Fixed Income Outlook

John Beaver, CFA | Jeffrey R. Porter, CFA

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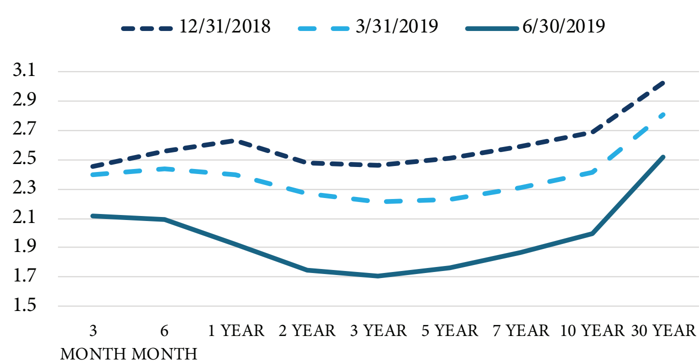
Yields fell in the second quarter as investors began to consider more seriously whether the Federal Reserve would cut interest rates in the upcoming months. These falling rates were propelled by a slightly slowing economy and further buffeted by trade tensions and tariff talk. Equity markets gyrated while fixed income markets rallied in the quarter on the changing outlook. The fixed income market moved strongly as it expects the Federal Reserve to cut rates in the near term. Arriving at a justification of one or more rate cuts by the Fed is a question that remains to be answered.

Figure 1 **US Treasury Yield Curve at Year End 2018, Q1 2019 & Q2 2019**



Source: FactSet

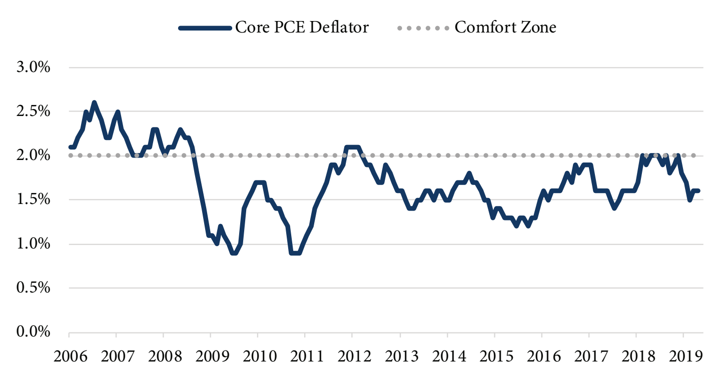
As the yield curve fell lower over the quarter, it developed a deep sag in the belly of the curve. At the end of the quarter, the yield on the U.S. Treasury 10-year note hovered just above two percent. This rate was solidly below the effective federal funds rate of approximately 2.4%. Clearly, the market is expecting the Federal Open Market Committee (FOMC) to lower rates within a short time frame. This expectation was also reflected in futures markets, which forecast multiple rate cuts in 2019.

These expectations of a cut in rates coming so soon after a rate hike of 25 basis points in December 2018 highlights the quandary facing the FOMC. The domestic economy is doing well, but it is slowing down. Recent housing data has been weaker, and second quarter GDP figures are expected to be much lower than the first quarter numbers. What exactly has changed to suddenly make the FOMC want to reverse its course? And most importantly, what would be the rationale used by the FOMC to cut rates?

International weakness could certainly be cited by the Federal Reserve. Europe remains weak and the European Central Bank is maintaining its aggressive interest rate policy to stimulate their economy. Japan continues to struggle to regain its footing and their central bank also maintains an accommodative interest rate policy. The interconnections between global economies remain strong, so weakness abroad can easily spread. With a nod to global pressures, the Fed could readily decrease rates.

Lingering tensions over international trade have been a concern for both the markets and the FOMC. Tarrifs interfere with free trade and can have direct impacts, such as price increases and slower growth, and also unintended impacts, such as displaced workers in adjacent industries or retaliatory tariffs on unrelated goods. The FOMC could easily justify a rate cut based on the negative effects of tariffs and ongoing trade squabbles.

Figure 2 **Core PCE Deflator & FOMC Comfort Zone (2006 - 2019)**



Source: FactSet

The most likely scenario surrounding a rate cut would be the lack of growing inflation, or more precisely, that inflation is running below the Fed's preferred 2% comfort zone. As we have noted in the past, inflation has remained stubbornly low based on many different gauges. While this is not a new story, the FOMC will probably pounce on this issue rather than addressing weaknesses domestically, global economic impacts, or trade tensions, thereby sidestepping any chance to politicize their decision making.

The falling yield curve boosted performance for fixed coupon bonds across the curve. Total returns for the past quarter, year-to-date, and trailing twelve-month periods are solidly in positive territory, all reflecting the lower interest rate environment. Credit spreads, or the additional yield investors require to compensate for default risk, decreased over the quarter as investors sought out the higher yields delivered by Corporate bonds. Spreads are narrow on a historical basis and we remain cautious with our outlook for Corporate bonds.

Performance primarily varied in the second quarter around credit quality. Corporate bonds edged out U.S. Treasury issues, continuing a trend we have seen for some time. Within the Credit sector, lower quality issues easily outpaced higher quality issues. Interestingly, below investment grade bonds trailed as these investments can be vulnerable to recessionary environments. While we do not see a recession as imminent, some investors appear to be shunning these riskier investments.

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Two Seaport Lane ▪ Boston, MA 02210 ▪ 800.234.4516 ▪ www.congressasset.com