Fixed Income Outlook

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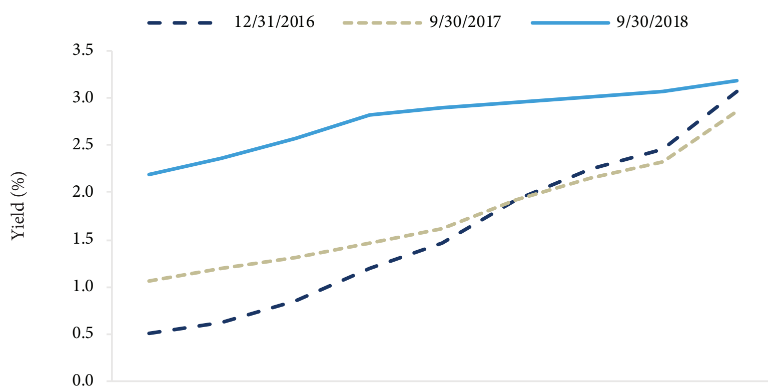
CONGRESS ASSET MANAGEMENT COMPANY

Prospects for fixed income investors grew over the last quarter as yields moved higher, making them more appealing to new entrants. To be sure there are some future rate hikes that may push yields even higher, but rates today are much more attractive than they were one year ago. This makes entry into bonds a more palatable investment for those previously sidelined by historically low yields. This is enhanced by yields that are not just outpacing inflation but also have eclipsed the S&P 500 dividend yield.

As we noted last quarter, the U.S. Treasury yield curve has become higher and flatter over time. The action has been primarily on the short end of the curve as the Federal Open Market Committee (FOMC) has hiked short-term rates three times this year. Current expectations are for one more hike at the tail end of this year and perhaps as many as four hikes in 2019.

U.S. Treasury Yield Curve



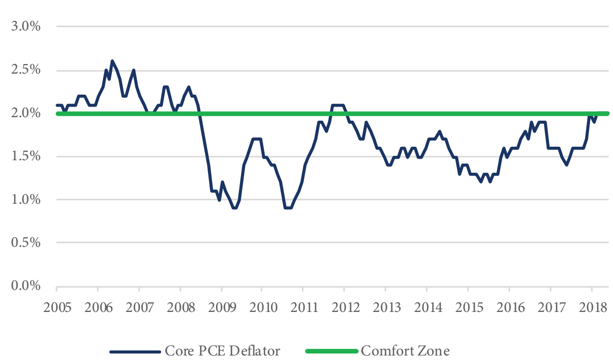
Source: Factset

The most recent statement from the FOMC dropped longstanding language that described its stance on interest rates as "accommodative." This suggests that the FOMC may be looking to slow the pace of its rate hikes and shifting their stance to a more neutral position. Such a middle-ground stance leaves the Fed the option to stand pat and not make any moves, or the option to continue hikes if the economy overheats.

We concur with the FOMC's assessment that the domestic economy is doing quite well. GDP for the second quarter steamed along at 4.2%, the strongest reading in roughly four years. At the same time some segments of the economy, notably existing/new home sales and durable goods orders, were softer towards the end of the quarter. Overall, however, the economy is performing strongly with low unemployment and modest wage growth.

Inflation remains near the FOMC's long term objective of 2%, its so-called comfort zone. The Core PCE deflator, which measures consumer spending inflation without the impact of volatile food and fuel prices, ended the last quarter at 2%. Recent comments from FOMC Chairman Jerome Powell show that the committee is looking ahead to expected growth in this data series, justifying the Fed's inclination to continue to raise rates into 2019. It is also worth noting that headline inflation, which includes the effects of food and fuel, runs only slightly higher at 2.2%.

Core PCE Deflator and FOMC Comfort Zone



Source: Factset

With a limited number of rate hikes ahead and a stable economy underfoot, investors looking towards fixed income securities should rejoice. Yields across the curve are generally at or above inflation, meaning real yields are positive and returns are not being eaten up by price increases in goods and services purchased by consumers. A stable economy suggests a stable bond market, one that has seen the share of corporate debt increase over time while also seeing reduced default risk premiums.

Yields on the 3-month U.S. Treasury Bill are now above the dividend yield of the S&P 500. At the close of the 3rd quarter, the T-Bill yield was 2.18% and the S&P 500 dividend yield was 1.89%. Many income-seeking investors look at this relationship as a telltale for directing their future investments. While the difference may seem small, investors appreciate that the T-Bill is a government-guaranteed return and only need to wait through the short 3-month time frame to receive full payment. Those with a longer investment horizon might also consider the 10-year U.S. Treasury Note which yielded 3.06%.

The second quarter trend in asset class performance reversed in the quarter just concluded. Corporate bond issues regained favor over the quarter and widely outpaced U.S. Treasury and U.S. Agency issues. Within Corporates, lower quality issues outperformed higher quality issues. Credit spreads, the additional yield investors require to compensate for default risk, contracted over the quarter and boosted returns. U.S. Treasury returns turned slightly negative as interest rates rose. Looking on a year-to-date basis, the difference in returns between U.S. Treasury and Corporate issues is narrow. Year-to-date total returns for these two asset classes lie at approximately negative 80 basis points, far from alarming levels as rates have risen.

Despite the resurgence of Corporate bonds, we have maintained our strategy of deemphasizing them in our clients' portfolios. Overall credit spreads remain narrow, especially when viewed in historical context. We aim to build liquid, investment-grade bond portfolios for our clients. At this point, we see no reason to deviate from our long-term strategy of seeking income and returns from the straightforward approach of purchasing high-quality issues. The current market environment remains well suited for conservative investors situated investment grade strategies.

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