MANAGER COMMENTARY

FIXED INCOME

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Second Quarter 2019

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MARKET REVIEW

The second quarter of 2019, much like last quarter, finds us with a similar shape of the yield curve, but with dramatically lower yields across the board. The shape of the curve still shows an inversion from 6 months to 10+ years; 2's are at 1.75%, 10's are at 2.00%, and the low yield point is at the 3 year maturity, yielding 1.71%. Once again, the dive in yields in the 2 to 10 year part of the curve last quarter was repeated this quarter. Corporate bond spreads are tighter than at the start of the year and with the curve shift, have performed very well over the quarter. Dovish talk from the Fed and various geopolitical squabbles continue to drive rates lower. May was particularly volatile, again, with the 10 year dropping 35 basis points lower in yield from 2.49% to 2.14% and finishing the period at 2.00%. As noted previously, a reversal from the Fed on policy and how to best normalize rates, weak European data, and a gradual but real slowing in corporate earnings are driving the ebb and flow in safe haven fixed income assets.

SECTOR HIGHLIGHTS

Credit: Corporate spreads were on a bit of a roller coaster ride during Q2. Spreads dropped to 109 in early April, then went back up to around 130 by the end of May, before ending the quarter down around 113. Lower quality Investment Grade corporates outperformed A rated Corporates by about 50 basis points, longer Corporates performed better than short-dated, and Financials, Industrials and Telecom had the best excess return for the quarter. The Bloomberg Barclays Aggregate Index returned 308 basis points for the quarter, the Bloomberg Barclays Intermediate Govt/Credit Index returned 259 basis points, and the Bloomberg Barclays Corporate Investment Grade index returned 448 basis points. Although the economy seems to be slowing and economic data has come in a bit weaker, risk assets could continue to perform well if the Fed decides to cuts rates by 50 basis points in Q3, extending the expansion. We continue to keep a close eye on the Fed's next move.

Treasuries: The rally in treasuries picked up more steam in the second quarter. Yields dropped significantly across the curve with anywhere between 29 basis points to 50 basis points on the short end (3m and 2yr respectively) to 40 basis points and 28.5 basis points on the long end (10yr and 30yr). A breakdown within the trade agreement between the U.S. and China led President Trump to increase tariffs from 10% to 25% on $200 billion worth of goods being exported from China. Discussions stalled and the President threatened to increase tariffs to 25% on an additional $300 billion before backing off for the time being at the G-20 Summit in late June. On top of the trade war manufacturing slowed globally, which helped drive yields down in the U.S. and even further negative in Japan and Europe. With Europe/Asia slowing, no end to the trade wars in sight, and potential rate cuts coming by the Fed, we see treasuries well anchored to these low yields.

Mortage-Backed Securities: As the market began to price in Fed rate cuts, the rally in the treasury market over the second quarter overtook the mortgage market gains from the first few months of the year. Year to date, mortgages have underperformed investment grade corporates and treasuries. With lower rates, nearly half of the 30 year MBS market is in the money to refinance. We expect prepays to remain fast for the second half of 2019 given the low interest rate environment, fintech advancements, and a strong consumer. With expectations of faster prepays, the mortgage market has experienced across the board spread widening compared to comparable maturity treasuries. But the uncertainty around prepays and expected supply and rate volatility both add challenges to the MBS market. Bullet-like structures such as Agency CMBS provide stable cash flows and protection from prepays during episodes of uncertainty.

Asset-Backed Securities: Halfway through 2019, the ABS market has seen a reversal of the spread tightening observed in the first 4 months of the year with spreads now standing at 2 year wides. Spread widening was mainly driven by market volatility versus fundamental credit issues. ABS supply has kept pace with 2018 at nearly $120bn in supply printing since the beginning of the year and supply-demand technicals remaining balanced. We expect ABS spreads to stay range-bound through the end of 2019.

Municipals: The first six months of 2019 have been strong for the muni market. Sector performance was impressive, with positive numbers across the benchmark spectrum, led by the Bloomberg Barclays Muni Bond Index which returned 5.09% YTD. State and Local Tax (SALT) still 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 tax bracket investors. Mutual Fund and ETF flows were once again record-breaking over the quarter, the strongest since 2007. New issue volume is ahead of last year, and demand continues to outstrip supply. Other benchmark returns for the second quarter, as mentioned, were strong:

Bloomberg Barclays 1-5 Year Muni	1.23%
Bloomberg Barclays 1-10 Year Muni	1.64%
Bloomberg Barclays 3-15 Year Muni	1.94%

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 of the curve.

Yield Curve: The Yield Curve shifted nearly parallel over the past quarter. Big moves lower in the 1 year to 7 year part of the curve were the result of a sea change of investor outlook from Fed easing to Fed tightening, with some expectations of a 50 basis point decrease in yields in Fed Funds in the month of July. This on the heels of group think being that the Fed would raise rates several times in 2019 to cool an expanding economy. The bond market and the stock market are at odds right now, and the bond market is saying that the economy is not awesome, but in fact the economy is stalling and recession in the near term is likely.

Specifically, yields moved 45 to 50 basis points lower in the 1 year to 7 year area, while the 10 year moved 40 basis points lower than it was at the end of 1Q, now at about 2.00%. The long end of the curve is about 30 basis points lower at 2.53%. The inversion is still very pronounced, with 6 months at 2.10% and 3 years at 1.70%. Fed meetings and Fed minutes, along with Tweets from the President, will likely make for another round of volatility in the bond market this quarter. The market is telling us to expect interest rate cuts, while the Fed is telling us that they intend to be patient.

INDEX RETURNS FOR THE PERIOD ENDING JUNE 30, 2019

	Q2 2019	YTD
BB Aggregate	3.08%	6.11%
Corporate	4.48%	9.85%
Treasuries	3.01%	5.18%
ABS	1.67%	3.17%
Mortgages	1.96%	4.17%
High Yield	2.50%	9.94%
Municipal	2.14%	5.09%
2-year Treasury	1.37%	2.36%
10-year Treasury	4.22%	7.44%
30-year Treasury	6.76%	12.08%

MARKET OUTLOOK

Much like last quarter, the move in rates and the shape of the yield curve was not anticipated, and still leaves us closely monitoring how best to position against benchmarks over the mid-term. Our decision to again move duration a bit closer to benchmark duration is still in motion, and we continue to analyze 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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