FIXED INCOME UPDATE – FIRST QUARTER 2019

KEY POINTS

• U.S. economic data has slowed, but has recently shown signs of bottoming.
• The Federal Reserve abruptly reversed course, abandoning their messaging for additional rate hikes and pivoted back to maintaining an accommodative monetary policy.
• Credit markets rallied during the quarter, largely reversing the widening experienced at the end of 2018.

CHANGE IN TREASURY YIELDS – FIRST QUARTER

Yields across the curve moved lower as the Fed attempts to backtrack from a potential policy mistake.

SOURCE: Northern Trust Fixed Income; U.S. Department of the Treasury
Fixed Income Update – First Quarter 2019

**MACRO UPDATE**

- Economic growth in the U.S. has slowed but we expect the expansion, which is poised to become the longest in history, to continue for the near future.
- Continued progress on U.S.-China trade discussions may prove to be a positive for economic growth.

![Duration of U.S. Economic Expansions](image)

**DURATION OF U.S. ECONOMIC EXPANSIONS**

As of 3/31/19  
SOURCE: Northern Trust Fixed Income; Bloomberg

**CENTRAL BANK UPDATE**

- Based on an acknowledgement of slowing growth and inflation, the Fed halted its hawkish rhetoric, removing all forecasted 2019 rate hikes and communicating to investors that they will be “patient” moving forward.
- After stating that the balance sheet was on auto-pilot in December, the Fed reversed course announcing it will end normalization earlier than expected.
- The European Central Bank announced an additional round of targeted longer-term refinancing operations (TLTROs) and indicated that no lift off in interest rates will occur in 2019.

**FED VS. MARKET EXPECTATIONS**

In many investors eyes the Fed has moved out of the way in an attempt to let the economy regain its footing, providing a tailwind for risk assets.

**Long-Term Views**

- Despite growth in the global economy moderating, ongoing trade tensions, and an inverted yield curve, we do not expect a recession to unfold over the next year.
- While the possibility of a Fed mistake remains a risk case, the market expects them to largely remain on the sidelines.
- We expect global central banks to largely be synchronized, supporting easy monetary policy.

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* Longer term represents FOMC expectations for where the rate is expected to converge over time. Fed funds futures data as of 3/31/2019.  
SOURCE: Northern Trust Fixed Income; Bloomberg
ULTRA-SHORT/CASH UPDATE

Market Overview:
- Overnight rates remain unchanged in the 2.25% - 2.50% channel and the Fed’s removal of all forecasted 2019 rate hikes may have signaled that money market yields have topped out.
- A benign inflation environment coupled with dovish central bank sentiments have led some investors to believe that the next policy move may be a cut.

PROBABILITY OF FED HIKE OR CUT 2019

- Contributor – Sector Allocation
- Detractor – Duration

Current Positioning:
We remain constructive on corporate credit and neutral on our duration target.

U.S. INFLATION – CONSUMER PRICE INDEX (CPI)

Fed Fund futures are pricing in a lower Fed Funds rate by year end with a 70% chance of at least one rate cut.

As of 2/28/19
SOURCE: Northern Trust Fixed Income; Bloomberg
TREASURYS & TIPS UPDATE

Market Overview:
- The 10-year U.S. Treasury note and 3-month U.S. Treasury bill temporarily inverted before reversing, further signaling the markets concerns over a slowdown in economic growth.
- Global interest rates declined during the first quarter, with the 10-year U.S. Treasury yield falling below 2.4% for the first time in over 1 year.

Rates Performance
- Modest Contributor – Duration

Current Positioning:
Portfolios are positioned with a neutral duration relative to their benchmarks.

Falling Interest Rates
German and Japanese 10-year bond yields have shifted into negative territory.

3 MONTH – 10 YEAR U.S. TREASURY SPREAD

FALLING INTEREST RATES
INVESTMENT-GRADE CREDIT UPDATE

Market Overview:
- Following the fourth quarter 2018 selloff, investment grade credit spreads have demonstrated a significant rebound this year.
- The spread tightening during the first quarter supports the view that credit fundamentals remain fairly solid and the spike higher was just indicative of a broader risk-off sentiment.

CORPORATE OPTION-ADJUSTED SPREADS

Greater IG demand pushed the OAS of the Bloomberg Barclays U.S. Corporate Index 34 basis points tighter during the quarter.

YEAR TO DATE PERFORMANCE – CORPORATE BONDS

As of 3/31/19
SOURCE: Northern Trust Fixed Income; Barclays Live
HIGH-YIELD BOND UPDATE

Market Overview:
- After significant outflows in 2018, fund flows turned positive at the start of the year responding favorably to dovish commentary from the Fed and investors renewed appetite for risk.
- The backdrop for high yield remains strong as default rates remain low and interest coverage ratios remain high. Additionally, issuance is expected to remain low for the remainder of 2019.

LARGEST BACK TO BACK INFLOWS SINCE 2016

High-Yield Performance
- Contributor – Sector Allocation and Security Selection
- Detractor – Curve Positioning and Duration

Current Positioning:
Portfolios are positioned in the mid-range of the credit quality spectrum. Issuer selection is of utmost importance as we have few sector overweights outside of banks and energy.

HY flaunted a 6% return through 1Q19 - demonstrating the best start to the year since 2001.

INCREASED DEMAND FOR HIGHER QUALITY BONDS

The ratio of CCC spreads to BB spreads is near its widest level since the end of 2016 during the commodity crisis.
MUNICIPAL BOND UPDATE

Market Overview:
- Longer maturity rates fell more than shorter ones, but we expect continued rewards for investors with extended maturity objectives.
- Muni-U.S. Treasury ratios are expensive out to 10 years, and are below historical averages at all maturities.

Municipal Performance
- Contributor – Yield Curve Positioning
- Detractor – Quality Bias

Current Positioning:
Interest rate exposure should be defensive, expecting a spring with better opportunities to invest at higher yields and cheaper ratios. General obligation issuers with well managed pensions and essential service revenue bonds are favored. Lease revenue and appropriated debt for specific projects should be reduced.

RATIO: AAA MUNI YIELD TO TREASURY YIELD

Increased Value in Municipal Bonds
Increased Value in Taxable Bonds

SOURCE: Northern Trust Fixed Income; Bloomberg
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