ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JULY, 2018

IN BRIEF: The U.S. Fixed Income Markets

At its meeting on June 13, 2018, the FMOC (Federal Open Market Committee) instituted an additional 25 basis point increase in the Federal Funds rate from 1.75% to 2.00%. As reflected in a subsequent Fed commentary, an additional two 25 basis point increases in Federal Funds are likely during the second half of 2018, with the possibility of further increases in 2019 to a so-called neutral rate of 3.0%. The 25 basis point increase was somewhat reflected in a marginal increase in intermediate and longer-term rates in the U.S., although the increase was more noticeable in the shorter end of the maturity range. Yields on two-year Treasuries rose from 2.27% to 2.58% during the second quarter, while the yield on five-year Treasuries rose from 2.56% to 2.74% and on ten-year from 2.74% to 2.86%. On the international front, yields on ten-year German bonds increased from 0.30% to 0.49% during the second quarter, while Japanese ten-year government rates remained close to zero.

Many in the financial press appear fixated on the reduced differential in U.S. interest rates between two-year and ten-year treasury maturities as an indicator that the U.S. economy will head into a recession. At this point in the cycle, we do not agree with this assessment and believe a flatter yield curve is not necessarily predictive of a recession, and only an inverted yield curve would be predictive of a U.S. recession within the next two years. Research from the Federal Reserve Bank of San Francisco supports recessions are preceded by an inversion of the yield curve, calculated as the difference between ten-year and one-year Treasury yields.

We expect that intermediate and longer-term rates will follow additional increases in Federal Funds and that the differential will remain positive. Fed Presidents are also looking to avoid an inverted yield curve situation and will consider the risk of an inverted curve with future Federal Funds rate hikes. With this outlook, we continue to pursue a strategy of maintaining shorter than average durations in our taxable and tax-exempt portfolios. In the taxable sector, especially in shorter maturities, the differential between Treasuries and corporate credit spreads has narrowed to the point where we are commencing to favor Treasuries in establishment of new positions.

THE FEDERAL RESERVE BALANCING ACT:

The FOMC Minutes Revisited

We continue to subscribe to the Fed's official narrative for the course of monetary policy through the end of next year. The members of the FOMC remain committed to gradually normalizing monetary policy. That means they will continue to taper the Fed's balance sheet, and to raise the federal funds rate by 25bps four more times before the end of next year. That would put the federal funds rate in a range of 2.75%-3.00%. And that is about where Fed officials expect the range to settle for the long term.

We can comfortably say once again that the Fed is likely to stay the course, after reviewing the minutes of the June FOMC meeting. The minutes stated that "members expected that further gradual increases" in the Federal Funds rate "would be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation" near 2.0% over the medium term. Participants in the FOMC meeting "generally" shared this view.

FOMC officials should be congratulated for finally achieving the Fed's dual mandate. Inflation, as measured by the core PCED, rose to the Fed's 2.0% y/y target during May after falling below it, since the target was first announced in early 2012. And the unemployment rate is at historical lows.

Meanwhile, U.S. economic growth is chugging along at a good clip, with the latest GDP release at 4.1% for Q2. Yet, officials should not be complacent, given too many significant uncertainties ahead. The FOMC minutes characterize these risks to the economic outlook as "roughly balanced." This gives credence to the fact that the Fed will continue an approach to policy that is not too fast or too slow.

Inversion of the Yield Curve

Noted within the minutes, "a number of participants thought it would be important to continue to monitor the slope of the yield curve, given the historical regularity that an inverted yield curve has indicated an increased risk of recession in the United States." The FOMC described the spread between the two-year and the ten-year treasury can be interpreted as a measure of the market's expectation for the direction of conventional near-term monetary policy. "When negative, it indicates the market expects monetary policy to ease, reflecting market expectations that policy will respond to the likelihood or onset of a recession. By that token, the current level of the near-term spread does not indicate an elevated likelihood of recession in the year ahead, and neither its recent trend nor survey-based forecasts of short-term rates point to a major change over the next several quarters."

If officials raise the Federal Funds rate too fast, the yield curve could invert, signaling a recession as it has in the past. Nonetheless, FOMC participants pointed to many "factors, other than the gradual rise of the Federal Funds rate, that could contribute to a reduction in the spread between long-term and short-term Treasury yields."

The authors note that an inversion of either short term our long-term yield spread does not mean that the spread causes recessions. In their words: "This does not mean that inversions of the near-term spread cause recessions. Rather, the near-term spread merely reflects something that market analysts already track closely—investors' expectations for monetary policy over the next several quarters and, by extension, the economic conditions driving those expectations."

Trade Risk Threat to Economic Growth and Investment

The section in the minutes titled "Participants' Views on Current Conditions and the Economic Outlook" stated that although district contacts were generally upbeat, they "expressed concern about the possible adverse effects of tariffs and other proposed trade restrictions, both domestically and abroad, on future investment activity."

More specifically: "Districts indicated that plans for capital spending had been scaled back or postponed as a result of uncertainty over trade policy. Contacts in the steel and aluminum industries expected higher prices as a result of the tariffs on these products but had not planned any new investments to increase capacity. Conditions in the agricultural sector reportedly improved somewhat, but contacts were concerned about the effect of potentially higher tariffs on their exports." Participants don't seem to be too concerned about the direct economic effects of Trump's tariffs. But they are worried about the "negative effects" that trade policy uncertainty could have on "business sentiment and investment spending."

Spillover Risk from Europe and Emerging Markets (EM)

Fed officials are concerned that economic weakness abroad could spill over back home. Many participants saw "potential downside risks to economic growth and inflation associated with political and economic developments in Europe and some EMs." In Europe, the Italian economic and political situation was noted as an area of particular vulnerability.

Upside Risk from Tax Cuts

Last year's tax cuts received a brief mention in the "Staff Review of the Economic Situation" section of the June minutes. The minutes stated that "the lower tax withholding resulting from the tax cuts enacted late last year still appeared likely to provide some additional impetus to spending in coming months." While some participants aren't sure that fiscal policy is on a sustainable path, a few see fiscal policy changes as an "upside risk."

On a separate but related note, the Fed's *Summary of Economic Projections* shows the median forecast for the Federal Funds rate moving up to 3.40% by the end of 2020, then back down to 2.90% over the longer run. Fed forecasters seem to be anticipating the need to cool off shorter-term growth, probably related to fiscal stimulus, which is expected to subside over the longer run. Some participants were worried about letting the economy run "beyond potential" for too long. As a result, inflation could overheat or bubbles could emerge in asset prices and the credit markets. Some worry that either of these scenarios could lead to a downturn. The question is whether the economy is currently running "beyond potential." Several participants noted that it was "premature" to conclude that the FOMC had achieved the 2.0% inflation objective. Participants also suggested "that there may be less tightness in the labor market than implied by the unemployment rate alone, because there was further scope for a strong labor market to continue to draw individuals into the workforce." As a result, a number of participants anticipate "wage inflation to pick up further."

Ten-Year Generic Treasury Yield

Source: Altman Investment Management Research and Bloomberg

CLOSE-UP:

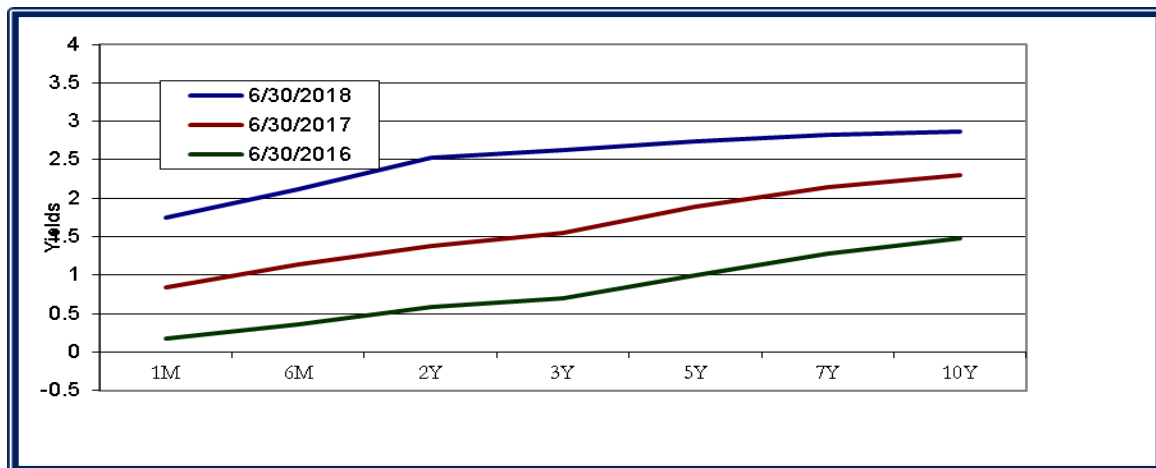
➢ Government Bonds

The U.S. Treasury Index was essentially flat in June with a gain of 0.02%. The Yield curve continued to flatten as the front-end yields climbed in sympathy with the Fed's second-rate hike of the year, while the 30-year yield declined amid ongoing trade tensions. The yield spread between the two-year and the ten-year U.S. treasury narrowed ~30 basis points, the lowest level since 2007. The flatter curve suggests that market participants remain unconcerned with inflation, looking past any near-term spikes over the next few months. We remain neutral on rates and the curve. We find 1 ½ to 3-year UST are attractive while five-year issues are rich.

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

Fixed Income Sector Performance – Q1 2018
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Fixed Income Sector Performance – 2018 Q1 - Sector	**Rating**	**Maturity**	**Duration Mod Adj**	**Yield**	**Spread**	**Price**	**Trailing 12 Month Total Return**
Treasury	Aaa/AAA	7.9	6.2	2.5%	N/A	$100.6	.5%
Agency	Aaa/AA+	4.9	3.9	2.5%	N/A	$104.4	.86%
MBS	Aaa/AAA	4.6	4.1	2.8%	30	$99.6	.17%
Municipal	Aa3/A+	4.6	3.6	2.1%	0	$108.9	.64%
Corporate (Intermediate)	A2/A-	4.8	4.2	3.5%	100	$99.8	1.3%
High Yield	B1/B	6.1	4.1	6.3%	380	$98.2	3.7%

Source: Altman Investment Management Research and Bloomberg

Fixed Income Sector Performance – Q2 2018

Fixed Income Sector Performance – 2018 Q2 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing 12 Month Total Return
Treasury	Aaa/AAA	8.0	6.3	2.7%	N/A	$100,2	(.6%)
Agency	Aaa/AA+	5.0	3.9	2.8%	10	$103.9	(.1%)
MBS	Aaa/AAA	4.6	4.1	3.0%	30	$ 99	(.5%)
Municipal	Aa3/A+	4.8	3.7	2.1%	0	$108.8	.4%
Corporate (Intermediate)	A2/A-	4.9	4.3	3.8%	110	$ 98.7	(.4%)
High Yield	B1/B	6.2	4.7	6.5%	380	$ 97.8	2.5%

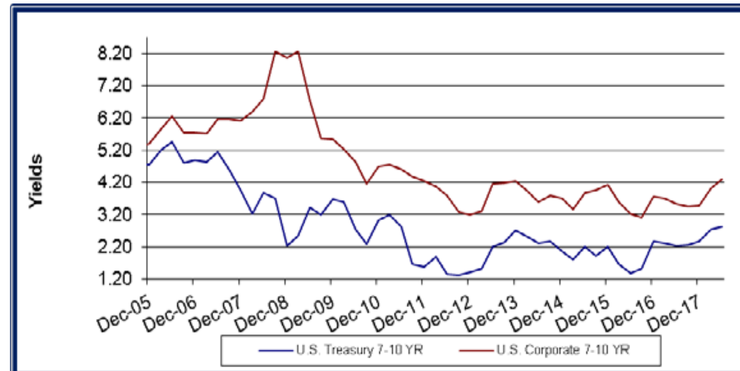
Source: Altman Investment Management Research and Bloomberg

➢ Investment-Grade Corporate Bonds

Spreads widened about 10 basis points in June, and gradually widened 15 basis points in the second quarter to 120 basis points over U.S. Treasuries with a similar duration. Spreads widening resulted in 50 basis points and 155 basis points of negative excess returns for June and year-to-date respectively. The yield-to-worst rose during the quarter, from 3.68% at the end of the first quarter to the end of the second quarter at 3.94%. Total return in June was -47 basis points.

The underperformance in June pushed spreads to the wide end of the year-to-date range, as renewed pressure on the technical indicators was supported by continued political unrest in Italy as well as trade tensions. Fund flows sharply decelerated in June, as slowing intermediate-duration funds and large redemptions from total return funds offset continued strong demand for short duration credit. Year-to date flows were up $69.4 billion. Supply for June was the largest since 2014, driven in part by acquisition-related deals.

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



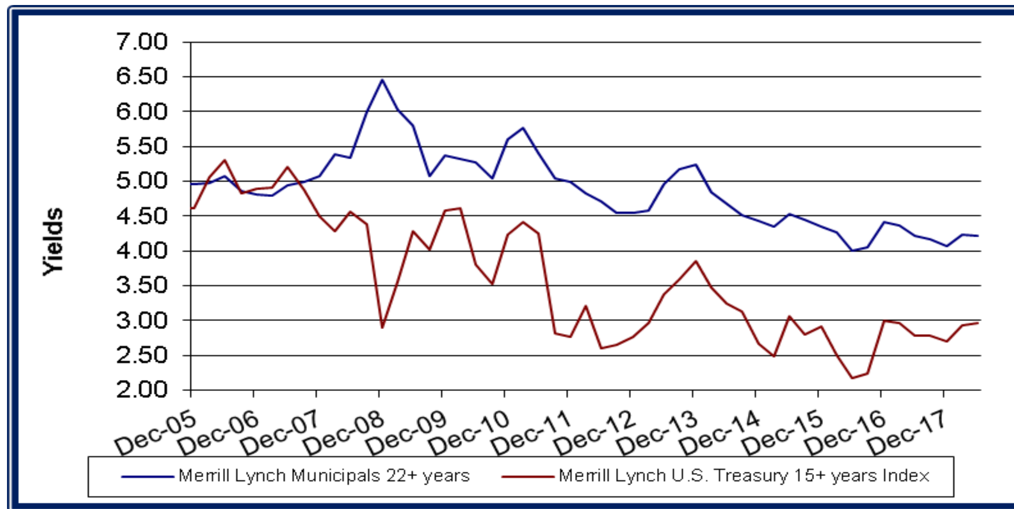
Source: Altman Investment Management Research and Bloomberg

➢ Municipal Bonds

As in the first quarter, the municipal bond market continues to adjust to new supply and demand conditions created by the Tax Cuts and Jobs Act enacted late last year. This eliminated municipalities' ability to issue tax exempt refunding bonds beyond the end of last year. The resultant rush of financings prior to yearend caused a surge in supply that brought 2017 new issue volume to a near record $438 billion. As anticipated, volume dropped dramatically in the first quarter of this year, with an estimated 32% decline from the first quarter of 2017. We continue to expect continued sluggish new issuance throughout the year.

As individual investors make up over 65% of municipal bond holders, we believe tax reform is unlikely to materially change their demand profile. In contrast, the reduction in the corporate tax rate from 35% to 21% makes municipals much less attractive to banks and property and casualty insurance companies. We will continue to monitor banks and insurance company demand and the impact on yields. Munis continue to represent a high-quality, low-default investment choice for individuals seeking to mitigate the burden of income taxes and diversify other portfolio holdings. We remain underweight the longest maturities.

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

It has become evident at this point that U.S. bond yields are tied to comparable German and Japanese yields, which are near zero. They are likely to remain there given the stated policies of both the ECB and BOJ to keep their official rates near zero for the foreseeable future. Inflationary pressures may appear anecdotally to be building, but July's average hourly earnings measure of wages remained subdued at 2.7% y/y. June's headline Personal Consumption Expenditures (PCE) was up 2.2% y/y and 1.9% on a core basis. These inflationary expectations remain subdued, when considering the comparable yield on Treasury Inflation Protected Securities (TIPS). Keep in mind that companies' record profit margins are likely to absorb some of the cost pressures before they show up in prices. And lastly, investors worry about the magnitude of debt that has been built up through accommodative monetary policies that could eventually lead to yet another financial calamity. Ironically, this has resulted in many buying government bonds because they are deemed to be safe assets. As the tug of war continues, until we see a clear winner, we remain cautious.

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