Fixed Income Strategies

QUARTERLY UPDATE

Brown ADVISORY
Thoughtful Investing.

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Review & Outlook

What is the bond market telling us? We sometimes talk about financial markets as though they are some kind of oracle, giving us cryptic messages about our economic fate. Market pros are just as guilty of personifying markets as anyone else. We have definitely claimed that the market "wants" to do this or is "saying" that, ascribing to it a level of agency that it does not have.

In reality, the market's "opinion" is really just a reflection of the collective opinions of its participants. It is "telling" us things in the same way that the bathroom mirror "tells" us that our hair is graying. It is passively, uncaringly reflecting back something that was already there.

Right now, trying to divine what the market is telling us is tricky because it seems to be contradicting itself. Look in some corners of the bond market, and there are ominous signs of an impending economic slowdown. Other corners seem to be brimming with optimism. We do not think there is a lot of utility in trying to figure out which view is right and which is wrong, but, this dichotomy is definitely presenting some value opportunities.

The flattening yield curve is probably the bond market signal getting the most attention. We say the yield curve is "flat" when the difference between short-term rates and long-term rates becomes small. For example, at the beginning of 2017, the 10-year Treasury yielded 1.26% more than the 2-year Treasury. That gap was down to just 0.33% by the end of the second quarter. If short-term yields actually become higher than long-term yields, we call that an "inverted" yield curve.

Curve inversions often presage a recession, so people are certainly worried about what a flattening curve could lead to. We suggest taking the yield curve seriously, but for the right reasons. The curve almost always flattens as the Fed hikes. The more the Fed hikes, the flatter the curve becomes. In this sense, the market is telling us something we already know.

The curve tends to become completely flat when the Fed is at the end of its hiking cycle. The reason is pretty simple: If the Fed is done hiking, the next step might be a cut, and if so, investors want to lock in long-term rates. Demand from these buyers is enough to keep a lid on longer rates. This is the key to thinking about the shape of the yield curve. The flatter the curve gets, the closer we are to the end of rate hikes. We are getting closer to the end of the hikes because we are closer to the end of the expansion.

Despite how flat the yield curve has become, the market does not seem to be pricing in a period of Fed rate cuts. If we look at futures contracts, the market is expecting short-term rates to rise to 3% and then hold there for the next 10 years, with inflation steady at 2% that whole time. That suggests the market thinks the Fed will hike just enough to keep inflation under control, but not so much that it will cut off the recovery.

In addition, different markets seem to have different expectations. The municipal yield curve is not flattening at all; rather, it is steepening. During the quarter, the gap from two-year to 10-year munis rose from 0.76% to 0.82%. To us, this is a value opportunity. In municipals, we have invested substantially in floating rate munis, which have a coupon rate that rises along with other short-term rates. These bonds typically benefit when short-term rates keep rising. We pair those with bonds in the 8-12 year maturity range, which will benefit if the shape of the municipal yield curve catches up with the Treasury curve. This pairing worked very well this quarter, where the floating rate component added substantial value and was a major driver of outperformance in our tax-free strategies.

Another market indicator worth watching is corporate bond spreads. Credit spreads are the difference in yield between a corporate bond and a Treasury bond with a similar maturity. As such, they are basically a measure of how much of a yield premium investors are demanding in order to take on credit risk. For Baa-rated bonds, this premium increased by 0.19% in the quarter. It has been rising steadily since the beginning of February, when that premium was 1.08%; it ended the quarter at 1.57%.

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INDEX PERFORMANCE AS OF 06/30/2018 (%)

INDEX NAME	3-MONTH	PAST 12 MONTHS
Bloomberg Barclays U.S. Aggregate Bond Index	-0.16	-0.40
Bloomberg Barclays Int. Aggregate Bond Index	0.09	-0.32
Bloomberg Barclays U.S. Treasury Index	0.10	-0.65
Bloomberg Barclays Long U.S. Treasury Index	0.31	-0.13
Bloomberg Barclays Mortgage-Backed Sec. Index	0.24	0.15
Bloomberg Barclays U.S. Corporate Index	-0.98	-0.83
Bloomberg Barclays U.S. Corporate High-Yield Index	1.03	2.62
Bloomberg Barclays U.S. Municipal Bond Index	0.87	1.56

Source: Bloomberg. Please see disclosure statements on page 2 for additional information and for a complete list of terms and definitions.

Typically this would happen during a period where investors are worried about an economic slowdown. Rising credit spreads imply rising default risk, which generally happens during periods of economic stress. We find the lack of rising risk premium among the riskiest corporate bonds to be odd. High-yield bond spreads were about unchanged during the quarter, rising only 0.09%, and the spread for the lowest-rated category, Caa, actually narrowed by 0.45%.

What does all this tell us? It may be that the investment-grade market was more influenced by foreign demand and/or U.S. companies repatriating cash from overseas. Both of these sources of demand have declined lately; the former because of increasing currency hedging costs and the latter due to U.S. tax reform.

We do not necessarily see this as an immediate opportunity to increase exposure to investment-grade corporate bonds. Even at 1.57%, Baa spreads are still below their five-year average. We prefer to pick corporate bonds individually based on company-specific factors and let the mix of credit ratings evolve naturally from this bottom-up process. We found some new opportunities in the second quarter, but we actually wound up with a slightly lower portfolio weighting in corporate bonds in most strategies compared to the end of the first quarter.

We have focused on adding companies with less cyclical risk—if we can lower our exposure to the business cycle without decreasing the portfolio yield, we do not have to guess when the cycle turns. If the economic expansion continues, we will keep earning the same yield. If the economy weakens, the less cyclical names may outperform.

During this quarter, we sold companies with more cyclical names like chemical company Celanese, window treatment producer Springs Industries and auto part supplier Lear. At the same time, we bought names like defense contractor Harris and Alexandria Real Estate, which specializes in life sciences facilities. While every company has risks, we see these buys as having less exposure to the macro economy, which, coupled with a strong fundamental story on their own, makes them attractive new investments.

It is always hard to know when a cycle will turn. If the U.S. economy is turning weaker a year from now, we will look back at the flattening yield curve and widening credit spreads as warning signs. However, both of these indicators have produced false signals many times in the past. We believe that we should be able to perform well whatever the macro economy does by buying bonds with attractive yields and focusing our analysis on downside risks.

Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged, market-value-weighted index composed of taxable U.S. investment-grade, fixed rate bond market securities, including goverrnment, government agency, corporate, asset-backed, and mortgage-backed securities between one and 10 years.

Bloomberg Barclays Intermediate Aggregate Bond Index is an unmanaged index that consists of 1-10 year governments, 1-10 year corporates, all mortgage and all asset-backed securities within the Aggregate Index.

Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays Long U.S. Treasury Index includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value.

Bloomberg Barclays Mortgage-Backed Securities Index is a market-value-weighted index that covers the mortgage-backed securities component of the Barclays U.S. Aggregate Bond Index. The index is composed of agency mortgage-backed passthrough securities of the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac) with a minimum $150 million par amount outstanding and a weighted-average maturity of at least 1 year. The index includes reinvestment of income.

Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers that meet specified maturity, liquidity and quality requirements.

Bloomberg Barclays U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. The U.S. Corporate High-Yield Index was created in 1986, with history backfilled to July 1, 1983, and rolls up into the Barclays U.S. Universal and Global High-Yield Indices. The U.S. Corporate Index rolls up to other Barclays flagship indices, such as the U.S. Aggregate and the multi-currency Global Aggregate Index.

The **Bloomberg Barclays U.S. Municipal Bond Index** covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

An investor cannot invest directly in an index.