Navigator® Taxable Fixed Income

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Fourth Quarter 2018 — Portfolio Commentary

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FIXED INCOME UNDERDOGS ARE THE CHAMPS OF 2018

As equity investors slowly put their Dow 25,000 hats in their bottom desk drawer, let's take a second to talk about the biggest underdogs of 2018…bonds. Look, we get it. It is so easy to be seduced by a multi-year long bull market constantly hitting new highs. And let's face it— even in our last quarter's market review, we were focused on the high probability of a December rate hike and analyst expectations of several more in 2019.

But all that has changed in the fourth quarter. Whether it was the more dovish tone of the Fed, the stock market sell-off, a newly minted Democratic House of Representatives, weak oil pricing, continued tariff talk, or any combination of the above, the fact remains that fixed income got up off the mat in September and has been punching its way to a surprise quarter-long rally.

Every (Under)Dog Has His Day

At the start of 2018, the pews in the church of fixed income were empty to say the least. The mega-congregation of equities continued to find new believers with each new high that was hit, filling even the cheap seats in the back. Bonds, on the other hand, suffered a multi-quarter affliction as U.S. Treasury yields hit their highest levels since 2011, creating a double-edged sword of price loss at the expense of higher reinvestment yields.

But what goes up must come down, right? And as equities hit the skids from October to December, bonds finally had their time in the sun, with the rush to safe haven assets helping to fuel the Q4 rally.

To illustrate how far we have come, at the end of Q3, the Bloomberg Barclays U.S. Aggregate Bond Index was down -1.60% and finished the year at 0.01%. Over in tax-exempt land, the Bloomberg Barclays Municipal Bond Index had declined -0.40% through 9/30/18 and finished the year with returns of 1.28%.

Will the Champs Repeat in 2019?

Top of mind for investors and market participants is how long the Fed tightening cycle will last. Based on the more dovish language we've seen from the Fed, the answer may be not very long at all. Based upon the latest Fed models which focus on U.S. Treasury spreads, the probability of a recession may not be that far off.

Data dating back to the late 1960s shows us that the yield curve normally inverts 12-24 months prior to the start of the recession. While we have still not yet seen an inversion in the 10-Year/3-Month curve, it is getting close, with the spread at only 31 basis points at year end, which is the flattest it has been since September 2007.

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We are not economists, nor fortune tellers; however, we cannot completely discount what the data is saying…and for now, it points to the likelihood of lower rates.

When the curve inverts this cycle (and we're getting close), we will surely pay attention and start the clock speculating the timing of the next recession. While the credit impacts of an economic slowdown or a recession would point us to seek the safety of higher rated entities, the portfolio management impacts would direct us to remain fully invested to take advantage of price appreciation should rates head lower.

Taxable Bond Portfolio

In the second quarter of 2017, we wrote in our article "Back Where We Started":

"The Fed is in an interest rate tightening mode. The initial hikes in the economic expansion don't mean a whole lot until suddenly they do. With no history of unwinding a balance sheet of this size, the Fed will monitor if this in itself magnifies the rate hikes so far. Back where we started?

No, its 2017 and the adage 'Don't fight the Fed' is back because here we go around again."

With that statement in mind, the Fed's policy finally started to matter and on December 3rd, 3-Year Treasury yields inverted to the 5-year Treasury. Ten days later, 2-Year Treasury bonds inverted to the 5-Year. The inversion dramatically increased equity volatility as the sell-off began on December 4th and made a closing low on December 24th. Adding to the pressure during the quarter were credit spreads on investment grade corporates, which widened out 40-50 basis points. High yield spreads widened as well but were remarkably orderly in their retreat.

Starting in January 2017, we had been positioning the portfolios in a bar-bell strategy in anticipation of the possibility of a flatter yield curve. When the curve inverted in early December, a large supply of bonds came into the market in the 3 to 4-year range. In our view, that area of the curve started to become undervalued. As some of our bonds matured in the fourth quarter, we reinvested slightly longer than the 1 to 2-year range we were investing in during the previous eight quarters.

We view the December 2018 volatility as a liquidity event and not a credit event as we witnessed in 2008. Since we invest in individual securities with a fixed maturity, investing in an environment of widening credit spreads is OK in our view. Ultimately, the bonds can mature and can result in higher yields for individual investors.

Source: Bloomberg, Ned Davis Research

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The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI Emerging Markets Index is a freefloat-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The S&P 500 Index measures the performance of 500 large companies in leading industries of the U.S. economy, capturing 80% of U.S. equities.

The Bloomberg Barclays U.S. Government and Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries, government-related, and investment grade U.S. corporate securities that have a remaining maturity of greater than 1 year. In addition, the securities have $250 million or more of outstanding face value, and must be fixed rate and non-convertible.

The Bloomberg Barclays U.S. Corporate High-Yield Index covers the U.S. dollar denominated non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

The Bloomberg Barclays 30-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The Bloomberg Barclays 10-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The Bloomberg Barclays 5-Year Municipal Bond Index is the 5 Year (4-6) component of the Municipal Bond index. It is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. The index tracks general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds rated Baa3/BBB- or higher by at least two of the ratings agencies.

The CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices and which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk. The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities. The Bloomberg Barclays Capital U.S. Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury inflation-protected securities are excluded, due to tax treatment issues. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. The Bloomberg Barclays Capital Aggregate Bond Index is an intermediate term index.

The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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