ALTMAN INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

APRIL, 2019

IN BRIEF: The U.S. Fixed Income Markets

The first quarter of 2019 was the best three-month period for stocks in a decade, as the S&P 500 index posted a 13.6% return, the strongest quarter since 2009 and the greatest start to a year since 1997*. Central Bank policy continued to aid the rally in fixed income markets as well. This bullish position along with the Federal Reserve's increased dovish stance laid the foundation for the European Central Bank (ECB) to follow suit. In early March, Mario Draghi extended the ECB's forecast for its first interest rate increase since July 2011, announcing that it expects key interest rates to remain at current levels throughout the year. In conjunction with a delay in rate hikes, the ECB also announced a new stimulus package, the third of its kind, which provides lower lending rates to banks with the hope of creating a better credit condition for consumers on the continent.

In response to the aggressive shift by ECB, the Fed made its most dramatic policy change as well in mid-March by releasing at the FOMC its revised dot plot for 2019 - which in effect reduced interest rate policy to zero rate hikes for the year, and only one rate hike in 2020. This was of course down from three hikes and two hikes respectively. The Fed also announced that the balance sheet normalization process was coming to an end sooner than the market participants expected with the process concluding by the end of September. Note that upon completion of the Quantitative Tightening, the Fed's balance sheet will have approximately $3.7 trillion in bonds, which is close to 4 times (~$900 billion) the amount it held prior to the crises of 2008-09.

Compared to the 3-month T-bill, the yield curve was recently inverted out to 10 years, with the deepest inversion occurring in the 3 to 5-year range. We would take a yield curve inversion more seriously if we had tighter financial conditions, which we do not have. Moreover, the yield curve is inconsistent. Usually various curve relationships invert around the same time. But the benchmark 10 year to 2-year yield spread, for example, has not yet inverted. And the forward curve is clearly steeper five years out.

Toward the end of March, the 6-month Treasury bill yielded more than the 10-year Treasury note, the first inversion (using this measure) since July 2007. The performance of the bond market has been surprisingly mixed following yield curve inversions: Treasury bond performance was mixed but generally underperformed Treasury bills, in the months following the first month of inversion. Bonds underperformed 3, 12, and 18 months after the inversion and only modestly outperformed six months later. Credit was mixed but underperformed its historical average across all time horizons that we studied. 1959 and 2006 were clear exceptions, with investment grade credit outperforming across the board.

Fixed Income Sector Performance – Q1 2019

Fixed Income Sector Performance – 2019 Q1 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing12 Month Total Return
Treasury	Aaa/AAA	8.2	6.4	2.4%	N/A	$102.6	4.2%
Agency	Aaa/AA+	5.4	4.1	2.5%	10	$106.5	3.8%
MBS	Aaa/AAA	3.9	3.6	2.6%	20	$ 100.8	4.1%
Municipal	Aa3/A+	5.0	3.7	1.8%	0	$110.5	4.4%
Corporate (Intermediate)	A2/A-	4.9	4.2	3.3%	110	$ 101.3	5.2%
High Yield	B1/B	5.8	3.8	5.8%	340	$ 99.7	6.3%

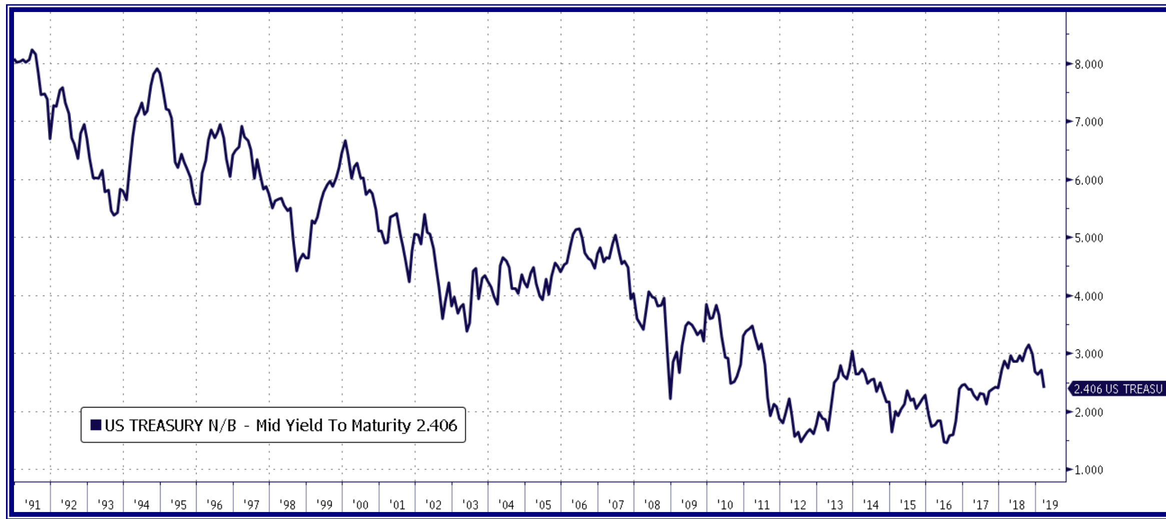
Source: Altman Investment Management Research and Bloomberg

*Source: Bloomberg quarterly data for the S&P 500 Total Return Index from June 30th, 1997 through March 29th, 2019.

THE FEDERAL RESERVE UPDATE:

In the days following the FOMC announcement, we saw the first warning signs of a recession as the spread between the 10-year U.S. Treasury (UST) yield dropped below the interest rate on the 3-month bill. Market participants have long held the belief that a yield curve inversion portends an imminent recession, since the last seven recessions have been preceded by such an inversion. There have however, been two notable false signals - first in the late 1996 with a recession following three years later, and another incident in 1998 during the Asian financial crisis. The last time the 3-month Treasury yield was more than the 10-year UST was early 2007, before the global financial crisis hit in December of that year. Recession indicators at that time were giving mixed signals at month end, with the yield curve actually slightly positive.

Ten Year Generic Treasury Yield



Source: Altman Investment Management Research and Bloomberg

CLOSE-UP:

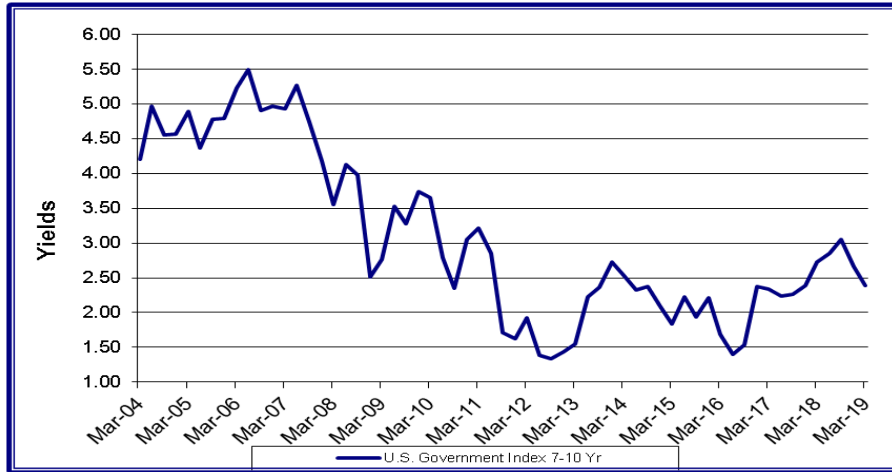
➢ Government Bonds

Treasury yields gradually moved lower from the levels seen at the beginning of the year, with the pace of the decline accelerating following the FOMC meeting. The 10-year UST yield reached its lowest level year to date on March 27th, while the 10-year US Treasury volatility reached the highest level seen this year in March.

Yield inversion became a major focus in late March as the spread between the 3-month UST and the 10-year turned negative for the first time since 2007. As a reliable precursor of economic downturn, the yield curve inversion prompted fears that recession risk has become elevated in comparison to previous quarters.

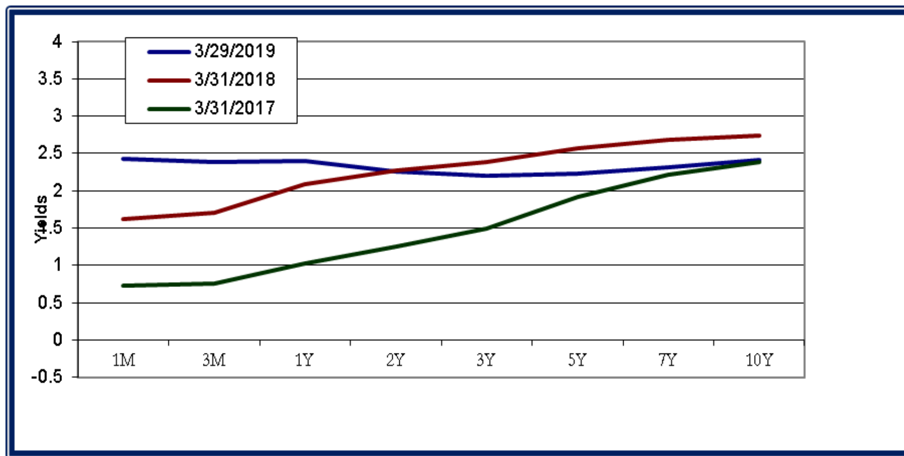
With no further interest rate increases now forecasted for the year, the Fed pivoted to a more dovish stance. Central bankers' have now increased their tolerance towards above trend inflation, coupled with stronger energy prices, became the stimulus behind Treasury inflation protected Securities (TIPS) break-evens.

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

Source: Altman Investment Management Research and Bloomberg

The Bloomberg Barclays Investment Grade Corporate Index generated excess return of 24bps, through the end of the quarter. Spreads fell 2bps to 119bps as the pace of spread tightening slowed from last month, when spreads fell 7bps. Spreads benefited from a dovish Fed, which was offset by continuing global growth concerns. In addition, overall rate volatility declined, which was positive for spreads. Finally, lower Treasury rates helped boost investment grade (IG) corporate total returns.

From a credit perspective, S&P 500 Index companies reported operating earnings growth of 12 percent in 4Q18 on a year-over-year basis, marking the fifth straight quarter of double-digit growth, per Bloomberg. However, as the benefit of tax cuts rolls off and some economies slow and wages rise, operating trends are expected to moderate. The technical picture also remains supportive for the corporate sector. March investment grade corporate supply was light at just under $100 billion, which is down almost 30 percent year-over-year. New issues were well received. Fund flows were solid in March, with inflows totaling $18.9 billion, bringing net year-to-date inflows to $66 billion.

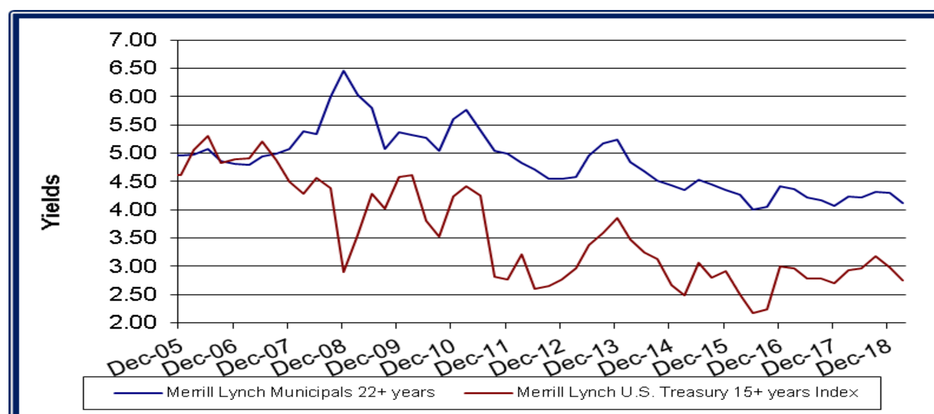
We think that corporate credit spreads in the U.S. will continue to widen in conjunction with a slowing U.S. economy. Our forecast is for the spreads of speculative-grade bonds to rise by well over 100bp currently at about 400 basis points, on average, by the end of 2019.

On closer examination, the option-adjusted spread (OAS) over Treasuries of the Bank of America ML U.S. High Yield Master Index of speculative-grade corporate bonds has increased by almost 100bp in the past month. This has accompanied the drop in the S&P 500, underscoring our view that bonds and equities are now synchronized. The rise in the spread reflects growing concerns over the U.S. economy and the global backdrop, following the escalation in the U.S.-China trade war and, more recently, the threat of U.S. tariffs on imports from Mexico.

At the sector level, spreads have widened the most, on average, for energy and auto firms. That is probably due to the sharp fall in oil prices, as well as the vulnerability of automakers to U.S. tariffs on Mexican imports. Despite its recent jump, the spread on speculative grade bonds is still not high by past standards. It is roughly level with its 5-year average, and below its 10-year average. This implies that there is still room for the spread to increase from here. We think that this will happen over the rest of the year, as the U.S. economy loses some momentum. Not only did the spread surge during the last deep recession a decade ago, but it also rose significantly during the two more recent cyclical slowdowns in 2011/12 and 2015/16. Our forecast that U.S. GDP growth will slow over the coming quarters is consistent with the spread climbing closer to 500bp by yearend. As the possibility increases for further U.S. protectionism during the next several months, that would translate into a lower than expected economic forecast as the year progresses.

➢ Municipal Bonds

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

Municipal yields fell in March, as strong inflows from municipal mutual funds continued to support pricing. For the week ending March 27, year-to-date inflows totaled $22.5 billion – the highest level of inflows since 1992. The demand was largely prompted by individual investors seeking tax-exempt assets to combat higher tax obligations. In addition, the longer end of the curve in January and February represented better value for institutional investors.

At the same time, supply remained modest, reaching $24.2 billion for the month – the lowest March supply since 2011, per the Bond Buyer. Primary dealer inventories, per the Fed, have dropped 50 percent since the recent peak in 3Q18, and are at the lowest level since 1Q15. Net supply could fall further in the near term given that expected maturities are at record levels in five of the next nine months.

In contrast to January and February, when shorter munis outperformed, municipal bond yields declined most in the long end in March, and the curve flattened. Yields fell roughly 40bps for bonds maturing in 20 years and higher. Meanwhile, yields for maturities five years and below fell roughly 10bps, and 10-year bonds fell 24bps.

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ALTMAN INVESTMENT MANAGEMENT, LLC
33 Witherspoon Street, 2nd Floor – Princeton, NJ 08540 – (609) 252-0048 – www.AltmanInvest.com