# Quarterly Commentary

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**Second Quarter 2018**

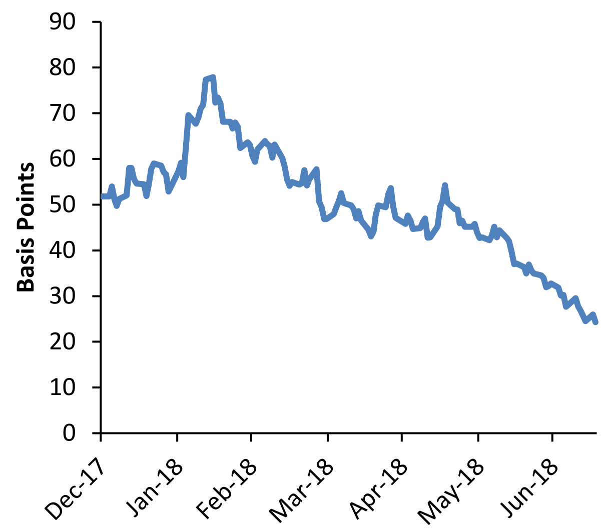
The second quarter of 2018 was characterized by a general "risk-off" sentiment by market participants. Corporate credit spreads widened 15 basis points during the quarter, roughly on par with the widening seen over the prior quarter, on concerns stemming from trade tariffs, slowing international economic growth, and central bank actions. JP Morgan Global Manufacturing PMI has already decreased sharply this year, indicating weaker export orders. Balancing these concerns is the continuation of solid US economic growth, with expectations high for the continuation of the credit cycle on the heels of tax reform. The yield curve continued to flatten, largely due to the Fed's latest rate hike, with two-year US Treasury (UST) yields rising 26 basis points versus ten-year UST yields rising 12 basis points. This rise in rates, combined with spread widening, led to a negative return for the Bloomberg Barclays Aggregate Index of -0.16% on the quarter (-0.63% annualized).

**Fed action reflects US economic growth and the specter of inflation**

The Fed again raised rates at its June meeting, the second hike this year and the seventh since the current tightening policy began in 2015. While the move was largely expected, forward guidance was revised to indicate two subsequent rate hikes projected later this year, for a total of four hikes in 2018; prior guidance had shown only three total hikes this year. Many interpret this as a sign that the Fed is attempting to get ahead of inflation, which they acknowledge will likely overshoot the 2% target level later this year. Core CPI and Core PCE are currently growing 2.2% and 2.0% year-over-year, respectively.

Furthermore, wage inflation is expected to continue as a consequence of tax reform and an imbalance between job seekers and employment opportunities. Unemployment has fallen to 4.0%, while initial jobless claims are near multi-decade lows. Survey results show consumer confidence and business optimism remain elevated. All of this culminates in real GDP forecasted to grow in the high-2% / low-3% range for the year.

**Exhibit 1:** Interest rate curve steepness, as measured by the 2yr-10yr Treasury yield difference, has flattened to its lowest level since 2007.




Source: Bloomberg

**International picture shaped by political populism, central bank tightening**

The Italian general election earlier this year and the subsequent formation of a populist government highlighted the fact that the brand of politics embodied by Donald Trump's election and Brexit continues into 2018. This event was followed by the resignation of conservative Spanish Prime Minister Mariano Rajoy and the ascendance of a Socialist government supported by the left-leaning populist Podemos party. In the recent Mexican presidential election held on July 1, the leftist candidate Andrés Manuel López Obrador won convincingly on a platform of economic populism, which included a willingness to renegotiate NAFTA.

These moves come at a time when central banks in the rest of the world have committed to further tightening. The European Central Bank made remarks recently that it would aim to end quantitative easing next year, a sign of faith in further economic growth on the continent. In the UK and Canada, central banks have signaled their intentions to raise overnight borrowing rates at least once more this year, in each case a continuation of tightening which began late last year. While further gradual rate hikes are warranted, such actions run the risk of slowing economic growth from an already meager pace in many cases.

**Tariffs have spooked the market**

Further details emerged during the quarter regarding the Trump Administration's proposed changes to trade policy, specifically the implementation of tariffs on many of the United States' major trading partners. Tariffs on $50 billion of Chinese goods were announced in response to China's failure to uphold prior trade commitments and intellectual property theft; China responded in kind with tariffs on US exports. The US also announced tariffs on steel and aluminum from Canada and Mexico, which many see as the beginning of an impending NAFTA renegotiation.

Steel and aluminum tariffs were also levied on EU countries, and the Administration threatened further tariffs on automobiles manufactured in the EU. Such moves have had a negative effect on equity market returns, particularly in the industrial sector: the S&P 500 Industrial Select Sector had a negative total return (3.18%) on the quarter, versus 3.43% positive total return for the broad S&P 500 Index.

**Concluding remarks**

Echoing our sentiment from last quarter, we acknowledge that we are in the late innings of the long-running credit cycle, which has kept us maintaining credit risk to the portfolios we manage (albeit with an "up-in-quality" bias). However, we are still seeing momentum for prevailing solid economic conditions to continue going forward, bolstered in part by tax reform. We will continue to take advantage of opportunities in the market caused by volatility and event risks (primarily mergers and acquisitions), and look opportunistically for spread product in sectors other than corporates.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