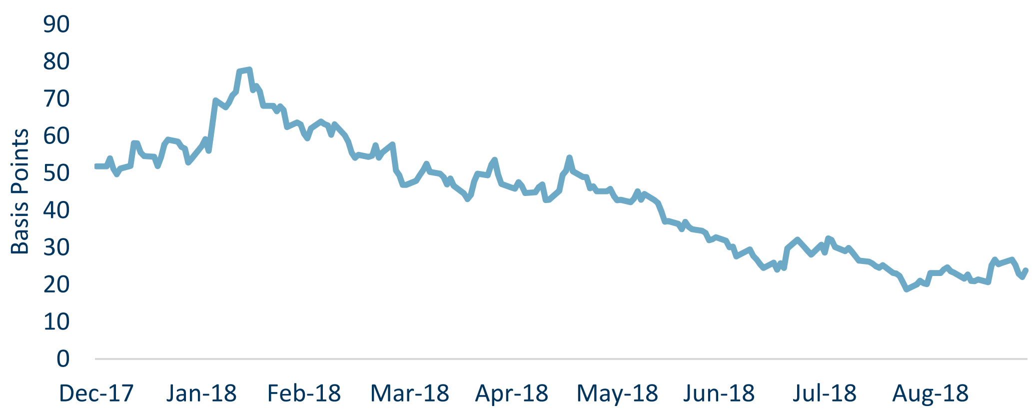
OCTOBER 2018

Third Quarter Commentary

Interest rates rose in the third quarter as inflation (Core PCE) hit the Fed's 2% target and economic conditions remained solid, both of which contributed to the Fed raising rates again at the September FOMC meeting to 2%-2.25%. The decline in bond prices was largely offset by their income component, leaving the total return for the broad market, as represented by the Bloomberg Barclays U.S. Aggregate Bond Index, just barely positive at 0.02% for the quarter.

Many commentators are pointing out how narrow the gap is between short and long-term Treasury yields. Flat or inverted yield curves receive a lot of attention since they usually develop in the later stage of the economic cycle as investors begin to anticipate an end to the Fed's tightening campaign and a turn in economic trends. As we enter the fourth quarter of 2018, we believe the economy is on firm footing with the unemployment rate below 4%, GDP growth (2.8% over the last four quarters) that is above its long-run sustainable pace according to most economists, including the Fed, and other indicators such as the ISM Manufacturing and Non-Manufacturing surveys pointing to continued expansion. Still, with growth slowing across most of the rest of the world, higher energy prices, and a strong dollar, plus the diminishing effects of federal fiscal stimulus over the next year or two, we believe this economic cycle is beginning to face more headwinds than tailwinds.

EXHIBIT 1: The yield difference between two-year and ten-year Treasuries has been declining, an occurrence typically found in later stages of economic cycles



Source: Bloomberg

Markets are forward-looking, and it is important to form a view on what may happen over the ensuing period rather than simply focusing on what has transpired in the most recent period. Higher uncertainty from the "tariff war" is likely to weigh on trade and investment flows, while higher interest rates and the strong dollar are examples of tighter financial conditions that are also likely to constrict investment and chip away at business confidence. Lastly, changes in asset prices (i.e. bond prices moving lower, which may eventually pressure stocks lower) and the flow of credit are more likely to result in a slower pace of economic activity, which is typical late-cycle behavior. We believe these changes are likely to develop due to the Fed's continued removal of policy accommodation via higher short-term rates and the shrinking of its balance sheet, a move which is expected to be copied by the ECB at the end of this year.

How high will interest rates climb?

One of the key factors considered by the Fed in its monetary policy deliberations is inflation: indeed, maintaining stable prices is one of the Fed's explicit goals. Since the Fed's preferred inflation measure, Core PCE, is only now at its target of 2% after years spent mostly well below it, and since wage inflation has failed to spike higher, runaway inflation seems unlikely at this juncture. Unless we are wrong about inflation, we believe Treasury market yields could climb further later this year or early next, but we do not believe markedly higher yields would be sustained for very long before beginning to decline once again in the next year or two.

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Are any significant portfolio actions necessary at this juncture?

Spreads on corporate bonds finally began widening earlier this year after years of a steady tightening trend. All else being equal, this means corporate bonds have not offered positive excess returns over like-duration Treasuries this year (-1 basis point year-to-date). Some of this widening was justified since spreads had reached such absolute tight levels on a historical basis, while some was warranted since companies have piled on debt to take advantage of low rates, buy back stock, or engage in mergers. Looking at the corporate bond market today compared to 2007, the weighting of the BBB-rated sector has grown by about 50%. At the same time, the broker-dealer community carries less inventory of bonds and is less willing to take risk due to new banking regulations, so spreads could widen more in the next recession since liquidity will likely be reduced and more companies may be subject to ratings being downgraded to below investment grade. All of this suggests continued caution and selectivity around portfolio positioning within the corporate sector.

At the same time, spreads on RMBS have been pressured wider due to the Fed's balance sheet normalization process which has negatively affected supply, and their excess return year-to-date is -7 basis points. Taxable municipals could be a good alternative, but their availability is quite limited. This leaves CMBS and ABS, which generally are high quality securitized bonds and offer some yield spread over Treasuries. In all cases, income-focused investors could still benefit from higher income via these exposures since the excess return performance cited above is a total return (or relative performance) issue and does not typically affect book income.

Looking ahead, investment challenges are the norm and this time is no different. Our key task is to balance the need for income and total return performance over the long term, and we are constantly engaged in dialogue with our research team to position portfolios optimally given these persistent challenges.

The economy is performing well, but we are not only looking at the rear-view mirror but also are focused on what comes next. There do not appear to be any major imbalances in the economy at this time, which is one reason the Fed feels it can take plenty of time to normalize interest rates and the balance sheet. Indeed, most economists opine that the next downturn is likely to be shallow rather than a deep or prolonged recession.