

IN BRIEF: The U.S. Fixed Income Markets

The shift to tighter monetary policy may be upon us, after years of quantitative easing that drove down credit premiums and suppressed volatility. While the U.S. Federal Reserve (Fed) is leading the way, other developed world central banks appear to be joining in, perhaps sooner than many investors expected. According to Bloomberg, in a recent policy statement the European Central Bank (ECB) dropped its assurance to increase asset purchases in the event the economy deteriorates. The Bank of England (BOE) lifted its growth forecasts, cautioning that rate hikes could come “earlier”, and to a “greater extent” than originally expected. And the Bank of Japan (BOJ) is subtly reducing the amount of its bond purchases.

In tandem with the removal of accommodative policy, the U.S. is unleashing fiscal stimulus via tax cuts and budget increases that may in the short term cause an increase in Treasury supply. Rates seem inevitably set to move higher over time. Still, we believe inflation will be the ultimate determinant of where things sort out. We are watching closely to see if the early signs of inflation have staying power, which could force the Fed into a faster schedule of rate hikes than are currently forecast - or if both growth and inflation slow below expected levels, allowing the Fed to proceed at its measured pace.

In February of this year, we saw a reversal from calmer markets as investors grew concerned that strong U.S. wage growth could force faster-than-expected rate hikes from the Fed. Volatility returned to both rates and risk assets. Looking ahead, we expect that the market will continue to face bouts of heightened volatility, amid continued uncertainty around the pace of rate hikes, along with the still unclear implications of tax reform and the administration’s trade protectionism. Although we are mindful that we may be late in the credit cycle, investment-friendly behavior continues. In this environment, we believe it may be too early yet to be concerned with credit risk.

Ten-Year Generic Treasury Yield



CLOSE-UP:

➤ Government Bonds

The gradual path of monetary policy normalization, initiated under Janet Yellen, continues under the Fed's new chairman, Jerome Powell. As expected, the Fed raised its benchmark rate at its March meeting by 25 basis points (bps), citing an improving economy and strong job market, bringing the target rate range up to 1.50% to 1.75%.

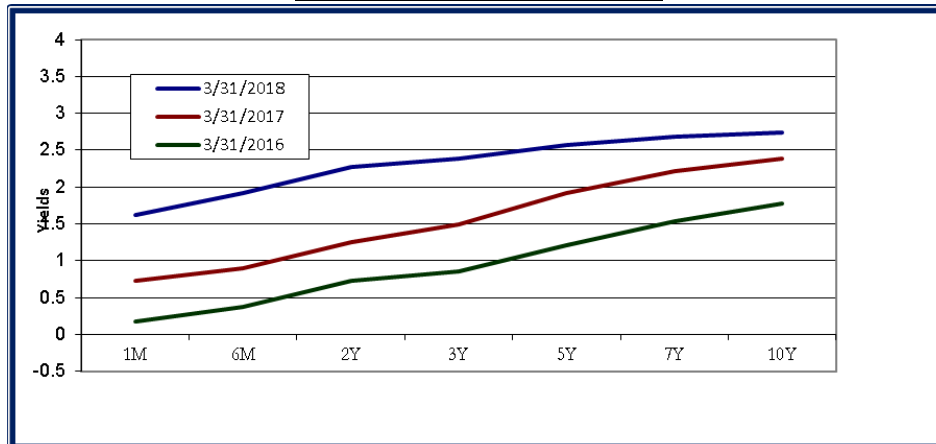
Going forward, however, the path of Mr. Powell's Fed is becoming less clear as the market starts to be buffeted by crosscurrents. On one hand, economic growth is improving and the job market remains very tight; the Fed even raised its forecast for both metrics during its latest meeting. On the other hand, inflation, while trending higher, does not appear to be breaking out to the upside anytime soon.

While the Fed indicates a consensus estimate of three total rate hikes in 2018, some fed officials have also indicated a potentially more hawkish stance in future years should economic growth continue to run hotter than expected. This could raise the median estimate for the benchmark rate by the end of 2019 to 2.9%, and 3.4% by the end of 2020, up from 2.7% and 3.1% respectively.

U.S. Government Index 7-10 year



Active Government Yield Curves



Source for above charts: Altman Investment Management Research and Bloomberg

Fixed Income Sector Performance – Q1 2018

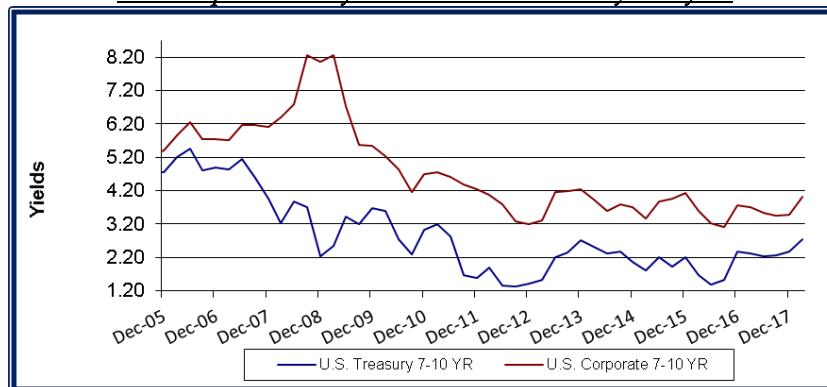
Fixed Income Sector Performance – 2018 Q1 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing 12 Month Total Return
Treasury	Aaa/AAA	7.9	6.2	2.5%	N/A	\$100.6	.5%
Agency	Aaa/AA+	4.9	3.9	2.5%	N/A	\$104.4	.86%
MBS	Aaa/AAA	4.6	4.1	2.8%	30	\$99.6	.17%
Municipal	Aa3/A+	4.6	3.6	2.1%	0	\$108.9	.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

➤ Investment-Grade Corporate Bonds

In the corporate bond market, credit spreads in the investment-grade market have widened only about 5 basis points (bp) this past quarter, whereas credit spreads in the high-yield market have widened slightly. While there was a slight divergence this quarter, year-to-date corporate credit spreads have widened slightly across both the investment-grade and high-yield sectors. Corporate credit markets have been closely correlated with the ongoing volatility of the equity markets.

Most corporate bond issuance (and, therefore, most supply) is within ten years. About 25% of the available market is within three years, and about 70% is within ten years. For example, moving from a two to three-year bond will increase the yield approximately 21 basis points. Investment-grade corporate bond issuance improved last quarter with \$174 billion in deals coming to the market, but activity remains well below last year. Investment-grade corporate bond yields ended last week at 3.69%, while the spread level over comparable Treasury yields was 95 bps. Intermediate Investment-grade corporate bonds have a year-to-date total return of negative 1.53% and .43% over the past 12 months.

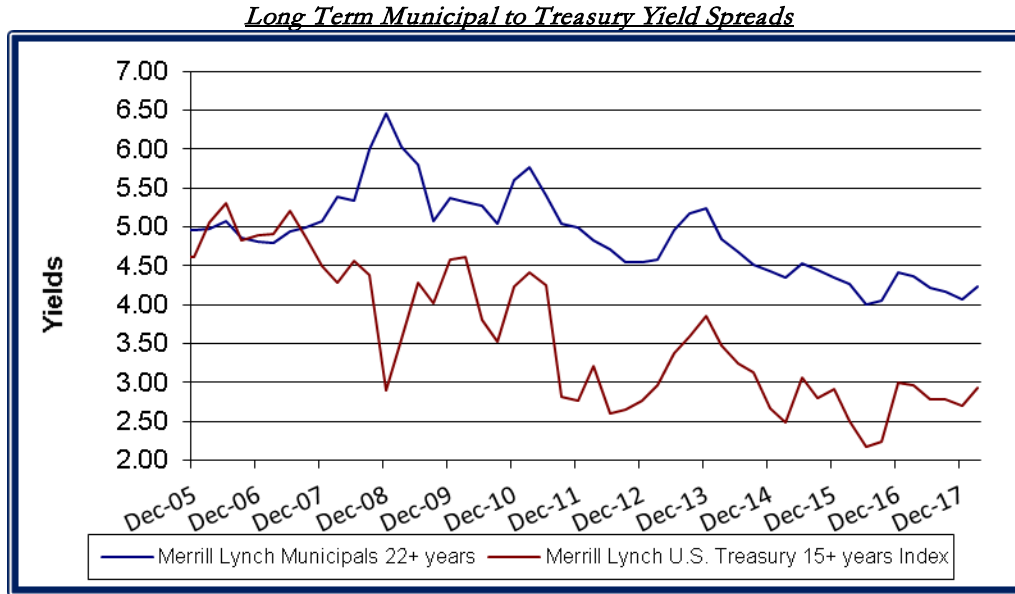
U.S. Corporate 7-10 year versus U.S. Treasury 7-10 year

Source: Altman Investment Management Research and Bloomberg

➤ Municipal Bonds

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 anticipate 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.



Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

The Federal Reserve should continue to carefully increase overnight rates during the balance of 2018, after the 25-basis point increase to 1.50% to 1.75% at the March FOMC meeting. In our view, an additional two increases appear to be the most likely outcome, which would bring the Federal Funds rate to 2.0% to 2.25% by yearend. These increases should be reflected in interest rate rises across the maturity spectrum, although to a lesser extent than is the case for short term rates. With this outlook and the tail risk of rising inflation, we adhere to our strategy of maintaining shorter than average durations in our taxable and tax-exempt portfolios and we expect to re-invest shorter-term bonds at higher rates over the next several years.

Yields in the U.S. continued to increase gradually during the first quarter of 2018, even with a partial retracement late in the period. Yields on two-year U.S. Treasury obligations ended the first quarter at 2.27% versus 1.88% at the end of 2017. The yield on ten-year Treasury notes rose to 2.74% as of March 31, 2018 as compared to 2.41% on December 31, 2017. Outside the U.S., yields were little changed during the first quarter, with ten-year German obligations yielding 0.49% on March 31, 2018 versus 0.42% on December 31, 2017. The yield on ten-year Japanese bonds remained at 0.4% throughout the quarter.

We remain positive towards corporate bonds. First, we believe that inflation expectations are likely to increase over the next several months, as raw material prices rebound and wages respond to an accelerating economy. Although it has taken some time for the trailing effects of the historical low rates to roll off, the Consumer Price Index (CPI) is likely to move higher and possibly even push through the 2.0% threshold in the coming quarter.

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