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

> After ending three years of gradual tightening, the Federal Reserve pivoted and signaled a more accommodative policy stance that helped investment grade spread product achieve healthy gains in the first quarter, led by BBB corporate issues. But a synchronized global slowdown increased the probability of a global recession and rate cut later in the year.

> Robust demand for investment grade municipal bonds was largely driven by the cap on state and local tax (SALT) deductions under tax reform. As the muni yield curve flattened, many investors, particularly in high tax states, bought bonds with longer maturities and lower credit ratings, which in turn provided the best muni returns in the quarter.

INVESTMENT GRADE—TAXABLE

Dovish Fed Propels Risk Markets

The first quarter of 2019 added new meaning to the word "pivot," as the Federal Reserve (Fed), clearly spooked by a sharp decline in the stock market in December, reversed its previous stance on monetary policy and turned demonstrably dovish. For many investors, the most pivotal moment may have been a January 4th panel featuring Fed Chairman Jay Powell and his two predecessors, Janet Yellen and Ben Bernanke. With muted inflation readings, Powell signaled a new watchful waiting approach whereby the Fed would patiently watch financial conditions (namely, **STOCK PRICES**, credit spreads, interest rates and the value of the dollar), ever ready to alter policy if necessary to promote its "statutory goals."

To say that risk markets loved that U-turn by the Fed would be an understatement. After all, Powell went on to say the Fed is prepared to adjust policy quickly and flexibly, and to use all of its tools to support the economy. That, in our view, is code for saying the Fed is prepared to take rates back to zero and do more quantitative easing, should financial conditions or macroeconomic conditions deteriorate. Some Fed officials have even gone so far as to talk about adding negative interest rates to their monetary policy toolbox in the next recession.

Fast forward to March 20: mindful of a slowdown in China and recessionary conditions in Europe, the Federal Open Market Committee (FOMC) revised its infamous "Dot Plot" to reflect its median outlook for NO rate hikes in 2019, down from two hikes in the December median outlook and one additional rate hike in 2020. What surprised the market, though, was a statement that not only would quantitative tightening end in September, but the FOMC went on to say that it was going to cut the balance sheet run-off for Treasuries from $30 billion a month to $15 billion a month in May. The March FOMC meeting outcome was similar to most other public appearances from Powell and the rest of the "open mouth committee" over the quarter, where dovish expectations were met with even more dovish action. Risk markets reacted accordingly, and the carnage that was the fourth quarter of 2018 quickly gave way to a melt up in asset prices globally.

The Bloomberg Barclays US Aggregate Bond Index was up 2.94%, led by longer duration issues. The spread sectors were led by corporates, which were up 5.14% during the quarter. Within corporates, BBB rated issues led the way with a 5.73% total return. Interestingly enough, the Treasury market also responded favorably to the Fed pivot, driving yields lower and offering the investment grade market attractive nominal returns. Although obviously in conflict with the risk on move, the Treasury market was offering a more sobering interpretation of the Fed's pivot to patience amid concerns about continued sluggish growth.

Corporates generated 273 basis points (bps) of excess return, which in essence measures how the asset class performs versus a duration-neutral, risk-free asset (i.e., a 10-year corporate bond versus a duration matched 10-year Treasury). Commercial mortgage-backed securities generated 118 bps of excess return in the quarter. Asset-backed securities generated about 40 bps. The residential mortgage-backed security sector was the laggard, generating about 28 bps.

In the investment grade credit space, the industrial sector was the best performer, generating 295 bps of excess return, followed by financials with about 257 bps and utilities with 156 bps.

Does Slowing Growth Signal Recession or a Soft Landing?

For all the encouraging data on employment, the U.S. economy is clearly decelerating. GDP growth in 2Q18 reached 4.2%, but it dropped to 3.4% in 3Q18, 2.2% in 4Q18, and tracking models for 1Q19 currently estimate GDP in a 1.4% to 2.3% range. The middle quarters of 2018 represented the high water mark of fiscal stimulus that came from the late 2017 tax reform legislation. Most of this stimulus will be exhausted by the middle of 2019; hence a return to trend growth is likely. Remember, the U.S. labor force is growing about a half a percent, and productivity is growing 1%, hence the economy's potential growth rate is the 1.5% combination of those two factors. Absent aggressive stimulus, this is a generally reliable indicator of the steady-state growth rate of the economy in a post financial crisis world.

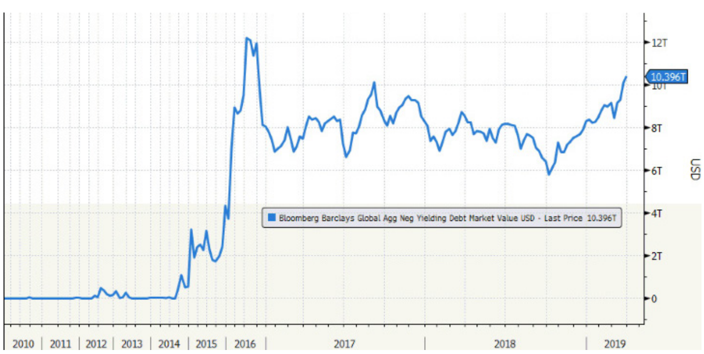
Whether all that presages lower stock prices is open to question, but this much is clear: while the S&P 500 Index was up about 13.65% in 1Q19, the trend in earnings per share estimates is being revised downward, which certainly raises questions about the sustainability of the massive rally in equities.

Will lower corporate earnings be transitory, or a more protracted development? With increasing signs of a synchronized slowdown among major economies, we believe there is a higher probability of a global recession. Italy is already in recession, Germany is close to being in recession, China is decelerating, and organizations like the World Bank, the Organization for Economic Cooperation and Development, the International Monetary Fund, the Fed, and the European Central Bank have all cut their growth forecasts.

We continue to pay close attention to the New York Fed's recession probability model. Since former Fed chairman Greenspan altered the way the Fed conducts monetary policy (with much more focus on financial markets and stock prices in particular), a low 40% probability typically presaged a recession. As of April 5, 2019, that model is implying about a 27% probability of a recession in the next 12 months. The Treasury market is pricing in a 70% probability of a recession in the next 12 months, according to JPMorgan strategists. The equity market, on the other hand, is pricing in an 8% probability of recession, and the high-yield market is pricing in a 6% probability.

Against that backdrop, global bond markets now have more than $10 trillion in negative yielding debt—a tally that was as low as $5.8 trillion back in early October 2018, according to Bloomberg. Should the signals global sovereign debt markets are sending prove to be valid, it stands to reason that the Fed could effect a rate cut as early as this summer.

NEGATIVE YIELDING DEBT HAS RISEN TO MORE THAN $10 TRILLION



Source: Bloomberg

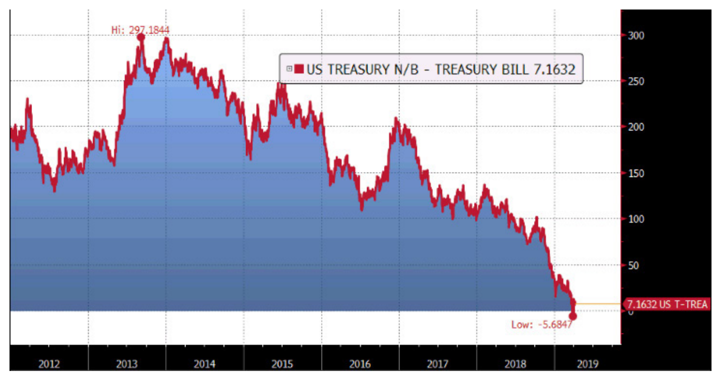
A Swing at The Yield Curve

As mentioned earlier, while many investors typically associate a risk-on market with rising rates, we actually saw rates decline further in the first quarter (remember, they also fell amidst the turmoil of the fourth quarter). At the front end of maturities, two-year and five-year issues were down 23 and 28 bps, respectively; the 10-year was down 28 bps, and the 30-year was the laggard, down only 20 bps.

In fact, parts of the yield curve started inverting at the end of 2018. The widely watched 3-month/10-year spread inverted late in the first quarter, albeit briefly. While the spread on this curve metric is now moderately positive again, many market watchers remain focused on this relationship given its history as a harbinger of recession.

How predictive is an inverted yield curve? The last seven economic recessions occurred anywhere between 140 and 487 days after the 3mos/10yr yield curve inverted for ten straight days, according to Bianco Research. There was a false alarm in 1998, when the yield curve inverted for a couple of days, but did not lead to a recession. However, 11 of the last 12 earnings recessions (without an oil price shock) led to an economic recession. If earnings estimates continue to be marked down, that would also be a critical leading indicator of an impending economic recession.

THE BELLWETHER 3MOS/10YR TREASURY CURVE SPREAD



Source: Bloomberg

All Eyes On China

While some investors expect that U.S. GDP could benefit from "a residual seasonality effect" and a post-shutdown rebound in the second quarter, we are concerned about the effects of China's slowdown on global economic growth because China doesn't have a lot of room to stimulate further. Fiscal and monetary stimulus may have stabilized a decelerating growth rate in 2012-2013 and 2015-2016, but current stimulus efforts are very targeted and domestically focused—far different than the so-called Shanghai Accord of early 2016, when the Fed backed off on projected rate hikes (the Dot Plot projected four hikes in 2016) and China injected massive amounts of credit into its economy, driving commodity prices up and with it, risk assets in general.

Our Outlook

Growth, inflation, and interest rates have all likely peaked in this economic cycle. In terms of investment exposure, we remain underweight the primary spread sectors, as we have

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been for quite some time, given an overarching aversion to inordinate risk. Generically speaking, the weighting to the corporate credit sector and residential mortgage-backed securities is roughly half that of the benchmark. An overweight in commercial mortgages, largely through the agency commercial mortgage-backed market, represents "safe income at a reasonable price" while we wait for more attractive valuations in the primary spread sectors. In other words, we will add risk to portfolios when we believe we're being compensated for it.

An upcoming conference at the Federal Reserve Bank of Chicago in June warrants close attention. This is being held for the Fed to review the strategies, tools, and communication practices it uses to pursue its congressionally-assigned mandate of maximum employment and price stability. Recall that former Fed Chairman Bernanke announced that the Fed had an inflation target of 2% back in 2012. Now every major central bank is targeting 2% inflation, and it makes no sense from an economic and standard of living perspective, that 2% inflation somehow represents price stability. Given that global debt went from $173 trillion at the end of 2008 to $244 trillion by the third quarter of 2018 (according to the Institute of International Finance), this cycle illustrates the unfortunate consequences of responding to a debt crisis with only more debt. One could argue that what central banks are trying to achieve is a stealth devaluation of this debt through higher inflation. This could be the primary driver of the aforementioned conference, as the Fed now needs to move the goal posts since unconventional policies (zero interest rates and quantitative easing) have failed. Unconventional policy now becomes conventional, temporary becomes permanent, and the grand monetary policy experiment takes a further leap into the great unknown (or the Twilight Zone?). At a minimum, watching the Fed abandon the current tightening cycle at 2.375%, or barely above 0.5% in 'real' (inflation adjusted) terms, also illustrates how vulnerable the global economy is to higher rates and dependent on exceptionally low rates under this ever expanding debt load.

Looking ahead, in the aftermath of this policy review, it seems reasonable to anticipate monetary policy moving to a price-level targeting regime, thereby adopting a form of nominal GDP targeting that would give the Fed more leeway to keep monetary policy unusually easy if it doesn't meet its inflation target. To understand the implications of such a move, suppose the Fed's average inflation target is 2% and inflation is running at 1% for five years. Under an average inflation targeting framework, the Fed would in theory accept an inflation rate of 3% over the ensuing five years to reach that 2% average.

INVESTMENT GRADE—TAX EXEMPT

If you had to summarize 1Q19 for the tax-exempt market in three words, it would be demand, demand, and more demand, largely driven by the cap on state and local tax (SALT) deductions under The Tax Cuts and Jobs Act of 2017 (TCJA). As the muni yield curve flattened, spreads narrowed, and volatility increased. Many investors, particularly in high tax states, bought bonds with longer maturities and lower credit ratings for optimal returns. While the Bloomberg Barclays Municipal Bond Index returned 2.9% for the quarter, the Long Bond index was the best performing muni category with a return of 3.85%, and the BBB index returned 3.59%. The One-Year index, on the other hand, returned 0.81%, and the AAA index returned 2.67%.

Headline supply for the first quarter was $76.4 billion. That was much higher than 1Q18, since a lot of issuers tapped the market in December 2017 before TCJA became effective. But if you take a longer view, that $76.4 billion is actually $8 billion below the average first quarter since 2006.

Daily trading volume, however, rose to $11.8 billion, which is above the three-year average of $11.3 billion. And with limited supply and high demand (12 straight weeks of inflows, more than $25 billion, according to the Investment Company Institute), weaker credits such as Illinois, Connecticut, New Jersey Transportation Trust Fund, and Chicago, were all well received.

From a fundamental perspective, upgrades continued to outpace downgrades, with states largely reporting increased tax revenue. As a result, we feel comfortable that most states are able to continue to operate within the confines of their current taxing authority. Looking at governors' state-of-the-state addresses, we see that 25 states are considering additional tax proposals. Five of the 25 states are actually considering new or increased taxes; 11 want to lower, and four have initiatives that would actually do both.

From an investors' perspective, the good news is that fiscally strapped states are becoming more proactive and creative in solidifying and firming up their budgets. What may be concerning, however, is that some of these proposals are one-time shots, and some have yet to materialize. Illinois, for instance, is banking on legalizing marijuana and taxing that, but projected tax revenues may be overly optimistic, and actual revenue generation could take some time as the logistics of implementation are ironed out. (Note: In both California and Colorado taxes on legalized marijuana did not add as much to the state budget as initially anticipated.) For its part, New Jersey is betting on legalized betting, but estimates of tax revenue from such activity have stirred some skepticism. Meanwhile, Connecticut is still grappling with a hefty budget deficit, pension reform, and ways to attract bigger businesses. But the state recently made progress with a $1 billion bond sale, which was up from a planned $850 million.

Most states are fairly well positioned from a revenue standpoint. Municipal bond investors will continue to monitor Puerto Rico's restructuring, particularly in the wake of recent rulings surrounding the redistribution of highway tax revenue, which went in the face of the bankruptcy code.

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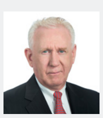
While many states face infrastructure issues, the chances of Congress reaching agreement on a legislative package appear slim. That raises the question of whether Congress will push infrastructure improvements down to states and municipalities already saddled with other fiscal challenges.

The bottom line: we remain confident that municipals will be an asset class that continues to perform and be in demand, but we are more cautious on the fundamental side as states continue working on fiscal responsibility and ability to weather a recession.

The key will be credit research that helps investors understand what they own—and understand the variances from state to state. All of which underscores the importance of active management: Understanding what is going on within the municipal market from both a top-down level and a bottom-up approach.

Authored by:

Investment Grade – Taxable



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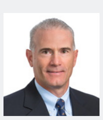

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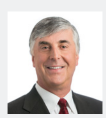
Investment Grade – Tax-Exempt



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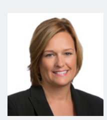

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