ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JANUARY, 2018

IN BRIEF: The U.S. Fixed Income Markets

The stock market may be a market of stocks, but it also occasionally has a collective agenda to force new Fed chairs to pay respect. The market did that to Fed Chairman Alan Greenspan in October 1987 with a meltdown that caused the new Federal Reserve chair to introduce the 'Greenspan Put'. Could it have been just a coincidence that the stock market plunged on Friday as Fed Chair Janet Yellen was leaving the building in that role for the last time, to be replaced by Jerome Powell the following Monday? (1).

The higher-than-expected 2.9% increase in wages in the employment report at the same time might not have concerned investors/traders at all, if Yellen had remained in charge. Perhaps she could have calmed markets by responding that while 2.9% is welcome, she wants to see 3.0%-4.0%. Left to his own devices, Powell probably would have said the same, and stressed that Yellen's policy of gradual monetary normalization will be maintained. However, the market's selloff may be the market's way of forcing the new chairman to declare his unwavering support of the current Fed policy and show he is willing to provide a 'Powell Put' if necessary.

Of course, the issue for the stock market this time isn't earnings over the foreseeable future, but rather inflation and interest rates. Our view is that inflation is likely to remain subdued around 2-2.5%. Bond yields, on the other hand, may be normalizing around the world as the major central banks stop excessive easy monetary accommodation. We view this positively, because it confirms that the global economy has achieved self-sustaining growth and no longer requires propping up by the central banks.

Ten-Year Generic Treasury Yield

Source: Altman Investment Management Research and Bloomberg

(1). Will the Fed be there to keep market turmoil contained? The answer is most likely, but there is a risk central bankers will be slow to respond to a market downdraft that threatens the economy. Shortly after the market crash of 1987, the Fed cut rates, changing course in the middle of a tightening cycle. That action has famously become known as the "Greenspan put" because of the implied promise that central bankers led by Fed Chairman Alan Greenspan would bail out market participants who indulged in risky behavior. Subsequent similar actions by the Fed have reinforced beliefs that it continues to use the "Greenspan put". Tim Duy, Bloomberg View 2-14-18

It no longer makes much sense for Germany's 10-year government bond yield to be below 1.00%, as it has been since the fall of 2014. Neither does it make much sense that Japan's government bond yield remains near zero. From this perspective, the U.S. Treasury bond yield at 2.80% certainly is already a lot more normal than comparable yields overseas. If the Fed proceeds with three rate hikes this year, as is widely expected, that will push the top of the federal funds rate target range from 1.50% to 2.25%. The U.S. bond 10-year yield could rise to 3.00%-3.50% in that scenario. The bull market in stocks could certainly resume in that environment, especially if the higher interest rates confirm that solid economic growth is boosting earnings.

CLOSE-UP:

Government Bonds

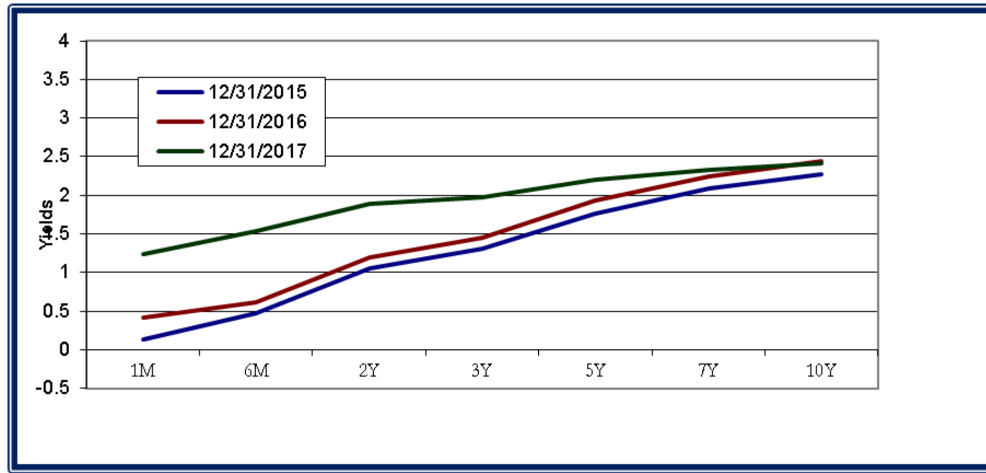
- **Total return performance in the fourth quarter was mixed, as the shape of the yield curve compressed to its flattest level since before the 2008-09 global financial crisis and corporate credit spreads increased between the investment-grade and high-yield sectors.** Similarly, year-to-date performance was significantly affected by the flattening curve, as the performance of short-duration indexes was muted, whereas long-duration indexes outperformed. While there were a few spikes in volatility earlier in the year, it was subdued in the fourth quarter and ended the year near historical lows.

- **During the fourth quarter, the yield on the 2-year Treasury bond rose 40 basis points and has risen 69 basis points since the end of 2016.** The yield on the 2-year has risen even more, thus far this year, and is trading at its highest yield since October 2008. While short-term rates have been rising quickly, the yield on the 30-year Treasury bond declined 12 basis points in the fourth quarter and dropped 25 basis points over the course of the year, trading in its lowest quartile since the global financial credit crisis. As the yield on short-term bonds rose and the yield on long-term bonds fell, the spread between the 2-year Treasury and the 10-year Treasury compressed to 53 basis points at year-end, its narrowest level since before the global credit crisis.

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 – Q4 2016

Fixed Income Sector Performance – 2016 Q4 - Sector	**Rating**	**Maturity**	**Duration Mod Adj**	**Yield**	**Spread**	**Price**	**Trailing1 12 Month Total Return**
Treasury	Aaa/AAA	8.7	6.2	1.9%	N/A	$102.5	1.1%
Agency	Aaa/AA+	4.9	3.8	1.8%	N/A	$104.5	1.5%
MBS	Aaa/AAA	6.4	5.4	2.8%	90	$103.7	1.7%
Municipal	Aa3/A+	4.6	3.5	1.9%	0	$109.2	(.1)%
Corporate (Intermediate)	A2/A-	4.9	4.2	2.9%	100	$102.0	4.2%
High Yield	B1/B	6.3	3.9	6.1%	420	$99.6	17.5%

Fixed Income Sector Performance – Q4 2017

Fixed Income Sector Performance – 2017 Q4 - Sector	**Rating**	**Maturity**	**Duration Mod Adj**	**Yield**	**Spread**	**Price**	**Trailing1 12 Month Total Return**
Treasury	Aaa/AAA	8.0	6.3	2.2%	N/A	$102.5	2.4%
Agency	Aaa/AA+	5.1	4.0	2.2%	N/A	$105.5	2.2%
MBS	Aaa/AAA	4.3	4.0	2.4%	20	$101.3	1.9%
Municipal	Aa3/A+	4.8	3.7	1.8%	0	$110.4	2.6%
Corporate (Intermediate)	A2/A-	4.6	4.1	2.7%	50	$101.6	3.3%
High Yield	B1/B	7.2	4.4	5.8%	360	$101.0	8.2%

Source: Altman Investment Management Research and Bloomberg

➢ Investment-Grade Corporate Bonds

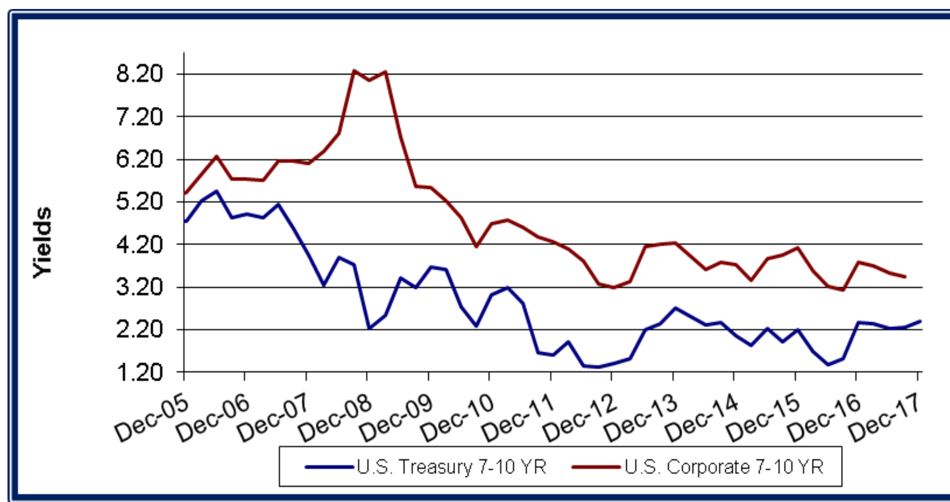
In the corporate bond market, credit spreads in the investment-grade market have tightened this past quarter, whereas credit spreads in the high-yield market have widened slightly. While there was a slight divergence this quarter, year-to-date corporate credit spreads have tightened across both the investment-grade and high-yield sectors. Corporate credit markets have been buoyed by a combination of generally improving credit metrics, fewer debt-funded mergers and acquisitions or shareholder-enhancement programs, and the market's expectation that revisions to tax and regulatory policies will bolster corporate credit strength by invigorating economic growth and boosting earnings.

The Aggregate Core Bond Index, our broadest measure of the fixed-income universe, eked out a gain of 0.40% in the fourth quarter, as declining long-term interest rates provided enough price appreciation to offset the pressure from rising short-term rates.

Underlying the Aggregate Bond Index, the Short-Term Bond Index registered a loss of 0.24% as short-term rates rose to their highest levels in over a decade. The Intermediate-Term Aggregate Bond Index was nearly unchanged, registering a loss of 0.04%, as rising rates more than offset the yield carry from the underlying bonds in the index. The outperformer this past quarter was the Long-Term Bond Index, which rose 1.93%. In the Treasury market, the U.S. Government Bond Index registered a gain of 0.10%, as the negative impact of rising short-term and intermediate-term rates on bond prices offset much of the yield carry for the quarter. Similarly, the Agency Bond Index eked out a 0.02% return. After lagging much of the rest of the fixed-income universe in the first half of the year, Treasury Inflation-Protected Securities (TIPS) performed well in the fourth quarter. The TIPS Index rose 1.31% as inflation expectations held steady.

In the corporate bond market, the investment grade Corporate Bond Index rose 1.10%, supported by a modest tightening in corporate credit spreads and a slightly longer duration than other indexes. In the high-yield market, the BofA Merrill Lynch High Yield Master Index rose 0.39%, as the higher yield carry of the index was offset by a slight widening of corporate credit spreads in the junk bond market and the increase in medium-term interest rates.

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

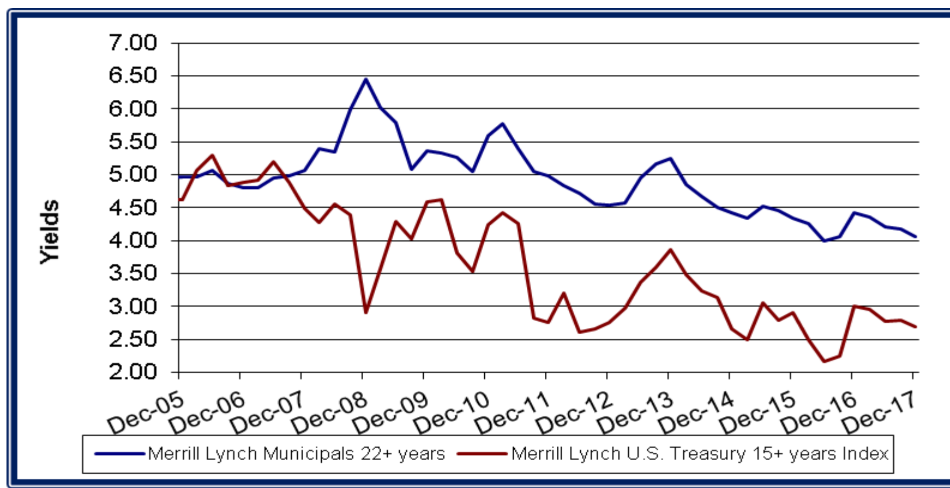


Source: Altman Investment Management Research and Bloomberg

➢ Municipal Bonds

Municipal bonds generally outperformed Treasuries in the fourth quarter due to higher income levels, while interest rate changes for both asset classes were very small. The municipal-to-U.S. Treasury yield ratio remained virtually unchanged. Intermediate municipal bonds are experiencing the strongest investor demand, and the 10-year yield ratio at 86% is very close to the long-term average. The 30-year portion of the municipal yield curve has performed well so far in 2017, but ratios remain somewhat cheap at 100% compared to the historical average of 93%. We think municipal valuations remain relatively attractive, given that defaults are trending lower (excluding Puerto Rico), upgrades are exceeding downgrades, and taxes for higher earners are unlikely to experience significant change.

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

IN SUMMARY:

We remain cautious towards U.S. government 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 may take a few months 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 punch through the 2.0% threshold over the next several months. In addition to rising inflation expectations, any proposed infrastructure plans or defense spending will likely be financed by long term debt.

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