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WINTER IS COMING FOR GAME OF THRONES FANS, BUT IS IT SPRING FOR FIXED INCOME?

If the health of the U.S. economy remains on solid ground, then the speed and direction of the Fed policy change this year is quite interesting. We could chalk up the change to the Fed's actions as either meeting the market on rate expectations or that the Fed sees something frightening "beyond the wall" and is trying to prime the market for further easing.

Being optimists, we choose to believe the former and not lose sleep over an invasion of economic White Walkers. When the Federal Open Market Committee (FOMC) met in December 2018, they not only hiked the Fed rate, but also signaled further hikes throughout 2019. Fast forward to several weeks later, and the Fed indicated it would be pausing its hikes for the remainder of 2019 and suspending any balance sheet unwinding. This sharp dovish turn lit a fire under the prices for both fixed income assets and equities, helping create solid returns to start the new year.

If the end of 2018 and start to 2019 have been a euphoric summer for bonds, then Winter is most likely due to come to the fixed income markets. Much like the intentions of Game of Thrones creator George R.R. Martin, bonds should heed the sentiment that even if things are good now, we must always remain vigilant for a darker period. Imagining a catalyst that could prolong the bond rally is difficult given the level of absolute rates in the corporate and, especially, tax-free markets. Yet, several headwinds remain.

Night Gathers, and Now Our Watch Begins...

Based on the positioning of the latest Fed dot plot, 11 members see the target federal funds rate in the range of 2.25% to 2.50% at the end of 2019; four members see a target range of 2.50% to 2.75%, which would indicate one rate hike; and two members see a target range of 2.75% to 3%, which would indicate two rate hikes. The sentiment of a majority eyeing no change through the year was communicated by Chairman Powell at their March 2019 meeting.

Despite Fed dot plot outlooks, our role as the "Night's Watch of rates" remains one of high alert and unwavering vigilance. The continued rallying in bonds created a universe which favors sliding farther out the duration curve to help lock in more attractive spreads, relative to associated risk profiles. The flattening of the yield curve in tandem with the Fed's expectation to pause hikes for the year, helped to ensure that longer dated assets would perform better relative to shorter dated counterparts. We believe that this trend may have run its course.

Part of our preparedness for a bond Winter comes with a continued focus on barbell structuring in the SMA program. We use this structure in an effort to provide protection against

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higher rates in the front end of the curve and take advantage of more attractive ratios on the longer end of the barbell.

While duration was one component of positive return in the first quarter, the other part of the success story was credit selection. Credit selection and continued negative screening within the portfolios continue to be a differentiating factor as spreads within investment grade corporates and municipal bonds continue to tighten. In our taxable portfolio, we remain focused on sectors that are less sensitive to interest rate volatility, while on the tax-free side, we find additional value in revenue sectors such as healthcare and higher education.

Is the Bond Market Overbought?

There is no denying that the bond market moved fast and furious during February and March. Following the laws of physics, what goes up must come down, right? Even though there seems to be some support to even higher bond prices as the market is implying odds of a cut in the fed funds rate later this year, we remain skeptical of such a move higher from already lofty valuations.

On our immediate radar are early April economic indicators such as payrolls and manufacturing, which, when combined with stabilizing inflation figures, could prove to be headwinds for the persistent rally in U.S. Treasuries.

Tax-Free Portfolio

A lower and flatter yield curve took center stage for tax-free bonds through the first quarter of 2019, taking an encore from the sound performance during the back half of 2018. Safe haven assets, in general, did not skip a beat from the close of 2018, as the broader U.S. Treasury rally took its cue from a more dovish Fed and helped push municipal ratios reaching their lowest levels since 2017.

Both the Bloomberg Barclays Aggregate Municipal Index and the SMA-focused Bloomberg Barclays 5-Year Municipal Bond Index are off to strong starts, with the former having its best first quarter since 2014, and the latter having its strongest start in over a decade. Municipal bonds outperformed their taxable equivalents by a wide margin, driven by the lower supply and increased demand due to the impacts of tax reform. The 10-year AAA municipal rate declined by approximately 40 basis points since the start of the year compared the 10-year U.S. Treasury, which declined by only 28 basis points.

Despite the continued rally trend in bonds, the movement post-Fed meeting has created a tale of two yield curves in a sense, as a flatter

curve has rewarded those investors who were at the long end of the 30-year spectrum. To illustrate, year-to-date returns for the Bloomberg Barclays 5-year Municipal Bond Index were 2.11%, while returns for the Bloomberg Barclays 30-year Municipal Index were almost double at 3.85%. Out of that 3.85% year-to-date return, more than half was generated in March alone. The municipal yield curve slope, while not inverting like its taxable equivalent, did compress to the flattest levels that are available to track on Bloomberg.

With positive performance providing huge tailwinds to start the year, we remain focused ahead on the next three quarters. While we cannot predict future performance, we can tease out the likelihood of return direction given issuance statistics and general muni market seasonality.

Compared to the first quarter in 2018, tax-free municipal bond issuance has increased by almost 22% year-over-year. While this number appears strong, it is important to keep views tempered given how anemic the start to 2018 was after tax-reform took hold. It is reassuring to see issuers return to the market and continue to take advantage of historically low absolute borrowing rates.

Deals that have come to market have seen solid demand, evidenced by continued compression of credit spreads for “headline” names such as Illinois, Chicago and Connecticut. The current cash rolls for April combined with projected issuance would lead us to believe that municipal bonds will continue to have a firm foothold that will be supportive of positive performance.

As tax season continues, the realization that State and Local Tax (SALT) limitations may have adversely impaired a fair number of 2018 returns, which will only help increase the valuations for bonds in states such as California, New York and New Jersey, as high net worth households look for ways to offset taxable income. While absolute rate movement lower will depend on the direction of the U.S. Treasury, the increasing likelihood of a rate cut this year is another positive tailwind for muni bonds.

Our focus in the tax-exempt fixed income strategy continues to center on current income, managing duration, and prudent credit selection. As the curve becomes flatter, we can gain exposure to the longer end of the curve by taking on increasingly less duration, even more so than a month ago. Our credit focus continues to be on essential service issuers, as well as solidly capitalized healthcare and higher education names, which will help provide portfolio diversification away from public pension and fixed cost ratio risk that are growing trends in the tax-backed sector.

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.

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