Fixed Income Strategies

QUARTERLY UPDATE

Fourth Quarter 2017

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Review & Outlook

The bond market generally was staid in the fourth quarter. The 10-year Treasury rose by just 0.07%, ending the year at 2.41%. Credit spreads continued to drift lower, as investor confidence remained high. Municipal bonds, having suffered consternation over tax reform all year, wound up basically unscathed in the final bill. Even the transition of the Federal Reserve Chair seemed to go off without a hitch. For a year where we came in with so much political and economic uncertainty, perhaps the biggest surprise for the bond market is that volatility actually declined.

Beneath the surface, though, there were some important things going on that were meaningful drivers for fixed income performance in 2017. First, the yield curve has flattened quite a bit. This means that the yield gap between long-term bonds and short-term bonds has narrowed. For example, the 10-year Treasury began the year at 2.44% and the 2-year at 1.19%—a yield gap of 125 basis points. Those same maturities ended the year at 2.41% and 1.88%, respectively; the 10-year hardly moved, while the 2-year rose by 69 basis points and shrunk the yield gap to only 53 basis points.

What that means for bond investors is that maturity mix mattered quite a bit in 2017. Investors were better off owning a mix of longer-term and shorter-term bonds than anything in between. Owning floating-rate bonds, which generated more income as short-term rates rose during the year, especially rewarded investors. These bonds are a staple of Brown Advisory Strategic Bond portfolios and were a key contributor to that strategy's strong performance.

The maturity mix issue was most acute in the municipal market this quarter. For most of the year, municipals resisted the curve flattening going on in Treasury bonds. Munis maturing in the 2-5 year area were actually falling in yield or at least holding steady, while those same maturities in Treasury bonds were rising rapidly.

We did not see this as sustainable. The same economic forces pushing 2-5 year Treasury bond yields higher should also have impacted municipal yields. In muni portfolios, we have been substantially underweight that part of the curve for most of the year. It was something of a drag as the overvaluation in those maturities worsened in the summer. But as the outlines of tax reform became more clear and investors could see that munis would avoid substantial impact, investors rotated out of those short-term bonds into longer-term positions. This was a major driver of strong performance for our muni strategies this quarter.

Of course, a flattening yield curve is also often associated with impending recessions, and that has implications for more than just bonds. We take a more nuanced view of the historical relationship between the yield curve and the business cycle. It is true that the curve has inverted (i.e. where short-term yields actually become higher than long-term yields) ahead of each of the last four recessions; however, it is also true that the yield curve always flattens as the Fed is hiking short-term interest rates. Therein lies the causal relationship between interest rates and recessions. Tight Fed policy can lead to a recession and tight Fed policy also leads to an inverted curve. Our view is that a flattening curve is a sign that the Fed is getting closer to the end of a hiking cycle. It does not mean they are close, per se, just closer.

At any rate, it certainly does not seem like a recession is imminent based on recent indicators. Job gains continue at a brisk pace, business confidence is strong and growth seems to be picking up overseas. While we do not attempt to predict when the next recession is coming, it seems safe to say that this cycle will eventually turn, but that turn is not about to happen.

This matters to us most when we think about our corporate bond positions. Obviously, corporate bond quality tends to weaken during a recession, and hence those bonds tend to underperform. If we accept that we will not be able to predict the next recession better than anyone else, then it becomes incumbent on us to get our downside analysis right.

It is during stronger economic periods, like now, when the market does not differentiate much between bonds with a stronger or weaker downside profile.

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INDEX PERFORMANCE AS OF 12/31/2017 (%)

INDEX NAME	3-MONTH	1-YEAR
Bloomberg Barclays U.S. Aggregate Bond Index	0.39	3.54
Bloomberg Barclays Int. Aggregate Bond Index	-0.07	2.27
Bloomberg Barclays U.S. Treasury Index	0.05	2.31
Bloomberg Barclays Long U.S. Treasury Index	2.37	8.53
Bloomberg Barclays Mortgage-Backed Sec. Index	0.15	2.47
Bloomberg Barclays U.S. Corporate Index	1.17	6.42
Bloomberg Barclays U.S. Corporate High-Yield Index	0.47	7.5
Bloomberg Barclays U.S. Municipal Bond Index	0.75	5.45

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

We can pick more attractive risk/reward combinations without giving up near-term yield. That is why we feel this is a period where our intense focus on downside analysis is most important. We put all of our corporate bonds, no matter the current rating, through a bankruptcy analysis. This helps us know not just what the ultimate risk is, but also how far in price a bond might fall if conditions were to deteriorate. That matters not just for a macro-level recession, but also for a run-of-the-mill bad quarter for a given company. Our detailed downside analysis is a kind of roadmap for dealing with changing conditions. This allows us to confidently invest in attractive yield opportunities with little to no idea when the cycle might turn.

This is also a great time to be invested in high-quality structured credits. There are a large number of sectors and/or structures that are not really cyclically exposed, either because they have so much underlying protection or because of the nature of the asset.

While we expect short-term interest rates to keep rising, we believe that we have quite a few tools in our belt to garner performance in bond portfolios. Our combination of downside focus, disciplined decision-making and flexible positioning gives us a great deal of confidence going into 2018.