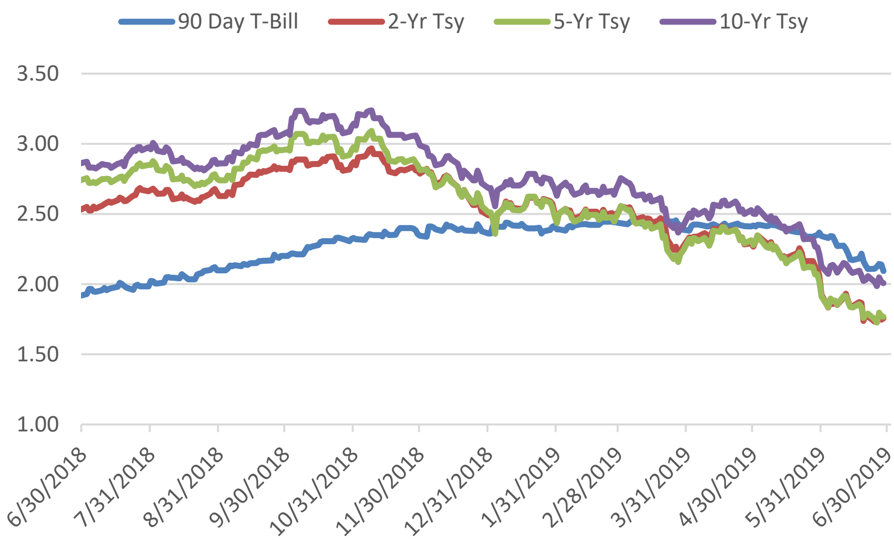
MARKET Commentary

Summer 2019

Goldilocks

Risk assets rallied, albeit not as sharply as in the opening quarter, and risk-free Treasury yields accelerated their decline (see Figure 1) as slowing economic growth and trade concerns led to increasingly dovish signals from developed market central banks. The 10-year Treasury yield peaked at 2.60% early in the quarter before plunging to 2.01% at the end of June.

Figure 1: Treasury Yields Fall



Source: Bloomberg

The Federal Reserve's 180-degree policy pivot was cemented at its June meeting when the bank signaled an upcoming cut due to looming economic uncertainties and tepid inflation. Consequently, the two-year Treasury yield fell 52 basis points over the quarter, the most since the fourth quarter of 2008.

Investment grade credit spreads tightened further topping all sector returns. The lowest-rated credits outperformed their higher-quality counterparts. Positive stock market momentum provided support for the sector as did technical support due to lower issuance over the first half of the year.

Monetary policy which had paused from cautious normalization has transitioned to accommodative policy with the July rate cut. Economic growth has slowed and central banks are poised to provide further accommodative policy measures to stave off further deceleration providing a supportive environment for markets where modest growth and easy policy are neither too hot nor too cold.

US Treasuries

As of 28-Jun

Benchmark	Yield
3 Month	2.09%
6 Month	2.09%
1 Year	1.93%
2 Year	1.76%
5 Year	1.77%
10 Year	2.01%
30 Year	2.53%

ICE BofAML Index Returns

Q2, 29-Mar to 28-Jun

Index	Return
1-3 Yr Gov/Corp ≥ A	1.46%
1-3 Yr Municipals	0.85%
1-3 Yr Agencies	1.30%
0-3 Month UST	0.62%
S&P 500	4.30%

Source: US Treasury, Bloomberg, ICE/BofAML, and S&P

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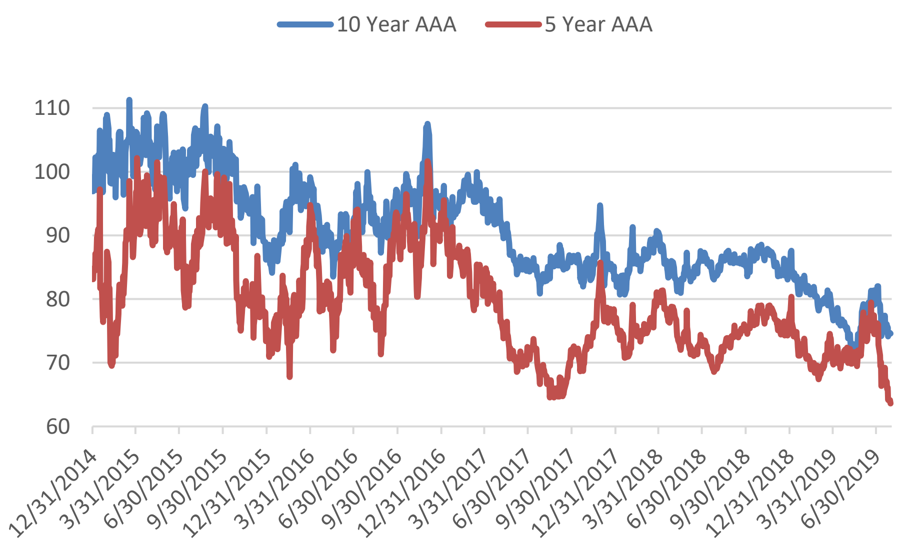
Municipal Slowdown Ahead?

The municipal sector has been on a tear over the past year. Returns in the municipal space mirrored the corporate sector as lower rated issuers outperformed their higher rated counterparts. Illinois and New Jersey issuer performance led all states. Inflows to the asset class are on record pace for the first six months of 2019 while the supply of bonds is shrinking. The Trump Administration's tax overhaul which limited state and local deductions have retail investors (the largest buyer base in the sector) clamoring for tax-free income. It also contributed to some of the decline in municipal securities outstanding by removing the tax exemption for advance refundings. More demand and less supply has created a great environment for borrowers to come to market. Also, fundamentals look reasonable as higher-than-expected tax revenues fill municipal coffers.

The sector has largely kept pace with the torrid pace of decline in Treasury yields year-to-date, even after the June setback (see Figure 2). Further, one-year municipal debt is trading at its lowest level (55% of comparable Treasury bonds) since 2001 while 5 and 10-year municipal debt ratios are 63% and 74% respectively far below their long-term averages.

Figure 2: AAA Municipal Bond Treasury Ratios (% 5 and 10 Year)



Source: Bloomberg

One year AAA-rated municipal debt yields 1.09% compared to a 1.99% Treasury yield. An effective tax rate of 45% is required to bring those two yields into parity suggesting investors should be looking to rotate out of rich municipal bonds into Treasury bonds or other securities and pay taxes. For most corporate investors, taxable bonds make more sense regardless of duration due to their lower tax rate. While we don't expect a mass municipal exodus, we expect to see some underperformance over the second half of the year especially as issuance picks up in the third quarter.

Easy Does It

The Federal Reserve (Fed) recently cut the federal funds rate by 25 basis points at their July meeting. The Fed also announced that balance sheet reduction would end on August 1st a full two months earlier than planned. Chairman Powell characterized the move as a "mid-cycle adjustment" and not the beginning of a "lengthy cutting cycle". Markets disliked the perceived hawkish commentary. However, Powell described the decision as a risk-management effort to mitigate the downside effects that the global slowdown and trade tensions could have on the relatively healthy U.S. economy. There were two dissents against the cut illustrating the decision to do so was not an easy one. In the end, the Fed delivered the cut that markets had expected and provided a neutral stance for future accommodative policy and will act, if needed, to sustain domestic economic expansion.

Prior to the Fed meeting, the European Central Bank (ECB) held pat at their July meeting but provided a heavy dose of dovish commentary signaling easy policy steps (rate cuts, quantitative easing and forward guidance enhancements) are likely to be announced in September. Chairman Draghi noted that risks remain tilted to the downside and the specter of a messy Brexit sits on the immediate horizon. Although, it's difficult to imagine that further accommodative policy measures can jump start a stagnant economic environment that is lacking the political capacity to introduce coordinated efforts to stimulate growth. The ECB may be pushing on a string at this point.

The global shift to accommodative policy has driven negative yielding debt levels to a record high (see Figure 3). For context, 85% of German sovereign debt and the entire Swiss sovereign yield curve is negative yielding upending traditional fixed income analysis. Additionally, some $2 trillion in corporate bonds have sub-zero yields. This dynamic continues to be supportive for debt issuers and will drag on U.S. Treasury yields even as borrowing to fund large deficits tops $1 trillion annually.

Figure 3: Global Negative Yielding Debt ($, tn)

Source: Bloomberg

Looking Forward

Monetary policy has regained prominence globally as developed central bank policy shifted from a short pause to accommodative over the first half of 2019 broadly supporting markets. While domestic growth is expected to slow, an outright recession does not seem likely over the coming year. The path for future cuts will be determined by macro risks and incoming economic data. Headline risk remains high as the U.S. heads into the next national election, Brexit stumbles towards another deadline and trade wars drag on. If volatility surges, selloffs will serve as opportunities to add exposure to spread product.

Modestly slower economic growth, limited inflation pressures, and renewed accommodative monetary policy should create a supportive environment for bond investors in the second half of the year.

Please contact the desk with questions or to discuss investment opportunities in today's market.

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