SEIX INVESTMENT ADVISORS LLC®
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Investment Grade: Taxable and Tax-Exempt Fixed Income

> The third quarter saw a continued lack of market volatility, still-low long-term interest rates, and minimal progress on President Trump's pro-growth legislative agenda. In the **investment grade-taxable** market, spread sectors continued to benefit from the insatiable search for yield, producing positive excess returns across both the investment grade and sub-investment grade markets once again.

> In the **tax-exempt municipal bond** market, limited supply and healthy demand has driven strong performance this year. As issues regarding tax reform are debated, more and more investors may stay on the sidelines until some clarity emerges.

INVESTMENT GRADE – TAXABLE

Quarter Three – More of the Same

Coming into 2017, the expectation was that long term rates would rise, the yield curve would steepen, the monetary authorities would pass the baton to fiscal authorities, and great progress would be made on tax reform, the repeal and replacement of Obamacare, regulatory reform, and infrastructure spending. In a rising rate environment, volatility would pick up and the dollar would continue to rise. There was even talk of the euro going to parity versus the U.S. dollar. The consensus is generally wrong but this year the miss is pretty remarkable.

For the third quarter, interest rates rose slightly with the yield curve modestly flatter. Spread sectors continue to benefit from the insatiable search for yield, producing positive excess returns across both the investment grade and sub-investment grade markets once again. Perhaps one of the most profitable trades this year was to sell volatility. Record low volatility was seen in both equities and fixed income as reflected by VIX on the equity side and MOVE on the bond side during the quarter. At the end of September, VIX was still under 10 and MOVE was just over 50. Commodity prices also rallied over the quarter led by oil and copper.

Second quarter GDP came in at an annualized 3.1%. Adding that to first quarter's growth of 1.2% resulted in 2.15% for the first half of the year, just where growth has averaged since the recovery started in July of 2009. For the trailing four quarters, Gross Domestic Income (GDI) has come in at 2%, just slightly below the corresponding rate of 2.2% for GDP.

While the U.S. economy continues to muddle along, a narrative that has gained followers in the marketplace is about a global synchronized upturn in growth. Our own analysis does not concur with this narrative. This is not the first time such a narrative has emerged this cycle, and thus far has never come to fruition. The broad macroeconomic estimates are not consistent with a global synchronized upturn and a disconnect persists between the hard data and the soft data. The soft data indicates an economy that is very strong, as reflected by measures published by the ISM (Institute for Supply Management) and Markit (Purchasing Managers' Indices). These robust data points, however, have yet to manifest in hard data measures like industrial production, income, and inevitably GDP.

Eyes on the Fed

The Fed is in the spotlight for a number of reasons. First, the Fed will commence a balance sheet normalization process in October, i.e., shrinking its $4.5 trillion balance sheet that was built up in the aftermath of the Financial Crisis by not reinvesting all of the interest payments and prepayments that it receives. As the Fed has articulated the plan, it will start by letting $10 billion run-off monthly in the fourth quarter, $6 billion in Treasuries and $4 billion in mortgage-backed securities (MBS). The Fed will increase that monthly runoff pace by $10 billion every quarter, such that January will see $20 billion in runoff monthly ($12 billion in Treasuries and $8 billion in MBS). A year from now, the Fed will be at a $50 billion monthly run-off level for the quarter, according to the plan as it stands today.

The second key item relating to the Fed pertains to any future rate hikes. Though the Fed can change its mind, as it has in the past, December is likely to see the third rate hike this year, based on Chair Yellen's most recent press conference and subsequent statements by key Fed officials. The Fed has consistently described the decline in inflation as largely transitory. Even on the economic side, any weakness in third quarter growth will be attributed to the effects from the hurricanes. For the most part, the Fed does not seem too concerned about economic weakness. From our standpoint, the Fed continues to increase rates due largely to persistently loose financial conditions (that are actually looser now than they were before the first rate hike off zero in December 2015) and the financial stability risks that accompany such conditions. The Fed took rates too low, kept them too low for too long and now they're finally beginning to normalize this extraordinary accommodation of having rates close to zero for seven plus years. As such, it seems more appropriate to view this as an "un-loosening" cycle rather than as a "tightening" cycle. Finally, but not necessarily any less important, President Trump's selection of a nominee to chair the Federal Reserve Board looms closer with the expiration of current Chair Janet Yellen's term in February 2018.

The current Fed's "DOT plot" (a summary of where each sitting member of the Federal Open Market Committee forecasts the target rate going forward) indicates one more hike in December and three additional hikes in 2018. These forecasts are obviously predicated on the current composition of the FOMC and thus are subject to change as the composition of the Fed

changes. Further, from a big picture standpoint, the effects from the Fed's unwinding of its balance sheet offers potential consequences well beyond just a changing of the guard at the FOMC. Rates have never been at zero in the U.S., nor historically have there been negative rates globally as there are now in some European countries and Japan. Hence, there are unintended consequences lurking globally as central bankers begin a process of normalization, albeit at a very slow rate.

Tracking Trump's Agenda

While some of Trump's original agenda items (healthcare reform and infrastructure spending) are not likely to see any progress until fiscal year 2019 as mid-term elections stand in the way, tax reform is on the docket right now. The devil is in the details and a lot of heavy negotiation lies ahead, which leaves little to say about its impact at this point. The one area where Trump has made great strides is on the regulatory front. The Federal Register, the document where all federal regulations are published, and which serves as a proxy for federal regulation, shows that the number of pages has declined significantly through the first seven months of this year. In President Trump's first seven months in office, regulations have been cut by more than a third, using this Federal Register as a proxy for regulatory reform. One of the reasons the National Federation of Independent Business Optimism index remains nearly as high as when it spiked post Trump's election is because regulations that have stifled the formation and growth of small businesses are now being cut.

It's too early to tell whether there is any argument worth making for the resurrection of the reflation trade. Considering tax reform, for example, as previously stated, there is far too much negotiating to be done, and how much growth tax reform will produce is the critical but unknown factor. Timing also is an issue, and meaningful progress by year end is aggressive. Infrastructure spending was another component of Trump's pro-growth legislative agenda. The public/private partnership that Trump advocated was ultimately deemed unworkable. The cost for basic repairs to existing infrastructure in the U.S. is immense and, as such, how it will be financed is a critical element against the backdrop of a Federal debt stock that already exceeds $20 trillion.

Expensing capital investment – 100% for the first five years after the tax bill is in effect – is a particular item people have been hanging their hats on to spur growth. But considering that excess global capacity is one of the secular structural forces sustaining disinflationary/deflationary pressure, the positive effects on growth of the capital investment write-off may be limited to a few quarters at best. Our view remains that the potential growth rate of the U.S. is between 1.5% and 2%. To achieve 3-4% growth on a sustainable basis would be a Herculean task and highly unlikely given that the long term drivers of economic growth are the growth of the labor force and the productivity of that labor force.

Our View

The amount of complacency in the investment environment, as demonstrated by historically low volatility, continues to confound us. No matter what happens in the world, be it a missile-firing by North Korea or unrest in Catalonia, markets do not seem to react at all. Therefore, one of the risks that is being mispriced is a popping of the complacency bubble, along with those in passive strategies and ETFs across the asset class spectrum. Our investment strategy of safe income at a reasonable price positions the portfolios under our stewardship well when volatility returns to the financial markets. Early is wrong until it is right and then it is usually VERY right.

INVESTMENT GRADE – TAX-EXEMPT

The tax-exempt municipal bond market generated strong performance in the third quarter. In a continuation of trends from the second quarter, indeed from the beginning of 2017, technical conditions have been the primary driver of performance. Supply has not come to the market as expected. Initial estimates of $400 billion to $440 billion in 2017 supply declined to a more likely estimate of $360 billion.

MUNICIPAL/TREASURY YIELD RATIO

10/1/12-9/30/17 Daily

Source: Thomson Reuters, Municipal Market Data.
Past performance is no guarantee of future results.

On the other side of the equation, demand for municipal product has been robust. Retail interest has been exceptionally strong in the one- to 10-year area of the yield curve, particularly in the five-year area. As a result, this part of the curve has become very expensive on a historical basis. Looking at the Municipal/Treasury ratios at the end of the third quarter, the two-year ratio is under 68% of Treasuries (the one-year average is 82%). The five-year and 10-year ratios are 70% and 86%, respectively, with one-year averages of 78% and 92%. At the longer end of the curve, the ratios are at their one-year average of 100%.

This year also has been characterized by very low market volatility. If volatility should increase, and retail investors step aside, our concern is whether there are buyers who will step in at

current ratios. If flows remain positive and the market stays calm, all is good. If market volatility increase, and retail investors reduce their investments in municipal bonds or redemptions rise, the effects could be adverse for the market.

Another area of concern is credit spreads, which are historically tight. Investors continue to reach for yield in this low interest rate environment, causing quality spreads to narrow. The question again is whether there are buyers who will step in to buy tight lower quality paper should volatility increase.

We still see credit issues surrounding pensions and healthcare liability which continue to pressure state and local government budgets. We believe that if the economy does slow down, there are some states and local governments that are not prepared and do not have the resources to make it through a slower recovery or another recession. The result may be a widening of credit spreads and potentially an increase in the number of downgrades.

As the quarter came to a close, the last-ditch effort to repeal and replace the Affordable Health Care Act failed yet again. While that removes some near-term pressure on the hospital and healthcare sector, the debate and challenges of healthcare are far from over. As we enter the fourth quarter, tax reform will dominate Congress. The debate could spur concerns in the municipal market that will lead buyers to stay on the sidelines until they see further details on how tax reform will affect them.

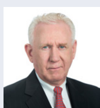
It appears that the highest priority of tax reform is to lower the corporate tax structure. The initial plan is to achieve a 20% corporate tax rate. We think 20% to 25% is probably realistic. There are also plans to lower the tax rate on certain pass-through businesses, such as S corporations from currently 39.6% to 25%.

Our View

Credit spreads have tightened to historically narrow levels. Going into the fourth quarter, it may be prudent to take some profits off the table and invest more conservatively. We think spreads will widen, but the question is when that happens and what causes it to happen. There is certainly a lot of geopolitical risk that can affect markets. As issues regarding tax reform are debated, more and more investors may stay on the sidelines until some clarity emerges. We thus might see a little less demand than earlier in the year and some adjustment in the ratios to more historical averages.

Authored by:

Investment Grade – Taxable



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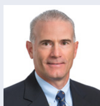

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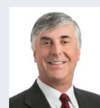
Investment Grade – Tax-Exempt



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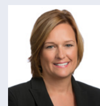

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