SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Investment Grade: Taxable and Tax-Exempt Fixed Income

- A flight to quality and a widening of spreads hurt investment grade spread product in the fourth quarter, and more volatility is likely in 2019 as global liquidity declines despite new dovishness by the Federal Reserve and moderately stimulative policies in China.
- Investment grade municipal bonds benefited from turmoil in equities markets in the fourth quarter, and higher quality issues outperformed. For the year, returns were modestly positive as supply declined and a shrinking market provided some price support.

INVESTMENT GRADE — TAXABLE

Expect More Volatility Despite a Likely Fed Pause

Markets saw a surge in volatility in the fourth quarter — the result of a "perfect storm" at the beginning in October. On October 1, the European Central Bank's quantitative easing (QE) program downshifted from €30 billion in bond purchases per month to €15 billion. This coincided with the blackout period for corporate share buybacks preceding third-quarter earnings reports, which was critical because corporations have been the biggest buyers of equities during this cycle, with purchases amounting to about $5 trillion. Compounding this, Federal Reserve Chairman Jerome Powell gave an interview on October 3 where he commented about the future path for the Fed target rate, "We may go past neutral, but we're a long way from neutral at this point, probably," suggesting that he still leaned hawkish and several more rate hikes were likely.

Concurrently, high-yield spreads were recording their tightest level of this cycle, nearly breaching 300 basis points (bps), crude oil prices were at their 2018 high of over $76 a barrel, and Apple's stock price had peaked, becoming the first trillion dollar company in history. But what then ensued was a perfect storm that saw high-yield spreads climb to nearly 540 bps, oil plunge to $45, and Apple's stock price losing more than 32%. The total return for the S&P 500 over Q4 was -13.5%.

Widening Spreads Drove Fourth Quarter Performance

As we noted last quarter, our expectation going into 2018 was that declining global liquidity would give rise to volatility across a range of markets. And what we witnessed in 2018 were bouts of turmoil in the LIBOR-OIS spread, volatility markets, in emerging markets, in FX markets and finally in U.S. equities and credit.

Although that rolling volatility took a while to arrive in the U.S., it did so quite dramatically, causing stocks to plummet and Treasury yields to fall in the fourth quarter. Early in the quarter, however, those yields were still rising, largely due to the aforementioned comments from Federal Reserve Chairman Jerome Powell. In fact, it wasn't until November that yields peaked. From there, a flight to quality took hold, causing them to decline through the end of the year. The 10-year Treasury yield peaked at 3.24% on November 8, but it ended the year at just 2.69%.

This flight to quality caused spreads in the investment grade market to widen, resulting in more attractive valuations, at least relative to the past year. At the end of the third quarter, valuations were still rich to fair, but by the end of the fourth quarter, they had become cheap over shorter term time periods. Relative to the past 10 years, however, the market still appears to be only fairly valued.

Generally, performance in the investment grade market suffered as a result of the fourth-quarter spread-widening, with excess returns shifting dramatically to the negative. (Excess return represents the return a spread product achieves relative to a duration-neutral risk-free asset.)

In the investment grade corporate bond market, the wider spreads were actually large enough to offset the decline in rates, resulting in negative total returns of -0.18% for the fourth quarter and -2.51% for the full year. Corporate bond spreads widened by 47 bps during the quarter and 60 bps for the year. Excess returns amounted to -310 bps for the quarter and -315 bps for the year, making 2018 the worst in excess return terms since 2011.

In the securitized asset classes, excess returns were uniformly negative but less severe than witnessed in corporates. Residential mortgage-backed securities (RMBS), the largest securitized segment, produced an excess return of -53 bps for the quarter and -59 bps for the year. On a total return basis, however, RMBS managed to achieve returns of 2.08% for fourth quarter and 0.99% for the full year.

In commercial mortgage-backed securities (CMBS), excess return came to -112 bps in the fourth quarter and -39 bps for the full year. Again, this segment managed to eke out positive total returns of 1.72% for the quarter and 0.78% for the full year. Similarly, in asset-backed securities, a tiny slice of the securitized market, excess returns were modestly negative for the quarter and modestly positive for the year.

The high-yield sector took a more serious hit than the investment grade market. Excess returns came to -675 bps for the quarter and -358 bps for the year. Total returns were also negative at -4.53% for the quarter and -2.08 for the year. Spreads for this sector widened by 210 bps during the quarter and 183 bps for the year.

Emerging markets also experienced a tough year, with excess returns amounting to -291 bps for the quarter and -345 bps for the year. Total returns came to -0.18% and -2.46% for the quarter and year, respectively.

While the magnitude of the fourth-quarter sell-off affected performance, the full-year pattern of returns points to a significant change regarding risk. Corporates, for example, lagged for most of the year, posting negative excess returns in eight of 12 months. Similarly, RMBS and CMBS produced negative excess returns in seven of 12 months. In contrast, 2017 saw those sectors lagging in only three months. So, regarding market risk, the more frequent downdrafts in 2018 suggest that change is afoot.

Global Liquidity Will Decline Despite Fed Dovishness and China Stimulus

We believe the rolling bouts of volatility that we anticipated at the beginning of last year will continue in 2019 since several factors that fostered 2018's turmoil remain in place at this point. First and foremost, major central banks in developed markets are still biased towards normalization by tightening, moving in that direction, or at least refraining from further monetary accommodation. Despite weaker economic fundamentals, the European Central Bank followed through on its commitment to end its quantitative easing program, though it continues to reinvest principal payments. The Fed's policy shift of late is a bit more nuanced. In the wake of the market's volatility during the fourth quarter, the Fed has retreated somewhat from its more hawkish stance. In September, the Federal Open Market Committee's (FOMC) "dot plot" resulted in a median expectation of three rate hikes in 2019, but in December that same median fell to two. Early 2019 interviews with various FOMC participants, including Chair Powell himself, have aggressively sold an updated policy stance that emphasizes "patience" given that inflation remains close to target with no expectation for any acceleration. The Fed continues to shrink its balance sheet, known more commonly as QT — for quantitative tightening. The pace of QT reached $50 billion per month last October, so 2019 will see the Fed's balance sheet decline by approximately $600 billion (RMBS cash flows are variable and as a result the actual portfolio run-off can be less than the QT goal). Given this continued QT in tandem with the ECB's end of asset purchases, the global central bank balance sheet is projected to contract considerably in 2019.

Second, credit creation in China is likely to remain a drag even with some expected targeted stimulus. Tariffs imposed by the United States threaten to slow economic growth, putting at risk the country's plan to restrain lending and deleverage the economy. Responding to the possible slowdown, the People's Bank of China cut the amount of cash banks are required to hold in reserve by 100 basis points on January 4th, freeing up those funds for additional lending. Further, new government spending plans and a reduction in income tax rates have been announced. Nevertheless, China's credit impulse will continue to contract. These stimulative policies represent small and very targeted efforts and are not like the large-scale programs undertaken in 2009 and in 2015-16.

Moreover, China is no longer in a position to implement large-scale stimulus programs; its current account balance has shrunk from a surplus of 10% of gross domestic product 10 years ago, turning negative through the first three quarters of 2018. (For the year, the International Monetary Fund predicts a current account surplus of 0.7%.) Though it has rebounded, it may go negative again this year, meaning that China has less financial flexibility to manage its economy than it did just a few years ago. So, despite this hiccup in China's deleveraging plan, investors should expect global liquidity to continue to decline as China's credit impulse continues to be contractionary.

Outlook

In the U.S., growth was expected to be above trend this past year due to a "sugar high" from the tax cuts and fiscal stimulus. Both of those impacts will wane in 2019, such that growth will decelerate to the trend-level seen over most of the recovery (~2.3%). In fact, given the current macroeconomic backdrop, there is an increasing risk of growth slowing even further, and clearly the risk of recession is elevated.

The slowdown of China's economy resulting from slowing trade and U.S. tariffs could increase the pressure to reach some sort of trade deal with the United States. It would seem to be in the interest of both President Xi and President Trump to come to some cosmetic agreement that allows for both to claim victory. In doing so, important issues pertaining to intellectual property theft and forced technology transfers will not fully be addressed. As a consequence, China and the United States are likely to remain locked in an economic cold war for some time.

Meanwhile, in the short term, markets may rebound. The emphasis on patience from the Fed likely means no rate hikes during the first half of 2019, so conditions for risk have already improved. Should China and the U.S. reach a trade deal, even one that is intended only to improve the "optics" of the trade relationship, markets will be further inclined to celebrate and rally.

As it relates to the interest rate backdrop, our "lower for longer" thesis remains intact. Although the yield on the 10-year Treasury surged to 3.24% this past year, it has, as we noted above, come back down dramatically and remains within the 2.5-3.0% range that prevailed for much of 2018. This range is likely to persist further into 2019.

INVESTMENT GRADE — TAX-EXEMPT

Municipal bonds rallied late in the year to produce a modest performance for the quarter, driven by a flight to quality. Performance for the year was positive as well, assisted by a decline in net supply. The Bloomberg Barclays Municipal Bond Index returned 1.69% for the quarter and 1.28% for the year.

During the fourth quarter economic uncertainty and equity volatility laid the ground work for credit spread widening. Higher credit quality took the lead with AAA bonds (1.84%)

continued

beating Baa bonds (1.35%). Despite the widening, lower rated credit outperformed higher quality issues for the year with AAA issues (1.05%) lagging Baa issues (1.96%).

The strongest performance of the fourth-quarter came in the intermediate portion of the curve, as 30-year maturities lagged. The Tax Cuts and Jobs Act of 2017 (TCJA) shifted institutional buying patterns as a reduction in the tax rate made tax-exempt bonds less attractive to corporate buyers. Banks and insurance companies, who had typically been buyers of the 20 and 30 year area of the curve, also pulled back.

The tax reform legislation continued to affect market technicals in other ways as well. Issuance for the quarter came to just $71 billion, off 69% from the year-ago quarter, a reflection of the law's elimination of advance refundings and of a surge in issuance at the end of 2017. For the year, gross issuance amounted to $338 billion, down 24% from a year ago. Net supply for the year, or gross issuance minus bonds reaching maturity or being refunded or called, was also negative.

On the demand side, municipal bond mutual funds saw outflows of $10.7 billion for the quarter. Investors may have been selling for tax purposes and may have been anticipating additional rate hikes by the Federal Reserve. But outflows ebbed in November and turned positive midway through December. For the year, flows were slightly positive at $5.5 billion, as reported by Investment Company Institute.

Valuations ended the quarter relatively attractive, with the ratio of the yield on a AAA 10-year municipal bond standing at 85% of that on a 10-year Treasury, roughly in line with long-term averages. For high-income households in high-tax states, whose combined state and local tax rate may approach 50%, this will be attractive, especially considering that this ratio may decline over the next few years given the trend in technical factors.

That is, the market is likely to receive support from constrained supply, at least over the short term. With a divided Congress, gridlock is likely to prevent the passage of an infrastructure spending program. If issuance matches that of 2018, net supply may shrink, providing some support to the market.

Retail demand, on the other hand, may strengthen. Continued volatility in the stock market will make the stability of municipal bonds more attractive, and high-income households will in 2019 increasingly notice the impact of the cap on the deductibility of state and local taxes. While some high-tax states have proposed allowing state and local taxes that exceed the cap to be deducted as charitable contributions, those efforts so far have failed. High-income households will still have a strong incentive to protect some of their income in the municipal market.

In the near term, investors may want to consider the higher credit quality portion of the market. We continue to believe that quality spreads are too tight, especially going into an environment in which the economy is slowing. A slowing economy could affect real estate taxes, which municipalities depend on heavily. Those states and local governments in more robust financial health are likely to withstand a downturn better than others. Similarly, the pension and health benefit obligations remain an issue for weaker credits, especially in light of recent stock market performance. We believe higher quality issues will provide not only better liquidity, but better capital preservation as well.

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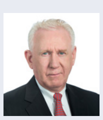
Investment Grade – Taxable



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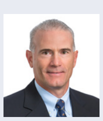

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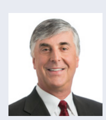
Investment Grade – Tax-Exempt



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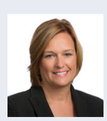

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up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

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