2019 Market Preview: Fixed Income

KICKING OFF THE YEAR WITH MODERATE VALUATIONS, A LESS-HAWKISH FED AND GROWING GLOBAL TARIFFS

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In the first half of 2018, the tax cuts and improved U.S.-North Korean relations fueled a risk-on market that kept securities prices at or near peak levels. However, the second half saw escalating global tariffs, volatility in emerging markets and a drop in the price of oil that widened most fixed income asset classes' spreads back to long term averages and caused the yield curve to invert on the short end. Core bonds were breakeven for 2018, protecting principal in the second half rout despite four rate hikes during the year. Bank loans returned 1.1%, benefiting from their floating rate. High yield bonds were down only 2.1%, while hard currency emerging markets debt was down 4.3% and local currency emerging markets debt was up 3.2%. Heading into 2019, the market is now equipped with moderate valuations and a less-hawkish Fed at its disposal. However, possible further tariff escalation, some structural deterioration within U.S. credit, and a continued slowing of the Chinese economy pose concerns.

A REVIEW OF FIXED INCOME IN 2018

The Fed hiked rates once in each of the four quarters of 2018. With the tax cut underway — despite a new, more hawkish Fed Chair in Powell — the first quarter was generally risk-on and featured improved North Korean relations as well as the start of proposed tariffs on Chinese imports. The second quarter continued the risk-on trend as the Trump-Kim summit defused North Korean tensions. Volatility outside the U.S. rose in the second quarter, however, due to the Brazilian truckers' strike and Argentina's $50 billion IMF bailout. The third quarter was risk-off, led by further volatility in emerging markets as Turkey detained a U.S. pastor and Argentina requested a faster payout from its IMF loan. The fourth quarter furthered the risk-off trend as the price of oil declined and the yield curve inverted between the 2- and 5-year Treasuries based on concerns over the tariffs and declining corporate earnings, thereby widening credit spreads.

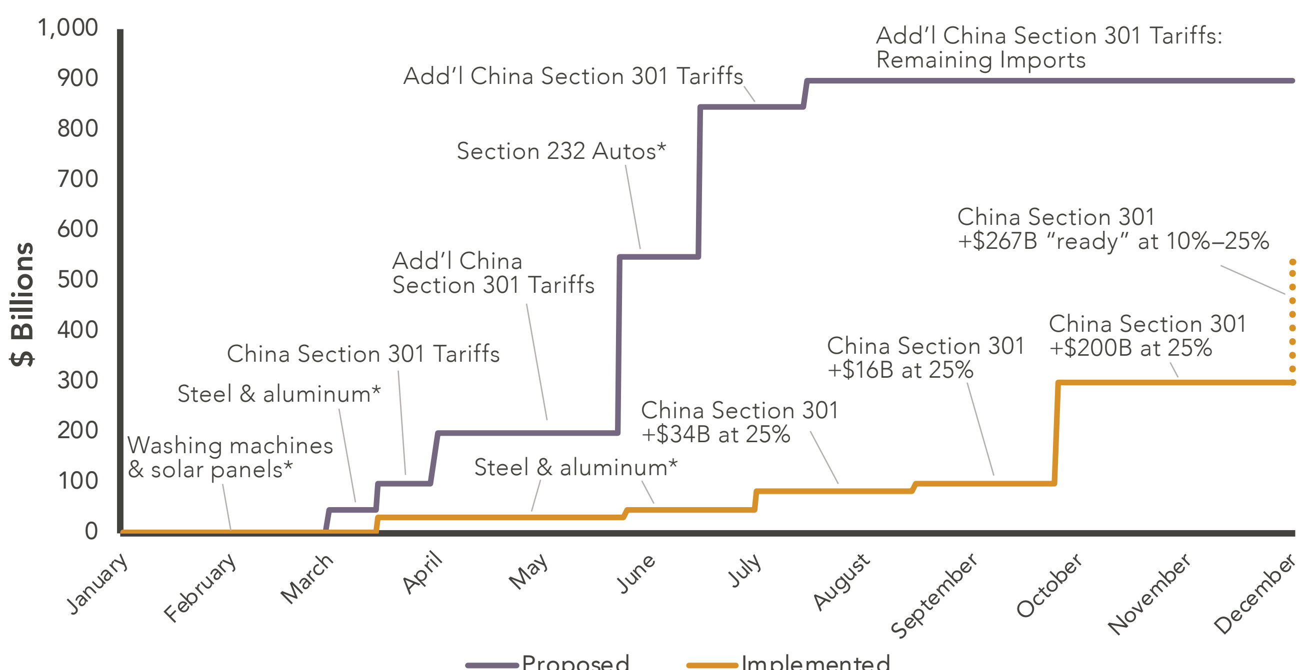
For most of the year the yield curve rose and flattened, signifying a closer step to the end of the cycle and lower growth ahead. The 10-year yield, which began the year at 2.46%, peaked at 3.24% in November but dropped back down to 2.69% at year-end. The biggest concern is still curve inversion, as an inverted curve has historically predicted a recession within six months to two years of inversion. With nine post-recession rate hikes now, partial curve inversion, and inflation that has backed down, the question is whether the Fed might keep rates where they are through 2019 or continue to raise rates.

KEY ISSUES AND EXPECATIONS FOR FIXED INCOME IN 2019

Core Bonds

The tariffs and Fed rate hikes remain the biggest determinants of core bond returns. Exhibit 1 shows the tariffs proposed on imports into the U.S. in purple and the corresponding orange line shows tariffs enacted. We can see that implemented tariffs are gradually rising and taking the shape of the proposed tariffs.

Exhibit 1: Proposed vs. Implemented Tariffs in 2018



***Not just China**

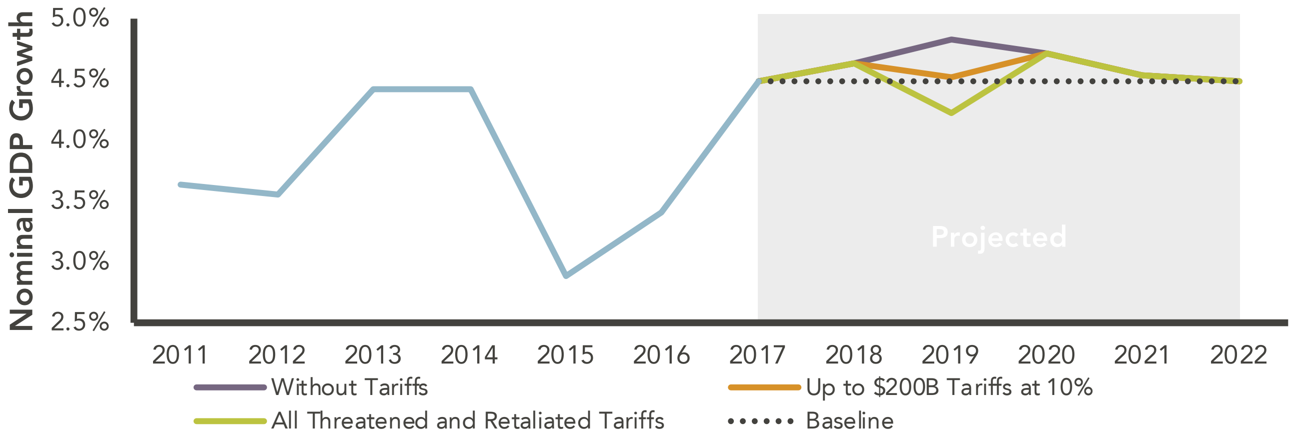
Sources: U.S. International Trade Commission, U.S. Department of Commerce, Goldman Sachs

Exhibit 2 on the following page shows GDP growth projections based on three scenarios. All three scenarios account for the tax cuts already enacted:

- The first, in the purple, shows the highest peak in 2019 and is a hypothetical scenario assuming none of the tariffs enacted in 2018;
- The second line, in the orange, includes tariffs up to the $200 billion enacted in September 2018 and China's retaliated tariffs so far, based on a Barclays study;
- Finally, the green line assumes all threatened and potentially retaliated tariffs, based on a Tax Foundation[1] study.

Policy is priced into assets quickly by the markets, and the 4Q18 market pullback presumably accounts for the effects of the orange line, which includes all tariffs enacted so far. If this scenario holds true through 2019, we may likely see bond returns be close to their coupons. If more tariffs are enacted, we could see GDP growth take the shape of the green line, and spreads widen further, cutting into bond returns. Conversely, if Trump decides to repeal the tariffs, we may see the purple line take shape, boosting bond returns.

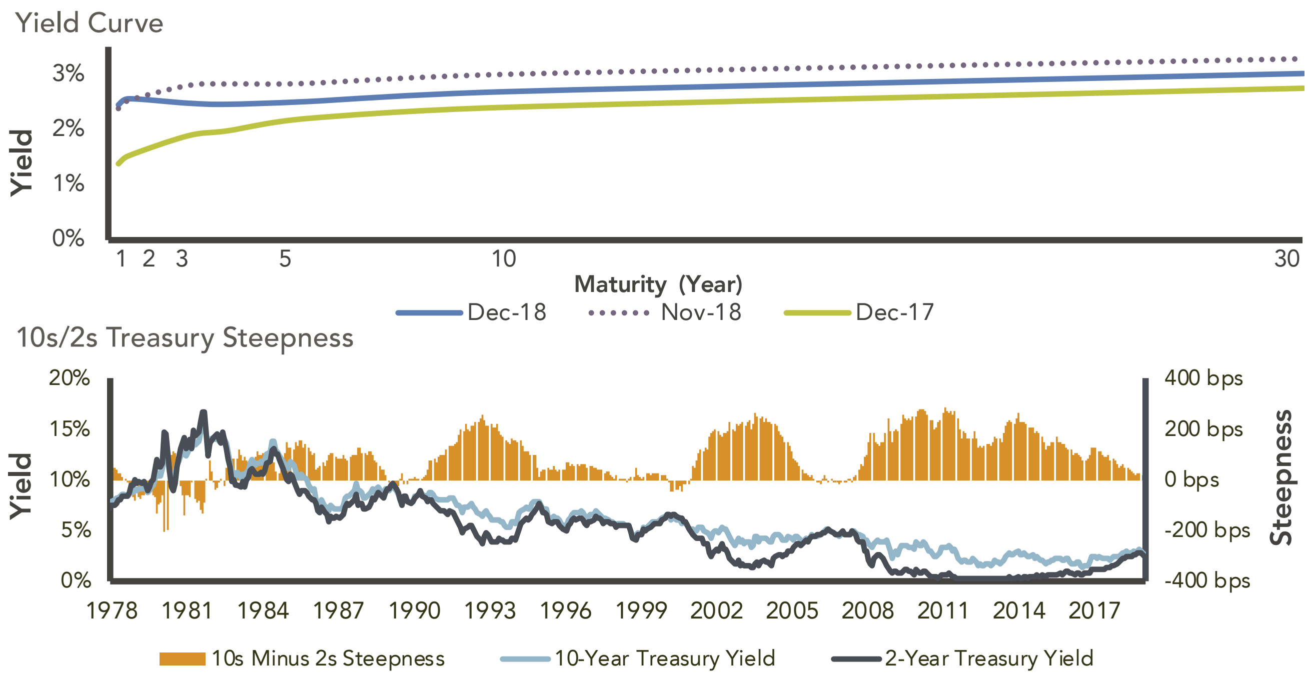
Exhibit 2: U.S. Nominal GDP Growth Projections



Assumptions: Senate Budget Committee's projected $1.5 trillion tax cut over ten years, range of multipliers based on academic studies — base case 0.8x multiplier effect. The GDP growth reduction from Trump's trade policy accounts for average of Barclays 0.2%-0.4% permanent reduction at 0.3% including tariffs up to the $200B and China's $60B retaliation "US-China Trade Tensions" (9/4/2018) to Tax Foundation's 0.6% including all available tariffs and retaliation
Sources: U.S. Bureau of Economic Analysis, U.S. Senate Budget Committee, latest as of December 31, 2018

While GDP and fiscal policy are significant drivers of bond returns, the yield curve and monetary policy also account for a significant portion. The yield curve inverted between 2-year and 5-year on December 3rd of 2018 and that portion remains inverted going into 2019. Exhibit 3 shows the yield curve rising and flattening versus the prior year, but starting to invert in the short end of the "belly."

Exhibit 3: Yield Curve and Steepness



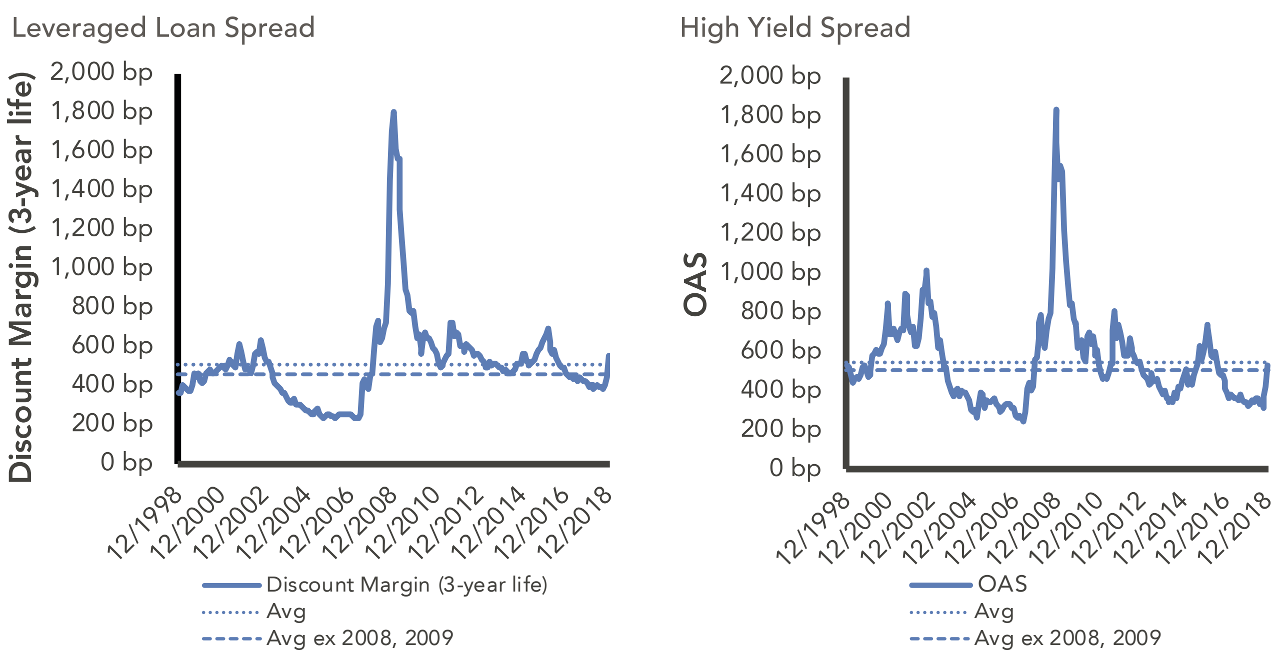
Source: Federal Reserve as of December 31, 2018

The Fed is expected to slow down or pause rate hikes. With this partial inverted yield curve and the continued tariff escalation, duration continues to provide principal protection in market corrections and we would continue to recommend holding a healthy amount of duration in core bond portfolios. Ultimately, if tariffs increase, rates rise, and yield curve inversion intensifies, we may see short-term headwinds to bond returns. Conversely, if tariffs decrease, rates decline and yield curve inversion reverses towards upwards sloping, we may see short-term accretion to bond returns.

Bank Loans/High Yield Bonds

Going into the new year, bank loan and high yield spreads are displaying moderate value after the 4Q18 correction, shown in Exhibit 4. They are no longer at post-2008 levels of tightness, which was where they were in 2017 and earlier in 2018, but are now near the 20-year average, and even slightly wider excluding the 2008 and 2009 outlier years. The current thinking is that this spread-widening accounts for the recently enacted tariffs. Holding global growth and equity market levels constant, if more tariffs are to be implemented, spreads could perhaps widen further; if some tariffs are repealed, spreads could tighten. Stronger global growth and a more bullish equity market might help tighten spreads, while, conversely, slower global growth and a bearish equity market might widen spreads.

Exhibit 4: Bank Loan and High Yield Spreads



Sources: Bloomberg Barclays, Credit Suisse as of December 31, 2018

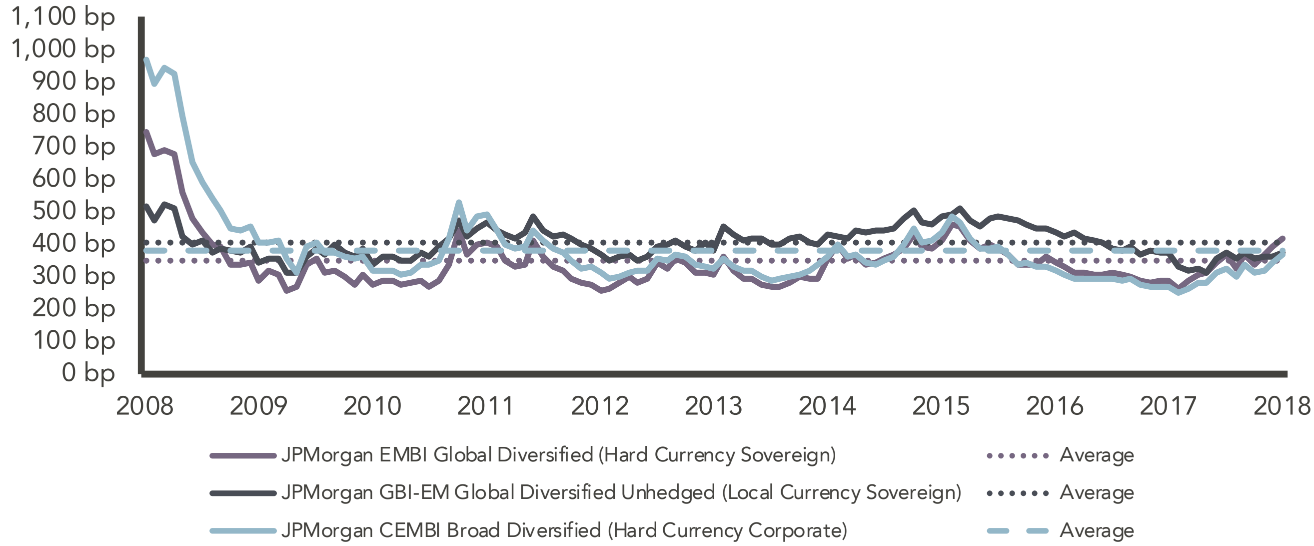
While valuations are moderate, bank loan aggressive issuance is currently high as use of bank loan issuance proceeds towards acquisitions/LBOs and 2nd lien bank loan issuance have been at 2007 levels for several quarters now. That said, high yield bond aggressive issuance is still low as financings for acquisitions/LBOs have shifted towards bank loan unitranche deals over the last few quarters. Other fundamentals, such as leverage, coverage, issuance and outstanding amounts are moderate. Finally, bank loan/high yield maturities remain low for the next five years, and default rates remain low.

However, we are seeing some structural deterioration in the bank loan market, as cov-lite deals continue to comprise a larger proportion of overall outstanding amounts. Recent studies by Credit Suisse show that recovery rates for cov-lite issuers are 10–15% worse than non-cov-lite issuers, and recovery rates for loan-only unitranche issuers are 15% worse than non-unitranche issuers. The spread-widening in 4Q18 has released some pressure and the market is perhaps pricing in some of these concerns. We expect, now that valuations are back to moderate levels, for 2019 high yield and bank loan returns to be close to coupon levels given no exogeneous shocks to the global markets. However, given the structural deterioration in terms of elevated cov-lite and unitranche deals that tend to have lower recoveries, there may be some concern on the horizon, perhaps not for 2019, but in the 2–3 year timeframe.

Emerging Markets Debt

Emerging markets debt spreads are showing moderate value after the 4Q18 correction, shown in Exhibit 5.

Exhibit 5: EMD Spreads



Source: JPMorgan as of December 31, 2018

Primary fundamentals — current accounts, growth, leverage — remain favorable. Moreover, despite sizeable maturities in the next few years, most of these issuers are Chinese and Middle Eastern countries with high reserves. We continue to advocate emerging markets debt as a strategic, long-term allocation for its high yield and diversifying properties, but there is concern over the large amount of Chinese real estate debt issued over the last few years without any accompanying occupancy, suggestive of a potential bubble in Chinese real estate and potential spillover concerns into broader EMD as well as the broader markets overall.

For 2019, we expect a heightened level of volatility similar to what we experienced in 2018 given the escalating global tariffs, China's slowdown and sizeable EMD maturities in the next few years. However, many of these concerns may have already been priced into the recently widened spreads, thereby making EMD a better tactical hold in the short term, and continuing to be a strong strategic hold in the long term given its diversifying benefits to complement a portfolio of U.S. assets.

Municipal Bonds

Municipal bonds continue to be attractive on a tax-equivalent basis. The persistent net negative supply of municipals should continue to be a tailwind.[2] While some states face budget weakness, recently 19 states reported better-than-expected revenue due to tax reform and the growing economy. With low gasoline prices, expectations are favorable for transportation bonds such as those issued by toll roads and ports. Assisted living and skilled nursing continue to benefit from the trends of retiring boomers and a shortage of senior housing.

Tobacco bonds are benefitting from the tax cut as greater disposable income has contributed to a softer decline in consumption, leading to higher cash flows to Master Settlement Agreement tobacco trusts. However, headwinds exist for higher education, where competitive tuitions, declining enrollment, rising personnel costs and pension liabilities, and the tax reform's 1.4% excise tax on education endowment earnings are forcing certain schools to merge or shut down. While tax reform continued to let hospitals issue private activity bonds, it did repeal the individual mandate, which has been raising hospitals' bad debt expenses. Moreover, labor costs are still rising due to the nursing shortage and hospitals continue to feel pressure on reimbursements from the value-based payments initiative. Finally, Puerto Rico remains the wildcard having been oversold and then overbought and is expected to normalize at some point.

CONCLUSION

Going into 2019, fixed income valuations are close to long term averages, a far cry from the near all-time peaks we saw entering 2018. In addition, with nine rate hikes since 2008, the Fed may take a pause from future rate hikes this year, which would be a welcome relief for the economy and capital markets. However, it is an imperfect market, as it always is. The chief concerns are further tariff escalations, structural deterioration in U.S. credit with the rise in cov-lite and unitranche loan deals, and volatile emerging markets with a potential asset bubble in Chinese housing. If nothing else, fixed income investors are encouraged to stay diversified and focus on principal protection while taking advantage of credit opportunities when they fit with plan objectives.

[1] A Washington D.C. tax policy think tank

[2] As municipal issuers had raced to issue a greater-than-normal amount of municipal bonds in 2017, in advance of the fear that tax reform might eliminate certain tax-exemptions — most of these eliminations did not come to pass. Private activity bonds kept their tax-exempt status, however, advance refunding bonds did lose their tax-exempt status.

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