ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JULY, 2017

IN VIEW: The Economic Landscape

It certainly was a good summer for stock and bond investors. From the end of May through the end of August, the S&P 500 rose 2.5%, while the bond yield remained relatively flat around 2.20%, earning the coupon. On the other hand, the trade-weighted dollar fell 3.5% over this period, but that helped to boost commodity prices as the CRB raw industrials spot price index rose 2.0%. It was a good summer for global investors too, with a solid gain in the All Country-World ex-US MSCI stock price index (in local currencies), up 1.3%, led by the MSCI stock price indexes for Emerging Markets (7.6%) as Europe fell 2.1%.

There may be rough patches during the rest of the year, as domestic political tensions heat up over the debt ceiling and tax reform, and geopolitical tensions with North Korea could come to a boil. The good news is that U.S. and global economic outlooks remain relatively calm.

The growth rate in real GDP has been inching up over the past several weeks from 2.6% to 3.0% for the second quarter. On a y/y basis, real GDP was up 2.2%. It has been fluctuating around 2.0% since mid-2010. Excluding government spending, which has been relatively weak during the current expansion, it was up 2.7%. The Fed is now looking for GDP to hit the estimate of 3.2% in the third quarter. Inflation-adjusted consumer spending in real GDP rose 2.7% y/y during July. Capital spending rose 4.4% y/y to a new record high during Q2, confirming the post-election strength in the CEO confidence index. Leading the way are record-high capital outlays on information processing equipment (up 7.0% y/y) and industrial equipment (6.8%).

Released along with the first revision of GDP was data on corporate profits during Q2. On an after-tax basis, reported profits also continued to remain at record highs, recovering this year from their energy-related declines last year. Inflation so far remains sanguine. The GDP implicit price deflator rose just 1.6% y/y during Q2. The Personal Consumption Expenditures (PCE) again posted a directionless trend, edging down on a y/y basis during July to 1.4% for both the headline and core readings. Once again, wage inflation is unspectacular. The Average Hourly Earnings (AHE) measure rose 2.5% y/y for all workers in the private sector. It has been hovering around this pace since the fall of 2015.

While wage inflation remains subdued, it continues to outpace the PCE headline inflation rate. Real average hourly earnings for production and nonsupervisory employees, who currently account for 70% of all private-sector workers, rose to yet another record high during July. This measure is up 17.5% since the start of 2000, contrary to the widespread myth that real wages have stagnated since then. While private-sector payrolls disappointed during August with a gain of 165,000, the comparable ADP Research Institute data release showed a solid increase of 237,000. Overall business activity, new orders and employment continues to sustain solid levels in the recent quarter.

IN BRIEF: The U.S. Fixed Income Markets

We believe rates are probably close to fair value in the bond markets. In particular, it looks like the market has priced in a fair amount of tightening in the year to come in both the U.S. and Europe. Furthermore, we've seen that the Euro has already begun to rise in response to the range of positive developments on the continent. That, in and of itself, may sufficiently take the edge off of European growth and inflation, pushing the ECB away from any aggressive course towards reduced accommodation. In short, the current configuration of yield curves relative to the fundamental backdrop appears just a bit too high and too steep. As a result, government bonds appear poised to continue to outperform cash over the intermediate to long term.

No doubt, spreads have narrowed to below average levels in the non-government sectors, and, yes, there are a range of risks on the horizon that are difficult to measure. Nonetheless, the global expansion appears poised to continue, supporting credit fundamentals. While the expected ECB taper and Fed runoff will take a bite out of the demand side of the bond market equation, other investors, both private and official, seem likely to pick up the slack, allowing spreads to continue tightening in the absence of an unexpected material change in the environment.

Ten-Year Generic Treasury Yield

Source: Altman Investment Management Research and Bloomberg

CLOSE-UP:

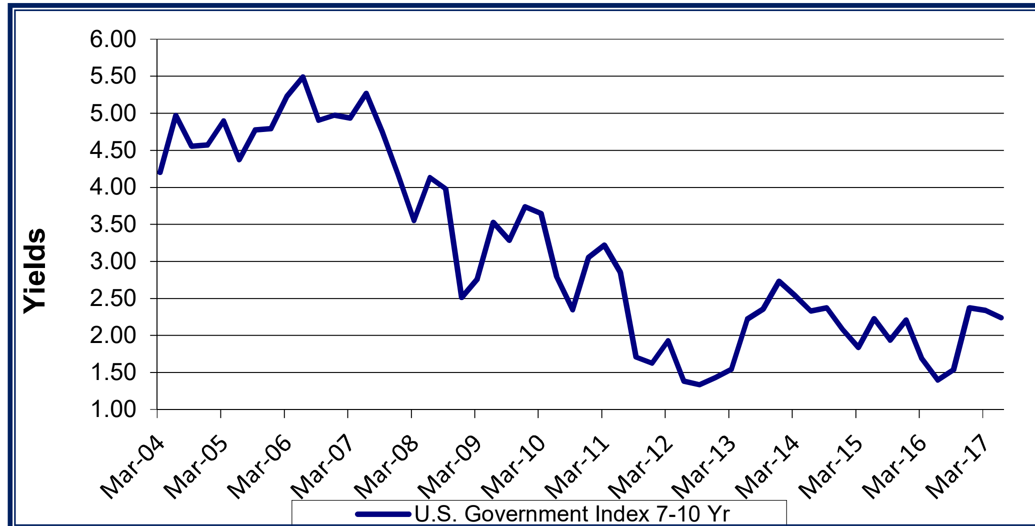
➢ *Government Bonds*

There were several themes that dominated the headlines by the close of the second quarter: changes to Federal Reserve monetary policy, the direction of U.S. interest rates and the persistent low volatility across several asset classes. For the most part, the first half of the year was a continuation of the latter half of 2016 as more credit sensitive sectors such as convertible bonds, high yield and emerging market debt continued to outperform. Although Treasuries and mortgage-backed securities lagged, they maintained a positive total return.

As anticipated, the Fed brought the fed funds rate target to between 1.00% and 1.25%. After two successful hikes through the first half of the year, it appears that the Fed has finally been able to begin meeting their goal of normalization after years of disappointing markets. According to Bloomberg, the implied probability of another hike by year-end is 47%. Aside from subpar GDP, which came in at 1.4% in the first quarter, the Fed will have to fight falling inflation, which appears to have peaked for the year barring exogenous shocks. The CPI fell 1.9% year-over-year during May after reaching a high of 2.7% in February of 2017. Core CPI fell to 1.7% year-over-year, after reaching a high of 2.3% in January 2017. And flat to weaker energy prices have kept a lid on higher inflation expectations through the second half of the year.

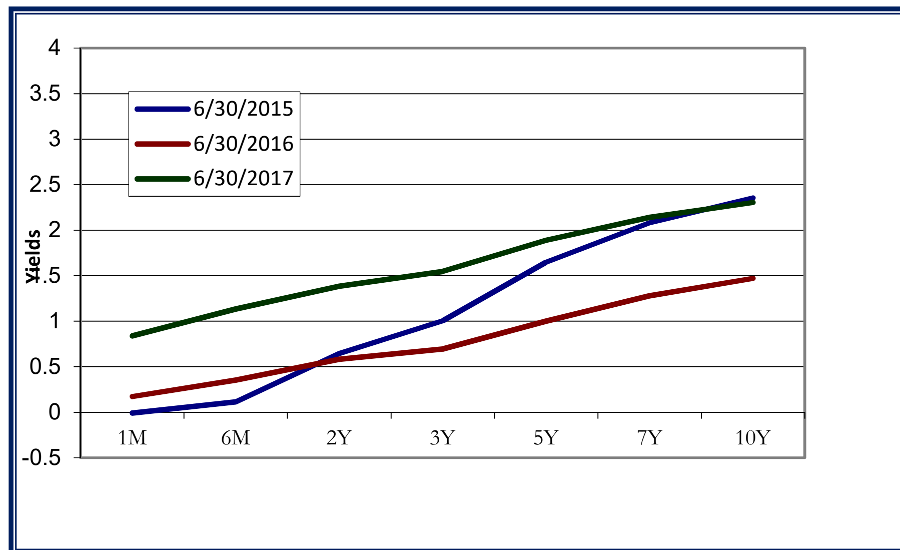
The UST curve continued to flatten for most of the second quarter, as it has for most of the year. The break out to 2.3% in the 10-year yield in June was coincident with a jump in global developed sovereign yields, with stronger growth and the possibility of less accommodative monetary policy in Europe. We are using this level as the near-term resistance that could trigger bond purchases in the second half of the year.

U.S. Government Index 7-10 year



Source: Altman Investment Management Research and Bloomberg

Active Government Yield Curves



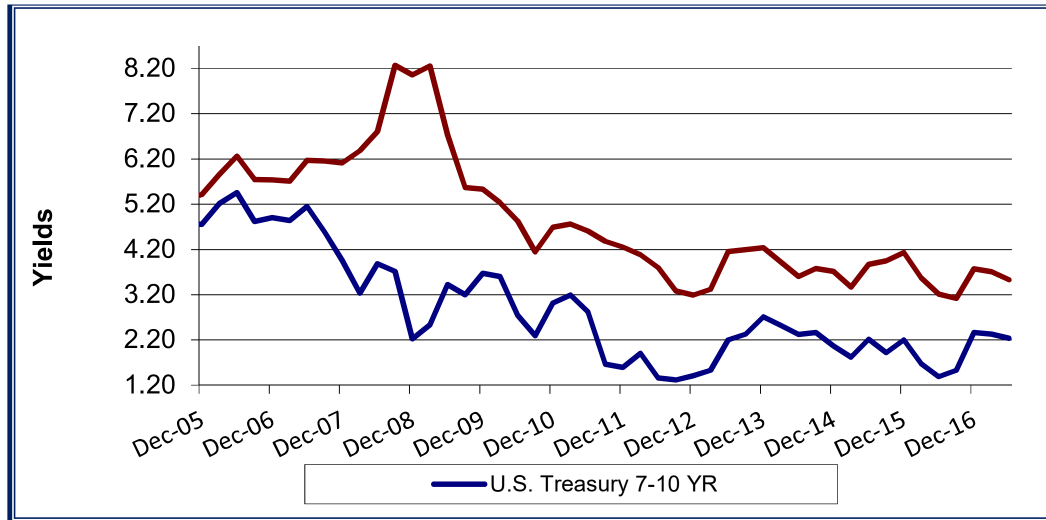
Source: Altman Investment Management Research and Bloomberg

➢ *Investment-Grade Corporate Bonds*

U.S. corporate bonds delivered a solid return in Q2, against a backdrop of modest but acceptable economic growth, solid investor demand in the face of record issuance, and positive earnings momentum. U.S. corporate spreads narrowed by 9 bps, posting an excess return of 151 bps over similar-maturity U.S. Treasuries.

We remain positive on the U.S. credit markets, as U.S. corporate spreads tighten in the coming quarter, given little to no risk of a U.S. recession and continued investor demand spurred by non-U.S. quantitative easing programs. We favor U.S.-centric issuers that may benefit from positive economic growth. We remain overweight BBB-rated intermediate maturity credits, due to a steep spread curve and possibly higher pension funding, which could lead to increased demand and potentially flatten the spread curve. We continue to be neutral on A-rated and higher industrials due to event risk concerns. Intermediate broad investment grade bond index has return 1.62% through the first half of the year.

U.S. Corporate 7-10 year versus U.S. Treasury 7-10 year



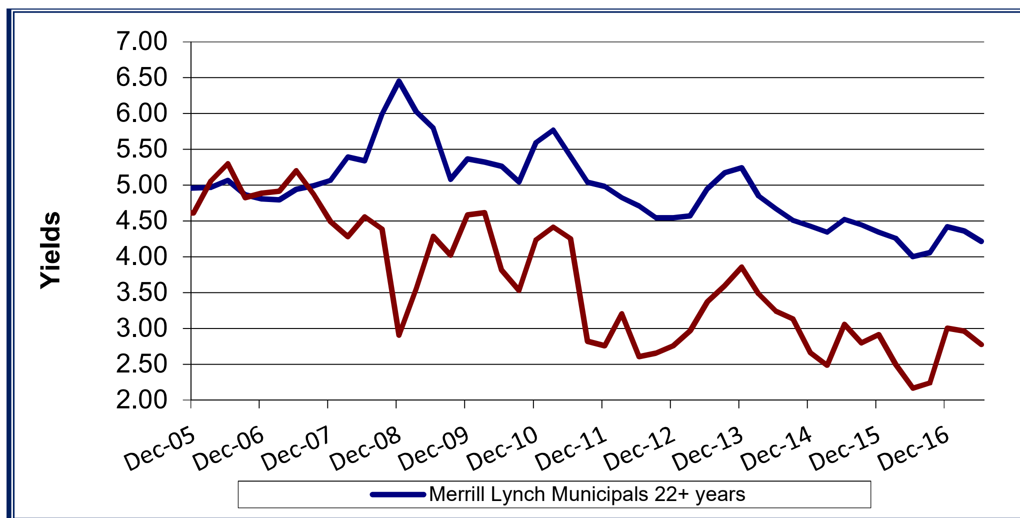
Source: Altman Investment Management Research and Bloomberg

Municipal Bonds

Municipal market performance remains strong with high demand for U.S. tax-exempt bonds. The 10-year muni yield is close to 40 basis points lower year to date, indicative of strong municipal bond performance. For perspective, consider that we've had four Fed rate hikes in the past 20 months, with 100 basis points of policy adjustments, and yet the yield on the 10-year Treasury is up only three basis points, and the 10-year muni is lower by two basis points.

While technical indicators should remain favorable through much of Q3, we would expect the environment to be less supportive by the end of the quarter. A range-bound interest rate environment should continue to be supportive of mutual fund flows. Tax-reform discussions will be closely monitored, but are not expected to negatively impact the market in 2017.

Long Term Municipal to Treasury Spreads



Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

While we don’t forecast a recession in the immediate future, further delays and disappointments in economic policy, rising bond yields and subpar growth are all events that could create investor uncertainty. Although Fed chairwoman Janet Yellen does not expect "another financial crisis in our lifetime", we believe that any market dislocations or mispricing can be opportunities over the longer term.

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