Portfolio Commentary

Navigator® Taxable Fixed Income

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2020: Time to Play the Stimulus Music

The fourth quarter of 2019 and last year of the decade ended in a bullish froth in both equities and bonds. The S&P 500 closed the year up 31.48%. The Bloomberg Barclays Aggregate Bond Index finished up 8.72% and the Municipal Bond 5 Year Index was up 5.45%.

Fearful of an economic slowdown and flattening yield curve in the third quarter, the Fed cut interest rates on August 1st and September 19th. Entering the fourth quarter of the year, the bond market appeared to be pricing in a third rate cut of 25 basis points depending on the October economic data. Then rumors started to surface of liquidity problems in the repo market.

The Fed announced on October 11th that it would begin buying Treasury bills resulting in several hundred billion dollars pumped into the system for liquidity in the quarter. In addition, on October 11th the President announced a Phase One trade deal with China. Finally, as October closed, the Fed cut rates for a third time during the year by an additional 25 basis points.

There was Dancin'... and Singin'... and Movin' to the Stimulus...

The October events of liquidity in the repo markets, a Fed rate cut and the possibility of the de-escalation of the tariff war with China paved the way for the "risk-on" rally into year-end:

- The yield curve steepened, which is a positive sign for now in averting a potential economic slowdown
- Investment grade corporate bond spreads tightened
- High yields continued to be refinanced with ease
- BB high yield credits continued to rally in spread versus Treasuries
- And of course, the S&P 500 broke out to new highs

Now first it wasn't easy...

The fixed income rally that we saw in 2019 began during the 4th quarter of 2018. As we entered 2019, we said, "*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.*"

That seemed to be a prescient statement as 2019 turned out to be a pretty good year for fixed income. We really saw the benefits of using a barbell structure to construct our portfolios when the Fed became accommodative.

Perhaps the Fed is building another bubble or perhaps inflation surprises to the upside. In my opinion, as a long time tactical fixed income manager, I would go with Fed bubble. In either scenario, we believe an actively managed bond SMA can adjust to market forces whether its credit or interest rate risk.

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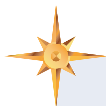

Taxable Fixed Income Portfolio

As 2018 came to close, volatility was in high gear and we closed with the following statement, "*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*." Those words really came to fruition as the Fed shifted gears with three rate cuts during the year and provided year-end liquidity to apply salve or maybe gasoline to a risk-on market.

The quarter was highlighted by some credit upgrades in our BB holdings and bonds being called as issuers were able to refinance at favorable rates. To give you an example, a long-term BB holding of ours had remained a BB credit for years and in our view, was a value as we owned the 5.125% bonds due 2021 for the front end of our barbell strategy. An upgrade to Baa3/BBB- in October enabled the company to issue debt for 5 years at 2.80% and 10 years at 3.45%.

Returns in the quarter were driven by:

- Spread compression in investment grade corporate bonds
- Record low yields of BB credits in the portfolio
- Stable prices in our BB credits as several were called away, allowing us to just collect larger cash flow from the higher coupons versus investment grade
- Barbell strategy continues to perform in a favorable fashion versus the benchmark

2019 ends a banner year in the fixed income markets and we believe 2020 should be more challenging. Market watchers are concerned with an equity market trading over 19x earnings. As a fixed income manager, I am concerned with both investment grade and high yield spreads, which have been driven to the tightest level of the year by dawn of the new decade. We can navigate through credit shocks, and we can navigate through higher rates by using the barbell approach. But credit spreads widening can cause some underperformance at the start of that cycle.

With the roaring 20s ahead, the question is if central banks finally create an "inflation" hangover this decade. Having lived through the 1970s and early 80s, I saw the effects of inflation on a household budget. Inflation is a tax on future spending, but what is left to go up in price? College? Healthcare? Energy? That doesn't even include the expenses of cell phones and internet bills, which were never part of a 1970s household budget.

People generally have more financial resources today and higher interest rates would be welcome to most households awash in cash from equities and savings over the last few years. However, we saw what happened when the 2-year Treasury moved to 3% last December to the equity market—a sell-off ensued.

The roaring 20s lie ahead. The punch bowl has been spiked for a decade now. Central banks have not only intervened time and time again, and they are intertwined with the economy now more than ever—but can they ever really stop? As tactical managers, we will assess the markets and adjust our portfolios accordingly to what lies ahead. Wild Cherry had it right in the late 1970s, C'mon Fed boys, lay down and boogie and play that funky stimulus till you.....?

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The Barclays Capital 5 Year GO Municipal Bond Index represents the performance of long-term, investment grade tax-exempt bonds with maturities ranging from four (4) to six (6) years.

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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