Bond Market Update

As of June 30, 2018 / Volume 7, Issue 2 / FFTAM.COM

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The 2nd Quarter of 2018 for the fixed income market saw a Federal Reserve that raised the short-term rate and an administration that escalated rhetoric on trade, imposing tariffs and threatening more. The U.S. economy continued to show life, bucking the multi-year trend of a slow and bumpy growth trajectory. GDP forecast for the 2nd quarter is projected to come in at 3.40%. For the quarter, AAA taxable yields increased slightly and AAA tax-exempt yields where essentially unchanged.

Total returns for the quarter were mixed for taxable and tax-free investors. For the 2nd quarter, the Barclays Aggregate Bond Index recorded a total return of -0.16% and the Barclays Muni Index recorded a total return of 0.81%, YTD returns are -1.62% and 0.10%, respectively. As mentioned above, the economy continued to show signs of life from its slow and bumpy growth trajectory as 1st quarter GDP came in with a final growth reading of 2.00%. ISM Manufacturing and ISM Nonmanufacturing continued to see strong monthly prints, with all prints in the high 50's or better (a print above 50 indicates expansion). The unemployment rate for June came in at 4.0%, down slightly from year end. The labor participation rate held constant at 62.9%. The quarterly average growth in jobs produced on average 210k a month. Average hourly earnings held constant at a 2.7% year over year pace.

The 2nd quarter was highlighted by the Federal Reserve. The Fed Chair at the June meeting raised the overnight lending rate by 25bps, continuing the process put in place by his predecessor. The 2nd quarter also saw an administration that continued to raise the stakes with trading partners. Calling out unfair trade agreements and introducing tariffs. This path of negotiation has the ability to create pockets of fear in the market as tariffs ultimately lead to weaker growth, however, if trade agreements can be renegotiated more fairly, this will immensely benefit the long term growth prospects of the United States of America.

Below to the left is the U.S. Treasury Yield curve as of 03/31/18 and 06/30/18. As you will see, the yield curve has risen in a flattening fashion during the quarter. Below to the right is the AAA Municipal Yield curve as of 03/31/18 and 06/30/18. As you will see, the yield curve has declined very slightly and steepened during the quarter.

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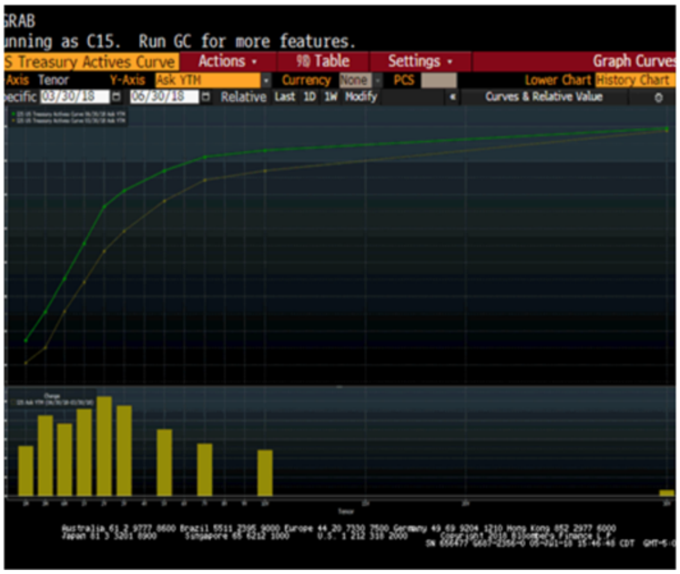

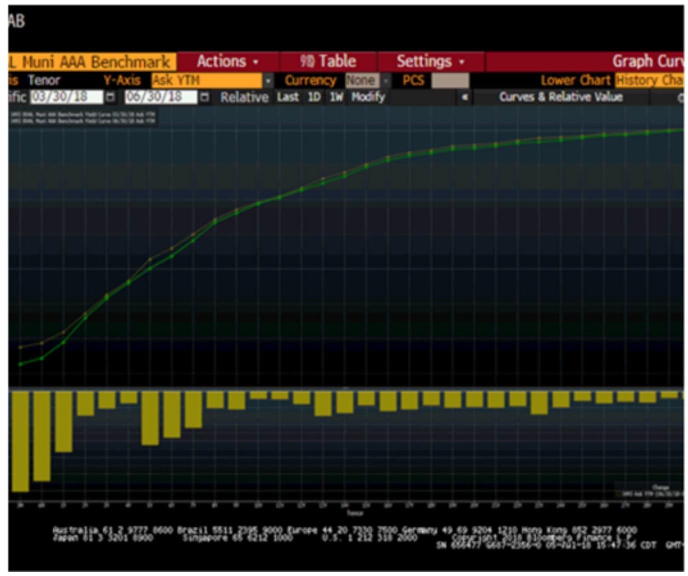

*(Source: Bloomberg Finance L.P.)

For the quarter, investment grade credit spreads were wider by 12bps and high yield credit spreads were tighter by 14bps versus the risk-free rate, YTD spreads are wider by 30bps and 2bps, respectively.

Looking forward, the historic tax reform signed by the President at the end of 2017 will give the Fed more room to raise short term rates before they enter the policy misstep arena. After several quarters of solid GDP prints, the Fed will continue to raise short term rates in 2018. Projections are for 2 more 25bps moves this year. We do anticipate short term rates to continue to edge higher as the economy continues to perform well. 10 year rates have about 50bps of cushion before stresses start to emerge. In short, we remain committed to a very high credit quality portfolio with a reduced tilt towards credit risk in the short term. As opportunities present themselves, we may selectively change our portfolio composition to take advantage of higher interest rates.

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