Focus on short-term fixed income

Q1 in Review

March 31, 2019

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IN BRIEF

- The first quarter was a complete reversal of the volatility we experienced in 4Q18 with sentiment turning positive and strong performance from risk assets.
- Economic data released in the first quarter supported our expectation that growth will be slower this year than in 2018. Residual seasonality, the government shutdown and tighter financial conditions all put a drag on first-quarter growth
- The Fed kept rates unchanged at its March Federal Open Market Committee (FOMC) meeting, a move that was widely anticipated, but turned more dovish than expected by lowering its forecast for rate hikes from two to zero in 2019, and announcing its intention to end balance sheet runoff in September of this year.

GENERAL MARKET COMMENTARY

Risk assets rebounded in the first quarter of 2019 following the rocky end to 2018. Optimism about the U.S.-China trade agreement and dovish Federal Reserve (Fed) rhetoric propelled risk assets higher despite a string of weak economic data releases in Europe and China. Markets expect these economies to stabilize and avoid a hard landing.

After a prolonged standoff between the White House and the House of Representatives over border security funding, the 35-day partial government shutdown ended in late January with a three-week extension. Lawmakers ultimately reached a bipartisan compromise on U.S. border security to avoid another government shutdown. Market participants worried that the shutdown could negatively impact economic growth as many economists ratcheted down their first quarter forecasts, but the Congressional Budget Office (CBO) expects the economy to recover most of the negative impact on first-quarter GDP in subsequent quarters.

The U.S. and China engaged in trade negotiations, with both sides showing optimism and willingness to make progress. China offered to buy more U.S. agricultural products and the U.S. considered pulling back tariffs on Chinese imports. President Trump ultimately extended the March 1st deadline for implementing new tariffs, citing progress in negotiations.

As was widely anticipated, the Fed kept rates unchanged at its March Federal Open Market Committee (FOMC) meeting, but surprised the market with a more dovish than expected move, lowering its forecasted number of 2019 rate hikes from two to zero and announcing its intention to end its balance sheet runoff this September. The Fed still expects to raise rates one more time in 2020. The committee reiterated its intention to exercise patience in the face of muted inflation and global economic uncertainty.

The Fed addressed its balance sheet, stating it intends to taper its monthly cap on redemptions of U.S. Treasuries, lowering it from 30 billion USD to 15 billion USD a month starting in May 2019. It will continue to let mortgage-backed securities (MBS) run off and reinvest the proceeds in Treasury securities across the curve. Rates rallied in response, and the Treasury yield curve temporarily inverted in the 3-month to 10-year part of the curve. The two-year Treasury yield ended the quarter down 23 basis points (bps) at 2.26%. The five-year Treasury yield ended down 28bps at 2.23%.

Earnings results for the fourth quarter showed a majority of companies beating estimates that had, however, been revised downward. While worries that we have seen the peak in earnings growth have somewhat faded, market participants are actively monitoring for any sign of headwinds to earnings growth. Credit spreads retraced much of the widening that had occurred in the fourth quarter. The ICE BofAML 1-5 Year U.S. Corporate Index ended the quarter 35bps tighter.

U.S. MARKET COMMENTARY

Economic data released in the first quarter supported our expectation that growth will be slower this year than in 2018. Residual seasonality, the government shutdown and tighter financial conditions all put a drag on first-quarter growth. Nonetheless, expectations for first-quarter growth have risen recently from below 1% to between 1% and 2%.

Labor market conditions continued to improve, with wages rising gradually. Non-farm payroll growth in February came in well below expectations, at 20,000, after January's strong print of 311,000 but three- and six-month monthly hiring rates are running at 186,000 and 189,000, respectively—above the pace of job growth necessary to maintain downward pressure on slack and the unemployment rate. The unemployment rate declined from 4% to 3.8%. The U-6 unemployment rate, a broader measure, declined from 8.1% to 7.3%, a new cycle low. Average hourly earnings rose 0.4% month-over-month (m/m) and 3.4% year-over-year (u/u) in February. Anecdotal and survey based reports, such as regional business surveys and the Fed's beige book, continue to indicate that labor shortages exist in some sectors and that employers plan to raise wages. Initial jobless claims also declined over the quarter, mainly in March, after looking modestly elevated at the start of the year. As of late March, the four-week average stood at 317,000.

Consumer spending moderated in the first quarter, running at about 1% vs. 3% to 5% for most of 2018. With incomes remaining steady, the savings rate rose to 7.6%. Strong income data suggests that spending should pick up in the second quarter, as long as consumer confidence remains elevated. The University of Michigan consumer confidence survey remained near cycle highs over the quarter. The Conference Board measure of consumer sentiment moderated in March but it, too, also remained elevated.

The February CPI report, published in March, showed the core CPI rose 0.1% m/m and declined 2.1% y/y. The three- and six-month run rates stood at 2.1% and 2.3%, respectively. Headline CPI rose 0.2% m/m, and declined y/y from 1.6% to 1.5%, reflecting challenging base effects on energy relative to a year ago.

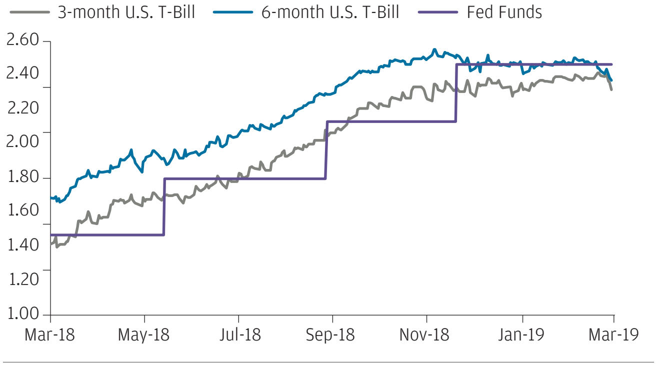
KEY U.S. ECONOMIC DATA

USA	Current Month	Prior Month	Dec 31, 2018
DJIA	25,928.68	25,916.00	23,327.46
S&P	2,834.40	2,784.49	2,506.85
2-Yr U.S. Treasury yield (%)	2.26	2.52	2.49
10-Yr U.S. Treasury yield (%)	2.41	2.72	2.69
Unemployment Rate*	3.8	3.8	3.9
Chg in Nonfarm Payrolls (3 mo. avg)*	180	191	233
Housing Starts (000s, saar)*	1162	1273	1140
ISM Manufacturing Survey	55.3	54.2	54.3
U. of Mich. Consumer Confidence Sentiment	98.4	93.8	98.3
Consumer Price Index (y/y %)*	1.5	1.6	1.9

* Currently showing the most recent published number as of February. March data has not been released.

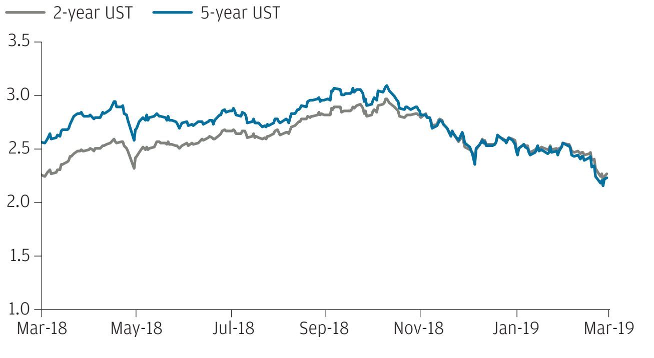
SARR: Seasonally Adjusted Annual Rate

TREASURY BILL YIELDS (%)



Source: Bloomberg; data as of March 31, 2019.

TREASURY YIELDS (%)



Source: Bloomberg; data as of March 31, 2019.

U.S. PORTFOLIO COMMENTARY

The weighted average maturity (WAM) of our **Liquidity strategy** was in the 20- to 30-day range for the quarter. Money market yields fell considerably and floating rate security spreads compressed, as markets priced in expectations that the Fed will ease by the end of 2019. Three-month LIBOR closed the quarter down 21bps to 2.60%, and 1-month LIBOR closed down less than 1bp at 2.49%. We focused purchases on high quality fixed rate securities in the one- to nine-month area. We generally carried 25% to 30% in overnight liquidity and 42% to 45% in monthly liquidity. We will continue to focus on term security purchases, both fixed and floating, as we monitor economic data and the Fed reaction function.

We lowered our rate forecast in our **Managed Reserves** portfolios to no hikes for the remainder of 2019. Current valuations, and an inverted Treasury yield curve, led us to favor adding duration through credit while we wait for more attractive yields to add Treasuries. Although we remain constructive on credit, we are cognizant that we are in the later stages of the credit cycle. We expect the positive environment for investment grade (IG) corporates and risk assets to continue and were comfortable adding spread duration in our portfolios. A steepening in the credit curve and tightening valuations for one-year and in credit led us to trim rich money market instruments and leg into longer fixed and floating rate instruments at attractive levels. We added to our asset-backed securities allocation where permitted, given solid fundamentals, strong consumer sector and robust employment backdrop.

Our **Short Duration** portfolios were well-positioned for the rally in risk assets, as we had spent December and January adding credit at much wider levels, which led to significant outperformance during the quarter. We took the opportunity to start taking profits, trimming the outperformers in March. We are now positioned more conservatively across portfolios, while still maintaining our overweight positions. Technicals in credit remain very strong and spreads have tightened year to date. We covered our duration short in February and were running portfolios neutral to their benchmarks at quarter end as the Fed is on hold and the direction of future policy is uncertain. We feel ABS spreads are currently tight but with credit tightening significantly this year, we still view the sector as a nice portfolio diversifier.

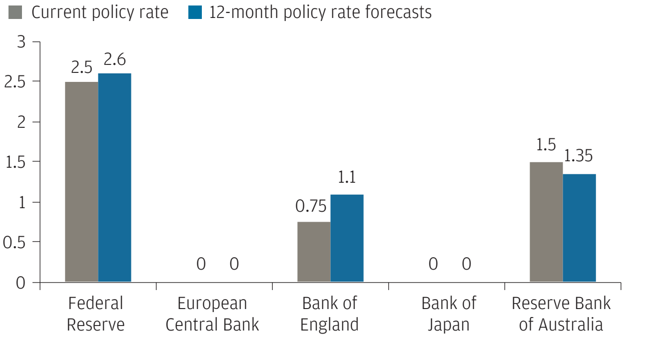
OUTLOOK: EXCERPTS FROM OUR QUARTERLY GLOBAL FIXED INCOME VIEWS

Will the global growth slowdown end in a soft landing or recession? Data has softened in the U.S., but the U.S. economy is far from recession. The consumer sector is in fantastic shape, with strong balance sheet, full employment and wage growth. Any de-escalation of trade tensions between the U.S. and China will increase business confidence and spending. And in China, fiscal and monetary stimulus seem to have stabilized the economy, helping to counter the drag from trade pressures. We expect China's growth to be supported at around 6.3%-6.4% in 2019, as opposed to the 5.9% we feared three months ago. Despite concerns about Brexit and Italian deficits and trade; the eurozone looks reasonably stable. The European Central Bank is on hold for the foreseeable future, and fiscal austerity is giving way to fiscal stimulus in France and Italy; both should support the broader economy. While we are not expecting the array of global policy stimulus to lead to a GDP surge reminiscent of 2017 and 2018, we also cannot see the onset of recession. We expect the central banks to leave rates and balance sheets unchanged, as inflation remains stubbornly below their targets.

We reduced the probability of our base-case scenario of Above Trend Growth to 45% from 50%, and raised the probability of Sub Trend Growth to 40% from 35%. It appears that the global economy will glide toward a soft landing with growth roughly at trend. We kept the probability of Recession at 10%. We do believe that the central banks have extended the cycle, and we don't see recession as a 2019 or early 2020 event. But we are late cycle, and a policy error, however minor, might be enough to bring forward that probability. Finally, we kept the probability of Crisis at 5%. Geopolitics are a constant concern but, for now, cooler heads seem to be prevailing.

The U.S.-China trade negotiations remain at the top of our list of concerns. If the trade battle escalates, the impact on business spending and consumer sentiment will be globally significant, and could lead to a stagflation spiral. A hard Brexit would also be a challenge for the eurozone and global economy. Further out, we have the U.S. 2020 general election. As 2019 progresses, we are likely to hear from a growing chorus of campaigners with less market-friendly views … think higher taxes and greater regulation.

MARKET EXPECTATIONS FOR RATE MOVES (%)



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