

## Investment Grade: Taxable and Tax-Exempt Fixed Income

- > Rising short-term rates dampened total returns in the investment grade-taxable market in the second quarter as the yield curve continued to flatten. A flatter curve does not mean that recession is imminent, though so-called “synchronized global growth” appears to be at an end.
- > The tax-exempt municipal bond market continues to digest the effects of the new tax law as banks and insurance companies became active sellers, and the elimination of advance refundings resulted in diminished supply.

### INVESTMENT GRADE – TAXABLE

#### Second Quarter Performance

Short-term rates continued to rise as they did in the first quarter, though more moderately, and the yield curve continued to flatten. Rates on the front end of the curve rose while those on the back end were nearly unchanged. Altogether, 14 points of flattening occurred during the quarter, as represented by the spread between two-year and 10-year Treasuries, bringing total flattening for the year to 19 basis points (bps).

Against this backdrop of rising short-term rates, total returns were relatively muted, and the Bloomberg Barclays US Aggregate Bond Index posted a total return of -0.16% for the quarter and -1.62% for first half of the year. Investment grade corporate bonds remained the underperformer, registering -100 bps of excess return, slightly worse than the first quarter's -79 bps. (Excess return removes the influence of the duration of the asset by measuring returns relative to a duration-neutral risk-free asset.) Weakness came predominantly in longer maturities, which suffered -288 bps of excess return. Among intermediate maturities, the excess return came to only -11 bps.

Within investment grade credit, sector returns were driven largely by the underperformance of the long end of the curve. The laggard, Utilities, suffered -137 basis points of excess return, largely because Utilities tend to issue longer-term debt. The outperformer was Financials at -67 bps while Industrials delivered -113 bps of excess.

The shortfall of the investment grade sector was particularly glaring when compared to the high-yield market. There, excess returns in the second quarter came to +96 bps, resulting in a difference of nearly 200 bps between the investment grade corporate market and the high-yield bond market. In emerging markets, excess return came in at -242 bps.

In residential mortgage-backed securities, the other primary spread sector of the investment grade market, excess return amounted to +15 bps, a modest improvement over the first quarter's negative performance. In the commercial mortgage-backed sector, excess return was flat, and in asset-backed securities, it amounted to +17 bps.

#### Financial Conditions Remain Loose

Contrary to expectations, the US dollar has strengthened in 2018, advancing by 5% in the second quarter. The strengthening of the dollar contributed to a tightening of financial conditions during the second quarter, but relative to December 2015, when the Federal Reserve (Fed) began to raise short-term rates, these conditions are still fairly accommodative. That is, despite 44 bps of tightening during the second quarter, the Goldman Sachs Financial Conditions Index finished the quarter still more than 100 bps looser than when the Fed began increasing the fed funds target rate in December 2015. (This index gauges financial conditions as represented by credit spreads, equity valuations, the value of the dollar, and interest rates.) Since the inception of the tightening cycle, stock valuations have risen, credit spreads have tightened and the dollar has weakened. This has allowed the Fed to continue increasing rates, which it has done seven times since the beginning of this “unloosening cycle,” for a total of 175 bps.

These still-loose conditions are one reason we've been expecting the Fed to continue to raise rates while others have been predicting a pause. We anticipated four rate hikes in 2018, and the latest dot plot shows that Fed governors now anticipate four hikes, up from three at their previous meeting.

The Fed's hawkish turn means it is alone among the major central banks, and this has contributed to the dollar's relative strength. The European Central Bank (ECB) remains dovish, and Mario Draghi, ECB president, has said not to expect tightening until after summer of 2019. The Bank of Japan is accommodative as well and is likely to remain so.

#### The Fed Balance Sheet Continues to Shrink

Further “unloosening” is also occurring as the Fed continues to shrink its balance sheet. It began tapering its balance sheet through a measured reduction in reinvestment in October 2017 at a rate of \$10 billion per month, but the pace has increased as the Federal Open Market Committee's published plan laid out and it is now at \$40 billion per month for the third quarter. This pace increases one more time to \$50 billion per month in the fourth quarter and is expected to continue until the size of the balance sheet returns to normal, though the Fed has not been specific about the balance sheet's optimal terminal size.

At some point, the balance sheet normalization, combined with the rate hikes, should begin to have a negative impact on risk assets. However, we do not anticipate that interest rates will return to pre-crisis levels any time soon. We continue to believe that long-term interest rates will remain “lower for longer” due to a host of structural factors, including aging demographics, high levels of debt and unfunded liabilities, low productivity growth, and excess global capacity.

### Not so Synchronized Global Growth

In the near term, however, U.S. economic growth will look robust as gross domestic product (GDP) is expected to expand by 3-4% in the second quarter. This, however, has occurred alongside broader disappointment in Euro area economic growth over the first half of the year, in addition to considerable stress across many emerging market economies. This has proven to be a formidable challenge to the much-touted narrative of “synchronized global growth.” Although domestic business activity slowed in the first quarter, this is an outcome many have grown comfortable looking through as the weakness is seen as the result of poor seasonal adjustment of the data (residual seasonality). The slowdown seen in Europe in the first half of 2018 is also being characterized as transitory, such that the narrative for a return to a synchronized expansion persists. Japan’s economy actually shrank in the first quarter, ending a two-year growth stretch. Claims of weaker than reported growth out of China continue to circulate, certainly all the more heightened by its very weak stock market performance as the Shanghai Composite is down 12.9% year-to-date through June and down 19.1% from its January peak.

We have been skeptical of the synchronized global growth narrative since its inception. Much of it was, in fact, based on 2016-17 data from regional purchasing managers’ indexes (PMI), not actual growth in GDP. While the two measures are correlated, the GDP expansion suggested by robust PMI results did not always materialize as expected.

We noted in 2017 that while global PMI indices had improved, they were not much higher than in 2014-15. In addition, optimistic PMI data in Europe and Japan did not produce growth rates that were significantly higher than in previous years. Japan’s rate of growth appeared less volatile than in the previous three to four years, but not much higher.

The global growth narrative included emerging markets (EM), but higher rates of expansion there in 2017 were due largely to base effects. That is, EM growth in 2017 appeared strong largely because it was so weak in 2015 and 2016 as a result of falling commodity prices and a slump in China. In any case, to the extent that it existed, synchronized global growth appears to have come to an end.

### Populism Is Alive and Well

Another macro development that appeared in the second quarter was the re-emergence of populism. When Emmanuel Macron was elected president of France in 2017, it was characterized as the event that marked the end of the populist/nationalist trend. We suspected, however, that the populism that fueled Brexit and other anti-euro movements, and threatened the European Union, would resurface. The only question in our minds was, would it come from the political left or the political right?

In Italy, the answer was both! There, a populist coalition combined factions from the right and the left to form a new government. More recently, the populist left won a landslide victory in Mexico with the election of Andres Manuel Lopez Obrador as president, the country’s first leftist president in decades. Meanwhile, the migration crisis in Europe continues to put Angela Merkel’s coalition under pressure in Germany. So, the populist/nationalist trend appears to be one we can expect to persist.

### Outlook

The flattening of the yield curve brought the two- to 10-year Treasury curve spread down to 33 bps in the second quarter, attracting quite a bit of attention from both market pundits and market participants. Although this attention was merited, given that this spread has been a reliable predictor of recessions, some caution is in order. Flattening also occurred in the late 1990s and the mid-2000s, and in both cases it persisted for quite a while before a recession emerged. So, although the yield curve can be a reliable predictor of recessions, a flat or inverted curve does not mean that a recession is imminent.

Fixed income investors generally appear to remain bearish, with moderately higher rates widely expected during the balance of the year. But year-end expectations have moderated in that few see the yield on the 10-year Treasury reaching 3.5% to 4.00%. After closing the second quarter at 2.86%, the July median forecast (per Bloomberg) now anticipates a 3.15% 10-year Treasury by the end of the year. The range offered by that survey is 2.30% to 3.63% from 58 participants.

Nevertheless, we believe we’re in a range-bound market in which rates on the 10-year Treasury will stay in the ballpark of 2.50% to 3.00%. One potential risk to this scenario is China. If a real trade war develops, China could use its purchases of Treasuries as a weapon. Any rhetoric that suggests that possibility would probably cause the 10-year Treasury yield to rise above 3.00%. But, in our view, that’s probably not sustainable.

Additionally, the long end of the Treasury market has been supported by pension fund buying, as corporations have been granted a grace period to make contributions to their pension plans using the old 35% corporate tax rate. This incentive, in tandem with a generally higher funding status, has fueled pension fund demand for longer duration assets and can be seen through Treasury stripping activity, which produces long duration principal and coupon strips. This Treasury strip creation has accelerated over the first half of the year in response to the pension fund demand. With the grace period ending this September, the tax incentive will disappear and this could lead to less demand for long duration assets. Again, this is not our base case expectation as the improved funding status can remain a powerful impetus for the pension fund long duration preference, but it is a risk nonetheless.

### INVESTMENT GRADE – TAX EXEMPT

The tax-exempt municipal bond market continues to digest the effects of the tax law enacted in January 2018. Supply has declined, resulting in a smaller market; at the same time, banks and insurance companies have become active sellers. The Bloomberg Barclays Municipal Bond Index returned 0.87% for the quarter and -0.25% for the first half.

Supply has been constrained in the first half of the 2018 and is expected to remain so for the rest of the year. Total issuance amounted to \$156 billion for the first six months, with about \$97 billion coming in the second quarter. Only about \$335 billion is expected to be issued in 2018, down from more than \$400 billion in 2017. This decline in issuance, combined with \$460 billion in bonds maturing or being called in 2018, will result in a net change in supply of -\$125 billion. For July alone, \$40 billion more is being called out of the market than projected issuance.

The decline in issuance is a result of two factors: issuer frugality and the elimination of advance refundings by the new tax law. The latter factor in particular has impacted supply as advance refundings accounted for about 20% of issuance in 2017.

Retail demand remained steady as year-to-date flows into municipal bond funds totaled \$7.1 billion, according to Lipper, but buying behavior shifted as major institutional buyers became active sellers. With the reduction in the corporate tax rate from 35% to 21%, the tax incentive for corporate investors to own municipal bonds was effectively reduced. This removed some support for the market as banks and property/casualty (P&C) insurance companies, which have historically been major buyers of muni bonds, scaled back their purchases. In addition, instead of opting for a buy and hold strategy, as many expected, these investors are now incented to be relative value investors and will consider their municipal bond allocation relative to other fixed income products.

This change in buyer behavior also made an impact on the municipal bond yield curve. Because banks and P&Cs tend to buy longer bonds, their reduced buying meant less demand in that part of the curve —15 years and longer — resulting in higher yields. In contrast, since demand among retail investors remained steady, and because these investors tend to invest in the shorter end of the curve, yields at that end declined. So, in the first six months of the year as the Treasury yield curve was flattening, the muni yield curve was steepening.

As for fundamentals, pension and healthcare liabilities continue to be a concern, and in this regard credit analysis is crucial. Huge downgrades of three or four notches have occurred recently because of the severity of these liabilities, and for that reason we remain pretty conservative, especially in the general obligation (GO) category. We are underweight state GOs and local GOs, and we've avoided Illinois, Pennsylvania, and New Jersey, specifically. These bonds have performed well this year due to the tightening of credit spreads, but these issuers have tremendous fiscal challenges. These bonds have attracted investors who have been reaching for yield, and credit spreads tightened quite a bit as a result. However, we're concerned that investors are not being adequately compensated for a high level of credit risk.

In fact, we continue to upgrade the quality of our portfolios. If the market enters a rough patch, liquidity could dry up and spreads could widen quickly. But with shift to higher quality, we should have a very liquid portfolio.

In the remainder of 2018, supply is likely pick up in the third quarter, and the net increase in the market could be positive. We also will be watching banks and P&Cs to see if they will continue to sell as they did in the first half.

**Authored by:**

**Investment Grade – Taxable**



**James F. Keegan**

Chief Investment Officer and Chairman,  
Senior Portfolio Manager  
Seix Investment Advisors



**Perry Troisi**

Managing Director, Senior Portfolio Manager  
Seix Investment Advisors

**Investment Grade – Tax-Exempt**



**Ronald H. Schwartz, CFA**

Managing Director, Senior Portfolio Manager  
Seix Investment Advisors



**Dusty Self**

Managing Director, Senior Portfolio Manager  
Seix Investment Advisors

Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up focused, top-down aware process. Seix employs multi-dimensional approaches based on strict portfolio construction methodology, sell disciplines, and trading strategies with prudent risk management as a cornerstone.

The commentary is the opinion of the subadvisor. This material has been prepared using sources of information generally believed to be reliable; however, its accuracy is not guaranteed. Opinions represented are subject to change and should not be considered investment advice or an offer of securities.

**Past performance is not indicative of future results.**

Distributed by **VP Distributors, LLC**, member FINRA and subsidiary of Virtus Investment Partners, Inc.  
2207 7-18 © 2018 Virtus Investment Partners, Inc.

