ALTMAN INVESTMENT MANAGEMENT

FIXED INCOME STRATEGY HIGHLIGHTS

October, 2019

IN BRIEF: The U.S. Fixed Income Markets

During the quarter, the Federal Open Market Committee (FOMC) cut the federal funds rate 3x, by 0.25 percentage points each time, leaving its target range at 1.75% to 2.00%. These were the first interest rate cuts since 2008, following a series of nine quarter-point increases that began in late 2015 and ended in December 2018. The Federal Reserve cited "sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective are the most likely outcomes, but uncertainties about this outlook remain."

Actions by the Federal Reserve led to a steepening of the Treasury curve, unwinding more than four months of inversion between short and intermediate rates, as 3-month Treasury bill yields fell 29 bps while 10yr rates increased from 1.68% to 1.91%. In addition to cutting rates, the Fed also announced an expansion of its balance sheet by purchasing $60B of Treasury bills each month through June 2020. The goal is not to lower long term rates as the Fed did with quantitative easing (QE), but is to provide much-needed liquidity to the overnight repo market. The depletion of excess reserves has caused rate spikes in the short-term funding markets, primarily repo. U.S. economic data confirmed a slowing of growth with 3Q GDP reported at 1.9%; above the 1.6% consensus estimate thanks to resilient consumer spending, but down from 2.0% in 2Q and 3.1% in 1Q. Political tensions continued as the U.S. House of Representatives approved a resolution that establishes rules for the impeachment process against President Trump.

EXHIBIT I:

Fixed Income Sector Performance – Q3 2019

Fixed Income Sector Performance – 2019 Q3 - Sector	Rating	Maturity	Duration Mod Adj	Yield	Spread	Price	Trailing12 Month Total Return
Treasury (Intermediate)	Aaa/AAA	4.0	3.7	1.8%	N/A	$106.9	7.3%
Agency	Aaa/AA+	5.7	4.3	1.9%	20	$109.4	8.1%
MBS	Aaa/AAA	3.6	3.3	2.2%	60	$ 102.3	6.7%
Municipal	Aa3/A+	5.0	3.7	1.4%	0	$112.0	6.0%
Corporate (Intermediate)	A2/A-	4.9	4.2	2.6%	100	$ 104.5	9.6%
High Yield	B1/B	5.9	3.2	5.9%	430	$ 99.2	5.2%

Source: Altman Investment Management Research and Bloomberg

Bond Market Performance:

All sectors of the U.S market posted positive returns in the month of October within a relatively small band. Emerging Market Debt (+0.68%) generated the greatest total return, followed closely by Investment Grade Corporates (+0.61%), which still leads the pack YTD (+13.89%). Hampered by rising 30yr rates, the Treasury sector (+0.07%) posted the lowest overall return in the month.

CLOSE-UP:

➢ Government Bonds

The Barclays U.S. Treasury Index posted a modest loss of 80 basis points in September, as yields bounced back from the lows posted earlier in the month. The index's gain was reduced to 7.5% and the quarterly return came in at 2.4%. The yield curve flattened in comparison to three months ago with the 10-year and 30-year outperforming the front end of the curve. In September, securities under the one-year maturity had the best performance, as the market anticipated interest rates cuts from the Federal Reserve. The long end of the curve held up reasonably well by positive economic data against rising yields in the eurozone.

A temporary reprieve between the U.S. and China put the trade war on the backburner during the first half of September, and economic data emerged as the driving force behind U.S. Treasury yields. A number of better than expected data releases pushed yields sharply higher. The direction of yields was also influenced by concerns over diminishing near-term trade deal prospects with China and the advancing impeachment inquiry of President Trump. Although yields ended higher at the end of the month, they closed lower over the course of the quarter.

During September, the largest decline in 10-year yields was the result of drone attacks on the Saudi oil fields - and visits with China on the trade negotiations were cut short against the Speaker of the House Nancy Pelosi announcing a formal impeachment inquiry. The largest increase occurred following the ADP employment and ISM non-manufacturing releases, strong retail sales, and a selloff in Sterling that put pressure on U.S. rates.

A Note on Inflation: While inflation in major economies remains lackluster, we believe that the global economic slowdown may be coming to an end, as more global economic indicators are showing some signs of life. However, as noted by several economists on Bloomberg recently, growth appears so far to be tracing an L-shaped recovery rather than either a U-shaped or V-shaped one. This is consistent with our view that global growth is being weighed down by too much debt and aging demographic trends.

Much of the weakness since early last year has been in global manufacturing, which may also be bottoming. Trump's trade wars have been blamed for the global factory recession. Yardeni Research believes in a more structural problem with excess manufacturing capacity relative to slowing demand. This is against a backdrop more "minimalist" attitudes by both young and aging groups in our economy.

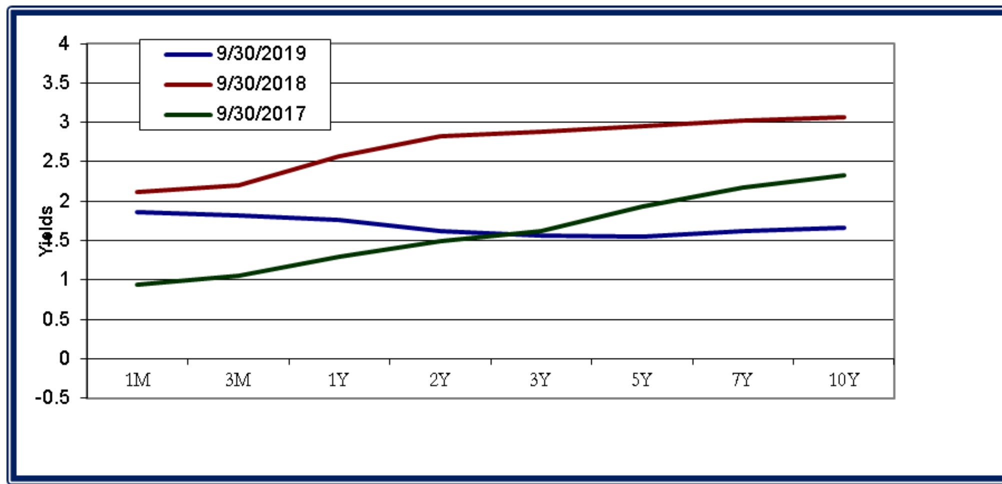
We are still thinking that the Fed is done finetuning monetary policy for the year and maybe for next year too. Given the most recent rate cut on October 31st, we are expecting that the Fed's target range for the federal funds rate will stay at 1.50%-1.75% through the November 2020 elections. We expect that the 10-year U.S. Treasury bond yield will range between 1.50% and 2.00% through the end of next year.

EXHIBIT II:

U.S. Government Index 7-10 year

Source: Altman Investment Management Research and Bloomberg

EXHIBIT III:
Active Government Yield Curves

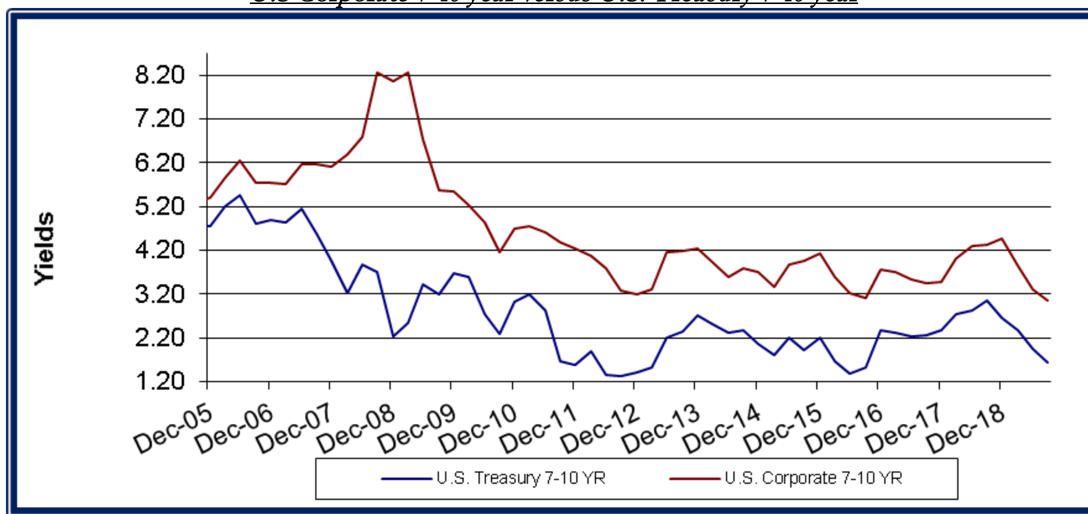


Source: Altman Investment Management Research and Bloomberg

➢ Investment-Grade Corporate Bonds

Corporate spreads ended the month 5 bps tighter at 110 bps as corporate earnings came in better than expected and China trade concerns lessened. In contrast, Agency Pass-throughs widened 3 bps to 49 bps as prepayments on recent MBS vintages have come in faster (worse) than expected, putting further pressure on the sector. Asset-Backed Securities ended the month 4 bps wider at 41 bps as this sector underperformed Treasuries on the front end of the curve. High Yield Corporates gave back a portion of the strong YTD tightening in October as inflows moderated from a robust YTD pace. Asset-Backed Securities ended the month 4 bps wider at 41 bps as this sector underperformed Treasuries on the front end of the curve. High Yield Corporates gave back a portion of the strong YTD tightening in October as inflows moderated from a robust YTD pace. On the new issue front, about $45 billion is expected to be issued going forward according to Bloomberg.

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



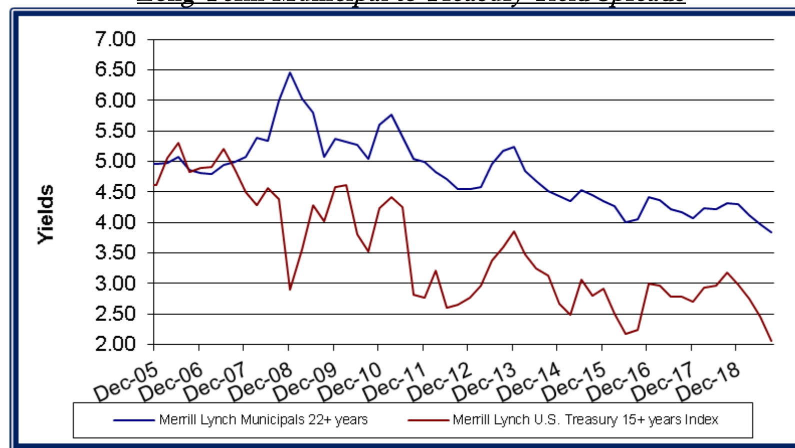
Source: Altman Investment Management Research and Bloomberg

Municipal Bonds

Following the lead of the U.S. Treasury curve, the municipal curve also steepened in October as short-term tax-free yields fell and intermediate and long-term yields were steady to slightly higher. The Fed's actions directly influenced the decline in short-term rates this month, first, by lowering the federal funds rate 25 bps for the third time this year (to 1.50% - 1.75%) and second, by announcing the purchase of $60B Treasury bills per month to provide additional liquidity for the repo market. The municipal market also benefited from continued inflows into tax-free mutual funds. The streak of consecutive weekly inflows stretched to 42 with YTD total inflows of $74B, more than 10X the $7B level at this point last year. New supply has also picked up with October issuance 38% higher than the same month last year and total municipal supply YTD 14% ahead of last year's pace. Breaking the supply down further, tax-exempt issuance has risen 6% YoY, but taxable issuance is up nearly 90%. An estimated one-half of the taxable supply this year has been issued to refund tax-exempt debt. With the decline in market rates, even after swapping from tax-exempt to taxable yields many municipalities are still able to realize a cost savings on their debt. Not surprisingly, the increase in taxable municipal supply has caused a widening of credit spreads relative to taxable corporate alternatives. According to Bloomberg Barclays index data, credit spreads between the Intermediate Taxable Municipal sector (+87 OAS) and Intermediate Taxable Corporates (+83 OAS) widened 8 bps in October and are 49 bps wider for the year. For non-taxpaying or low marginal rate investors who have the ability and inclination to diversify into the municipal sector, the value of taxable municipals has certainly improved with the boost in supply.

EXHIBIT V:

Long Term Municipal to Treasury Yield Spreads



Source: Altman Investment Management Research and Bloomberg

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