ALTMAN
INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

JULY, 2019

IN BRIEF: The U.S. Fixed Income Markets

The financial markets in the U.S. and globally have experienced solid gains in the second quarter. This has largely been driven by the shift in the Federal Reserve outlook for interest rate cuts, and extended the rally in both equity and bond markets that began in the first quarter. The yield on the 10-year U.S. treasury closed the quarter at 2.01%, 40 basis points below the yield at the end of the first quarter and close to 70 basis points from the yearend rate. Accommodative monetary policy globally further bolstered the rally. The European Central Banks initiated the easing with a two-year liquidity injection for the banks. This was accomplished through a targeted long-term financing operation (TLTRO) and set the stage for a global coordinated rate cut program during the second half of the year. The rally was bolstered by the March Federal Open Market Committee (FOMC) release of the new "dot plot" for 2019, which indicated zero rate hikes in 2019 and only one rate hike in 2020.

EXHIBIT I:
Fixed Income Sector Performance – Q2 2019

Fixed Income Sector Performance – 2019 Q2 - Sector	**Rating**	**Maturity**	**Duration Mod Adj**	**Yield**	**Spread**	**Price**	**Trailing12 Month Total Return**
Treasury	Aaa/AAA	8.3	6.6	1.9%	N/A	$104.5	7.3%
Agency	Aaa/AA+	5.4	4.0	2.1%	20	$108.3	6.2%
MBS	Aaa/AAA	3.7	3.4	2.3%	40	$ 101.9	5.8%
Municipal	Aa3/A+	5.8	3.9	1.6%	0	$112.1	5.6%
Corporate (Intermediate)	A2/A-	4.9	4.2	2.8%	90	$ 103.6	8.6%
High Yield	B1/B	5.8	3.4	6.1%	420	$ 98.9	7.6%

Source: Altman Investment Management Research and Bloomberg

Bond Market Performance During Easing Cycles:

We don't know if the Fed is about to embark on an easing cycle, which we define as two or more rate cuts within a 12-month period without an intervening rate hike. If they do, here is what we found to be true. Treasury yields generally declined during an easing cycle. High quality sectors generally performed well during an easing cycle. Lower quality sectors exhibited wider variability of returns. The yield curve was flat to steeper in all prior easing cycles. Credit spreads were little changed in past easing cycles. (1)

A Fed Rate Cut Could Stimulate the U.S. Economy:

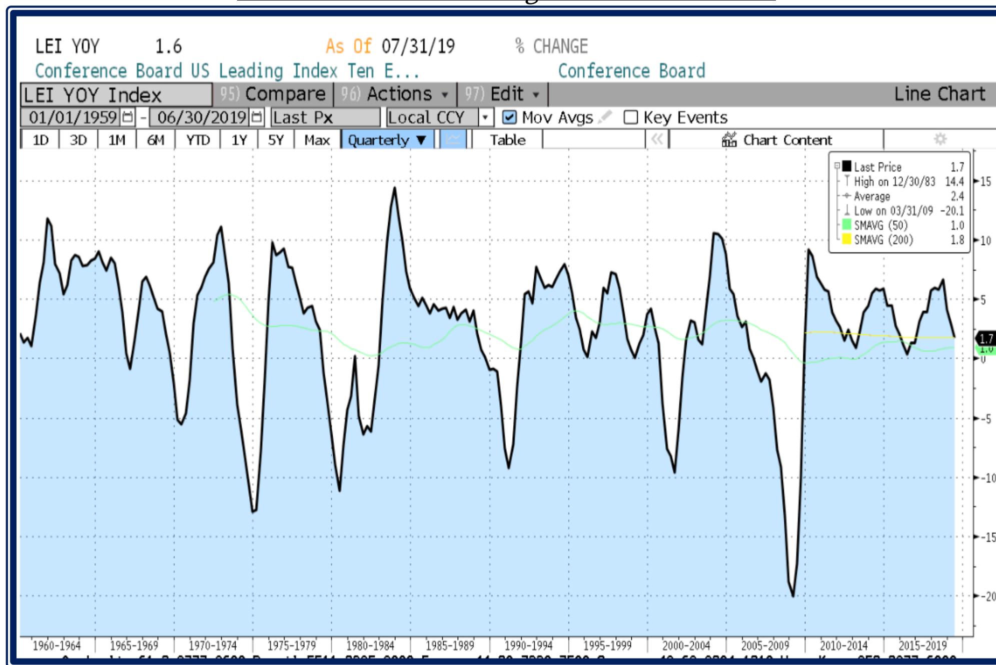
Since 1954, there have been 16 instances of first Fed rate cuts, most of which have turned into easing cycles. Nine of these cases had either taken place during a recession or had been associated with recession within a year's time. On average, real GDP growth on a year/year basis was slowing ahead of the first Fed rate cut, but stabilized within a year after the cut. Thus, one could argue that easier monetary policy had cushioned the economy, as the downturns could have been more severe without the rate cuts. Additional key takeaways from our analysis: rate cuts are more effective in stimulating economic activity during recessions than during expansions. A rate cut now will be a positive for corporate and government debt management and stock prices. It can support consumer spending through increased confidence and a positive stock market wealth effect.

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

THE FEDERAL RESERVE UPDATE:

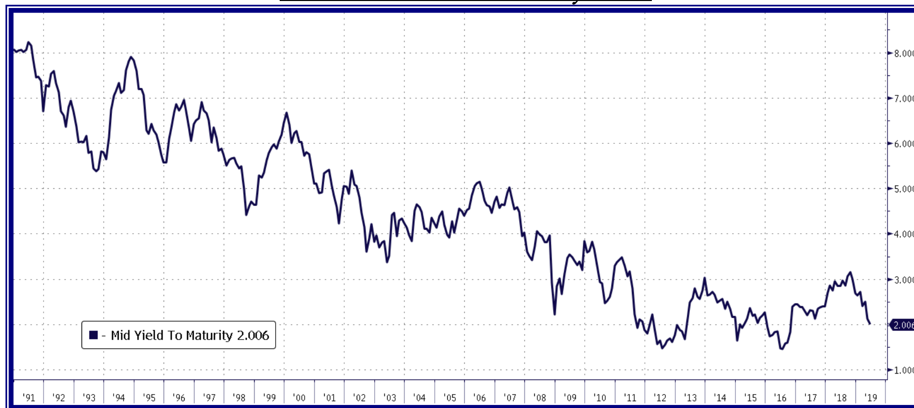
The Federal Reserve's dovish tone continued into June, as the ECB acknowledged the possibility of a rate cut if inflation and growth were to slow further. Chairman Powell highlighted this dovish sentiment as the Fed held rates within their target range 2.25% to 2.50%. An inverted yield curve is a signal to the Fed that policy may be too tight. Trade tensions and tariffs remained in the headlines for much of the first half of the year, and possibly has contributed to slower gross domestic product (GPD) growth downward earrings revisions and weakening global manufacturing. The Institute for Supply Management (ISM), the Purchasing Managers Index (PMI) and the ISM Non-manufacturing Index declined YTD coinciding with a contraction in the Eurozone PMI which has been contracting all year. Despite the University of Michigan sentiment index and the Consumer Confidence Index declining in June, the Leading Economic Indicators stayed positive at the quarter end. Historically, the U.S. has not entered into a recession without a negative Leading Economic Indicators (LEI) year-over-year reading.

EXHIBIT II:
Conference Board Leading Economic Indicator



Source: Bloomberg

EXHIBIT III:
Ten Year Generic Treasury Yield



Source: Altman Investment Management Research and Bloomberg

CLOSE-UP:

➢ Government Bonds

The Bloomberg Barclays U.S. Treasury Index gained 3.3% in the second quarter and 8.6% year to date. This significant quarterly gain was comparable to the first quarter of 2016. The yield curve steepened with the spread between the 5-year and 30-year reaching 80 basis points at the end of the quarter. The spread between the 3-month and 10-year moved up 15 basis points, but remained in negative territory by quarter end. Trade talks between China and the U.S. collapsed in May and continue to be the center of attention in the quarter as investors focus on the uncertainties surrounding the resumption of the negotiations. The escalation of the conflict between the U.S. and Iran in the Persian Gulf added to the tensions, pushing yields lower in the quarter coincident with the yields on sovereign bonds.

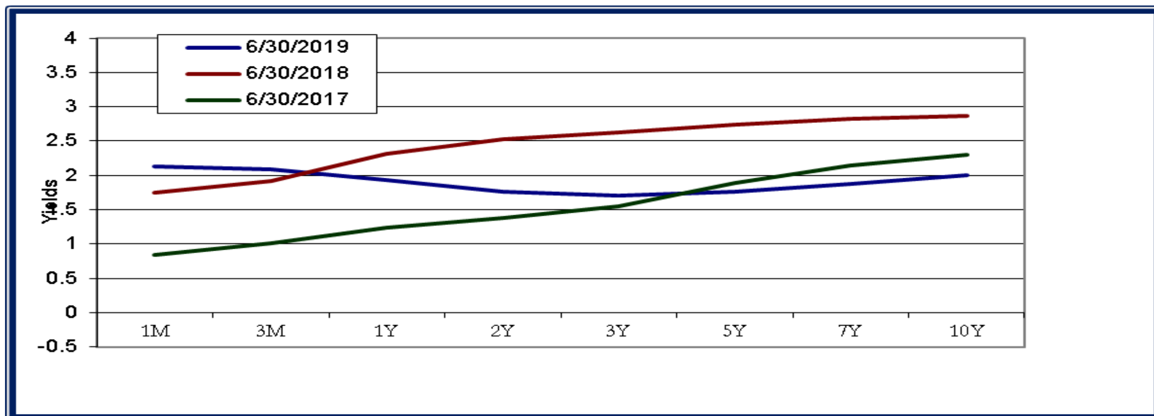
EXHIBIT IV:

U.S. Government Index 7-10 year

Source: Altman Investment Management Research and Bloomberg

EXHIBIT V:

Active Government Yield Curves

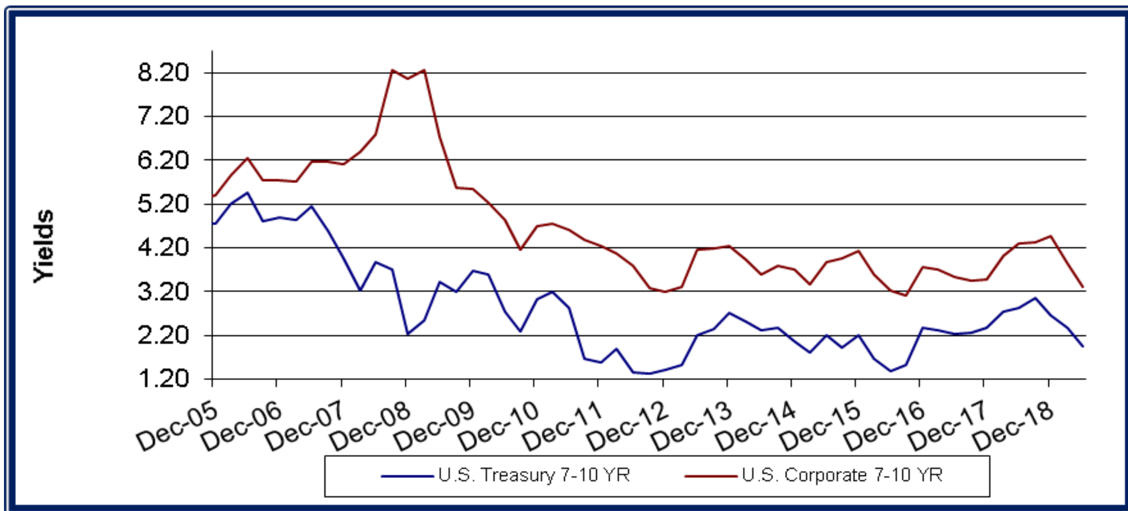


Source: Altman Investment Management Research and Bloomberg

➢ Investment-Grade Corporate Bonds

Corporate spreads tightened in June almost as much as they widened in May. The optimism reflected the hopes that the Fed would ease, a trade deal would finalize, supported by declining bond yields. During the quarter, the Barclays U.S. Credit Index tightened beating the U.S. duration matched index. This trend continued in July to 108 basis points, as the Fed eased and fixed income fund industry inflows continued at record pace. Year-to-date flows into fixed income mutual funds and ETFs now exceed $250B according to ICI (Investment Company Institute) data, on pace to break the previous high set in 2017. Meanwhile, corporate gross supply for July was manageable at just over $100B. Thus far, companies reporting second quarter earnings have posted flat to slightly positive earnings growth, exceeding conservative estimates for a small decline. Spreads in high quality mortgage and asset-backed sectors also tightened in the month. As interest rate volatility was relatively benign, agency "pass-throughs" tightened 8 bps, reversing some of the widening earlier this year.

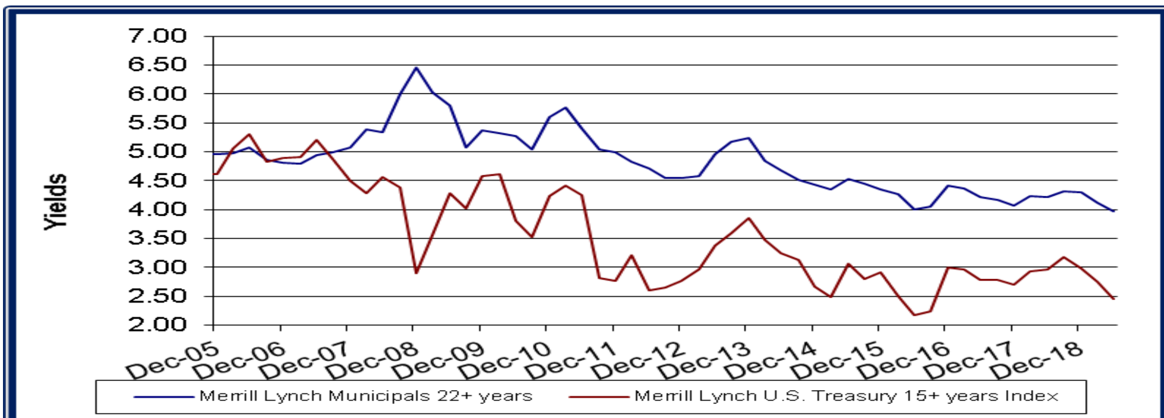
EXHIBIT VI:
U.S Corporate 7-10 year versus U.S. Treasury 7-10 year



Source: Altman Investment Management Research and Bloomberg

➢ Municipal Bonds

EXHIBIT VII:
Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

The recent higher performance of municipals has resulted in lower yields as compared to Treasuries of similar maturities across the yield curve, and most notably in shorter maturities. We believe that lower muni-to-Treasury ratios will not deter many retail investors, who are more focused on generating tax-advantaged income than relative valuations - and who now represent a larger proportion of market participants given that tax reform has reduced the incentive for institutional investors to own municipal bonds.

A favorable ratio of Muni to Treasury supply-and-demand environment is likely to persist. Periods of falling interest rates have historically led to increased supply due to municipalities issuing new debt at lower rates to pay off their existing, more expensive debt. However, the interest on such advanced refunding bonds is no longer tax-free under the new tax law. This change has made it more difficult for the market to find balance when muted supply and robust demand are creating a strong market dynamic, as we are seeing today and expect to continue.

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