Investment Strategy

Fixed Income

WINTHROP CAPITAL MANAGEMENT

1Q 2019 Report

GLOBAL ECONOMIC GROWTH CONTINUES TO SLOW

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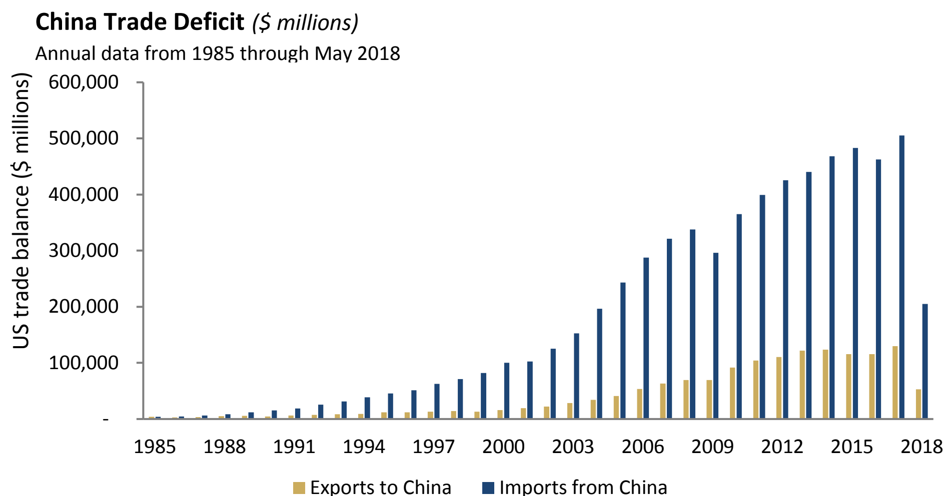
Domestic economic growth continues to slow into 1Q 2019. There are three key factors impacting the economy in the first quarter: the government shutdown, the threat of increased tariffs with China and Europe, and Brexit. Domestic GDP growth increased 2.6% in the fourth quarter of 2018 helping support one of the best annual periods of economic growth since 1987. While we expect the growth rate of corporate earnings to slow through the year, the bright spot remains job growth as the economy consistently creates over 230,000 jobs a month.

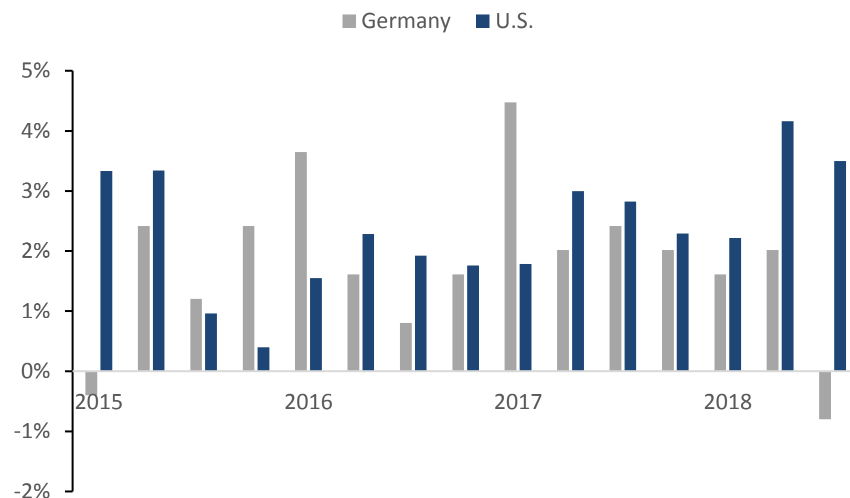


Source: U.S. Census Bureau

The threat of increased tariffs with China has had a disastrous effect on China's economy and trade balance, with both domestic imports and exports falling dramatically in the fourth quarter of 2018. We believe China has as much incentive to resolve the trade disputes with the United States as we do in order to turn on the economic growth engine. China has historically remained in the background with its global presence; however, the growing cooperation between China and Russia raises additional concerns with China's global presence.

CAPITAL MARKETS ARE ILL-PREPARED FOR BREXIT

Brexit is one of the biggest capital market events in the past three decades, and the capital markets don't appear to care much. We believe this is a significant risk for the capital markets and investors. We would normally expect to see a modest flight to quality rally. As uncertainty moves through the market and investors take steps to reduce risk, we would expect U.S. interest rates to decline. In addition, we would expect a coordinated infusion of liquidity from central banks to provide adequate access to liquidity to facilitate transactions. Finally, we would expect global banks and corporations to be setting up reserves for negative events as a result of friction in the Brexit process. Last week, for example, Barclays set up a reserve of €125 million for Brexit related events.



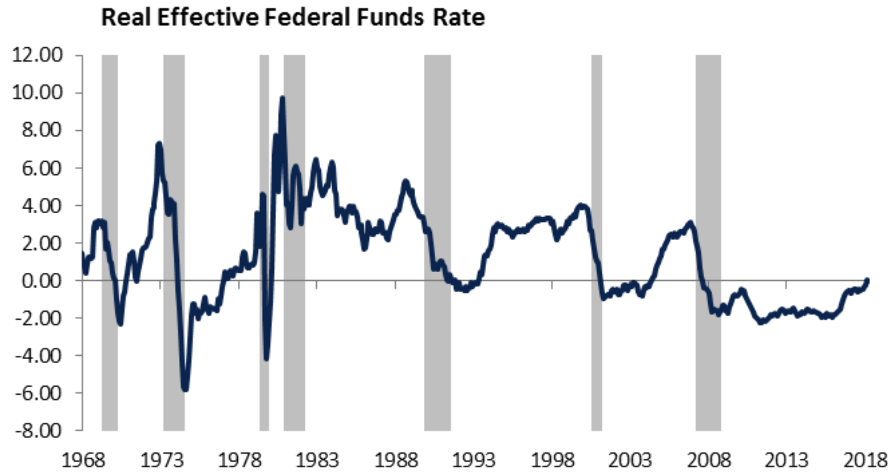
Source: DESTATIS, FRED

Parliament and Prime Minister Theresa May helped set the stage this week to extend the March 29th deadline to negotiate terms for the United Kingdom to leave the Eurozone. While the deadline may be extended, terms of the Brexit deal still need to be determined.

We believe it is still early to increase international and emerging market equity exposure in our asset allocation. The stimulus that China injected into its markets, combined with the prospect of a resolution to the trade tariff issue, will be a boost to China and the broader Asian markets. The Eurozone economy has slowed significantly, including Germany. We expect that once there is agreement to a China trade deal, focus will shift to getting a new trade agreement with Europe.

THE FEDERAL RESERVE IS ON HOLD FOR NOW

We believe that the Federal Reserve is on hold with its tightening policy for this year. Slowing economic growth, sustained low inflation, and a shifting employment picture will cause the Fed to pause its tightening program. In addition, the fallout from Brexit and dramatic slowdown in Eurozone economy will support the Fed's shift toward a more "wait-and-see" approach to further adjustments in short-term interest rates. The more interesting issue is the Federal Reserve's plans for balance sheet reduction. We expect that the Fed will slow its initiative to reduce its balance sheet over the next several years in order to support the U.S. currency through excess reserves on its balance sheet. The result will be sustained lower level of interest rates as the Fed continues to hold U.S. Treasury notes and mortgage backed securities.



Grey bars indicate U.S. Recessions

Source: Federal Reserve

One of the conundrums the Fed is facing is the low real Fed Funds rate. Under normal circumstances, we would expect the Fed to target roughly a 200 bps level over the rate of inflation for Fed funds. However, since the Financial Crisis, the Fed has struggled to move the real Fed Funds rate out of negative territory. With CPI coming in near 2.2% on an annual basis, inflation continues to be near the midpoint of the Fed's target range. Even though the Fed has pushed short term rates higher over the past two years, monetary policy is still arguably stimulative based on the level of real Fed Funds rate.

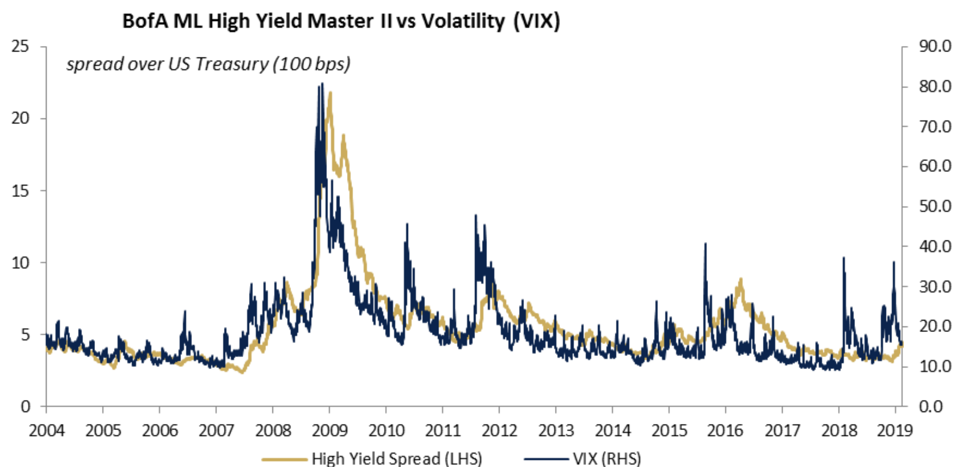
INTEREST RATES COULD MOVE LOWER OVER THE NEAR TERM

With slower global economic growth and subdued inflation, there is a stronger case for lower interest rates. As a result of the economic slowdown, much of Europe, including Germany, Spain, and France have moved into negative interest rates again. This means that an investor that lends money at a negative interest rate receives less back upon maturity. This is not a sustainable position in a capitalistic society. With that said, U.S. interest rates are more attractive on a global basis and may adjust lower if the European economy continues to slow.

Source: Federal Reserve

Interest rates will likely move lower into the summer, and we expect the 10 year US Treasury yield to trade near 2.35%. In addition, we expect credit spreads will tighten but not to the extent we saw last year. New issue corporate supply will likely be less than last year's volume, which will help to support tighter credit spreads. Demand from Asian buyers should also help support spread tightening.

We believe that the high yield sector is slightly undervalued and prefer the shorter duration part of the high yield curve. Refinancing demand will dominate the high yield calendar this year. Our investment thesis assumes that as volatility declines, spreads should tighten in high yield.



Source: CBOE; BofA Merrill Lynch

While we have not seen any significant problems in the leveraged loan market, our concerns are growing. In the search for higher yields, there has been significant growth in the structured securities market, including CLO issuance, which has now surpassed the HY market in amount outstanding.

MUNICIPAL BONDS OFFER GOOD RELATIVE VALUE

We believe the municipal market offers good relative value to investors. Traditional general obligation and revenue bonds of high quality issuers are still some of the safest investments in the credit markets today. Municipal bond yields have normalized since the spike in 2012, but they still trade close to 100% of US Treasury bond yields. On a tax-adjusted basis, municipal bonds offer competitive yields relative to other sectors within the credit markets.

Source: Barclays Capital

The Tax Cuts and Jobs Act of 2017 has created investment opportunities in the municipal bond market and changed the shape of the municipal yield curve. Immediately prior to the enactment of the Tax Act of 2017, there was a surge in municipal bond issuance. With the increase in state and municipal issuance, the increased supply put downward pressure of municipal bond prices. At the same time, the Tax Act of 2017 reduced the corporate tax rate from 35% to 21%, diminishing the historic advantage of investing in municipal bonds for U.S. banks and insurance companies. Historically, banks and insurance companies have been important investors in municipal bonds in the longer part of the yield curve. As a result of this change in the tax rate, the steepness of the municipal curve relative to the Treasury yield curve has increased due to a smaller supply of municipal bonds on the whole and lower demand for longer term municipal bonds. This has caused longer maturity municipal bonds to cheapen and offer excellent relative value.

FIXED INCOME STRATEGY

	Current	Change (bps)			
		1 Month	3 Month	YTD	TTM
US Rates					
UST 2y Yield	2.51	3	-33	3	26
UST 3y Yield	2.49	4	-41	4	9
UST 5y Yield	2.51	0	-44	0	-13
UST 7y Yield	2.62	3	-43	3	-17
UST 10y Yield	2.72	3	-42	3	-15
UST 30y Yield	3.08	7	-30	7	-4
Treasury Curve					
2Y v 10Y	20	1	-8	1	-41
2Y v 30Y	56	4	3	4	-31
10Y v 30Y	36	3	12	3	10
Investment Grade Credit					
Bloomberg IG Corporate Index OAS	119	-28	11	-28	29
US Credit Aa OAS	62	-19	-4	-19	5
US Credit A OAS	90	-28	-5	-28	12
US Credit Baa OAS	161	-36	7	-36	38
High Yield Credit					
Bloomberg HY Corporate Index OAS	404	-117	29	-117	61
US High Yield Ba OAS	224	-130	-24	-130	13
US High Yield B OAS	376	-155	4	-155	46
US High Yield Caa OAS	780	-209	75	-209	185

As of 2/28/2019

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