



Jamie Mullen
Senior Portfolio Manager



Eric Kazatsky
Portfolio Manager

IT'S THE FINAL COUNTDOWN...

As we head into the fourth and final quarter of 2018, the U.S. fixed income market finished September on slightly weaker ground. Rates crept up steadily throughout the past month, putting downward pressure on both the taxable and tax-free indices, leaving both indices solidly in the red.

The Bloomberg Barclays US Aggregate Index is down -1.60% year-to-date (YTD) compared to the Bloomberg Barclays Municipal Aggregate Index, which has declined by just -0.40% YTD. Despite the losses, tax-free bonds remain the clear winner YTD, outperforming their taxable counterparts by almost 120 basis points. For the remainder of 2018, future uncertainty may come from various corners such as the upcoming mid-term elections, continued trade/tariff talks, as well as the pace of future Federal Reserve (the Fed) rate adjustments.

Maybe we'll come back to Earth, who can tell?

While the 10-year U.S. Treasury rate breached the 3% level during the second quarter, the feeling of “higher rates” lasted only less than a week before rallying back to a low of 2.81% on August 24th. The recent march higher pushed the 10-year rate to 3.06%, marking the longest sustained period above the 3% threshold since earlier this year, indicating that higher rates may be here to stay. The U.S. Treasury 2s10s curve experienced additional flattening over the quarter as the 2-year U.S. Treasury rate topped 2.82%, driven to higher levels as the Fed continues along their path of tightening monetary policy.

Higher rates can be a mixed bag for investors. On one hand, higher rates can adversely impact the current price of bond holdings. On the other hand, this singular focus on bond prices ignores the new-found potential to reinvest cash flow from bond portfolios at higher rates, which can potentially help drive future total returns.

Furthermore, the increase in short-term rates can be a positive net benefit to savers. For example, the U.S. Treasury 3-month treasury bill money market yield has increased over 60 basis points this year to 2.16% after nearly a decade of rates in the single basis point range. We believe tactical bond management can help investors continually take advantage of duration allocations that will help navigate the Fed tightening cycle.

We're leaving ground...Will things ever be the same again?

Top of mind for many investors and market participants is how long the Fed tightening cycle will last. While the future of many policy decisions is rarely certain or clear, several indicators shed some light on the future. The economy has met the Fed's 2% inflation gauge and the unemployment rate, which is already low, continues to fall. These indicators point to the expectation of future rate increases.

Current estimates based on Bloomberg's World Interest Rate Probability (WIRP) place

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the odds of a December 2018 rate hike above 70% with analysts expecting additional rate hikes to continue in 2019. The market is somewhat expecting an end to monetary tightening in 2020, which coincided with the removal of “accommodative” language in the Fed’s September post-meeting statement.

Portfolio allocations using barbell strategies remain poised to perform well in the current flat yield curve environment. The benefits of a barbell portfolio include the ability to reinvest the proceeds (liquidity) of shorter-term bonds at higher rates, thus providing the opportunity for higher yields than a traditional bulleted portfolio approach. The strategy also provides the potential for higher yield income from longer dated bonds. With long duration bonds more sensitive to price fluctuations, diversification on both ends of the yield curve can provide price protection.

Taxable Bond Portfolio

Rates continued to rise during the quarter and the 2 to 10-year spread contracted another 9 basis points to 24 basis points. We have been taking a barbell approach in the portfolio since last year and as of this

September, we are seeing the first maturities we invested in roll off and mature. We will reinvest the proceeds in new 1-2 year paper that is 50 to 75 basis points higher than a year ago. As long as the Fed stays on the current course of rate hikes, we believe the barbell strategy remains prudent.

Going into the end of the quarter, high yield bonds reached new highs as the stock market soared and left no strains on liquidity. We maintained our same position in high yield, allocating approximately 15% of our holdings to the sector. We did, however perform some rotation within the high yield space, purchasing some names that, in our opinion, will be less sensitive to interest rate should rates continue to rise.

In investment grade corporate bonds, we look to increase our coupons. New issues are being priced with plenty of 4% plus coupons. We are selectively swapping out of lower coupons while adding to our 4% coupon structure, keeping in mind that we want to maintain par value in the portfolio.

Source: Bloomberg, Ned Davis Research

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The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI Emerging Markets Index is a freefloat-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The S&P 500 Index measures the performance of 500 large companies in leading industries of the U.S. economy, capturing 80% of U.S. equities.

The Bloomberg Barclays U.S. Government and Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries, government-related, and investment grade U.S. corporate securities that have a remaining maturity of greater than 1 year. In addition, the securities have \$250 million or more of outstanding face value, and must be fixed rate and non-convertible.

The Bloomberg Barclays U.S. Corporate High-Yield Index covers the U.S. dollar denominated non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

The Bloomberg Barclays 30-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The Bloomberg Barclays 10-Year U.S. Treasury Bellwethers Index is a universe of Treasury bonds, and used as a benchmark against the market for long-term maturity fixed-income securities. The index assumes reinvestment of all distributions and interest payments.

The Bloomberg Barclays 5-Year Municipal Bond Index is the 5 Year (4-6) component of the Municipal Bond index. It is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. The index tracks general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds rated Baa3/BBB- or higher by at least two of the ratings agencies.

The CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices and which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk. The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities. The Bloomberg Barclays Capital U.S. Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury inflation-protected securities are excluded, due to tax treatment issues. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. The Bloomberg Barclays Capital Aggregate Bond Index is an intermediate term index.

The volatility (beta) of a client's portfolio may be greater or less than its respective benchmark. It is not possible to invest in these indices.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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