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

> Rising interest rates dampened total returns in the investment grade-taxable market in the third quarter as the yield curve continued to flatten. Volatility has returned to global markets and is likely to remain, given tightening global liquidity conditions.

> The investment grade municipal bond market continued to feel the effects of the 2017 tax law, as the elimination of advance refundings reduced supply, and banks and insurance companies continued to reduce their holdings, primarily at the long end of the curve.

INVESTMENT GRADE — TAXABLE

Third Quarter Performance

Bonds generally produced minimal nominal returns during the quarter as represented by the 0.02% total return generated by the Bloomberg Barclays Aggregate Bond Index. Generically, yield spreads compressed across most spread sectors, a reversal of sorts from the second quarter that saw wider spreads in many sectors.

For the quarter, Treasury yields rose, and while the curve experienced some flattening, it was more modest than in the second quarter. In investment grade bonds, the corporate sector produced an excess return of 169 basis points (bps) over the quarter, helping to regain most of what it had lost earlier in the year. (Excess return is a metric that removes the influence of the duration of the asset by measuring returns relative to a duration-neutral risk-free asset.) Year-to-date, this sector had -11 bps of excess return. Nominal returns were positive despite higher rates as a result of the tightening in spreads and the positive excess return in Q3. For the quarter, the nominal return for investment grade corporate bonds came to 0.97%.

In residential mortgage-backed securities (RMBS), returns were muted. Since this sector is still under the influence of the U.S. Federal Reserve (Fed), there is much less natural price discovery occurring, but the sector still generated 17 bps of excess return for the quarter, making it nearly flat for the year. The nominal return for RMBS was -0.12%. In the smaller securitized sectors, commercial mortgage-backed securities (CMBS) delivered 77 bps of excess return while asset-backed securities (ABS) produced an excess return of 31 bps.

U.S. high yield saw relatively strong gains. The sector produced positive excess returns in all three months and was up 248 bps for the quarter, thereby generating a nominal total return of 2.4%. So, for the year, U.S. high yield is still easily outperforming the investment grade credit sector by over 300 basis points in excess return terms.

Like high yield, leveraged loans also experienced a strong quarter, with the Credit Suisse Leveraged Loan Index up 1.93%. Year-to-date, the index is ahead 4.36% in nominal terms. Emerging markets (EM) also outperformed over the quarter, generating an excess return of 210 bps. Despite this bounce back in the third quarter, however, EM has underperformed with -59 bps of excess return year-to-date.

With Liquidity Being Tightened, Volatility Has Re-emerged

The main theme coming into 2018 in our view was a regime change in volatility. Although volatility in U.S. stocks has declined from levels seen in the first quarter, the global markets have experienced rolling spikes in volatility. Early in the year, volatility emerged in the form of a spike in the LIBOR-OIS spread, a measure of the health of the banking system, followed by the unwinding of vol-based strategies tied to the VIX Index. In May, volatility appeared in emerging markets, primarily via Argentina and Turkey. This coincided with turmoil resulting from Italy's election where a coalition of populist parties from both the left and right formed a government, thereby setting up the current disagreement with the European Union over its planned budget deficit in 2019. In U.S. equities, despite volatility staying subdued for most of the third quarter, it has returned somewhat in early October, as the VIX Index wandered back up to 25 from around 12 at the end of September.

This regime change in volatility is being driven by three factors: 1) declining central bank liquidity, 2) hawkishness by the Powell-led Fed, and 3) a reduction in the credit impulse in China. Major central banks in developed markets are reducing liquidity and/or moving increasingly in that direction. Our analysis of central bank projections indicate that the global central bank balance sheet is going to inflect sometime in the fourth quarter of 2018 or in the first quarter of 2019. The punchline is that for the first time since 2008 the aggregate global central bank balance sheet will begin contracting.

The Fed is not only raising rates, but the reaction function of the Powell Fed is very different and less reflexive. Unlike previous Fed chairs Ben Bernanke and Janet Yellen, chair Jerome Powell appears less likely to provide support in the event of a simple, garden variety market correction. Based on the Fed's lack of reaction to the 10 plus percent sell-off in February 2018, we believe it would take a sell-off of 15-20% over a relatively short period of time before the Powell-led Fed would react at least initially with verbal intervention. With the market's expectation of the strike price of the so-called "Bernanke/Yellen put" moving lower under Powell, markets have become more volatile. (See "The New Fed," page 2.)

While China has been a tremendous source of credit/liquidity in the past, it has clearly cut back on credit creation. As a percentage of its gross domestic product (GDP), credit creation has been negative (on a year-over-year basis) since 2017 as China has sought to delever its highly leveraged economy.

China's demand for commodities has softened, which has had repercussions for emerging market economies that rely on commodity exports to China.

The New Fed

When Jerome Powell took over as chair of the Fed in February, our base case was that contrary to market consensus that he would be Yellen 2.0, Powell would manage the Fed more CEO-like than the theoretical, model driven academic approach of his two predecessors. Powell would conduct policy based more on financial conditions with an emphasis on financial stability risks. In our view, Powell is of a different mindset, seemingly very aware of the prior policy shortcomings and the imbalances that have been built up as a result of overly accommodative monetary policy. He will not shy away from raising rates to take some air out of the risk markets sails. Having come from Wall Street and not academia, he understands the risks that asset prices that go up parabolically (S&P +36% since President Trump election) can also go down parabolically. This is a high wire act and the degree of difficulty is probably a thirteen on a scale of one to ten, but Powell will endeavor to move the Fed away from the boom/bust liquidity playbook initiated by Alan Greenspan starting as far back as 1987 and err on the side of being more aggressive as long as financial conditions remain loose.

Broader financial conditions are also allowing for more hikes. Despite the rate increases (200 bps) that began in December 2015, financial conditions as measured by the Goldman Sachs Financial Conditions Index are still looser than when the Fed started its rate hiking cycle, largely because of the rise in the stock market, tighter credit spreads, and a weaker dollar. These looser conditions keep the tightening window wide open and allow the Powell-led Fed to maintain a bias toward raising rates.

In addition to a Fed chair focused more on financial stability risk, some governors and regional Fed presidents who have historically been dovish have recently become more hawkish. On the Board of Governors, for example Lael Brainard, who was probably one of the more dovish members before 2018, has since taken a hawkish turn. Governor Brainard has even implied that the Fed may need to become restrictive, suggesting that rates may be raised above 3% (the rate the Fed currently believes to be neutral). That would imply that we could see four or five more hikes in this cycle.

Outlook

A number of risks are on the horizon. First, the China-U.S. trade conflict has a high probability of turning into an economic Cold War. This conflict is really about China's "Made in China 2025" strategy, the theft of intellectual property, and mandatory technology transfers. This is a much bigger issue than the markets seem to be discounting and is therefore not reflected in current risk asset prices.

Should China be successful with its "Made in China 2025" strategy and move up the technology value chain, it will buy less and less over time from U.S. companies such as Boeing and Intel for example. So, corporations may be encouraging President Trump (privately) to take this tough stance with China, despite their more public admonishment of the Trump administration's trade war tactics.

Second, Italy's banks will continue to be a problem. This risk is significant, given the fact that Italy is the third-largest economy in Europe. Italian banks are the poster child for the sovereign debt "doom loop" phenomena. European banks own a lot of their home country's sovereign debt, and in the case of Italy, that debt represents more than 100% of Italian banks' Tier 1 common equity. So, it's a serious issue not only for the Italian banking system, but also for the broader European Union.

Third, U.S. corporate earnings growth is likely to soften in 2019. Earnings this year benefited from the tax cut, which made comparisons to 2017 quite favorable. Next year, comparisons become much tougher due to base year effects. Additionally, trade tensions and higher tariffs will likely pressure margins, as the competitive backdrop will likely prevent these additional costs from being fully passed on to the consumer via higher prices.

The bottom line is there are many reasons to believe that the new volatility regime that has emerged will pressure risk asset prices. In the case of investment grade fixed income, spreads are vulnerable to widening against this backdrop. If this plays out, the Treasury market would likely be the beneficiary of a flight to quality, particularly as the end of the year approaches. In the short run, Treasuries still lack sponsorship as long term technical levels have failed to support yields, higher currency hedging costs keep foreign market participants on the sidelines, and supply concerns persist amidst growing deficits. A range of 3% to 3.25% is likely to prevail until a broader risk re-pricing or fundamental economic slowdown incites an old fashioned flight to quality bid again. That environment would push yields on the 10-year note back down to the 2.5-3% range. Should investors start to anticipate a full blown recession, rates could go even lower. Finally, it is worth noting that the death of the secular bond bull market is once again a popular narrative, but premature in our estimation.

INVESTMENT GRADE — TAX EXEMPT

As in the first half of the year, issuance declined and institutional investors pulled back. For the quarter, the Bloomberg Barclays Municipal Bond Index slipped -0.15%. Year-to-date, the index is down -0.40%. While the short end of the curve has outperformed, the long end has largely lagged.

Year-to-date, new issuance came to $235 billion, down about 16% from the same period last year. Supply was constrained in the first three quarters of 2018 and is expected to remain so for the rest of the year. Total issuance is anticipated to decline 15-20% from more than $400 billion in 2017.

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The drop in new issuance is a result of issuer frugality and the elimination of advance refundings by the 2017 tax law. The new law has impacted supply as advance refundings accounted for about 20% of issuance in 2017.

While demand started out strong in the third quarter, fed by reinvested cash from coupon payments and maturing bonds, it waned later on. Flows into municipal bond mutual funds totaled $5 billion for the quarter, bringing the year-to-date total to $16 billion, according to the Investment Company Institute, down from about $24 billion in 2017.

Some of this decline in demand has occurred because banks and property/casualty insurance companies have become 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, removing some support from the market. The reduction in their holdings has been felt primarily among maturities 15 years and longer. In addition to cutting back their holdings, these institutional investors have dropped their buy-and-hold strategies in favor of a relative value approach. **For more on the municipal market's reaction to tax reform, read our recent white paper, *Much Ado About Taxes*.**

Yields rose across the municipal bond yield curve during the quarter but especially among short and long maturities. Yields on two-year AAA bonds rose 33 bps and 25 bps on 25- to 30-year bonds. Yields on five-year bonds rose 21 bps and 12 bps on 10-year bonds.

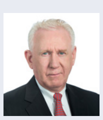
Despite this rise, quality spreads remain tight by historical standards. The yield on the 10-year Treasury breached the 3% level late in the quarter, and if a further breakout occurs, investors may shift some funds out of the municipal bond market.

Our outlook continues to advocate owning high quality issues. Although low quality bonds have been outperforming, we believe that if the market turns, the lack of liquidity will take a heavy toll on these issues.

We also anticipate an increase in demand from the retail sector, especially from higher-earning households in states with high income tax rates. With the new cap on the deductibility of state income taxes, these taxpayers might be surprised by how much their federal income taxes are going to rise. That may prompt them to seek tax-exempt income in the municipal bond market. We've already seen evidence of this in California and New Jersey.

Authored by:

Investment Grade – Taxable



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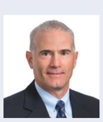

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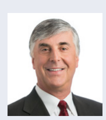
Investment Grade – Tax-Exempt



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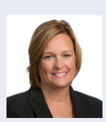

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up 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.