Fixed Income Strategies

QUARTERLY UPDATE

First Quarter 2019

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Review & Outlook

The U.S. Federal Reserve has done a complete about-face from the guidance we were hearing in December. The Fed has all but pledged to eschew rate hikes for the rest of the year, as well as signaled that rate cuts could be coming if necessary. We believe this is more than just a reassessment of the economy. This is a true shift in monetary policy strategy, the consequences of which could change how we think about Fed policy into the future.

From the 1980s until now, the Federal Reserve has viewed controlling inflation as its primary mandate. The Fed realized the mistake of the 1970s, which was to allow inflation expectations to get out of control, which in turn became a self-fulfilling prophesy. One reason why inflation expectations exploded higher was that the Fed did not have credibility. It had not acted decisively to fight inflation early in the '70's and therefore economic agents did not trust that the Fed took price stability seriously.

Since this time, the Fed has worked to maintain its inflation-fighting credibility above all else. Even in the throes of the Financial Crisis, the Fed consistently talked about fighting inflation if it were to rebound. In recent years, the desire to protect this credibility has led the Fed to hike rates preemptively as unemployment has fallen even though there has not been any sign of accelerating inflation.

Now the Fed is signaling a willingness to take risks on inflation. The decision to keep rates where they are indicates that the Fed thinks it will be more difficult to fight a recession than to fight inflation, should it start rising. It is a big change, and one that will force all of us to change the way we think about Fed policy.

Markets have taken notice. The bond market is now pricing in a 70% chance of a rate cut in 2019, with a 25% chance of more than one cut. Stocks have also responded, staging an impressive rebound, jumping 13% in the first quarter, which marks the best quarter since 2009.

We cannot say how this will play out. The Fed could wind up getting it just right—that is, by halting rate hikes now or perhaps cutting rates once or twice later this year, the Fed manages to stabilize the economy at a solid pace. Earnings growth continues, and risk assets perform well, while general interest rates remain low. Alternatively, it could be that global economic weakness drags the U.S. down into a full-blown recession. In that case, Treasury rates probably are meaningfully lower.

We can say that in any given economic scenario, the Fed is probably going to err on the side of having interest rates be too low. All else being equal, this probably reduces downside risks to equities and credit but also results in interest rate scenarios being skewed toward rates being lower.

Across all of our strategies, we attempt to garner outperformance primarily through security selection. If we think about this shift by the Fed in terms of our individual bond selections, we want to have portfolios that can perform well given either the "just right" scenario or one where the economy weakens further.

In corporate credit, this means finding companies that can weather a recession due to a less cyclical business model, balance sheet flexibility or both. In structured bonds, this means looking for structures with plenty of room to absorb greater loan loss rates. It also means avoiding bonds with substantial underperformance potential should interest rates fall considerably. Certain mortgage bonds are an example. A large chunk of the mortgage universe would be refinanceable if rates fell modestly from here. As a result, bonds with unfavorable coupon rates would likely not appreciate much should rates fall but could suffer if rates rise. In this environment, that is a particularly poor risk/reward.

In municipals, this shifting Fed stance had an especially profound impact. The municipal yields fell even more significantly than Treasury bonds during the quarter. Generic 10-year AAA bond yields have fallen almost 100bps (2.80% to 1.88%) from their recent November 2018 highs. Similar to last

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INDEX PERFORMANCE AS OF 03/31/2019 (%)

INDEX NAME	3-MONTH	PAST 12 MONTHS
Bloomberg Barclays U.S. Aggregate Bond Index	2.94	4.48
Bloomberg Barclays Int. Aggregate Bond Index	2.28	4.33
Bloomberg Barclays U.S. Treasury Index	2.11	4.22
Bloomberg Barclays Long U.S. Treasury Index	4.67	6.24
Bloomberg Barclays Mortgage-Backed Sec. Index	2.17	4.42
Bloomberg Barclays U.S. Corporate Index	5.14	4.94
Bloomberg Barclays U.S. Corporate High-Yield Index	7.26	5.93
Bloomberg Barclays U.S. Municipal Bond Index	2.90	5.38

Source: Bloomberg. Please see disclosure statements on page 2 for additional information and for a complete list of terms and definitions.

year, demand continues to outpace supply. While the Fed is unlikely to hike rates, muni investors are less worried about interest rate risk. We also believe that higher effective state-level tax rates are contributing to muni demand. This renewed demand for tax-free munis has been met with an anemic supply of bonds. Primary market issuance in the first quarter was down roughly 20% versus the trailing 10-year average of the same time period. We expect this favorable technical condition to hold for the near term, as municipal bonds generally remain one of the best tax shelters available for wealthy individual investors.

In all portfolios, we continue to aim for above-market income generation, using an overweight of credit instruments generally to get there. Of course, there is no way to position portfolios to guarantee outperformance, but we think by starting with strong income generation, we tilt the odds in our favor. From there, we focus our individual security analysis on downside protection, which helps us navigate negative economic scenarios. Finally, we maintain enough portfolio flexibility to take advantage of opportunities, which tend to arise during market downturns. This allows us to perform well as the cycle turns positive again. While this approach may or may not allow for outperformance in any given quarter, we think it is a strong road map for performance over the cycle and through this period of uncertainty.

Disclosures

Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged, market-value-weighted index composed of taxable U.S. investment-grade, fixed rate bond market securities, including goverrnment, government agency, corporate, asset-backed, and mortgage-backed securities between one and 10 years.

Bloomberg Barclays Intermediate Aggregate Bond Index is an unmanaged index that consists of 1-10 year governments, 1-10 year corporates, all mortgage and all asset-backed securities within the Aggregate Index.

Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays Long U.S. Treasury Index includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value.

Bloomberg Barclays Mortgage-Backed Securities Index is a market-value-weighted index that covers the mortgage-backed securities component of the Barclays U.S. Aggregate Bond Index. The index is composed of agency mortgage-backed passthrough securities of the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least 1 year. The index includes reinvestment of income.

Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers that meet specified maturity, liquidity and quality requirements.

Bloomberg Barclays U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. The U.S. Corporate High-Yield Index was created in 1986, with history backfilled to July 1, 1983, and rolls up into the Barclays U.S. Universal and Global High-Yield Indices. The U.S. Corporate Index rolls up to other Barclays flagship indices, such as the U.S. Aggregate and the multi-currency Global Aggregate Index.

The **Bloomberg Barclays U.S. Municipal Bond Index** covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

An investor cannot invest directly in an index.