Portfolio Commentary

Navigator® Taxable Fixed Income

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It's All I Can Do to Keep Waiting for You...Negative Yields?...

The last three months saw many ups, downs and news headlines including the untimely passing of rock and roll legend Ric Ocasik of the Cars (see if you can spot the Cars references in this quarter's commentary). We are ending the third quarter of 2019 with another news story that continues to persist—that of negative yields. In Europe, all 2-year bonds have negative rates except for in the UK. Extend it to 5-year bonds, and you'll find Italy at 0.21% and Greece at 0.69% in positive yields versus the U.S. 5-year rate at 1.54%.

There is talk if Italy even has a sustainable government, let alone people lending them money at 0.25% for 5 years! That is clearly "irrazionale esuberanza" as an Italian speaking Alan Greenspan might describe it. Don't even talk about Japan, which has been at negative yields for what seems like forever.

Since You're Gone...

During the drop in U.S. rates in August, it was estimated at one point that $17 billion of global bond market securities had negative yields. A Danish bank was offering mortgages with negative rates. This translates into the debtor being paid to borrow money for the term of the loan. I would think that once a debtor obtained a negative interest rate loan, would there be a need to refinance in the future?

Magic...

The flip side of negative short-term rates is the long duration 100-year bond issued two years ago by Austria (2.1% coupon due 9/20/2117). The bonds were issued at par and traded as high as $197 during the quarter or a 130 basis point rally from the issuance.

Unlike a stock that can trade at several valuations, price to sales, price to earnings, etc., these bonds are either reflecting the current view on inflation or an accommodative European Central Bank (ECB) that will continue to buy bonds. This bond is a lesson in duration and its effect on bond prices. It is not a lesson on inflation or an accommodative ECB because that will clearly be a changing scenario over the next 98 years until maturity.

Just What I Needed...

July started out with somewhat low volatility on the 10-year U.S. Treasury bond. The July range on the 10-year was between 2.00% and 2.13% only to close the month virtually unchanged at 2.01% according to Bloomberg price data. In August, recession fears and a global slowdown in growth was reflected in the flattening yield curve.

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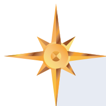

The 10-year bond was lower by 52 basis points on the month—the biggest monthly decline since January 2015 according to Bloomberg data. For bond managers, this meant you needed to be fully invested and long your duration benchmarks to drive performance.

Shake It Up...

The August drop in rates raised the question as to whether or not the Fed was behind the curve in lowering rates. The beginning of September saw 10-year rates increase over an 8-day period and alleviate August's overbought conditions.

A debate is beginning as to whether or not the economy is slowing or stalling. Jobs data continues to be firm as the unemployment rate remained at 3.7%. August's manufacturing ISM number slipped from 51.3 to 49.1. Recall that three consecutive readings below 50 are considered recessionary. (Spoiler alert since I write the commentary after 9/30): Manufacturing for September, which was released on October 1st came in at 47.8.

As ongoing trade tensions with China continue to ebb and flow, a new grenade was lobbed into the political arena. The Ukraine is now dragged into the political sphere of possibly being influenced to investigate a democratic political opponent in for the 2020 election and Democrats have called for an impeachment inquiry.

With a Republican controlled Senate, a move by the House for impeachment seems to have little chance of being accomplished. Market pundits were immediately looking for a "Clinton impeachment bounce", which was an equity market rally after a similar situation during that past administration.

All of this is noise for sure—a wall of worry no doubt. However, the stock market does not appear ready to move lower. As the bond market continues to close at lower yields, the market is starting to price in the possibility of another 25 basis point rate cut at the Fed's October meeting. October data will be the deciding factor to, as Ric Ocasik of the Cars sang, "shake it up."

Taxable Fixed Income Portfolio

I re-read my Q2 2016 commentary entitled, *Central Banks Playing Chutes and Ladders.* What was written back then still applies today. The Fed continues to measure economic data, some good (Ladders) and some weak (Chutes) and adjusts monetary policy towards full employment and 2% inflation.

The result has been that after hiking rates for the past several years, the Fed has been forced to reverse course and start an easing cycle. In Q3 2019, a peak in global negative bond yields reached $17 trillion by some estimates. The "don't fight the Fed" mantra of so many past bull markets is losing its effectiveness as we sit at these low levels of interest rates.

Stocks have moved higher over the last two years, but it has been the combination of monetary and fiscal stimulus in the tax cuts that have driven the equity markets higher. The stock market's wealth effect has aided the continuation of the economic expansion, which is now in its 10th year.

The negative interest rate siren continues to call with its allure of free money. I don't think it's a coincidence that the malaise of the Japanese and Eurozone economies is partly due to negative rates. On June 16, 2016 German 10-year bonds turned negative and the Eurozone arguably has stalled in its attempts at economic recovery.

Sometimes I believe that it is just simpler than economists make it out to be. The communitive property was taught to me in 1st or 2nd grade:

If: **A>B and B>C**

Then: **A>C**

Let's apply this to the simple world of the consumer:

- Car loan at 4% (A) > owner ability to pay
- Car Loan at 2% (B) > owner ability to pay
- Car Loan at 0% = owner ability to pay...huh?

It doesn't make sense except to create a world where the consumer is over-indebted and is spending beyond their means. Therefore, when C is a transaction financed at zero rates, it possibly means that the asset is overvalued to begin with. It's as simple as the communitive property.

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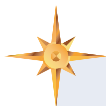

Let's apply this to our management style in an ever-increasing global negative rate environment with an active Fed.

If: **Positive rates > negative rates**

Active management > ladders

Then: **Actively managed positive rates > ladders in negative rates**

Yields continued their trend lower in the third quarter as the 2-year Treasury rallied from 1.78% to 1.63%. The 10-year Treasury rallied from 2.02% to 1.68% by quarter end according to Bloomberg data. The lower yields resulted in a tighter 2 to 10-year spread, continuing the trend toward a flattening of the yield curve. The bond rally resulted in the Bloomberg US Aggregate Bond Index returning 2.27% and the Bloomberg Barclays Intermediate US Corp Index up 1.74%.

Returns in the quarter were driven by:

1) A barbell strategy that has been underweight 2 to 3-year duration bonds relative to its benchmark and overweight 7 to 10-year duration bonds relative to its benchmark.
2) The strategy has been overweight Communication Services, Consumer Discretionary, and Energy versus the benchmark, which have been positive drivers of performance.
3) The strategy has been underweight REITs and Utilities. REITs are approximately 4.3% of the benchmark and have been the best performer in the benchmark year-to-date. Our underweight position in these two sectors has caused some drag in the portfolio.
4) Investment grade credits spreads remain firm and high yield continues to provide additional coupon income in our BB credit holdings.

Quoting from a Bloomberg news story, Standard and Poors has taken its most bearish stance on U.S. Corporate debt since 2015. According to S&P, 164 issuers were downgraded and 64 were upgraded. Of the issuers that were downgraded, 143 of them were in the high yield sector. In the investment grade space, there were 31 upgrades versus 21 downgrades. In our opinion, this is most likely due to the slowing U.S. economy and it seems logical to be contained more to the high yield sector.

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Bloomberg Barclays U.S. Aggregate Bond Index: The index is unmanaged and measures the performance of the investment grade, U.S. dollar denominated, fixed-rate taxable bond market, including Treasuries and government-related and corporate securities that have a remaining maturity of at least one year.

The Bloomberg Barclays US Intermediate Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers that have between 1 and up to, but not including, 10 years to maturity.

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