ALTMAN INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

October, 2018

IN BRIEF: The U.S. Fixed Income Markets

Since the recent breakouts, coincident with Fed Chairman Powell's remarks on Oct.3rd, yields have risen to their highest level in years. The 10-year yield has climbed to its highest point since May, 2011, while the 30-year saw its highest yield since July, 2014. The next logical question is whether the sell-off is overdone. We reviewed our favorite indicators:

- Interest Rate Futures Momentum Index is on the cusp of crossing into an "Extremely Oversold" area
- The 10-day stochastic on the Treasury bond future bounced out from its most extreme reading but lingers close to those levels.
- The pickup in volatility relative to trend is consistent with a short-term bottom.
- Bond sentiment has gotten sufficiently pessimistic, but not worse than what we had seen earlier in the year.

Flattening of the yield curve has been driven mostly by rising short term rates. There is minimal correlation between the 2- and 10-year Treasury spread. A common thought when the curve flattens is to shorten investment maturities. For example, on May 18, 2000, the 10-year Treasury was yielding 6.54% versus the 2-year which yielded 6.90%. In that scenario, an investor could pick up yield and at the same time shorten duration. Two years later, when the 2-year Treasury matured, investors faced a much different rate environment with reinvestment choices on the 2- and 10-year at 3.37% and 5.16% respectively (see below). Clearly hindsight divulges why an inverted curve does not necessarily dictate that staying short is the answer. When planning a fixed income strategy/allocation, the impulse to predict future rates needs to acquiesce to long-term planning. Even with interest rates much lower across the board, geopolitical uncertainty, lack of inflation and interest rate disparity may be formidable barriers to higher domestic rates.

EXHIBIT I

Ten-Year Generic Treasury Yield

Source: Altman Investment Management Research and Bloomberg

EXHIBIT II

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

Fixed Income Sector Performance – Q3 2018

Fixed Income Sector Performance – 2018 Q3 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing12 Month Total Return
Treasury	Aaa/AAA	7.8	6.0	3.0%	N/A	$98.2	(1.6%)
Agency	Aaa/AA+	5.0	3.9	3.0%	0	$103.5	(.6%)
MBS	Aaa/AAA	4.1	3.7	3.3%	30	$ 98.3	(1.5%)
Municipal	Aa3/A+	4.8	4.2	2.3%	0	$108.5	.4%
Corporate (Intermediate)	A2/A-	4.1	4.2	4.0%	100	$ 98.6	(.6%)
High Yield	B1/B	6.0	3.9	6.2%	320	$ 98.6	2.9%

Source: Altman Investment Management Research and Bloomberg

Does a Yield Curve Inversion foretell Recessions?

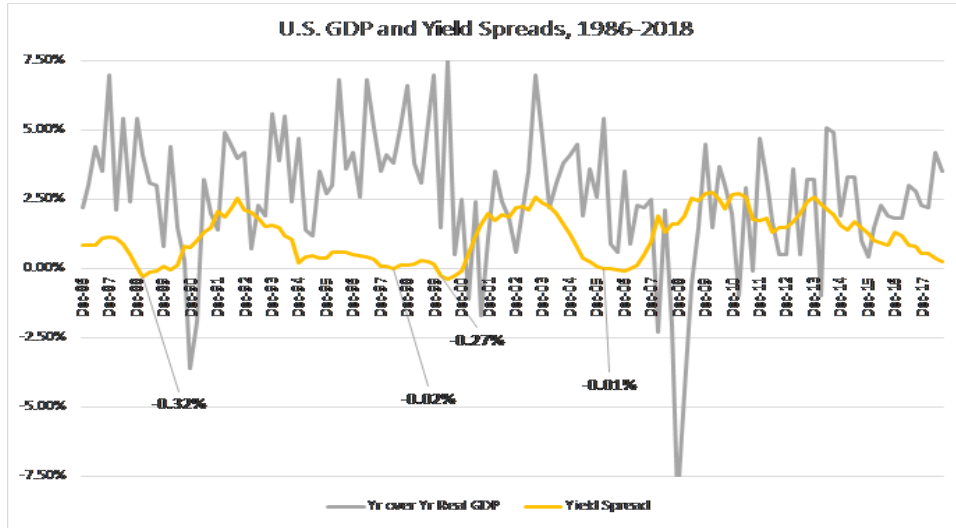
Investors are always looking for early signals that provide reliable guidance as to when adverse events foretell an economic recession and act accordingly by avoiding large market price corrections. Of course, that leads us to the recent observation that market pundits cite as a flattening-then-inverting of the Treasury yield curve as predictive of a near-term economic recession. However, we are not altogether convinced that the very limited set of relevant historical data fully supports this hypothesis. There have been just five cases of inverted yield curves since 1980, and going back further in time may not be as relevant given broad structural changes in the U.S. economy across the last four decades. Even the oldest of these periods (i.e., the inverted yield curve of September 1980) occurred inside a materially different economic environment: inflation had risen over 12%, the Fed Funds rate was increased from 10% to 18% in a very short time period (six months), and 10-year bonds yielded close to 12%.

We looked at the remaining four periods of "inverted yield curves": December 1988, June 1998, March 2000, and March 2006. Exhibit III illustrates the speed with which the U.S. economy experienced recessions following the inversion, demonstrating little correlation.

- According to the National Bureau of Economic Research (the official arbiter of U.S. economic cycles) a recession began in July 1990, roughly 18 months after the yield curve initially inverted.

- Another recession began in March 2001 (32 months after curve first inverted, 12 months after it re-inverted), and the Great Recession began in December 2007 (18 months later).

EXHIBIT III

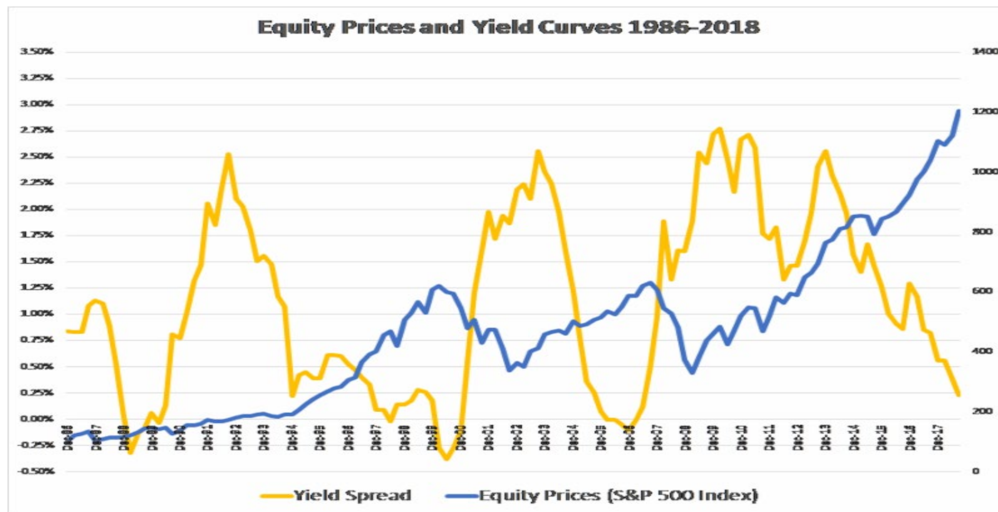


Source: Bloomberg, Capital International, Morgan Stanley

Statistically, this data in the above exhibit suggests a low level of consistency between negative yield spreads and the imminent onset of U.S. recessions. Given the recent equity market's downturn during a period of a flat-to-inverted yield curve, the longer-term data confirms that equity market trends and the shape of the yield curve are generally not highly correlated:

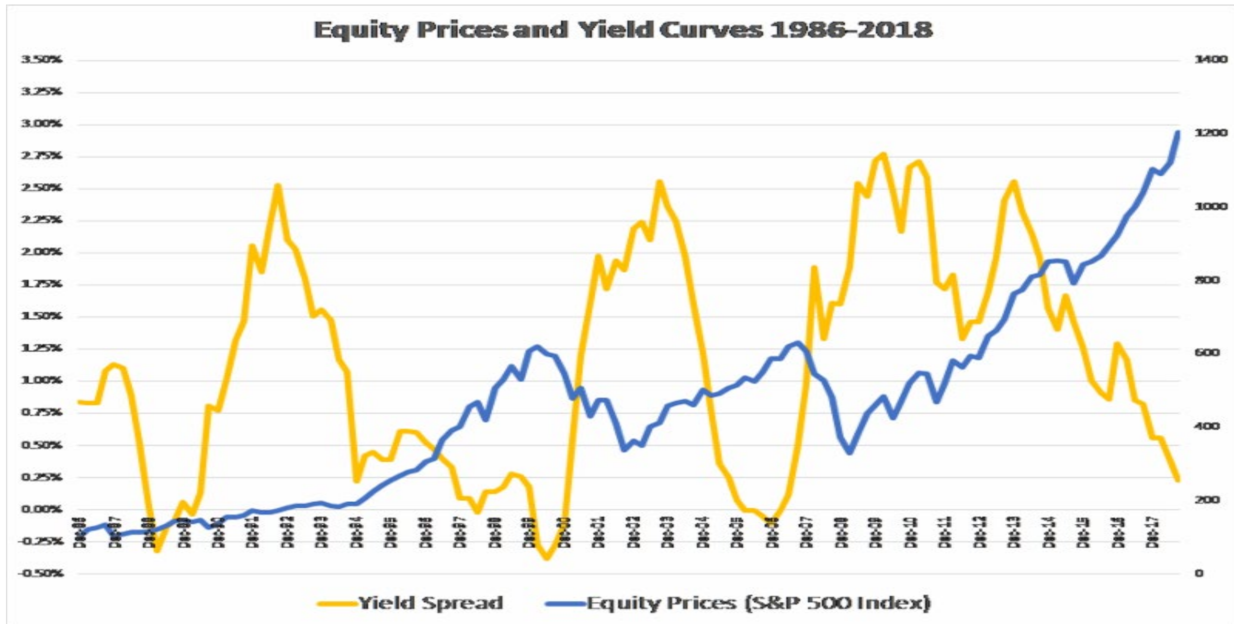
- 12-months after a yield curve inversion, equity prices were higher in 3 of 4 post-1980 cases; prices were also higher 18 months later in 3 of these 4 cases.
- In all but the March 2000 instance, stock market valuations were flat to somewhat higher 12 months later.

EXHIBIT IV



Source: Bloomberg, Capital International, Morgan Stanley

EXHIBIT V



Source: Bloomberg, Capital International, Morgan Stanley

We are not suggesting that investors should ignore the yield curve and changing interest rates altogether. A flat yield curve is the combined product of two forces at work in capital markets: Fed monetary policy which characteristically most directly impacts yields on securities with 3-year and shorter maturities, and long-term inflation expectations which most directly influence yields on longer maturities. Higher interest rates produce rising "financing costs" across government, corporate, and individual borrowers. And worries about borrowers' creditworthiness combined with less spread between bank lending and deposit rates can reduce banks' willingness to lend. Accordingly, rising interest rates do put the economy at a somewhat greater risk of a slowdown or a recession.

We believe that the slow speed with which rates have been increased (i.e., by year-end the Fed Funds rate will have risen only +200 basis points in two years) could dampen their near-term economic impact. Extreme systemic risks - such as a very high inflation, extremely over-valued stock markets, and highly leveraged consumers - have had the potential of tipping the economy into a recession. Recent inversions of the 2-year yield curve have often been followed by a recession within 12-18 months. This time, we believe that the bond market is giving a false signal on the direction of the U.S. economy.

In summary, we see some headwinds for 2019, even as we expect markets to rally into the end of 2018. The case for a yearend rally has faded recently, but the factors include strong seasonality; oversold conditions; risk-off investor positioning and improving trade tensions. The selloff in recent days could suggest that the markets are painfully shifting leadership away from Growth stocks towards Value stocks.

CLOSE-UP:

➢ Government Bonds

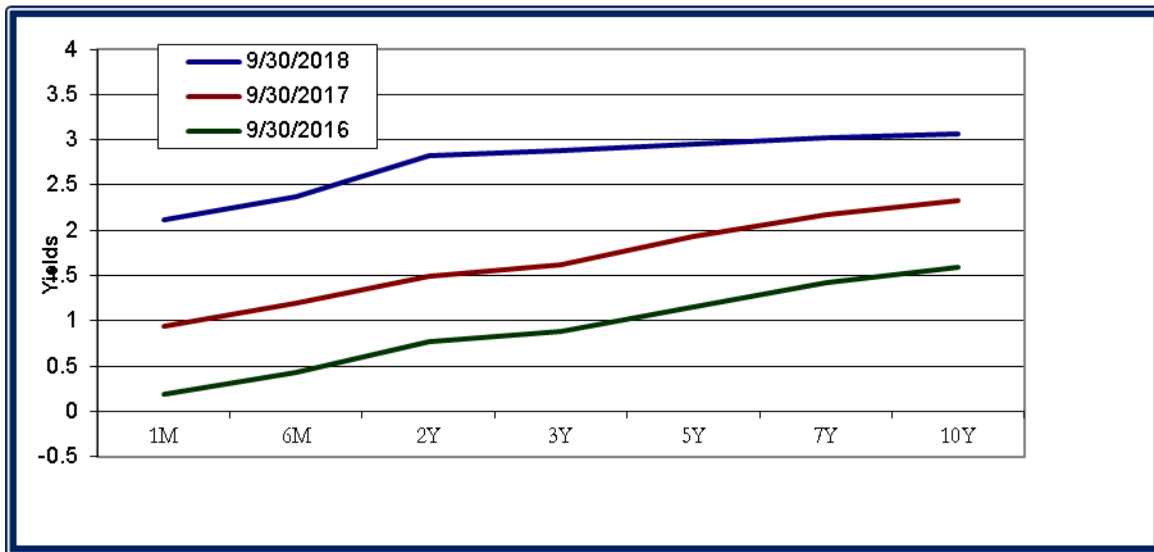
EXHIBIT VI

U.S. Government Index 7-10 year

Source: Altman Investment Management Research and Bloomberg

EXHIBIT VII

Active Government Yield Curves



Source: Altman Investment Management Research and Bloomberg

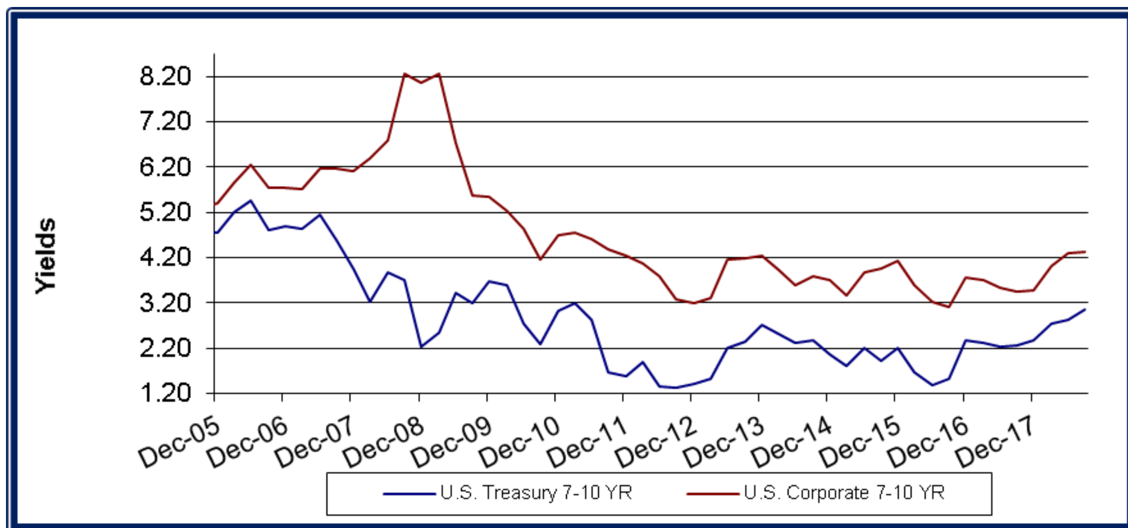
➢ Investment-Grade Corporate Bonds

So far in 2018, investment grade corporate yields have risen considerably. The yield of the Citi Broad IG Corporate index is about 75 basis points (bp) higher than it was at the beginning of 2018. The yield on a corporate bond is composed of the yield on its benchmark Treasury plus a spread. The benchmark Treasury for bonds with a similar maturity is going to be the same, so the component that differentiates one bond's yield from another is the spread.

The overall trend is towards higher rates, as IG corporate yields are ~10 basis points higher month-over month and ~110 basis points higher year-over-year. The corporate yield curve, although it has flattened over the past year, remains relatively steep compared to the Treasury curve. The 2yr-10yr spread in the Treasury market is currently ~23 basis points, while the same spread in the A-rated corporate curve is ~80 basis points, meaning for that for this maturity window, the corporate curve is nearly 4 times as steep as the Treasury curve. Differences such as this are important to keep in mind as an investor, as most commentaries that are published refer to Treasury yields, whereas most fixed income investors are investing in some sort of spread product (i.e. corporates, municipals, CDs)

EXHIBIT VIII

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



Source: Altman Investment Management Research and Bloomberg

➢ Municipal Bonds

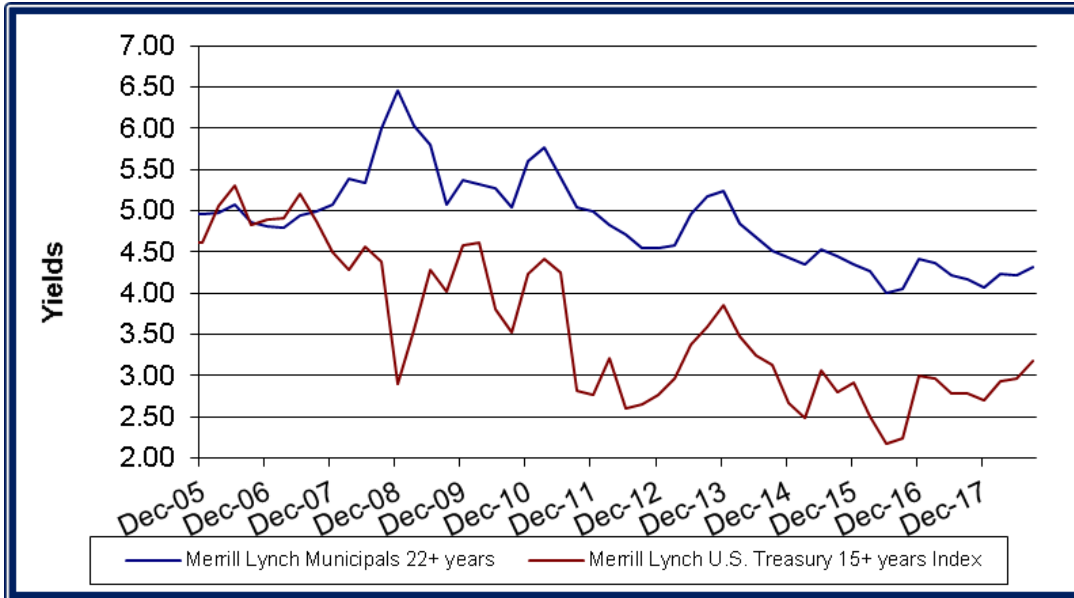
Municipal yields have recently moved lower, with the long-end outpacing the short- end, leading to a slightly flatter muni curve for the week. The very short-end of the curve finished the week less than a basis point lower than it started, while yields from 5-years out to 30-years moved lower by ~2-3 basis points. The 2yr- 10yr spread is currently ~66 basis points.

Our outlook for the muni market continues to be cautious until the technical environment improves. It is possible that demand could strengthen as volatility normalizes and rates settle in at their new, higher range; however, we are entering a period of seasonally weak demand driven by year-end tax loss selling.

We continue to maintain a 1yr to 4yr yield curve strategy. We prefer at least A- investment grade credits, revenue bonds, issues in high tax states, and the transportation sector.

EXHIBIT IX

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

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