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BOND MARKET UPDATE

As of 12/31/18 | Volume 7, Issue 4 | FFTAM.com

The 4th Quarter of 2018 for the fixed income market saw a Federal Reserve that raised the short-term rate, an administration that continued its rhetoric of the need for fair trade with China, and an economy that started to show signs of slowing. GDP for the 4th quarter is projected to come in at 2.60%. For the quarter, AAA taxable yields and AAA tax-exempt yields decreased significantly.

Total returns for the quarter were positive for taxable and tax-free investors. For the 4th quarter, the Barclays Aggregate Bond Index recorded a total return of 1.64% and the Barclays Muni Index recorded a total return of 1.61%, YTD returns are 0.01% and 1.64%, respectively. As mentioned above, the economy started the quarter strong only to see some slowing in December. GDP for the 3rd quarter came in with a final growth reading of 3.40%. ISM Manufacturing and ISM Nonmanufacturing saw strong prints in October and November, only to see a noticeable deceleration in December. All prints were above 50 (a print above 50 indicates expansion). The unemployment rate for December came in at 3.9%, down slightly for the year. The labor participation rate increased slightly to 63.1%. The quarterly average growth in jobs produced on average 254k a month. Average hourly earnings increased slightly at a 3.20% year over year pace.

The 4th quarter was highlighted by the Federal Reserve. The Fed Chair at the December meeting raised the overnight lending rate by 25bps, making this the fourth 25bps rate hike this year. At the Q&A, Fed Chairman Powell indicated that he felt good about the economy and thought it could withstand further hikes in 2019. These comments went over so poorly in the market that he eventually ended up walking his comments back at the beginning of January. The 4th quarter also saw an administration that continued its rhetoric of the need for fair trade with China. On a positive note, the administration did extend the 10% tariff rate for 90 days instead of imposing the planned 25% rate at the beginning of the year.

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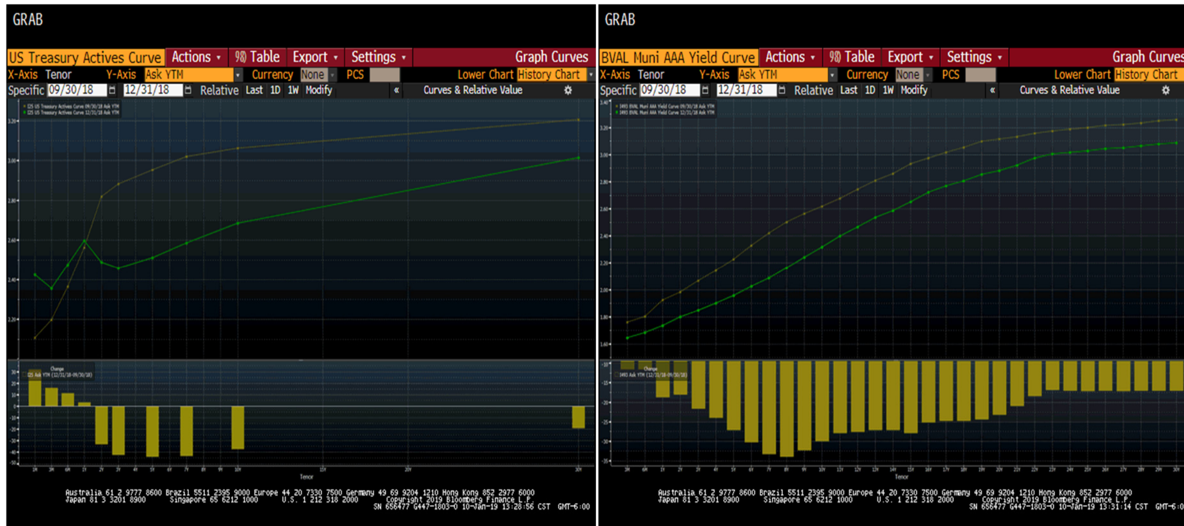
Below to the left is the U.S. Treasury Yield curve as of 09/30/18 and 12/31/18. As you will see, the taxable yield curve fell substantially during the quarter. Below to the right is the AAA Municipal Yield curve as of 09/30/18 and 12/31/18. As you will see, the tax-free yield curve fell substantially during the quarter



*(Source: Bloomberg Finance L.P.)

For credit markets in the quarter, spreads blew out on the heels of Powell's hawkish comments and oil's break of $50/barrel. Investment grade credit spreads were wider by 47bps and high yield credit spreads were wider by 208bps versus the risk-free rate, YTD spreads are wider by 59bps and wider by 168bps, respectively.

Looking forward, the economy is in a delicate spot. In December, ISM Manufacturing and ISM Non-Manufacturing decelerated noticeably. Credit spreads have blown out and credit is the grease that keeps the economic machine working properly. Powell in his interview on January 4th said everything the market wanted to hear. He acknowledged financial conditions have tightened materially in a short period of time and that the Fed would be flexible as it relates to future rate hikes and the reduction of its balance sheet. It appears the Fed will hold steady on future rate hikes but time will tell. Time will also tell if it's too late and the destruction in credit must play out some more. We continue to be light on credit but may look to increase exposure if compensation becomes attractive. We do expect rates to continue to drift lower, how much lower will be dictated by the Fed and whether or not they make another mistake.

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