# Fixed Income Monthly Market Update

## July 2019

**Prepared by the Portfolio Strategies Group**


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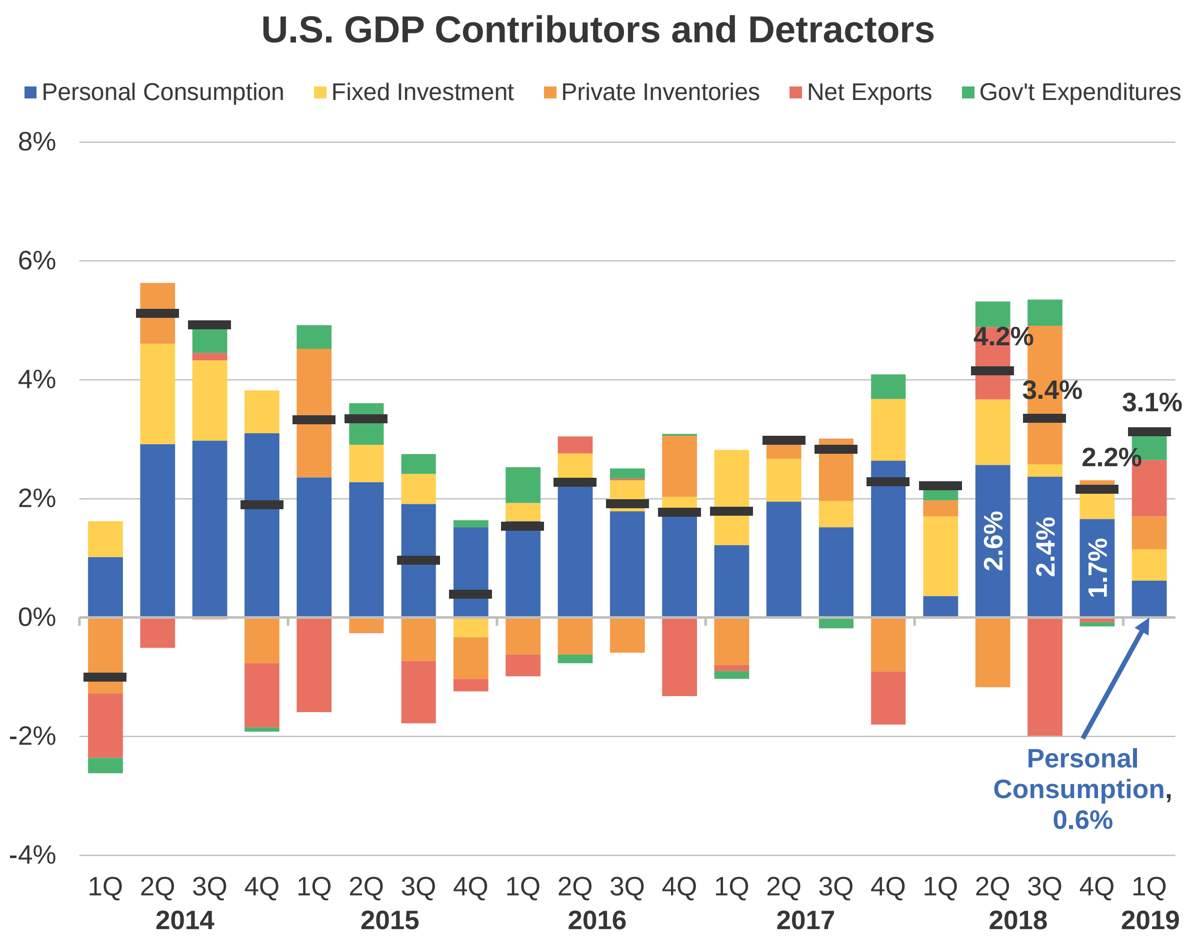
## Current Market Themes

- The second quarter saw plunging interest rates, surging equity prices, mixed economic data and increasing global growth concerns. While few economists expect the decade-long U.S. expansion to end soon, the Federal Reserve's (Fed) cautionary tone set the stage for rate cuts in the second half of the year.
- U.S. economic conditions are characterized by:
  - Solid gross domestic product (GDP) growth in Q1, but more tempered expectations for Q2 and Q3;
  - Strong job growth, with a low unemployment rate of 3.7%;
  - Softening inflation pressures; and
  - Increased downside risks, including a slowdown in manufacturing, weaker business investments and protracted trade wars.
- U.S. Treasury yields fell for a third consecutive quarter, reflecting expectations for Fed rate cuts and increased uncertainty about future global economic growth. The yield curve inversion deepened further, with yields on a majority of benchmark U.S. Treasury maturities now at their 18-month lows.
- U.S. GDP grew 3.1% in Q1, up from 2.2% in Q4. Growth was driven by an unexpected improvement in net exports and outsized growth in inventories, factors that are not likely to be sustained. Forecasts for Q2 are substantially lower – generally in the 1.5% to 2.0% range.
- At its June meeting, the Federal Open Market Committee (FOMC) left the overnight fed funds rate at a target range of 2.25%-2.50%, but acknowledged soft business investment, declining market-based inflation measures and increased uncertainty to the outlook. In subsequent communications, Fed chair Powell all but assured a first preemptive rate cut will occur at the Fed's next meeting on July 30-31.
- Equity investors seem to rejoice in the Fed's move dovish stance, reaching new record highs. The S&P 500 returned 4.3% for Q2 and is now up 17.3% for the year – the best first half of a year since 1997.

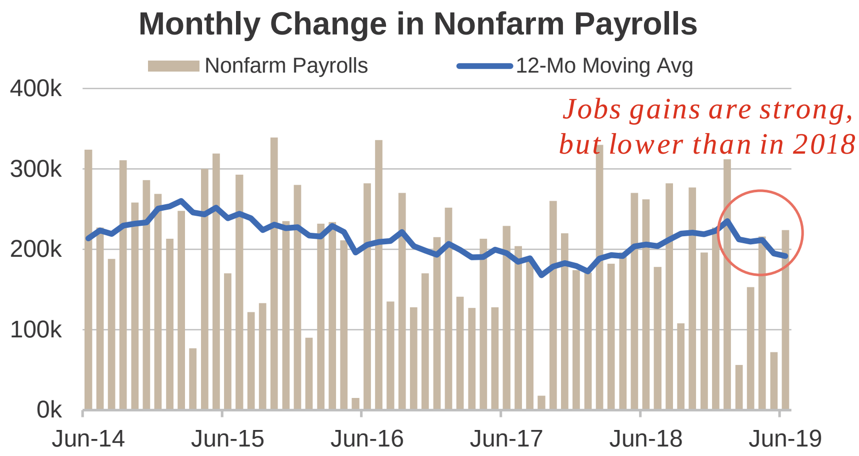
# Q1 GDP Beats Expectations

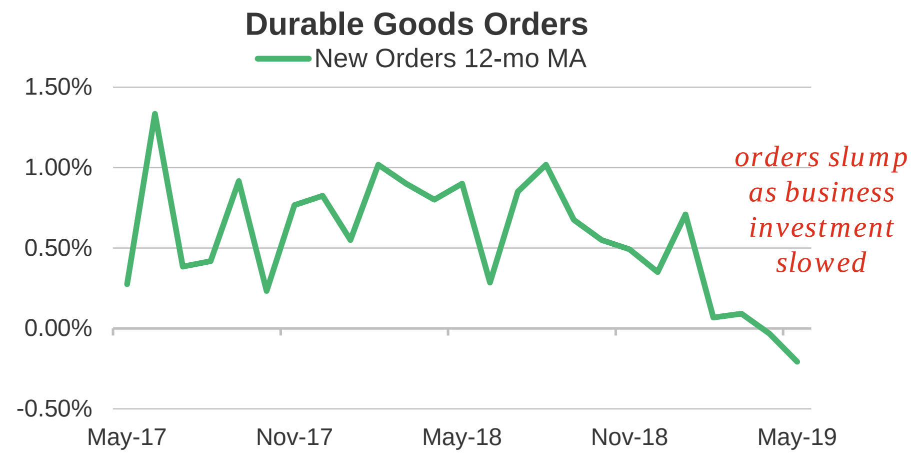


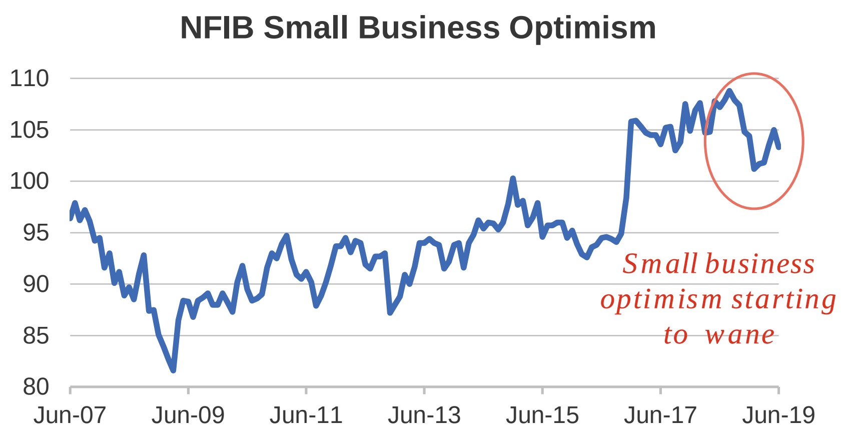

Source: Bureau of Economic Analysis

- The final reading for 1st quarter GDP remained unchanged at 3.1%
- **Personal consumption** was more subdued, revised lower and posted its lowest contribution since Q1 2018.
- **Business investment** was stronger than previously estimated, though still relatively weaker than in previous quarters
- **Net exports** and **inventory** growth contributed strongly to GDP, but are unlikely to be sustainable.

# Economic Data Somewhat Mixed



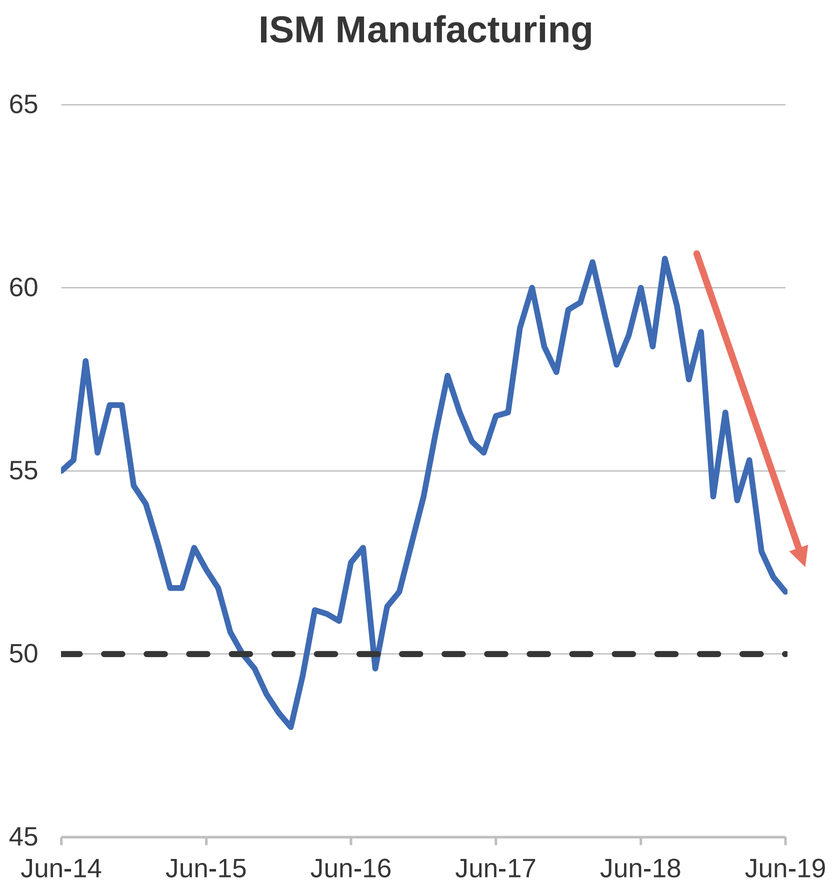



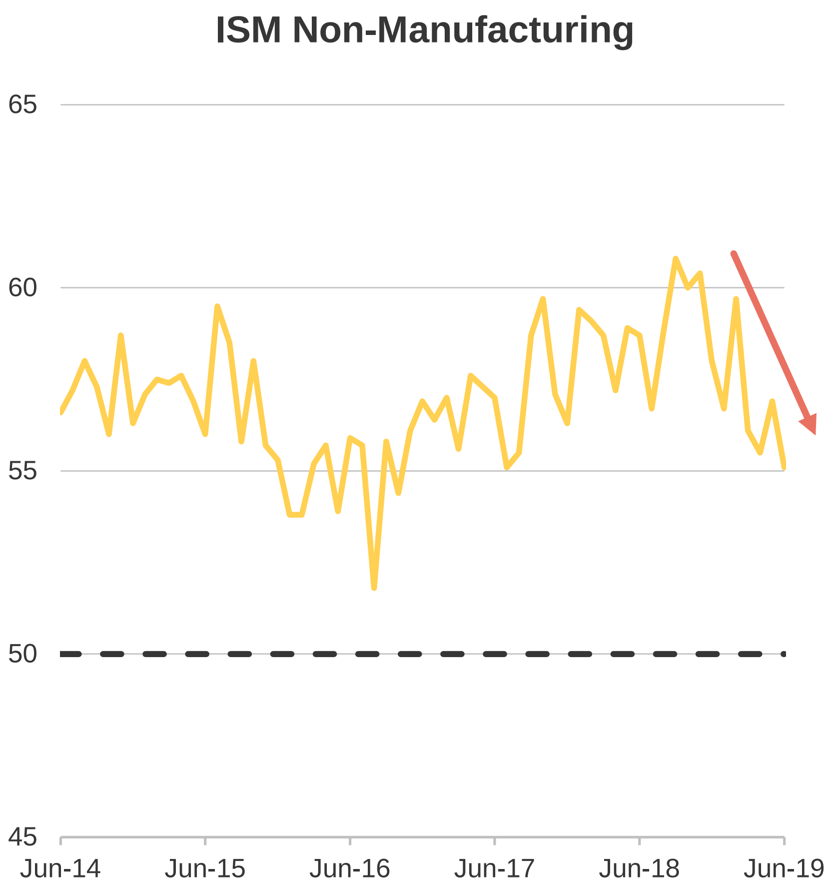





Source: Bloomberg, as of 6/30/2019.

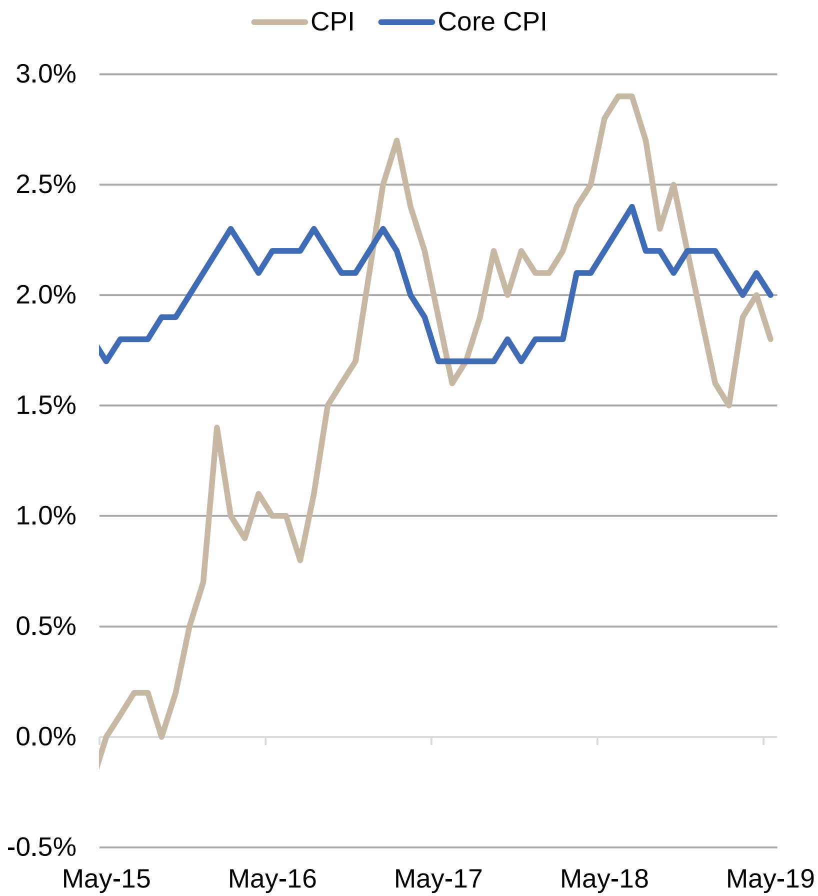
# ISM Survey Indices Slowing Sharply as Trade Wars Take a Toll

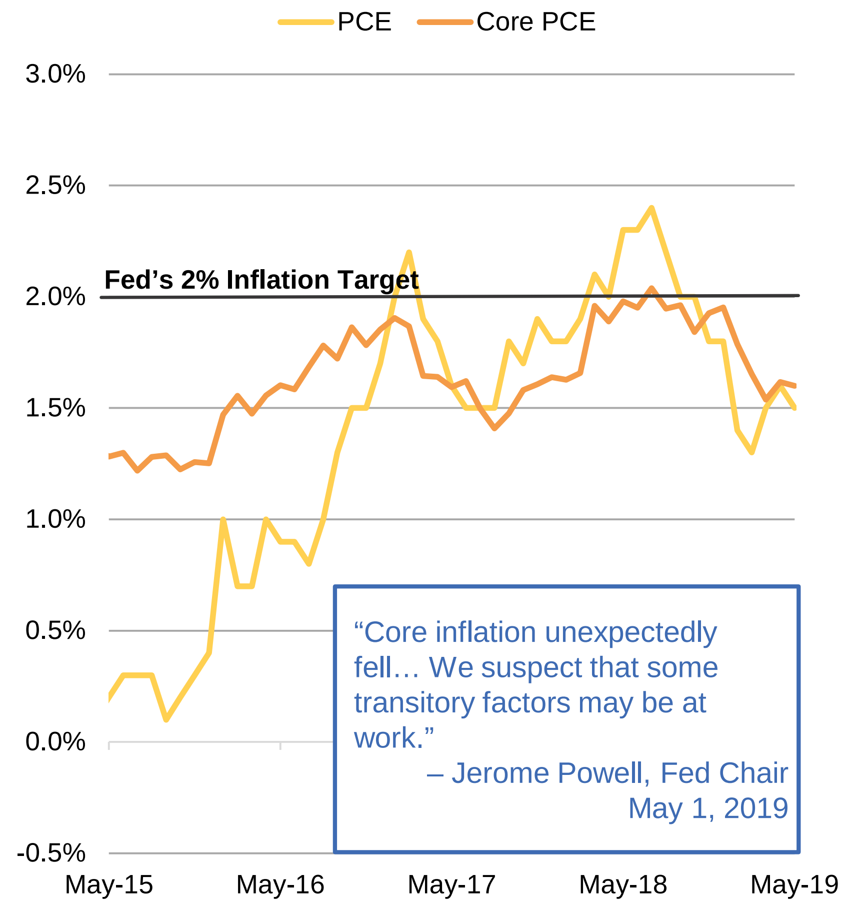



Source: Bloomberg, as of 06/30/19.

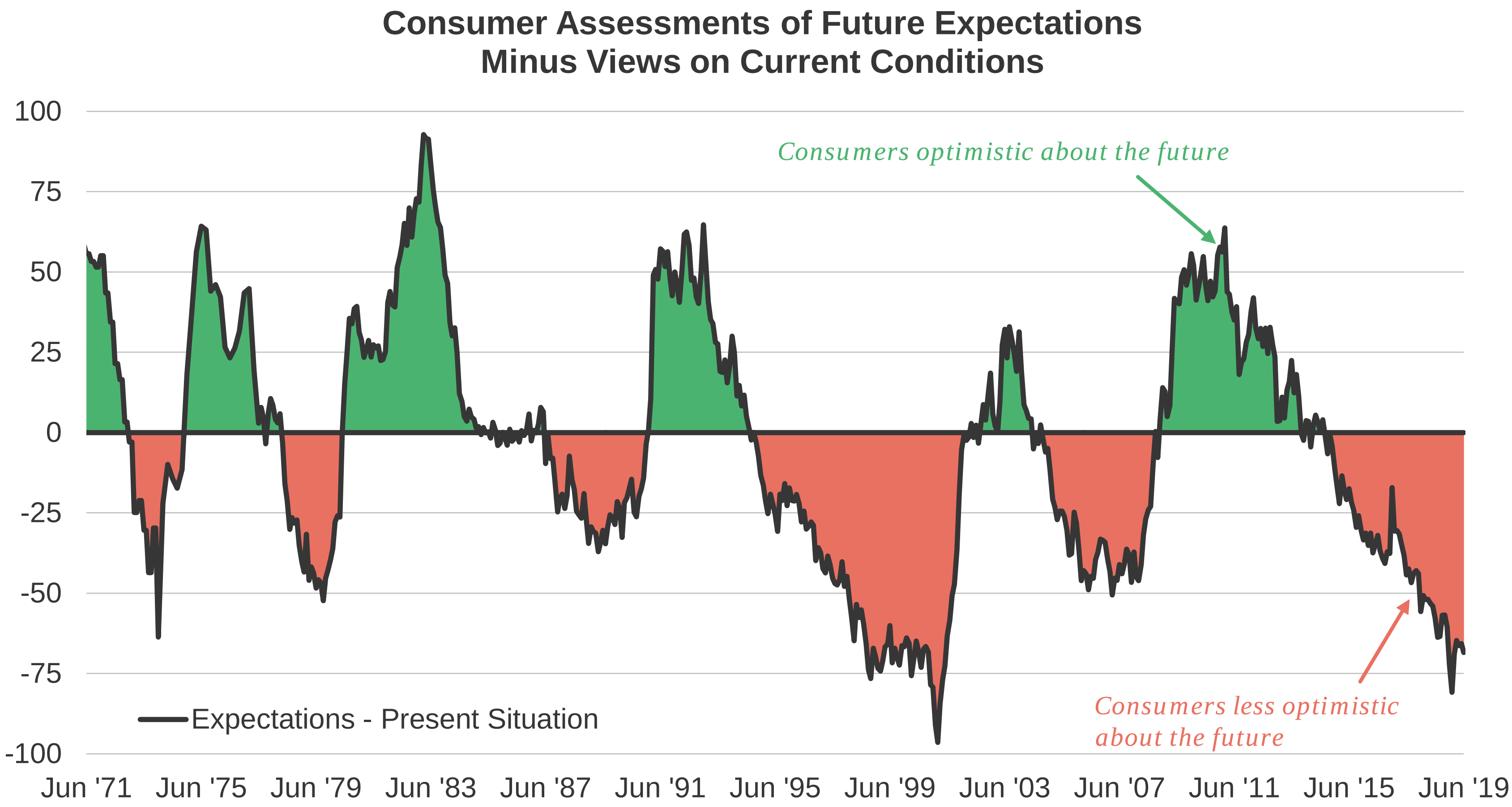
# Inflation Running Persistently Below Target



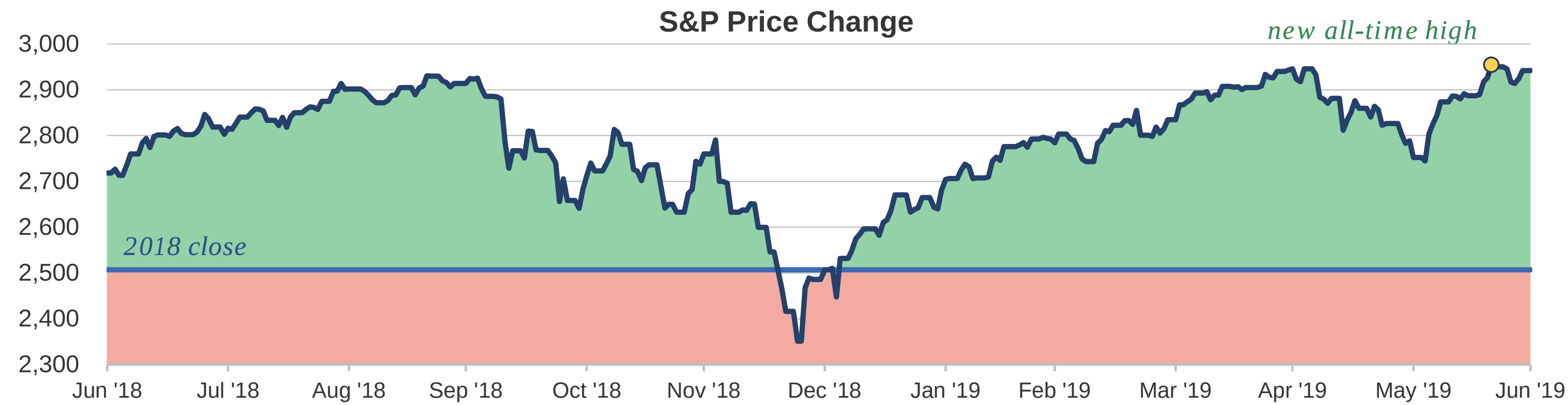

Source: Bloomberg, CPI as of 5/31/19. PCE as of 5/31/19.

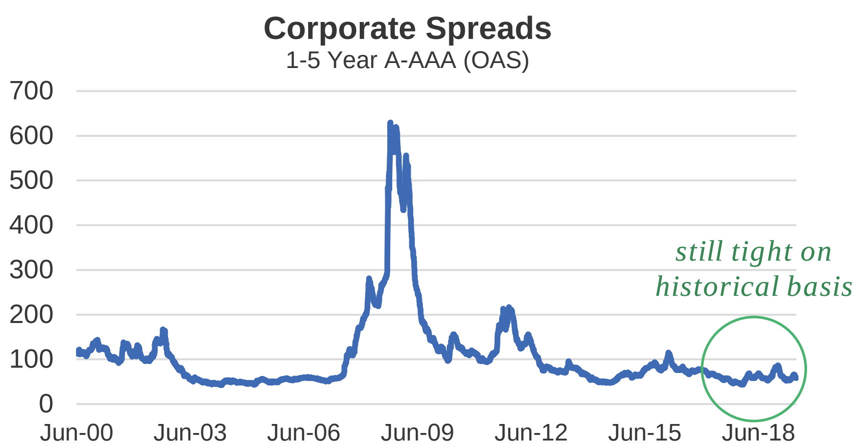
# Consumer Expectations Are Weakening

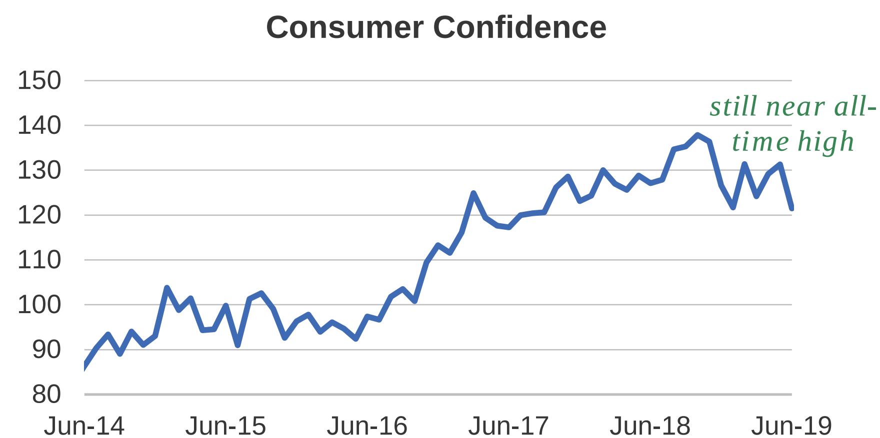



Source: Bloomberg and Conference Board, as of 05/31/2019.

# On the Other Hand, Key Market Metrics Remain Strong




Source: Bloomberg, as of 6/30/2019.

# Retail Sales Rebound from Weakness in Late 2018

*retail*
+0.5%

*auto and other motor vehicles*
+0.7%

*clothing and clothing accessories*
0.0%

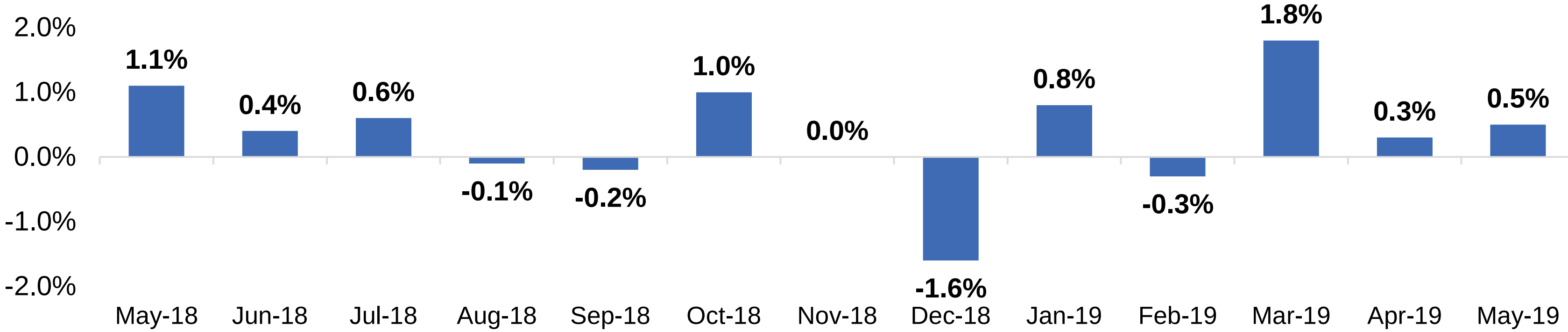
*furniture and home furnishings*
+0.1%

*food and beverage stores*
-0.1%

*restaurants and bars*
+0.7%

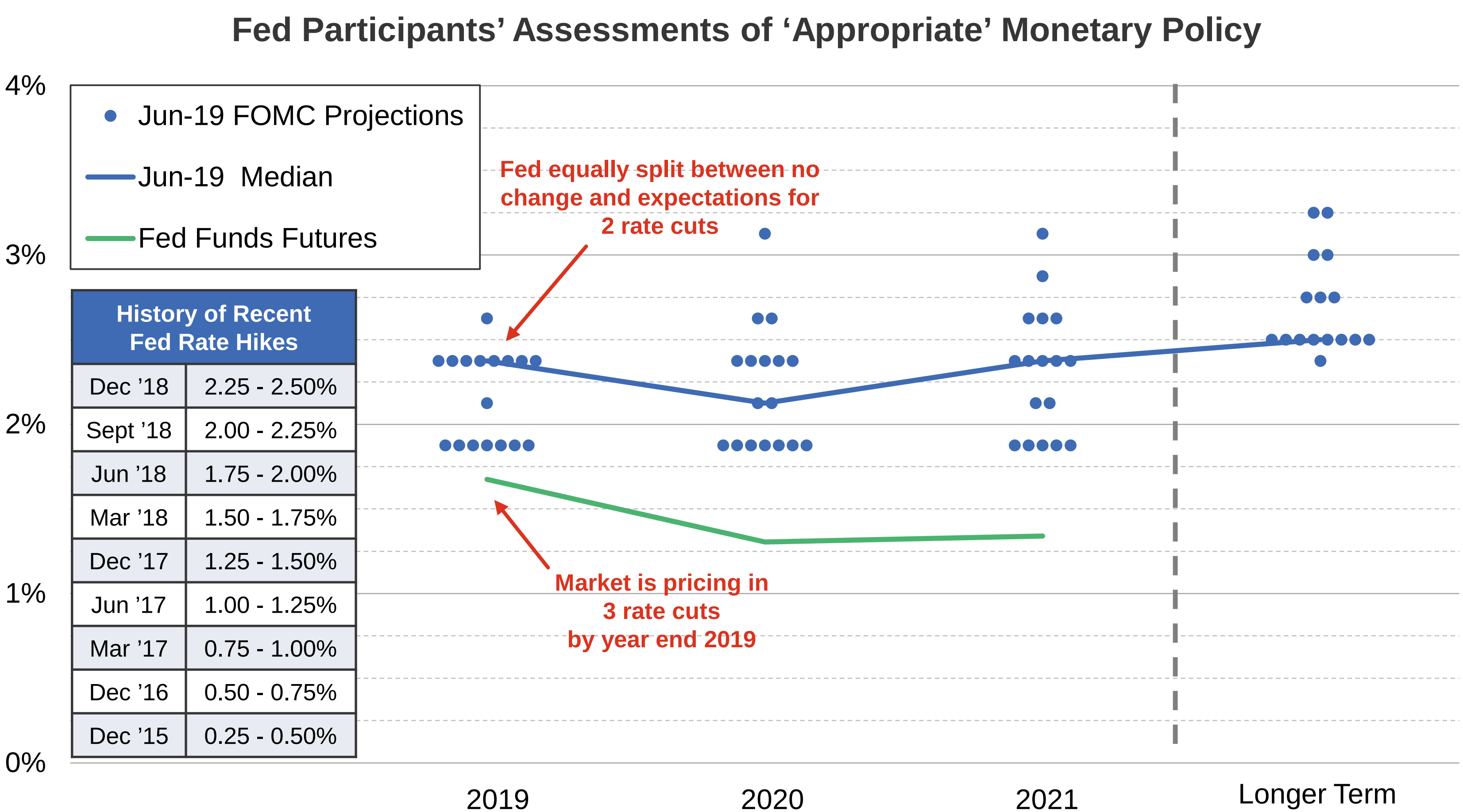
*electronics and appliances*
+1.1%

**Retail Sales**




Source (top): U.S. Census Bureau, as of 05/31/2019. Source (bottom): Bloomberg.

# Market Projecting Multiple Rate Cuts by Year End




| History of Recent Fed Rate Hikes | |
|---|---|
| Dec '18 | 2.25 - 2.50% |
| Sept '18 | 2.00 - 2.25% |
| Jun '18 | 1.75 - 2.00% |
| Mar '18 | 1.50 - 1.75% |
| Dec '17 | 1.25 - 1.50% |
| Jun '17 | 1.00 - 1.25% |
| Mar '17 | 0.75 - 1.00% |
| Dec '16 | 0.50 - 0.75% |
| Dec '15 | 0.25 - 0.50% |

Source: Federal Reserve and Bloomberg. Individual dots represent each Fed members' judgement of the midpoint of the appropriate target range for the federal funds rate at each year-end. Fed funds futures as of 6/19/19.

## Fed Keeps Rates Steady in a Dovish Statement

| June |
| --- |
| 19 |

- Information received since the FOMC met in May indicates that the labor market remains strong and that **economic activity is rising at a moderate rate.**
- Job gains have been solid, on average, in recent months, and the unemployment rate has remained low. Although growth of household spending appears to have picked up from earlier in the year, **indicators of business fixed investment have been soft.**
- On a 12-month basis, overall inflation and inflation for items other than food and energy are running below 2 percent. **Market-based measures of inflation compensation have declined**; survey-based measures of longer-term inflation expectations are little changed.
- The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but **uncertainties about this outlook have increased**. In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will **act as appropriate to sustain the expansion**…
- In support of the Committee's goals, the Committee decided to **maintain the target range for the federal funds rate at 2¼ to 2½ percent**.

Source: Federal Reserve.

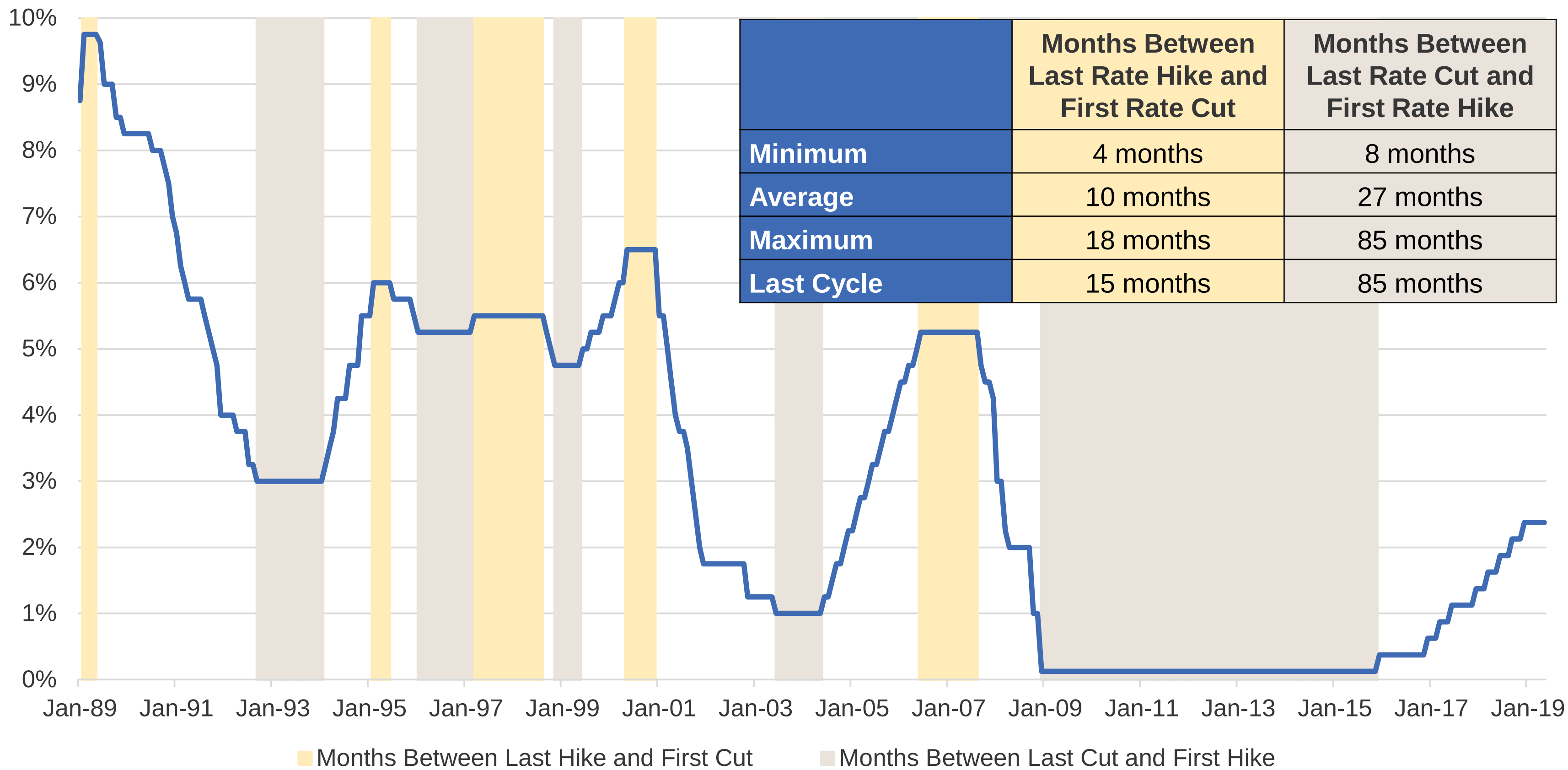
## The Fed's Updated Economic Projections – June 2019

| Indicator | 2019 | | 2020 | | 2021 | | Longer run | |
|---|---|---|---|---|---|---|---|---|
| | Mar. | Jun. | Mar. | Jun. | Mar. | Jun. | Mar. | Jun. |
| Real GDP (YoY) | 2.1% | 2.1% | 1.9% | 2.0% | 1.8% | 1.8% | 1.9% | 1.9% |
| Unemployment Rate | 3.7% | 3.6% | 3.8% | 3.7% | 3.9% | 3.8% | 4.3% | 4.2% |
| PCE Inflation (YoY) | 1.8% | 1.5% | 2.0% | 1.9% | 2.0% | 2.0% | 2.0% | 2.0% |
| Core PCE (YoY) | 2.0% | 1.8% | 2.0% | 1.9% | 2.0% | 2.0% | - | - |
| Federal Funds Rate (Median) | 2.4% | 2.4% | 2.6% | 2.1% | 2.6% | 2.4% | 2.8% | 2.5% |

Source: Federal Reserve, as of June 2019. Green denotes an improved projection in June compared to March, red for worse.

# Fed Has Historically Been Slow to Raise Rates, Quick to Cut

**Federal Funds Target Rate - Midpoint**

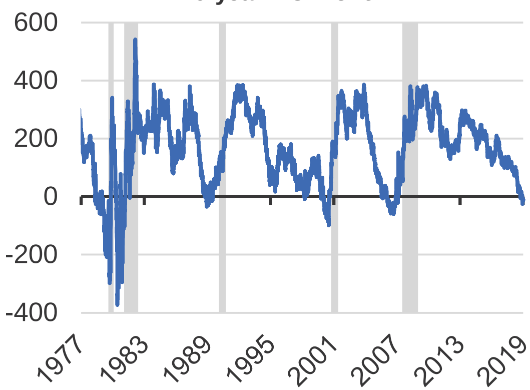



| | Months Between Last Rate Hike and First Rate Cut | Months Between Last Rate Cut and First Rate Hike |
|---|---|---|
| **Minimum** | 4 months | 8 months |
| **Average** | 10 months | 27 months |
| **Maximum** | 18 months | 85 months |
| **Last Cycle** | 15 months | 85 months |

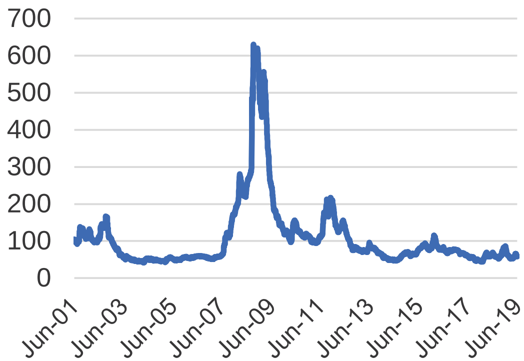
Source: Bloomberg, January 1989 – May 2019.

# Market Indicators Weakening, But Not Yet Pointing to Imminent Recession

**Yield Curve (bps)**
**10-year – 3-month**

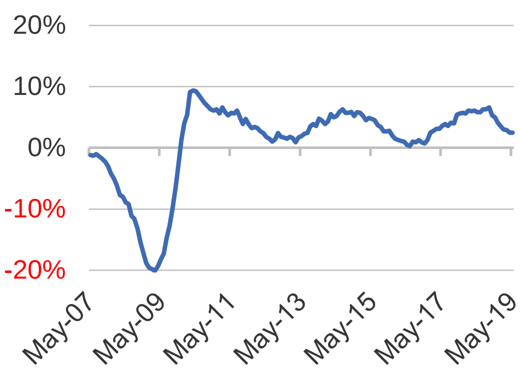



**Corporate Yield Spreads**
**1-5 Year A-AAA (OAS)**



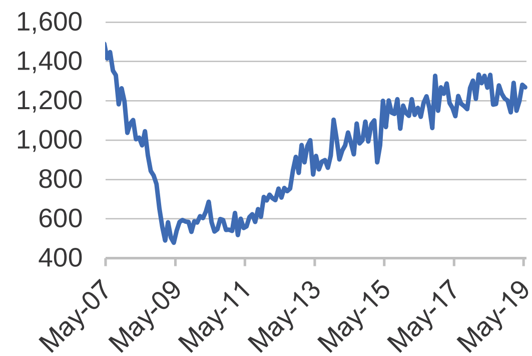

**ISM Manufacturing**


**Index of Leading Indicator**
**(SA, YoY)**



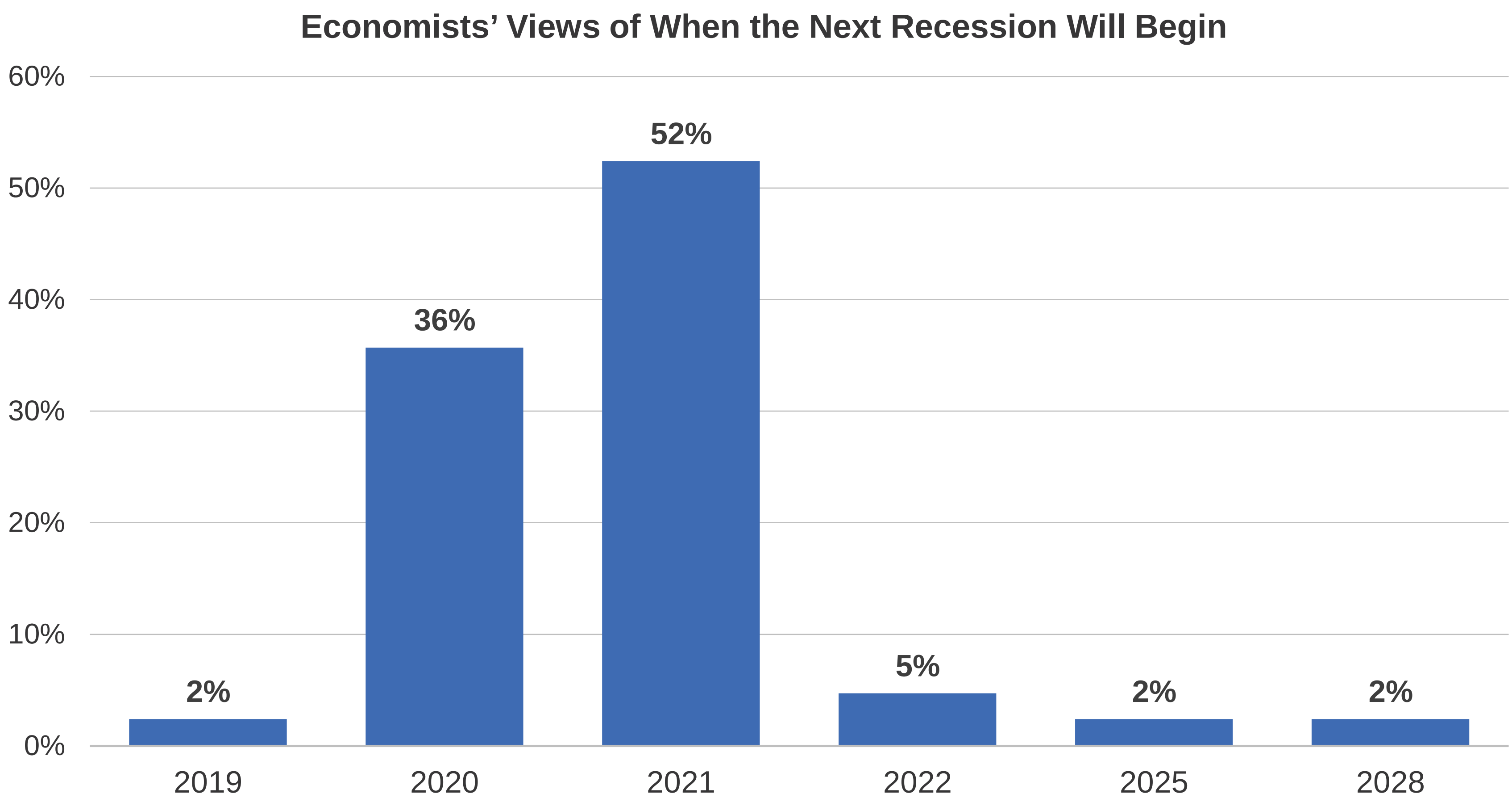

**Initial Jobless Claims**


**Housing Starts**
**(000s, saar)**




Source: Bloomberg, as of 6/30/2019.

## When is the Next Recession?




Source: Wall Street Journal, as of 5/31/19.

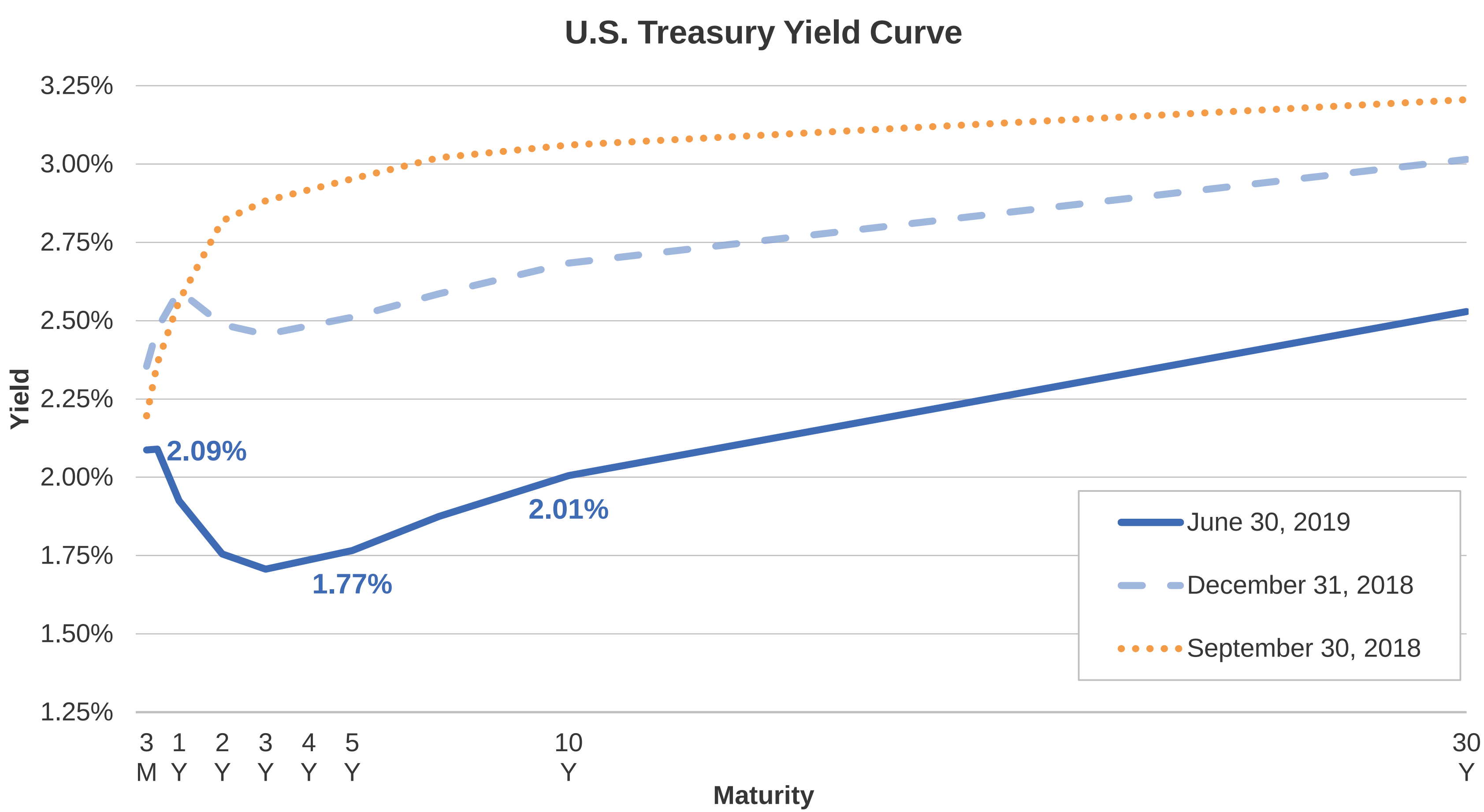
# Treasury Yields Continue to Plummet

2-Year Treasury


10-Year Treasury


Source: Bloomberg, as of 6/30/19.

# Yield Curve Remains Mostly Inverted



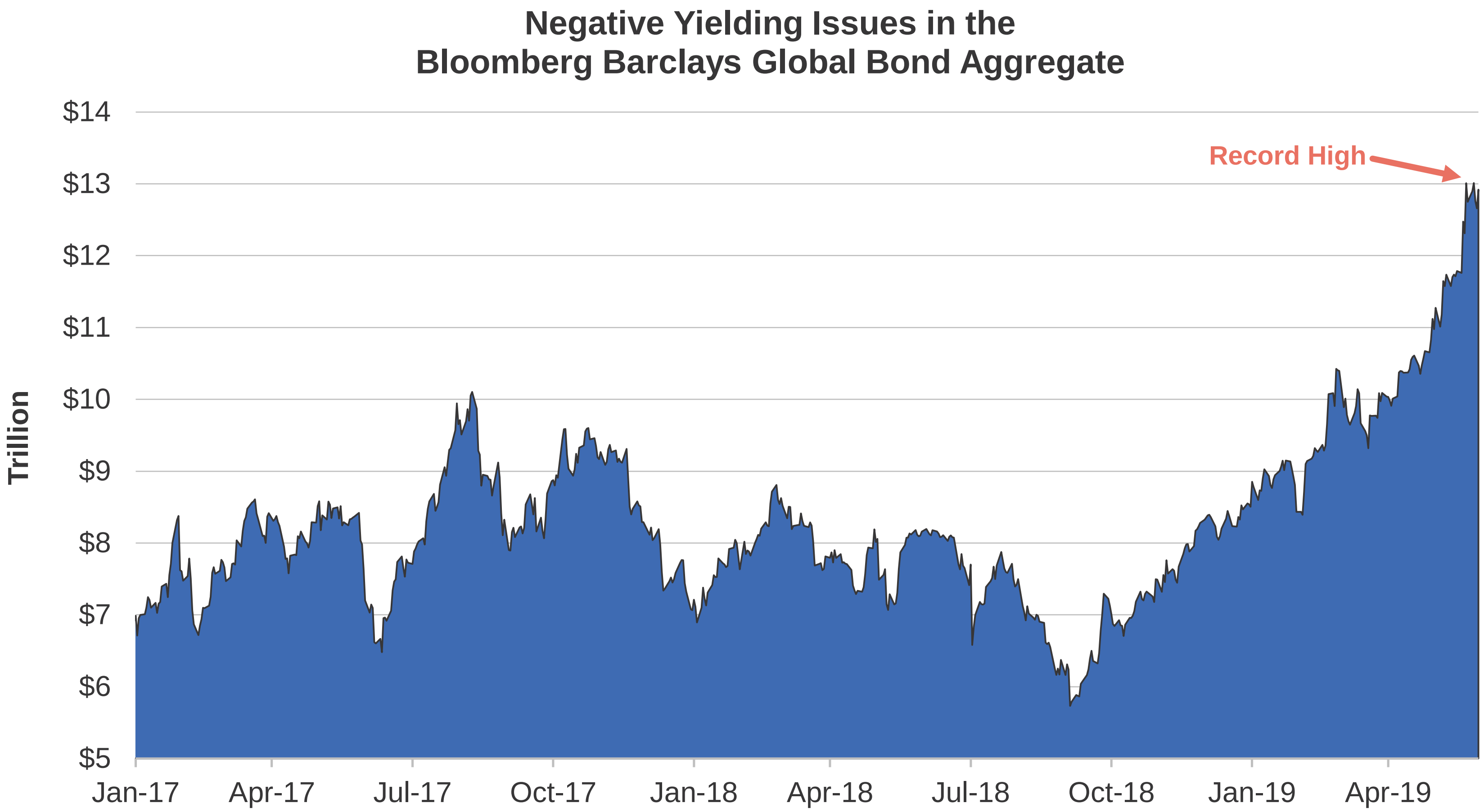

Source: Bloomberg, as of 6/30/19.

# Yield Environment as of June 30, 2019

| Maturity | Treasury | Federal Agency | AA Corporate | A Corporate | BBB Corporate |
|---|---|---|---|---|---|
| **3-Month** | 2.09% | 2.04% | 2.18% | 2.34% | 2.57% |
| **1-Year** | 1.93% | 1.96% | 2.15% | 2.29% | 2.54% |
| **2-Year** | 1.75% | 1.89% | 2.09% | 2.26% | 2.55% |
| **3-Year** | 1.71% | 1.88% | 2.09% | 2.26% | 2.59% |
| **5-Year** | 1.77% | 1.87% | 2.23% | 2.42% | 2.82% |
| **10-Year** | 2.01% | 2.26% | 2.68% | 2.93% | 3.48% |

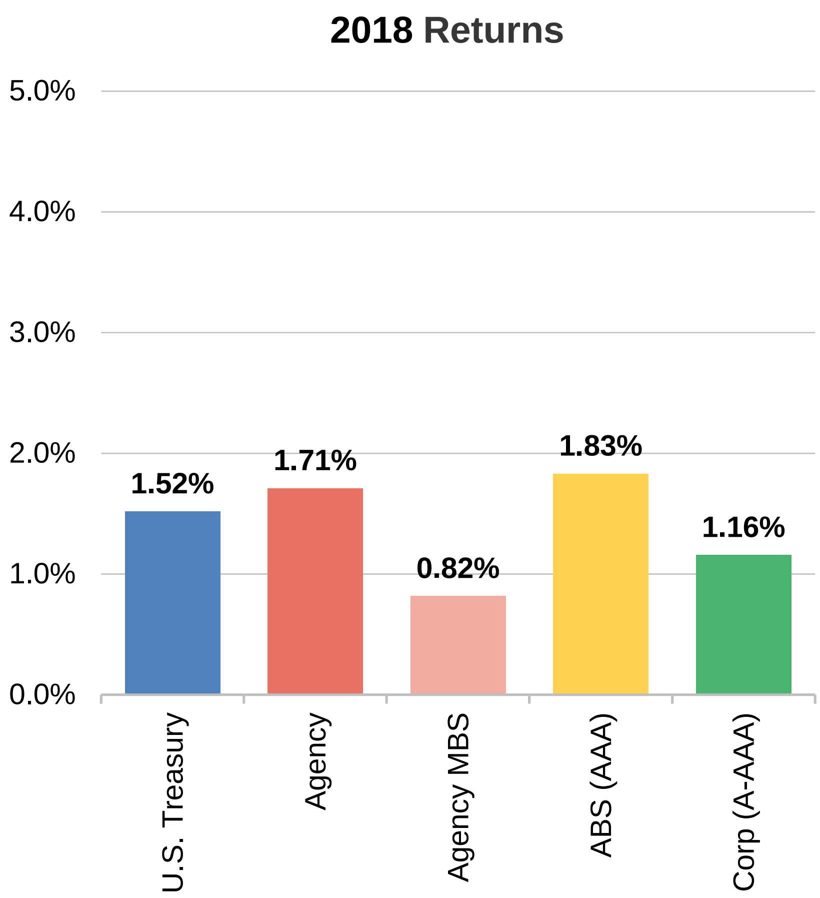
Source: Bloomberg BVAL yield curves for Treasury and Corporate. 3-month corporate yields from commercial paper; A-1+ for AA and A-1 for A. Yields are for indicative purposes only; actual yields may vary by issue.

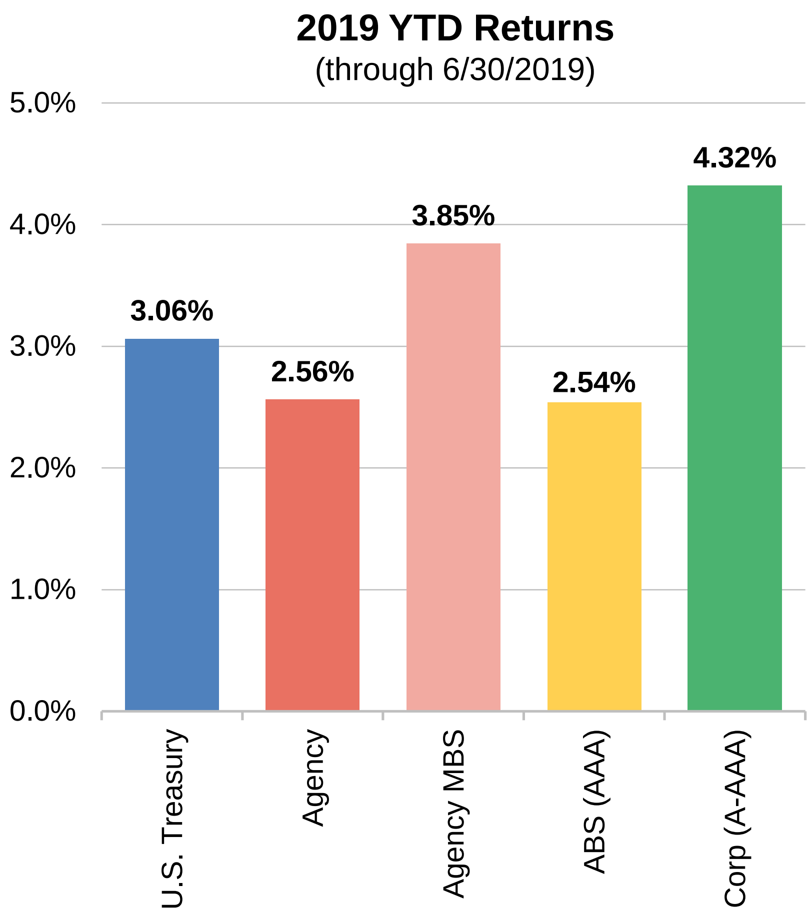
# Amount of Global Bonds Yielding Less Than 0% Soars to Record Levels




Source: Bloomberg, as of 6/30/19; Barclays.

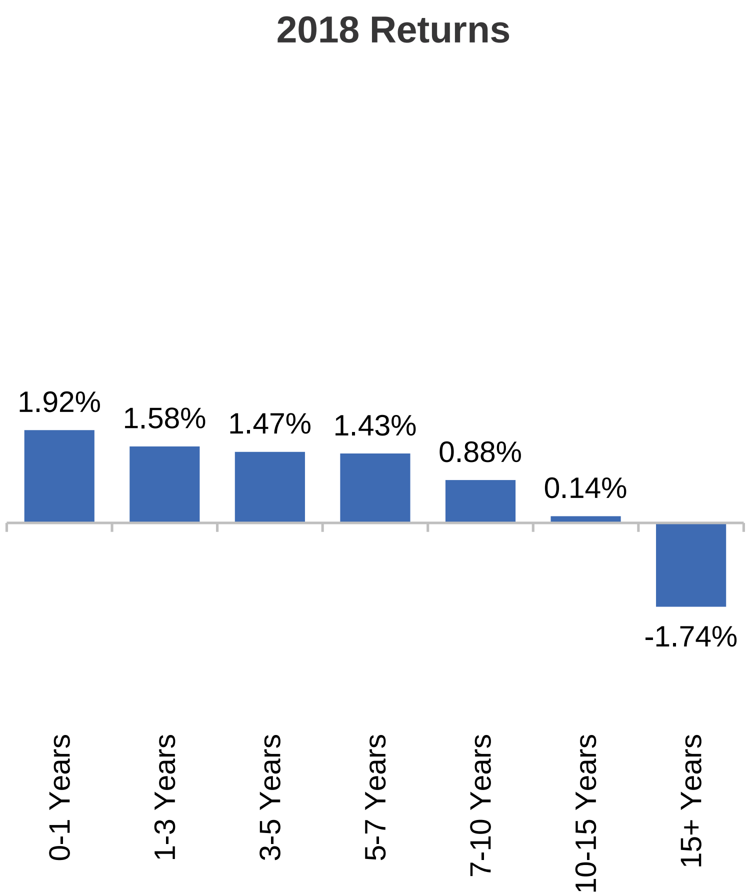
## Strong Fixed Income Returns Year-To-Date (1-5 Year Indices)

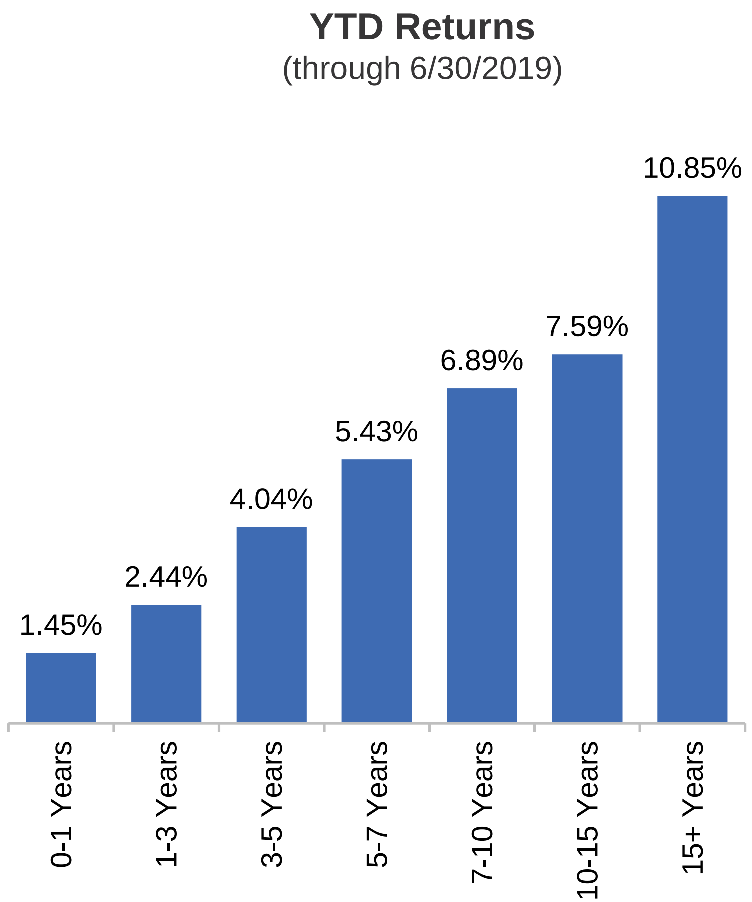



Source: ICE BofAML Indices. MBS and ABS indices are 0-5 year, based on weighted average life.

## Falling Rates Drive Strong Treasury Returns in 2019




Source: ICE BofAML Indices.

## Fixed-Income Index Returns

| June 30, 2019 | Effective Duration | Yield | YTD | 1 Month | 3 Month | 1 Year | 3 Years | 5 Years |
|---|---|---|---|---|---|---|---|---|
| **1-3 Year Indices** | | | | | | | | |
| **U.S. Treasury** | 1.82 | 1.81% | 2.44% | 0.52% | 1.44% | 3.96% | 1.29% | 1.21% |
| **Agency** | 1.46 | 1.82% | 2.28% | 0.42% | 1.30% | 3.88% | 1.46% | 1.33% |
| **Corp A-AAA** | 1.82 | 2.30% | 3.21% | 0.68% | 1.54% | 4.84% | 2.13% | 1.93% |
| **MBS (0 to 3 Years)** | 3.55 | 2.62% | 3.82% | 0.59% | 1.59% | 5.69% | 2.10% | 1.88% |
| **ABS (0 to 3 Years)** | 1.11 | 2.28% | 2.31% | 0.36% | 1.20% | 3.78% | 1.91% | 1.61% |
| **1-5 Year Indices** | | | | | | | | |
| **U.S. Treasury** | 2.56 | 1.78% | 3.06% | 0.65% | 1.82% | 4.89% | 1.31% | 1.54% |
| **Agency** | 1.75 | 1.79% | 2.56% | 0.47% | 1.44% | 4.30% | 1.46% | 1.53% |
| **Corp A-AAA** | 2.58 | 2.36% | 4.32% | 0.96% | 2.01% | 6.06% | 2.34% | 2.36% |
| **MBS (0 to 5 Years)** | 3.17 | 2.57% | 3.85% | 0.82% | 1.86% | 5.56% | 1.71% | 2.01% |
| **ABS (0 to 5 Years)** | 1.36 | 2.29% | 2.54% | 0.40% | 1.35% | 4.10% | 1.94% | 1.73% |
| **Master Indices (Maturities 1 Year and Greater)** | | | | | | | | |
| **U.S. Treasury** | 6.56 | 1.94% | 5.30% | 0.93% | 3.06% | 7.33% | 1.34% | 2.64% |
| **Agency** | 3.97 | 1.97% | 4.19% | 0.71% | 2.32% | 6.20% | 1.89% | 2.34% |
| **Corp A-AAA** | 7.36 | 2.86% | 8.66% | 2.08% | 4.04% | 10.11% | 3.32% | 3.90% |
| **MBS (0 to 30 Years)** | 3.80 | 2.73% | 4.32% | 0.84% | 2.01% | 6.32% | 2.10% | 2.56% |
| **Municipals** | 6.75 | 2.13% | 5.35% | 0.43% | 2.33% | 6.73% | 2.58% | 3.75% |

Source: ICE BofAML Indices. Returns greater than one year are annualized.

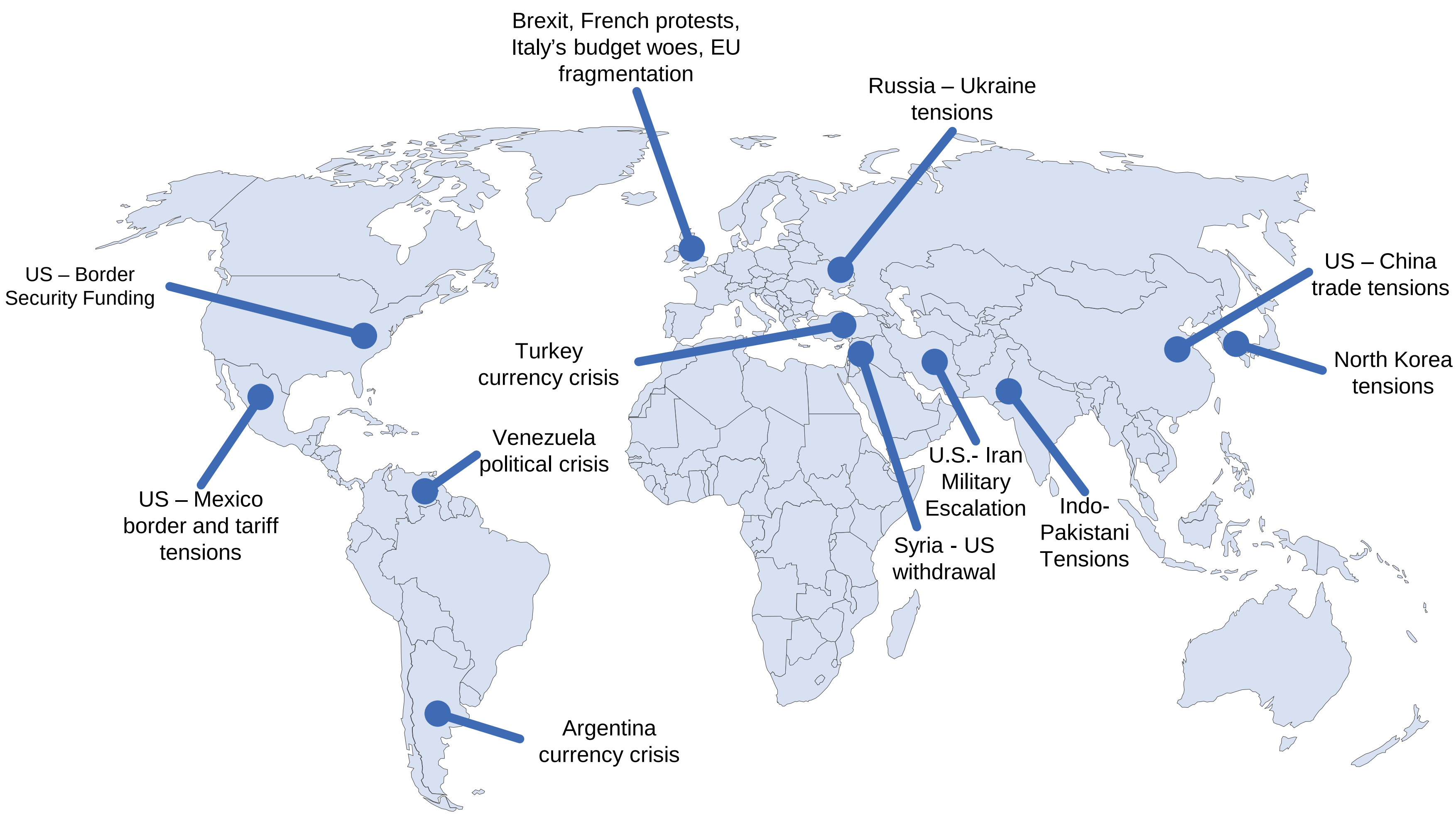
# Fixed-Income Sector Outlook – July 2019

| Sector | Our Investment Preferences | Comments |
|---|---|---|
| **COMMERCIAL PAPER / CD** | | • Commercial paper/negotiable CD spreads remain narrow. Short credit remains higher-yielding than some longer-dated Treasuries. |
| **TREASURIES** | | • Treasury Bill supply increased in March but slowed in April, putting downward pressure on rates.<br>• The 3-month to 10-year part of the yield curve briefly inverted in the past two months, renewing concerns about a possible recession. With a flat-to-inverted yield curve, there is little expected roll-down. |
| T-Bill | | |
| T-Note | | |
| **FEDERAL AGENCIES** | | • Federal agency spreads remain very tight. The only value has been in certain new issue securities<br>• With the likelihood of Fed rate cuts, callable agencies should be avoided. |
| Bullets | | |
| Callables | | |
| **SUPRANATIONALS** | | • USD supply has increased modestly however spreads remain near historical tights across the curve. We continue to favor UST or GSE |
| **CORPORATES** | | • Corporate yield spreads have narrowed back significantly, settling in around longer-term. Spreads are near post-recession tights. While the sector is no longer “cheap”, we plan to maintain allocations.<br>• The corporate spread curve remains positively sloped, offering modest value for extending maturities. |
| Financials | | |
| Industrials | | |
| **SECURITIZED** | | • The AAA-rated ABS sector continues to offer attractive incremental income vs. government alternatives and offers a defensive outlet to credit exposure.<br>• With an improving fundamental landscape, Agency MBS are an attractive alternative to other government sectors due to their incremental income potential. |
| Asset-Backed | | |
| Agency Mortgage-Backed | | |
| **MUNICIPALS** | | • Munis continue to be expensive vs. Treasuries amid limited supply. |

● *Current outlook* ○ *Outlook one month ago*

| Negative | Slightly Negative | Neutral | Slightly Positive | Positive |
|---|---|---|---|---|

# Geopolitical Risks Persist Around the Globe



# New or Topical Material

## Global Growth Outlooks Revised Lower

**World Bank GDP Growth Projections**
June 2019

| Region | 2019 | 2020 |
|---|---|---|
| World | 3.3% ↓ | 3.6% |
| U.S. | 2.3% ↓ | 1.9% ↑ |
| Euro area | 1.3% ↓ | 1.5% ↓ |
| China | 6.3% ↑ | 6.1% ↓ |
| Emerging Markets | 4.4% ↓ | 4.8% ↓ |

**IMF GDP Growth Projections**
April 2019

| Region | 2019 | 2020 |
|---|---|---|
| World | 2.6% ↓ | 2.7% ↓ |
| U.S. | 1.7% ↓ | 1.5% ↓ |
| Euro area | 1.2% ↓ | 1.4% ↓ |
| China | 6.2% | 6.1% ↓ |
| Emerging Markets | 4.0% ↓ | 4.6% |

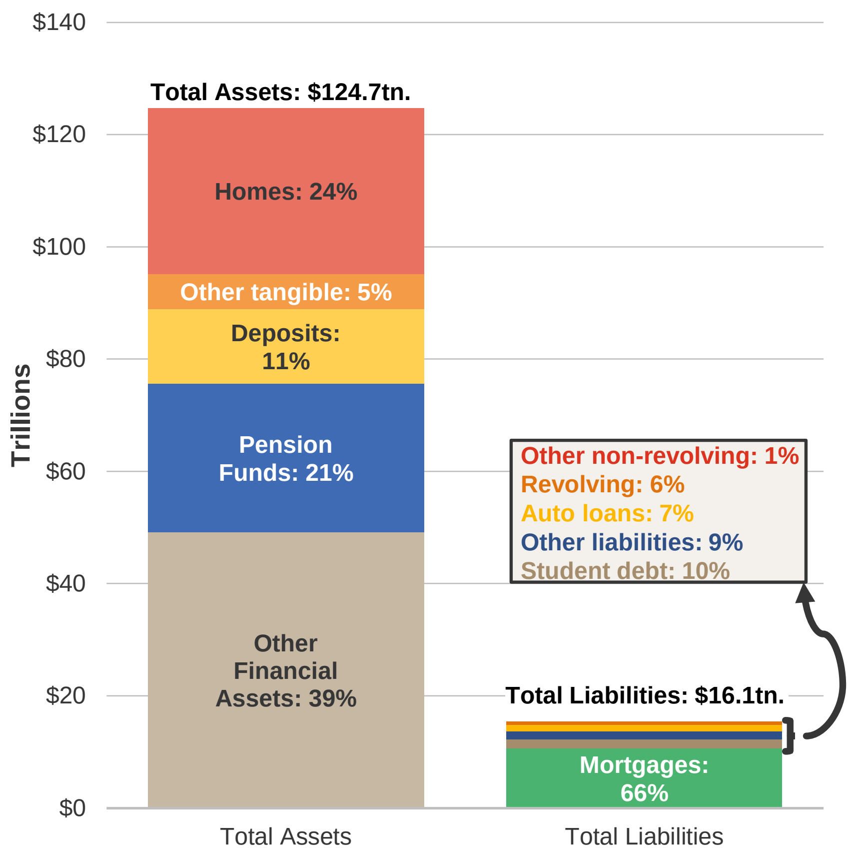
"Emerging and developing economy growth is constrained by **sluggish investment**, and risks are tilted to the downside. These risks include rising **trade** barriers, renewed **financial stress**, and sharper-than-expected **slowdowns** in several major economies…"

-The World Bank, June 2019 *Global Economic Prospects: Heightened Tensions, Subdued Investment*

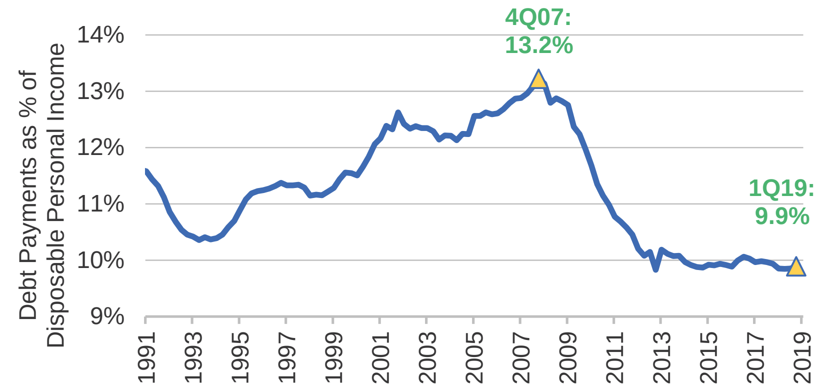
Source: World Bank and IMF. Arrows indicate change from prior projection.

# American Consumer Finances Are Strong

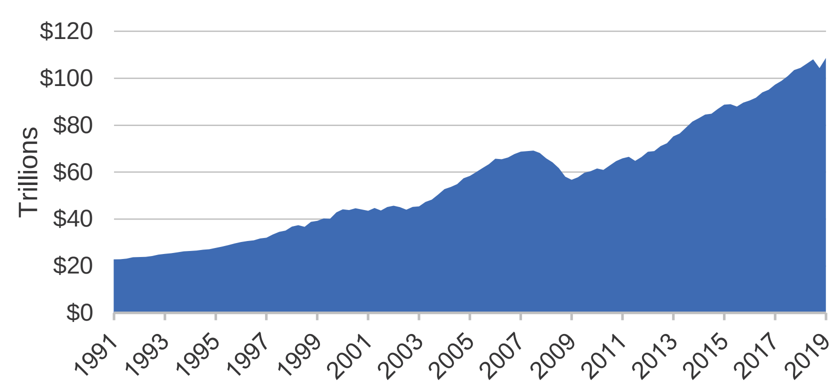
## Consumer Balance Sheet - 1Q19




## Household Debt Service Ratio

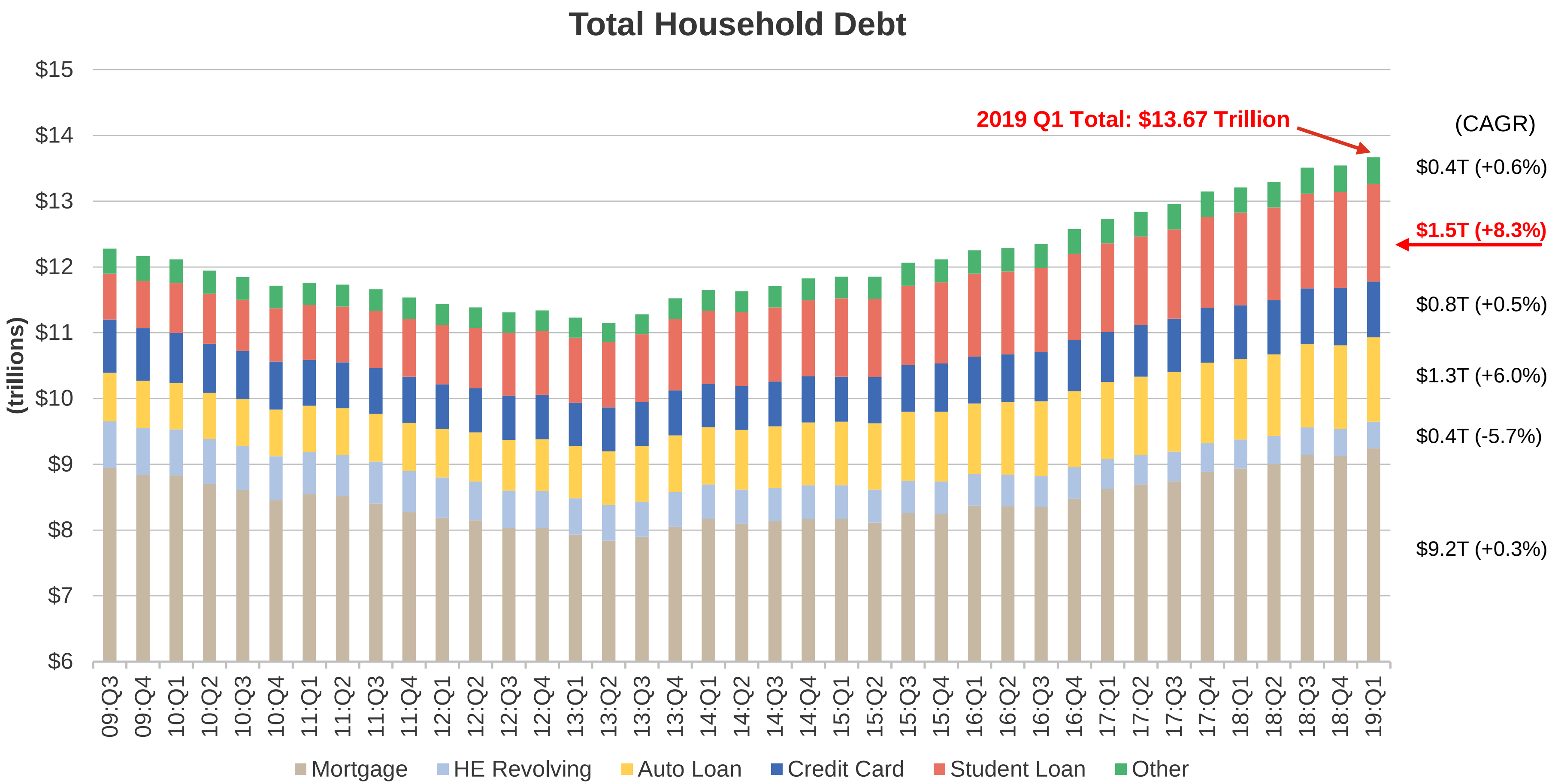



## Household Net Worth




Source: Bloomberg, and Federal Reserve's Financial Accounts of the United States - Z.1 (2019:Q1). Consumer balance sheet includes households and nonprofit organizations. Revolving credit includes overdraft plans on checking accounts and other loans without a fixed repayment schedule. All data, except the household debt service ratio is not seasonally adjusted.

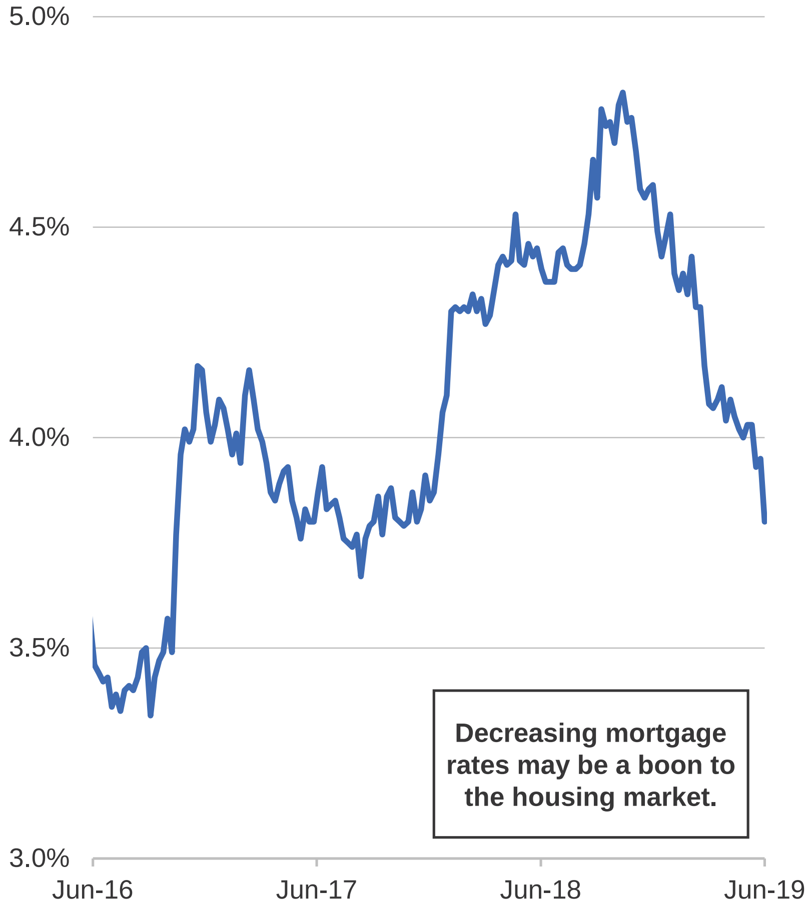
# Consumer Debt Hits New Peak; Fastest Growing Segment is Student Loans



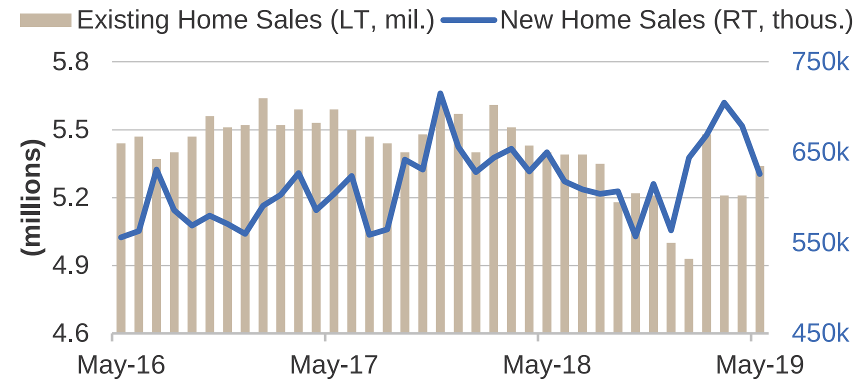

Source: Federal Reserve Bank of New York Consumer Credit Panel/Equifax, as of Q1 2019

# Low Rates Spark Housing Market Rebound

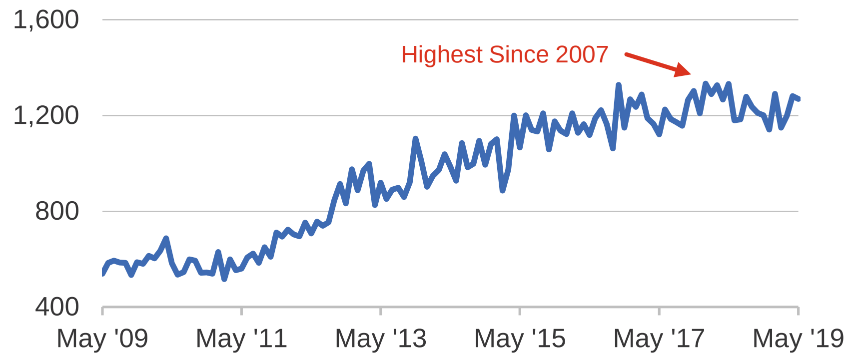
30 Year Fixed Rate Mortgage Average




Housing Sales

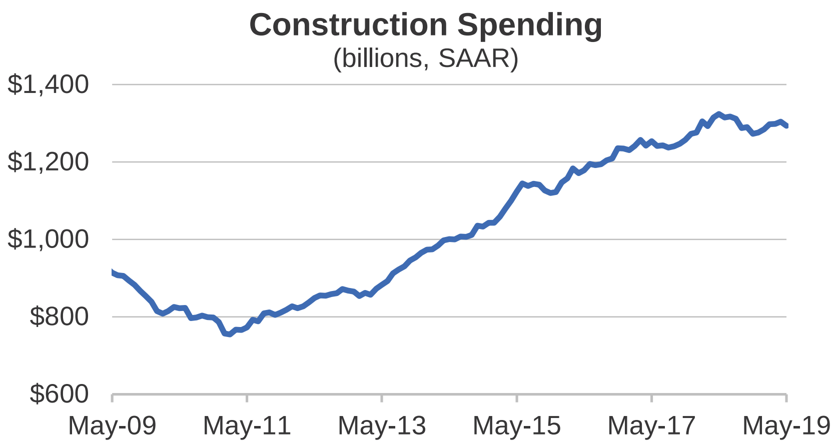


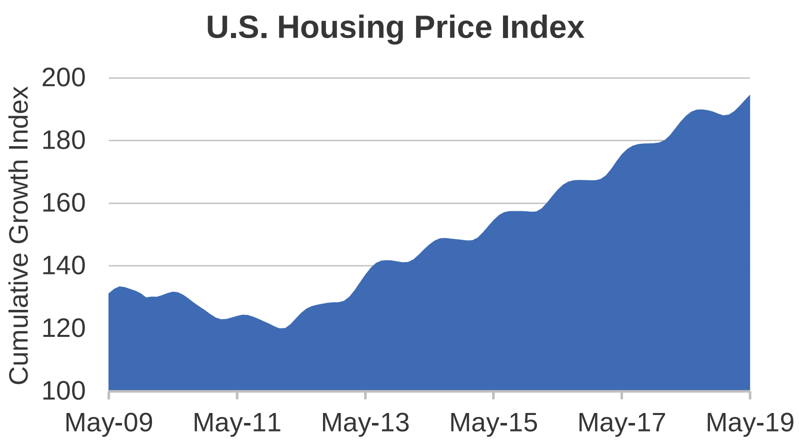

Housing Starts
(000s, SAAR)

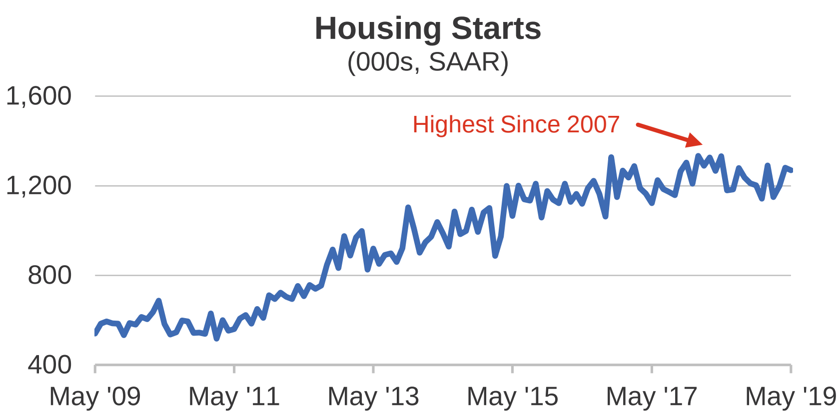


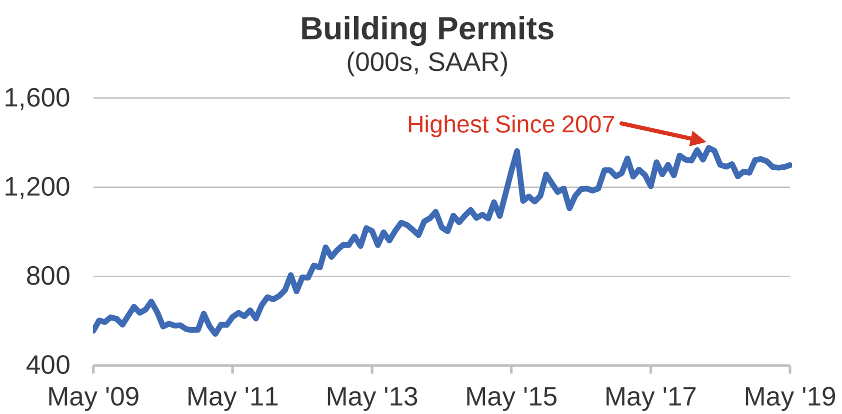

Source: Bankrate.com U.S. Home Mortgage 30 Year Fixed National Average; Bloomberg, as of 6/30/19.

# But, Future Housing Market Indicators Are More Neutral



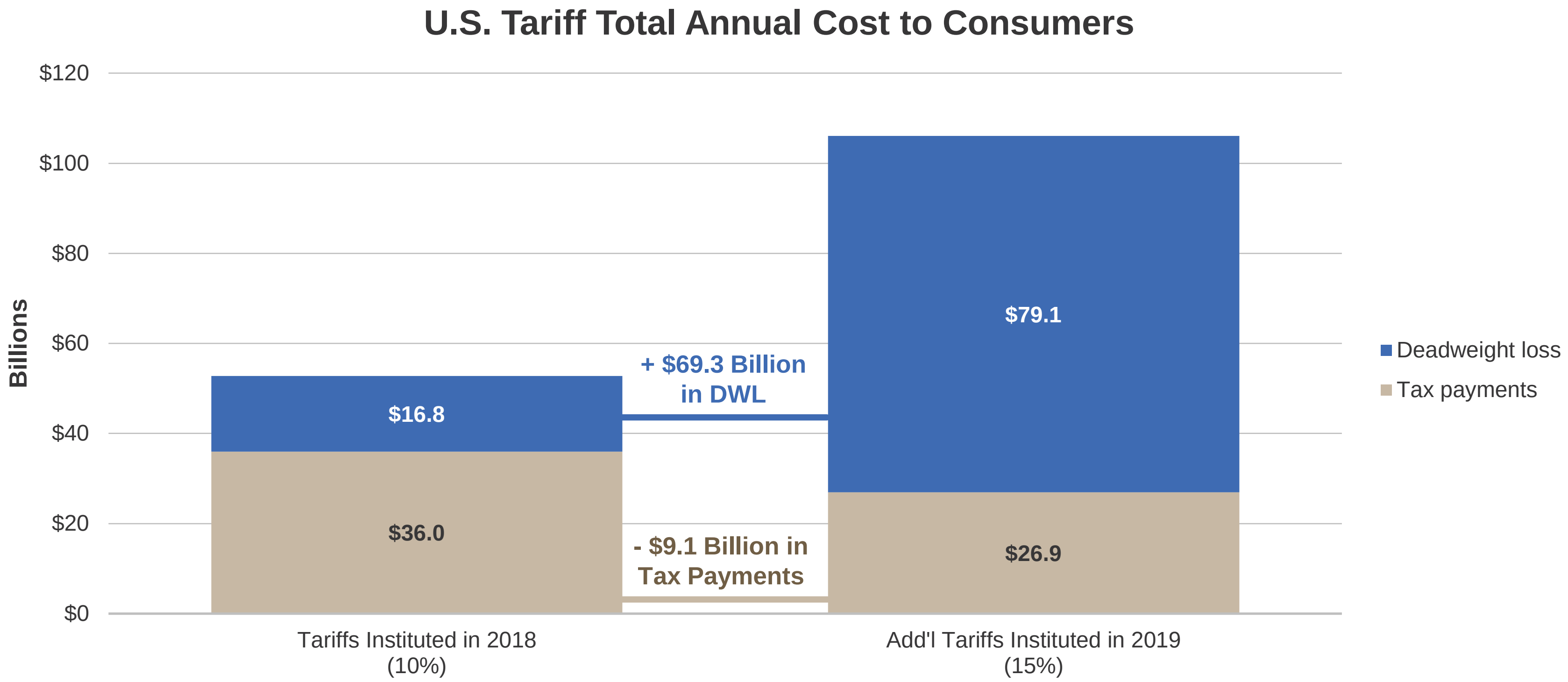




Source: Bloomberg, as of May 2019. SAAR is the seasonally adjusted annualized rate.

# Additional Tariffs on $200B of Chinese Imports Increases Costs to U.S. Consumers

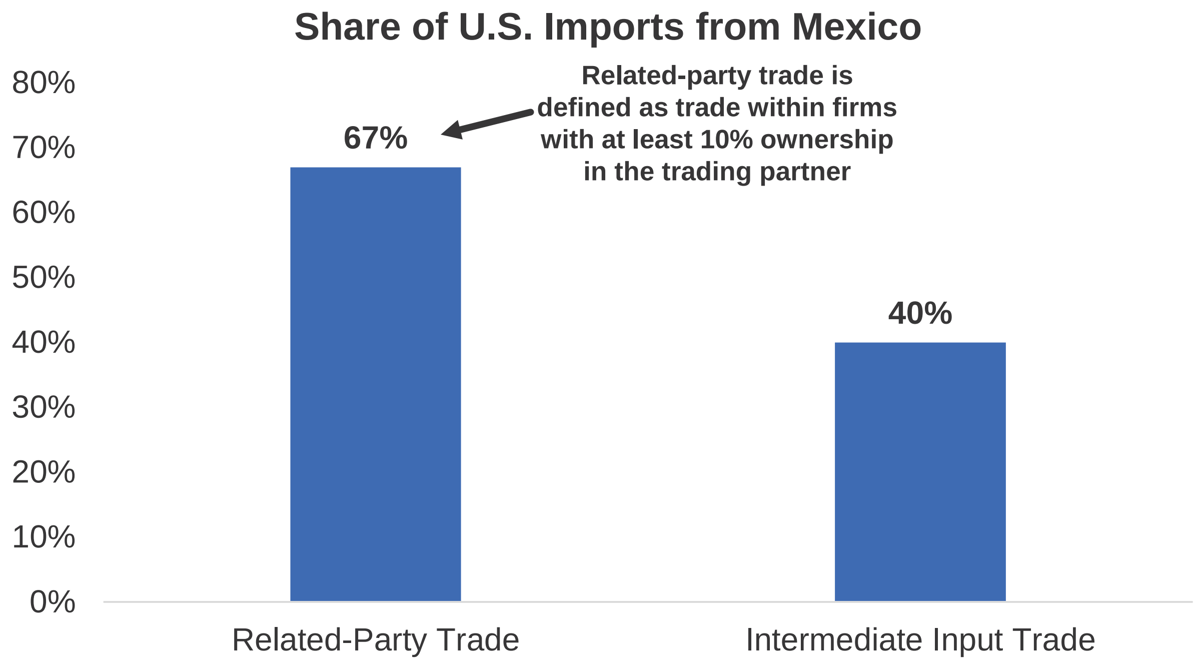
- **Tax Payments:** The increased cost to the consumer that is being captured by the U.S. government
- **Deadweight Loss (“DWL”):** The increased cost to the consumer that is lost to the U.S. economy as imports are being sourced from less efficient countries




Source: Federal Reserve Bank of New York.

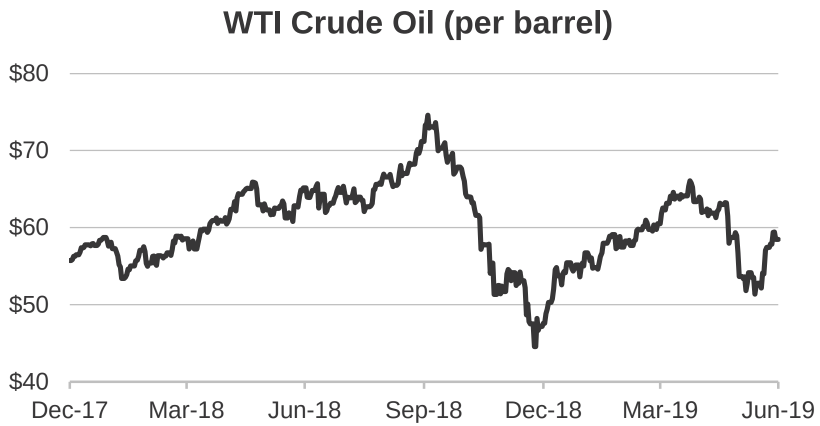
# Trump Administration Announces New Tariffs on Mexico

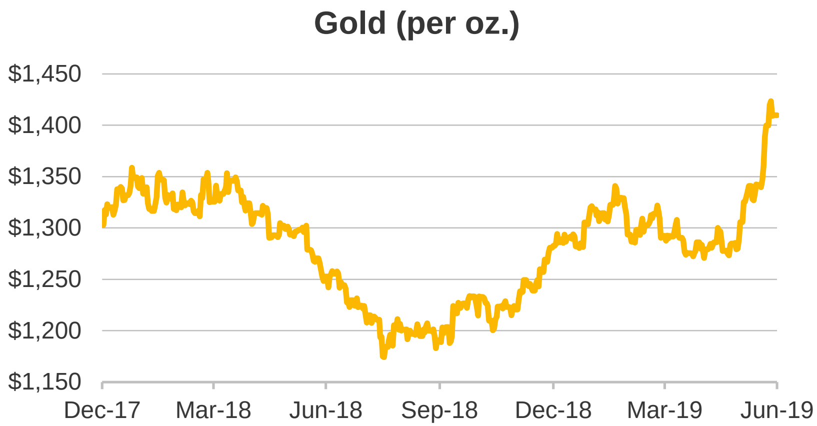
- A 5% tariff on all Mexican imports, including autos, auto parts, appliances, and fruits and vegetables, will be imposed in an attempt to force the U.S.'s number one trading partner to stop migrants from entering the U.S. illegally. The tariffs will go into effect June 10th and will rise as high as 25% by October 1st if the issue is not addressed.
- Approximately two-thirds of U.S. imports from Mexico take place between factories owned by the same firm.

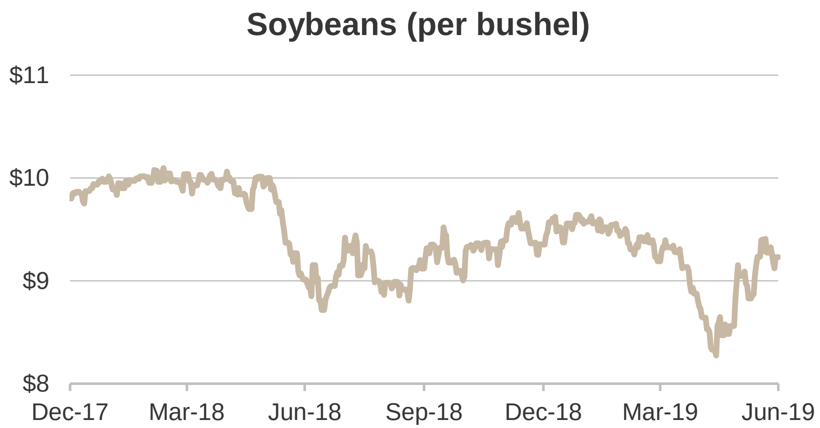


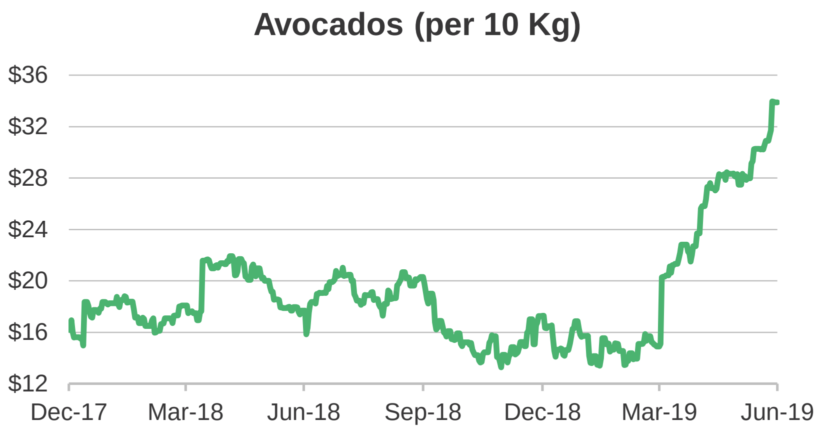

Source: Deutsche Bank Research and Wall Street Journal.

# Commodity Prices Mixed Amid Trade Tensions



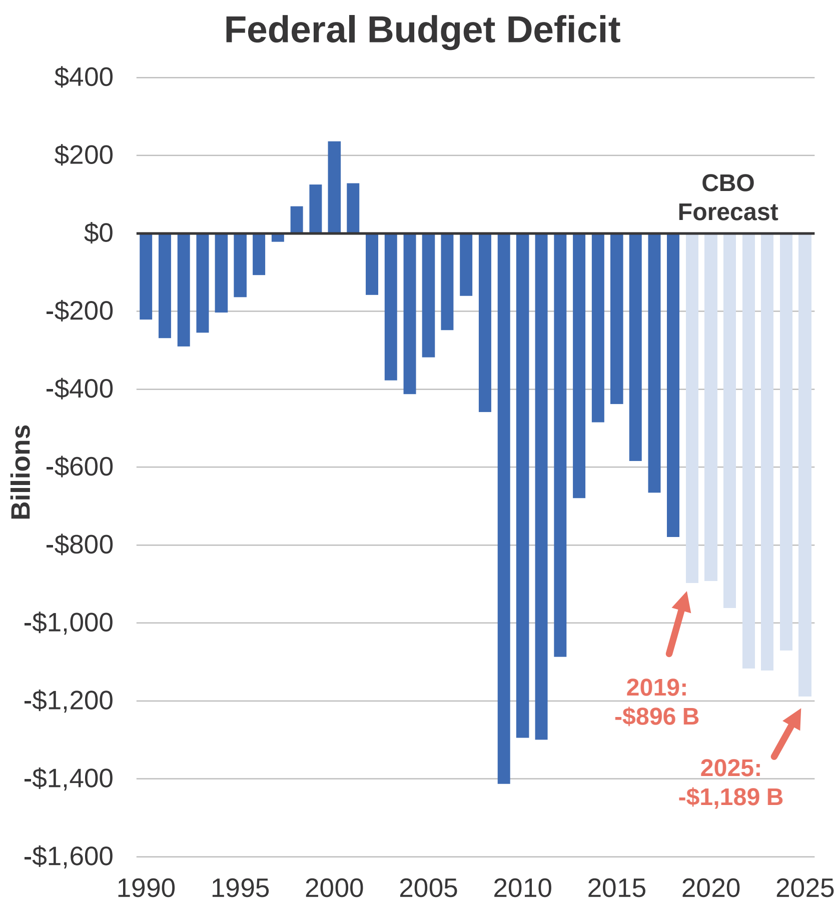



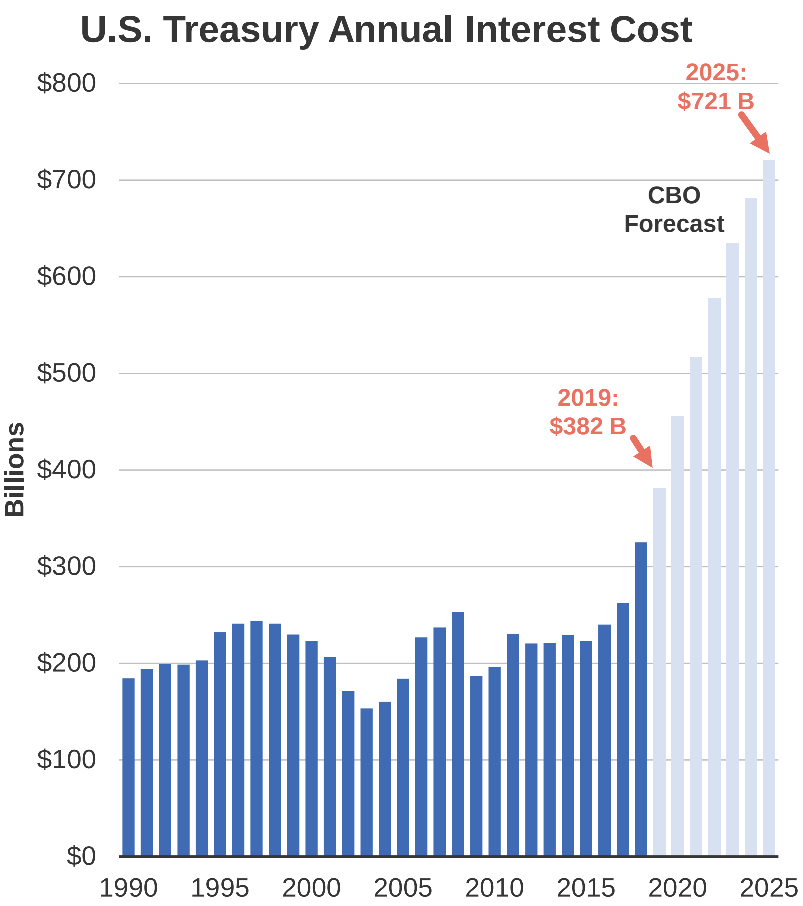




Source: Bloomberg, as of 6/30/19.

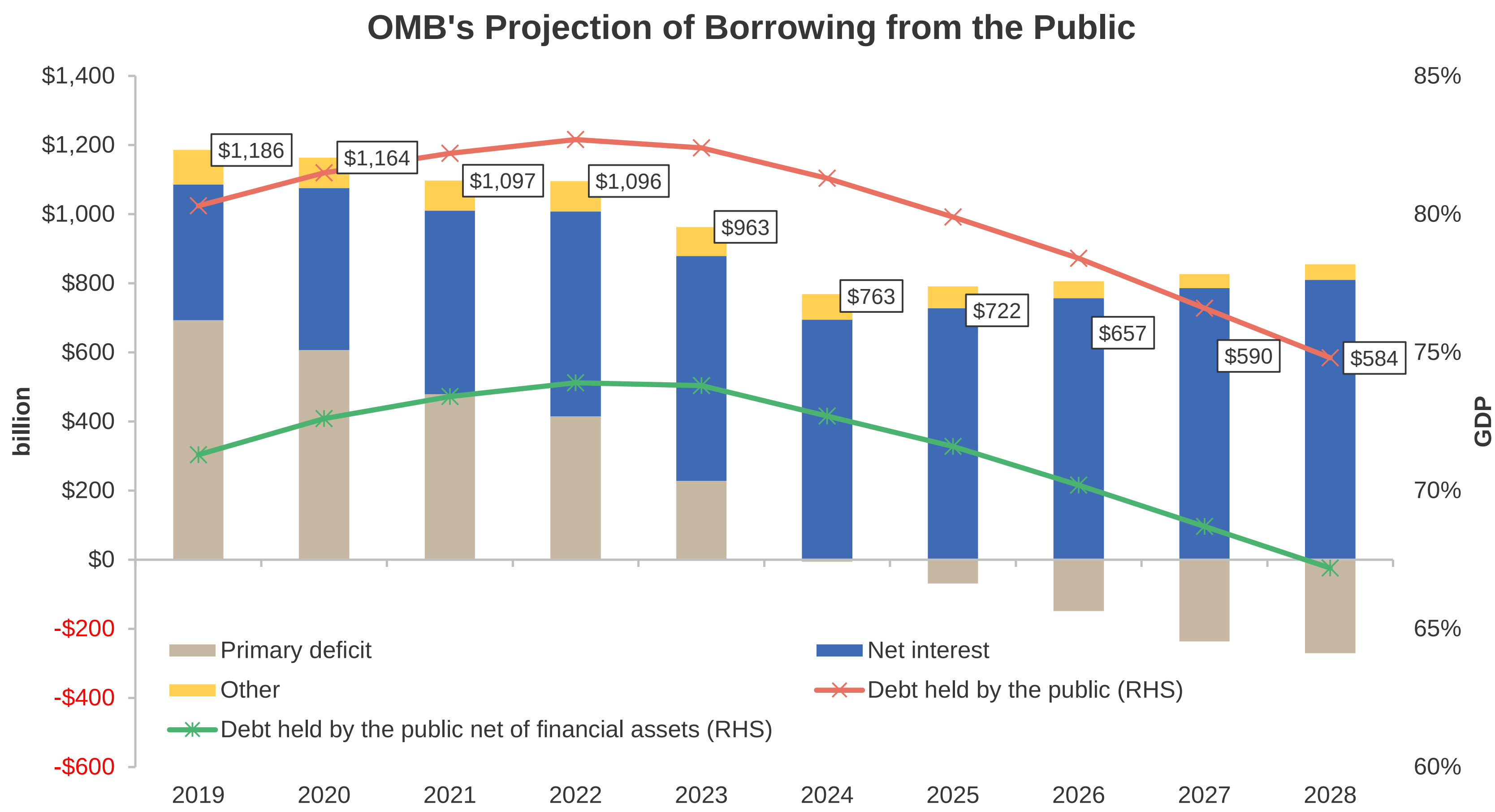
# U.S. Federal Budget Deficit And Interest Cost Projected To Soar




Sources: Bureau of Fiscal Service, Congressional Budget Office. Data as of May 2019.

# The Fastest Growing Segments of Federal Spending is Net Interest




Source: Debt Management Office’s Fiscal Year 2019 Q1 Report. The boxes represent the total net marketable borrowing for that year.

## Disclosures

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