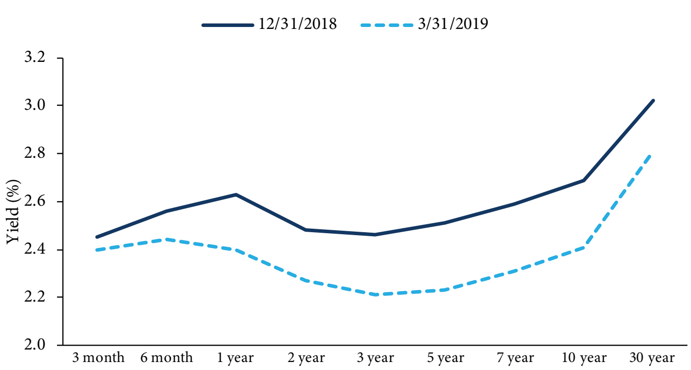
Happily for fixed income investors, the first quarter of 2019 was much calmer than the last quarter of 2018. The Federal Reserve decided to not raise rates and put future rate hikes on hold. This decision kept interest rates relatively stationary despite continued weakness abroad and unsettled trade policy. Inflation remained tame as employment remained strong in a domestic economy that is determined to move forward at a modest pace.

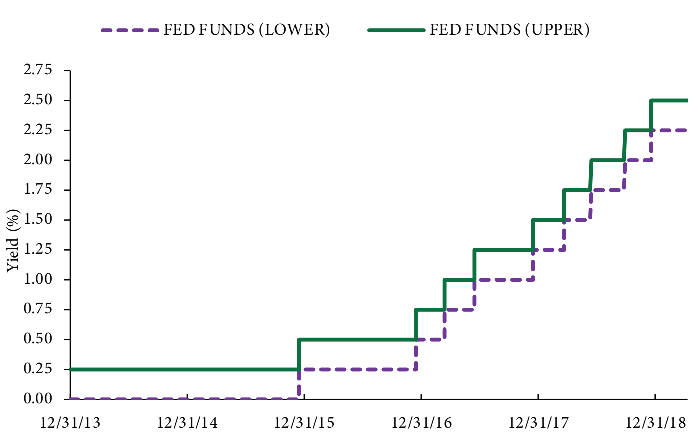
Figure 1 **US Treasury Yield Curve at Year End 2018 & Q1 2019**



Source: FactSet

The yield curve retained its flattish shape over the quarter as longer-term yields moderated slightly. By the end of the quarter the 10-year U.S. Treasury yield had fallen to 2.4%, which is roughly equivalent to short Treasury Bill yields. The inversion in the belly of the curve reflects some market uncertainty over the future direction of interest rates, a direction likely to be dictated by the Federal Open Market Committee (FOMC).

Figure 2 **Federal Funds Target Range Upper and Lower Bounds since 12/31/2013**



Source: FactSet

The FOMC has hiked interest rates 9 times since the end of 2013, with the bulk of the hikes coming in the last two years. While each raise was only a 25 basis point increase, we now stand with the upper bound of their range at 2.5%. This means that much of the yield curve today falls below the upper end of the target range for the federal funds rate, quite an astonishing situation. Overall, the impact of the hikes has been to raise the short end of the curve even as long-term rates have fallen slightly. This movement of the curve is described as a "bear flattener" in fixed income parlance.

The flatness of the curve should draw investors to the short end as they can receive the same yield without having to lock up their money for a long period of time. If all participants moved to the short end, it follows that the long end should rise, reflecting fears over higher interest rates in the future. Instead, the shape of the curve indicates that the markets have little fear of inflation looming ahead. Investors are happily positioning themselves almost evenly across the curve.

The FOMC, for their part, paused their policy changes to assess the state of the economy after a few economic data points in the quarter were a bit softer, notably in household spending and housing figures. Minutes from their recent meetings show the committee's concerns as to whether this softness might spread to other areas of the economy. The majority of the members expressed an uncertain outlook and that they would expect to leave short-term rates unchanged for the remainder of the year.

Economic data on inflation suggests little to no build up in price pressures. CPI and PPI figures, excluding volatile food and energy components, both show inflation running at 2%. Further, the Core PCE deflator, the Fed's preferred measure of inflation, fell again on a sequential basis from 1.9% in December to 1.8% in January. The FOMC need not raise rates after seeing these tame metrics of price increases.

Foreign economies remain soft, particularly in Europe. The European Central Bank is maintaining a three-pronged, aggressive interest rate policy featuring a 0% lending rate, a negative deposit rate, and an asset purchasing program to stimulate the region's economy. Government bonds issued by European Union member nations carry yields that are remarkably low as a result. These low rates are unlikely to change soon and assuredly usher international investors to the U.S. market instead of Europe when investing their cash.

Looking forward, we expect the level of low interest rates and the flat yield curve to persist. Modest U.S. GDP growth alone will not be enough to push either inflation or yields higher. Finalized trade negotiations may be of some help but ideally a revitalized European Union economy would be the best stimulus. The interconnections between economies across the globe are robust and their cross-border impacts are material.

Turning to bond market performance, one should not be surprised that Corporate bonds led the charge in the first quarter given the slight changes in the yield curve. The difference in returns between Corporate bonds and U.S. Government-guaranteed issues was significant. Corporate bond returns were greater than twice the returns of U.S. Government-guaranteed issues. This was a reversal from the previous quarter's more volatile results.

Credit spreads, or the additional yield investors require to compensate for default risk, decreased over the quarter, spurring the returns for Corporate bonds. Spreads are not as small as they were a year ago but do remain historically rich. We remain cautious with our outlook for Corporate bonds based on these narrow spreads, but do not feel the urge to make any changes to our investment strategy at this point.

We continue to favor high-quality, investment-grade bonds for our clients' portfolios. Even though the yield curve is flat, we are committed to our duration neutral stance for our intermediate strategy. We believe that over time our clients are best served by garnering their outperformance through security selection and asset allocation rather than through bets on the direction of interest rates. Our strategy is centered on buying liquid, high-quality issues for our clients in order to protect their principal.

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