

MANAGER COMMENTARY

FIXED INCOME



GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

First Quarter 2019

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MARKET REVIEW

The first quarter of 2019, much like last quarter, finds us with a radically different shape of the yield curve. The curve now shows an inversion from 6 months to 10 years; 2-years at 2.42%, 10-years at 2.41%, with the low yield point at the 3 year maturity, yielding 2.20%. However, the dive in yields in the 2 to 10 year part of the curve repeated. Corporate bond spreads are tighter than at the start of the year and with the curve shift, have performed very well over the term. Dovish talk from the Fed, and various geopolitical squabbles continue to drive rates lower. March was particularly volatile, with the 10-Year running 37 basis points lower in yield before ending the quarter 38 basis points off the highs in January. As noted, a reversal from the Fed on policy and how to normalize rates, weak European data, and a gradual but real slowing in corporate earnings are driving the ebb and flow in safe haven assets.

SECTOR HIGHLIGHTS

Credit: The corporate market was robust during the quarter with a decrease in risk premium due to a reversal of what we saw during the fourth quarter. Treasury yields were lower, and credit spreads tightened robustly which drove returns. Lower quality corporates outperformed higher quality corporates with the Barclays U.S. Credit tightening 38 basis points, which recouped 65% of the spread widening that happened in the fourth quarter. The Bloomberg Barclays U.S. Credit A rated tightened 29 basis points, which recouped 85% of the spread widening that happened in the fourth quarter. The Bloomberg Barclays Aggregate Index returned 294 basis points for the quarter, while the Intermediate Govt/Credit returned 326 basis points. The Bloomberg Barclays Corporate Investment Grade Index returned 514 basis points for the quarter.

Treasuries: Another moonshot quarter for treasuries, as yields dropped precipitously from one year to the long end, anywhere from 21 bps (1yr) to 28 bps in the 10yr and 20yr. Dovish Fed talk and safe haven demand are the main drivers of this volatile but sustained move lower in interest rates. The curve is inverted from 6 months to 10 years, a harbinger of a looming recession. With corporate earnings still positive but slowing, and a definite Euro/Asia slow down, we expect a continued rocky road over the next quarter.

MBS: Like other spread sectors, Agency CMBS performed well over the quarter advancing 2.27%. Much of the return was due to the overall drop in interest rates, but some was due to spread tightening. On a spread basis, mortgages tightened 15-20bps over the course of the quarter. This was likely a reaction to the substantial tightening we saw in the corporate market. Returns going forward will be heavily influenced by refinancing activity that will be possible with the decline in mortgage rates.

ABS: In asset-backed securities, market sentiment improved throughout the quarter as ABS spreads held up well against rate volatility. Credit card and auto ABS lead spread tightening within the sector while student loan ABS continues to underperform. Consumer credit performance remains strong given the support of a strong labor market; therefore, credit metrics for consumer ABS remain strong as well.

Municipals: The first 3 months of 2019 have been very good for the muni market. Sector performance was impressive, with positive numbers across the benchmark spectrum, led by the BB Muni Bond Index returning 2.90%, with a 158 basis point return in March. State and Local Tax (SALT) seems to be the main driver of demand for munis, as the loss of that deduction makes munis the asset class of choice for high bracket investors. Mutual fund and ETF flows were record-breaking over the quarter, the strongest since 2007. New issue volume is 14% ahead of last year, but the demand has more than met supply. Other benchmark returns for the quarter, as mentioned, were strong:

BB 1-5	1.49%
BB 1-10	2.21%
BB 3-15	2.68%

The ratio of tax-free yield to treasury yields (a common comparison) shows munis staying very rich on the short-end of the curve, and off the highs on the long end. The near 100% to 96% move on the long end is like



getting the tax-exemption for nothing, versus long treasuries, for a max tax bracket investor.

Yield Curve: The changes in the yield curve through January and February were quite different than in March. First, in January and February the curve was rather stable, moving down about 3-7 bps in January and then up about 5-8 bps by the end of February. However, March was a different story. The Fed turned decidedly dovish while holding rates steady in March. Participants shifted their expectations for rates in 2019 from two rate hikes down to zero, which drove rates significantly lower. The market flooded into treasuries, which flattened the yield curve as rates dropped about 30 bps on the long end and about 15 bps on the short end. The curve flattening went so far as to invert the 3month/10yr part of the curve, flashing warning signs of a pending recession and even pricing in rate cuts by the Fed. We believe these moves to be a slight overreaction. Even though economic data was weak in the first quarter and GDP growth is coming off a tax cut sugar-high, the economy should rebound in Q2. Growth should return to around 2%, unemployment continues to hold at all-time lows, and wage growth has picked up, which supports the largest part of the economy, the consumer.

INDEX RETURNS FOR THE PERIOD ENDING MARCH 31, 2019

	Q1 2019	YTD
BB Aggregate	2.94%	2.94%
Corporate	5.14%	5.14%
Treasuries	2.11%	2.11%
ABS	1.40%	1.40%
Mortgages	2.17%	2.17%
High Yield	7.62%	7.62%
Municipal	2.90%	2.90%
2-year Treasury	0.97%	0.97%
10-year Treasury	3.08%	3.08%
30-year Treasury	2.80%	2.80%

MARKET OUTLOOK

Much like last quarter, the move in rates and the shape of the curve was not anticipated, and still leaves us less sure how to position against benchmarks over the mid-term. Our decision to move duration a bit closer to benchmark duration is still in motion, and we continue to scrub portfolios for perceived weaker or weakening credits. Exposure to treasuries is increasing, albeit just slightly.

**For more information, please contact us at:
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