Fixed Income Outlook

John Beaver, CFA | Jeffrey R. Porter, CFA

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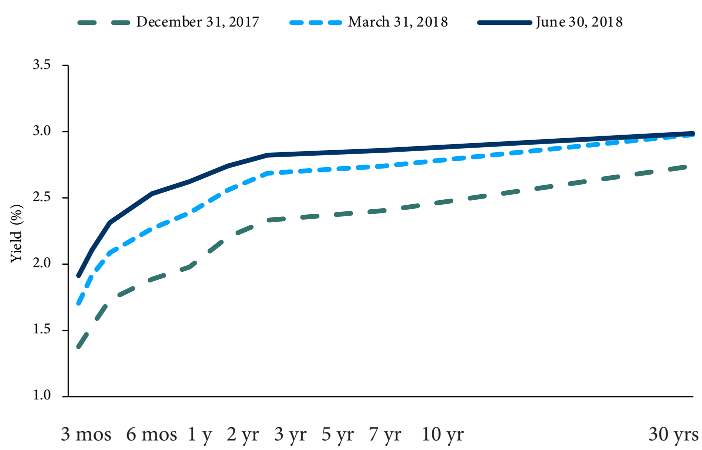
The U.S. Treasury yield curve has become flatter as we move further into 2018. The movement of the curve has been most pronounced in nearer maturities as the Federal Open Market Committee (FOMC) has hiked short-term rates twice this year and is intent on raising interest rates two more times before year end. The Fed's timing now appears to be more consistent with macroeconomic data as measures of inflation have slowly perked up in conjunction with the economy picking up steam.

U.S. Treasury Yield Curve



Source: Bloomberg Barclays

The low yields at the long end of the curve appear to be held firmly in place by global investors seeking higher yields. Yields in many foreign markets remain low or are negative as both Europe and Japan remain accommodative with their monetary policies. These foreign central bank biases are unlikely to change soon. To foreign investors, a yield of almost 3% on the U.S. Government-guaranteed Treasury 10-year note must look highly attractive even when considering currency conversion risks.

The domestic economy has continued to move forward with a waning amount of momentum. GDP for the first quarter was reported at 2.0%, a step down from the previous readings of 2.9% in Q4 and 3.2% in Q3. Consumers slowed their purchases at the tail end of the last quarter as inflation-adjusted purchases were flat in May. While not ideal, this slowdown comes on the heels of two very good quarters of consumer activity. It is a testament to the broader strength of the economy that GDP remained positive despite this consumer headwind. Future pickups in GDP should not be discounted.

Employment remains a steady strength of the economy. The most recent figures show unemployment at a paltry 3.8%, a new low for this cycle. We currently have more jobs available than workers to fill them. The FOMC has noted in the past that full employment would eventually lead to increased inflation. True to the Fed's expectations, we are finally seeing some of this anticipated inflation manifest in macroeconomic readings.

The most notable move was seen in the Core PCE Deflator, the FOMC's preferred inflation measure. This series tracks consumer spending inflation while stripping out the impact of volatile food and fuel prices. The Core PCE Deflator rose from 1.6% to 2.0% over the course of the quarter, making it the highest reading for the series since March of 2013. This 2.0% print is significant as it falls on top of the FOMC's comfort zone for the index. Readings above this range could spark the FOMC to act with more urgency with their rate hikes.

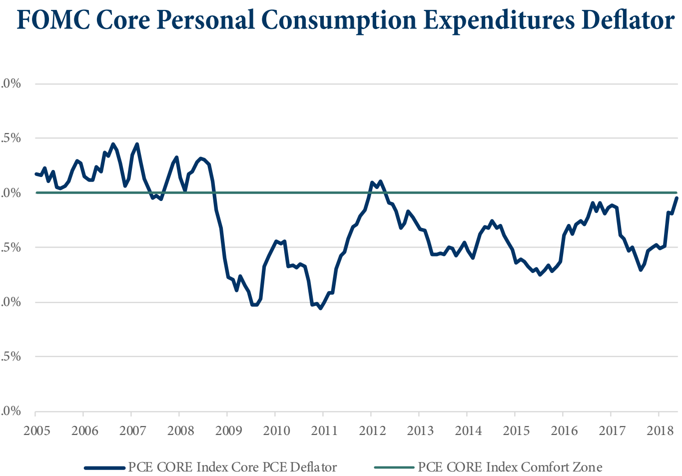


Figure 2 Core PCE Deflator and FOMC Comfort Zone (source: Bloomberg)

Through the current cycle of tightening monetary policy, the FOMC has increased interest rates seven times. The hikes have been spaced out as they came once in 2015 and in 2016, three times in 2017, and two times so far in 2018. Each of these hikes has moved up rates by 25 basis points for a total increase of 1.75%. Currently the interest rate futures market is expecting two more hikes this year, which is consistent with the Fed's messaging. Looking back to the last tightening cycle that ranged from 2004 to 2006, the FOMC raised rates 17 times for a total increase of 4.25%. If history is a guide, there are many more hikes to come.

Bond market returns have sagged as rates have risen (bond yields and prices move inversely). The Bloomberg Barclays Intermediate Government/Credit Index, a broad benchmark, was up 1 basis point for the second quarter but is down 97 basis points on a year-to-date basis. All of the prognosticators who suggested rising interest rates would cause "a bloodbath" or "bond Armageddon" could not have been more wrong so far. The hyperbole commonly found in today's media regarding the expected demise of bond investments has simply not played out in the marketplace.

Corporate bonds have been weaker performers when compared to US Treasury and US Agency issues. Within investment grade rated issues lower quality bonds have been hit harder than high quality bonds as investors sought to reduce credit risk in their portfolios. Credit spreads, the additional yield investors require to compensate for default risk, increased over the quarter. This signals a pull back from the credit spread lows seen in the first quarter. As we commented last quarter we feel that credit spreads were too thin and we have maintained our strategy of deemphasizing Corporate bonds in our clients' portfolios.

We strive to construct high-quality, investment-grade bond portfolios for our clients. While rates are slowly climbing, we do not believe that this is an opportune time to "re-risk" by purchasing longer dated paper given the flat shape of the yield curve. Instead we are maintaining maturity profiles that are roughly in-line with market benchmarks. Our long term strategic goal remains the construction of portfolios that provide liquidity, carry high-quality ratings, and favor principal protection.