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For fixed income, it's steady as she goes

After a strong first quarter, high yield and other credit securities settle into a clip-the-coupon environment.

Published 04-11-2019

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As we wrote three months ago, we felt the sharp sell-off in risk assets in the closing months of 2018 was overdone—the market was pricing in a recession that we just didn't see. This prompted our sector committee to take a moderately aggressive stance, adding to overweight positions in high yield and emerging markets (EM) on expectations of a snapback. Well, we sure got it. Returns jumped out of the gate at the start of the year and continued to climb, albeit at a moderating pace, through 2019's first quarter. High yield led the charge with its best first-quarter and overall fourth-best quarter ever, up

Municipal market also steady

Much as is the case in the rest of bond land, the municipal market experienced a strong first quarter and is off to a good start in the second on favorable credit dynamics and strong demand. Rising property values, robust employment trends and significant revenue growth continue to benefit state and local finances as the economic expansion nears its 10th birthday. Technicals also are strong, as the muni market is experiencing low supply and market rates amid record inflows fueled by affluent investors in high-tax states seeking haven as a result of the tax law's $10,000 cap on state and local tax deductions. Negatives include idiosyncratic cases of pension underfunding and lower bank demand as a result of the new lower corporate tax rate, with

7.26% as measured by the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index.

the latter diminishing the diversity of buyers for intermediate and long-term muni bonds.

—R. J. Gallo, senior portfolio manager

The rest of the year doesn't look to be anywhere near as exciting. It's as if we had our main course and dessert first, and have been left to nibble over the sides and appetizers. Even though the macro environment remains constructive—some call it Goldilocks, with enough growth to support jobs and incomes but not so much as to raise inflation fears or move the Fed off its new "no rate hikes this year" path—we expect returns primarily will be of the clip-the-coupon variety. After taking some profits in late January and early February as the gap between yields on credit and Treasury bonds narrowed, we are modestly overweight high yield, EM, investment-grade corporate, commercial mortgage-backed securities and leveraged loans, consistent to where each stood last October.

THE BIAS ON YIELDS IS (SLIGHTLY) HIGHER

On the rate side, duration is just shy of neutral, as the bias on longer rates arguably is up following the big rally that pushed 10-year Treasury yields down to a 16-month low of 2.37% in late March, even as risk asset prices were rising. It's rare to see Treasuries and stocks rally simultaneously, and we're not sure we have a good reason to explain it. We do think the up-move in rates will be restrained by two factors: low overseas rates as central banks in Europe, Japan and China add stimulus to spur struggling economies; and the market's perception of core U.S. inflation that remains around the Fed's 2% target despite a near 49-year low in unemployment. Fed policymakers have telegraphed a willingness to let inflation run above 2% for some time to bring symmetry around that number and lift low inflation expectations.

THE YIELD CURVE SHOULD STEEPEN, NOT INVERT

Despite all the buzz about an inverted yield curve, we actually have begun to position for a steepening curve, with short rates held down by the newly "patient" Fed and an expectation that longer rates will rise on signs of some pickup after winter softness. It's worth noting the yield-curve inversion everyone talked and worried about in March lasted a week's time and was comparatively small. It takes a more significant move over a sustained period for an inversion to really have any predictive power about a looming recession. Moreover, what many ignored during the period was that the longer end of the curve, out to 30 years, actually steepened.

ENJOY THE CALM WHILE IT LASTS

The second quarter so far is shaping up as rather benign, but we're just a few months away from the official kickoff of the 2020 presidential election season, with the first of a series of Democratic candidate debates slated for late June. The crowded field includes many espousing anti-capitalist, pro-spending agendas that are almost certain to rattle financial markets if they gain steam. By late September, Congress and the White House will be confronting a must-act deadline on the debt ceiling, an event not aided by an ever-increasing U.S. budget deficit. The Treasury Department reports it's 15% larger through the first six months of this fiscal year, and estimates that it will exceed $1 trillion by fiscal year-end in September. And throughout coming months, there's almost certain to be debate about the independence of the Fed if President Trump goes ahead with two presumptive Board of Governor nominees, Stephen Moore and Herman Cain, both of whom are relatively light on academics but heavy on political advocacy. These all represent longer-term worries that the market may have to deal with. In the meantime, it's steady as she goes.

TAGS

FIXED INCOME | INTEREST RATES | MARKETS/ECONOMY

Bloomberg Barclays US Corporate High Yield 2% Issuer Capped Index: The 2% Issuer Cap component of the US Corporate High Yield Bond Index. Bloomberg Barclays US Corporate High Yield Bond Index is an unmanaged index which measures the USD-denominated, high yield, fixed-rate corporate bond market. The index follows the same rules as the uncapped version, but limits the exposure of each issuer to 2% of the total market value and redistributes any excess market value index wide on a pro rata basis. The index was created in 2002, with history backfilled to January 1, 1993. Indexes are unmanaged and investments cannot be made in an index.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality and the lowest category of investment grade; credit ratings BB and below are lower-rated securities ("junk bonds"); and credit ratings of CCC or below have high default risk.

Diversification does not assure a profit nor protect against loss.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks and may be more volatile than investment-grade securities.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging-market and frontier-market securities can be significantly more volatile than the prices of securities in developed countries, and currency risk and political risks are accentuated in emerging markets.

Yield Curve: Graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

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