



# FIXED INCOME UPDATE – THIRD QUARTER 2018

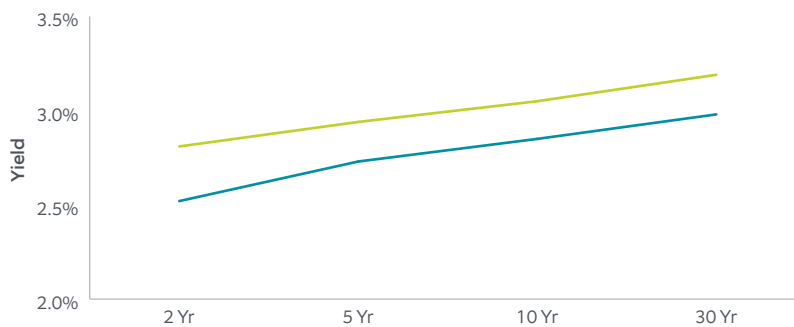
## KEY POINTS

- U.S. economic data was firm, as the positive benefits from the early-year fiscal package flowed through the economy.
- Treasury yields rose across the curve, although with a modest amount of flattening.
- The Federal Reserve removed its “accommodative” language and increased its target range by 25 basis points at the September Federal Open Market Committee (FOMC) meeting.
- While trade disputes with Canada and Mexico were resolved, the trade dispute with China continued to make headlines.

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## CHANGE IN TREASURY YIELDS – THIRD QUARTER



Unlike previous quarters, the treasury market experienced a parallel shift, reflecting more optimism on long-term growth.

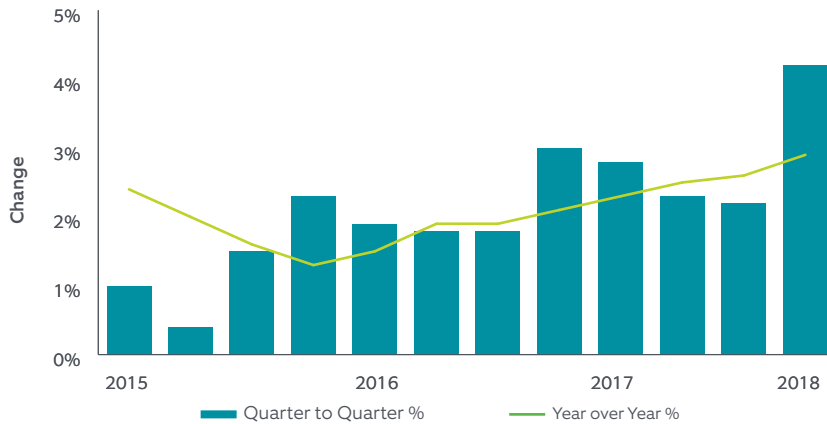
	2 Yr	5 Yr	10 Yr	30 Yr
6/30/2018	2.52%	2.73%	2.85%	2.98%
9/30/2018	2.81%	2.94%	3.05%	3.19%
Change	0.29%	0.21%	0.20%	0.21%

SOURCE: Northern Trust Fixed Income; U.S. Department of the Treasury

**MACRO UPDATE**

- Economic growth in the U.S. broke into a new channel with second quarter growth of 4.2%, although some investors remain skeptical that this type of growth can persist.
- Concerns over emerging market economies, political uncertainty in Italy, and a murky path towards a Brexit endgame continue to weigh on the economic backdrop.

**REAL GROSS DOMESTIC PRODUCT**

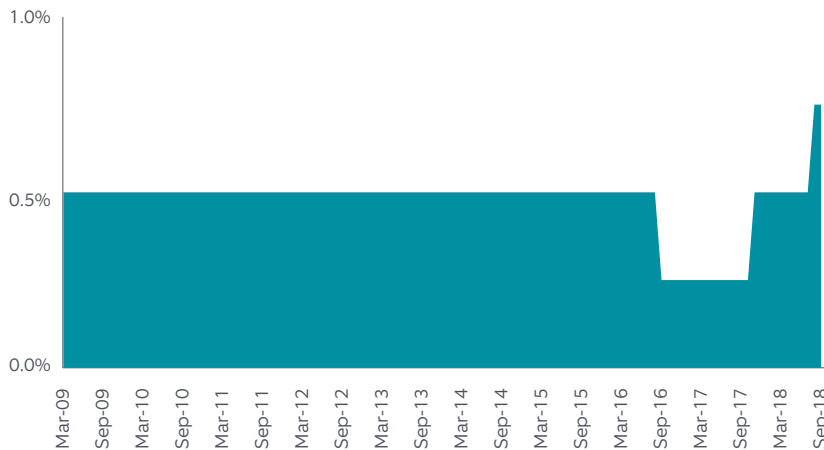


SOURCE: Northern Trust Fixed Income; Bloomberg

**CENTRAL BANK UPDATE**

- The Fed raised rates one fourth of a percentage point to 2.25% in September, the third rate hike this year.
- The European Central Bank kept rates unchanged and moved forward with its plan to halve the pace of bond purchases from October to December. They still anticipate ending QE purchases in early 2019, if the data remains supportive.
- The Bank of England (BOE) raised interest rates for only the second time in the past decade, amid concerns about quickening inflation.

**BANK OF ENGLAND (BOE) – BANK RATE**



SOURCE: Northern Trust Fixed Income; Bloomberg

**Long-Term Views**

- Interest rates are likely to move only moderately higher given low inflation.
- While the spread between market views and the Fed has moved closer, we remain more dovish.
- Low U.S. inflation and accommodative foreign central bank policies will constrain the Fed from aggressively increasing rates.
- We forecast a 10-year Treasury of 3% in five years.
- We forecast the BOE will not make an additional rate hike in the near term.

ULTRA-SHORT/CASH UPDATE

Market Overview:

- Short-term municipal rates finished the quarter flat, although rates moved more than 60 basis points during the quarter, as the volatility we have seen throughout 2018 continued.
- Assets in prime money funds are slowly increasing as investors are attracted by the higher yields, stable net asset values and adequate liquidity.
- Spread assets (ABS, CMBS, credit) rallied throughout the quarter. Front-end credit exposure remains attractive from a relative value perspective.

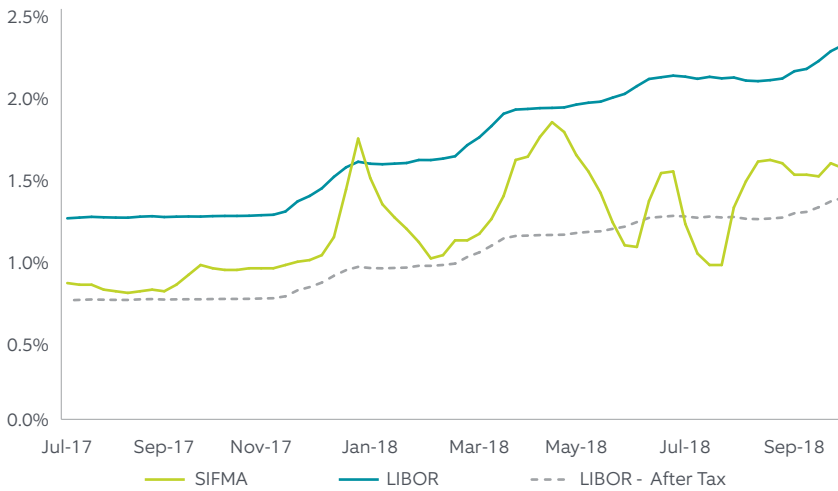
Ultra-Short Performance:

- Contributor - Sector Allocation
- Detractor - Curve Positioning

Current Positioning:

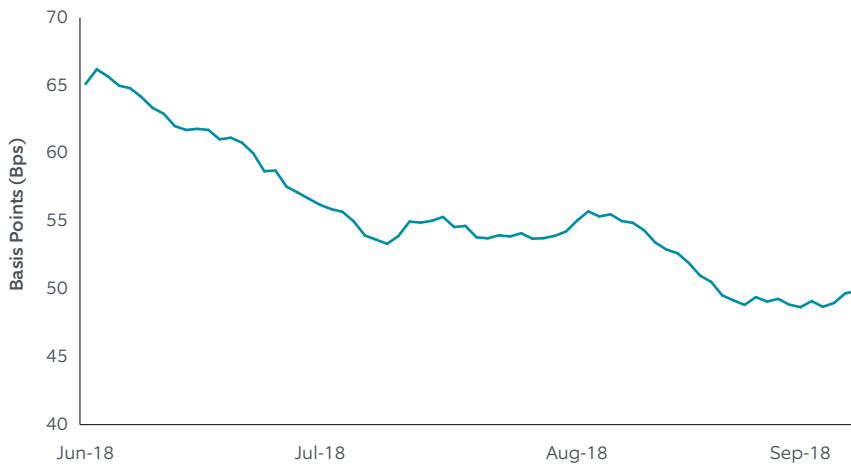
Ultra-short strategies remain overweight credit assets and are positioned with a modestly short duration.

SHORT-TERM RATES



SOURCE: Northern Trust Fixed Income; Bloomberg

1 – 3 YEAR CORPORATE OPTION-ADJUSTED SPREAD



SOURCE: Northern Trust Fixed Income; Barclays Live

1-3 Year corporate option-adjusted spreads (OAS) tightened by 18 basis points during the quarter.

TREASURYS & TIPS UPDATE

Market Overview:

- The 10-year U.S. Treasury – German bund spread ended the quarter at -260 basis points, matching levels not seen since the late 1980's. Ultra-accommodative monetary policy, muted inflation, and political instability across the Eurozone have kept the German bund anchored.
- Foreign demand from traditional buyers of U.S. Treasuries has diminished. Although nominal interest rates are higher in the U.S. versus the world, the currency differential is causing the hedged spread to be negative.

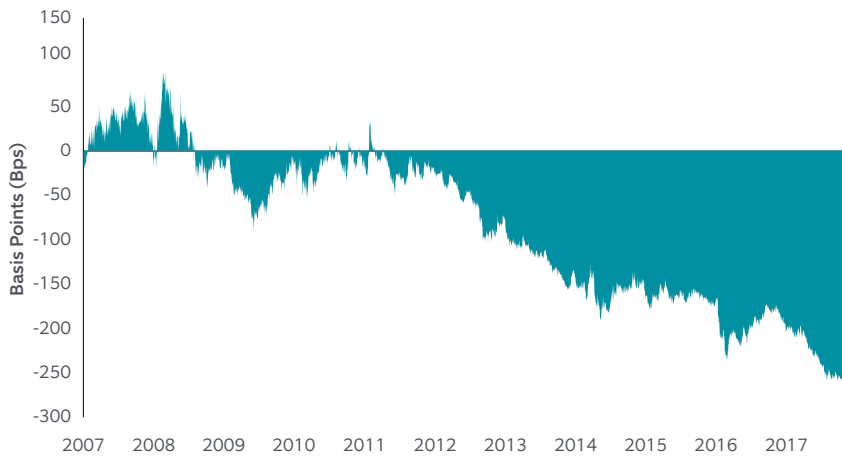
Rates Performance

- Modest Contributor - Duration / Curve Positioning

Current Positioning:

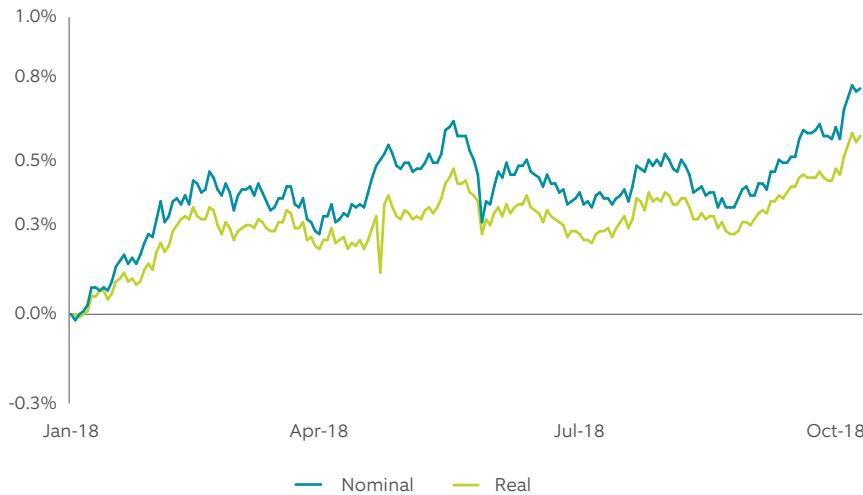
Portfolios increased Treasury exposure during the quarter and are positioned neutral to benchmarks.

10-YEAR U.S. TREASURY – GERMAN BUND SPREAD



SOURCE: Northern Trust Fixed Income; Bloomberg

YTD CHANGE IN REAL & NOMINAL 10-YEAR UST YIELDS



Improving growth pushed real and nominal yields higher.

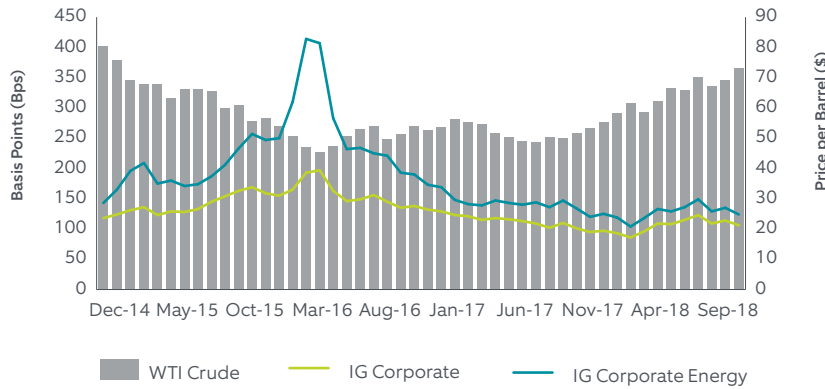
SOURCE: Northern Trust Fixed Income; U.S. Department of the Treasury

INVESTMENT-GRADE CREDIT UPDATE

Market Overview:

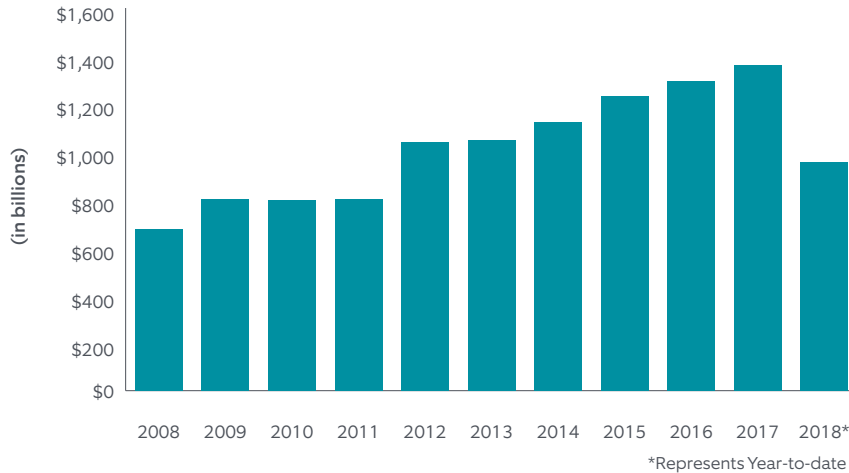
- Corporate earnings remained robust and are expected to remain positive, supporting low credit spreads.
- Backed by increasing oil prices, the energy sector has continued its recovery from the 2016 commodities crisis, with credit spreads at 4-year tights.

OIL PRICES RELATIVE TO IG OPTION-ADJUSTED SPREAD



SOURCE: Northern Trust Fixed Income; Barclays Live; Bloomberg

CORPORATE NEW ISSUANCE



SOURCE: SIFMA (Securities Industry and Financial Markets Association); Thomson Reuters

Credit Performance

- Contributor – Security Selection and Sector Allocation

Current Positioning:

Our overweight to credit has been reduced and portfolios are positioned neutral, relative to benchmarks. We will look to opportunistically add credit during any bouts of market volatility.

Year-to-date investment grade supply is down, contributing to a positive technical environment.

**HIGH-YIELD BOND UPDATE**

**Market Overview:**

- The high-yield market continues to benefit from solid credit fundamentals, driven by corporate earnings growth. The CC to D rating category continued its substantial outperformance.
- A low and declining default rate, along with positive technical factors (new issuance is down 28% YTD) support high-yield valuations.
- Agreeable supply and demand dynamics, along with strong corporate earnings have benefitted performance.

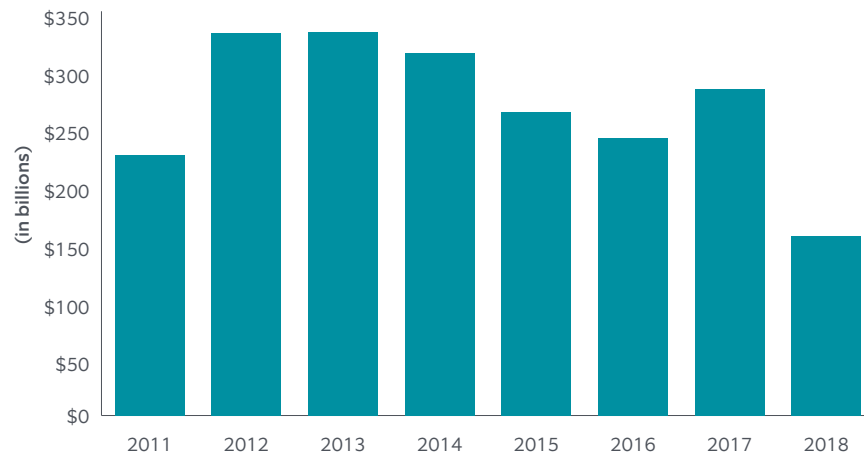
**High-Yield Performance**

- Contributor - Sector Selection
- Detractor - Security Allocation

**Current Positioning:**

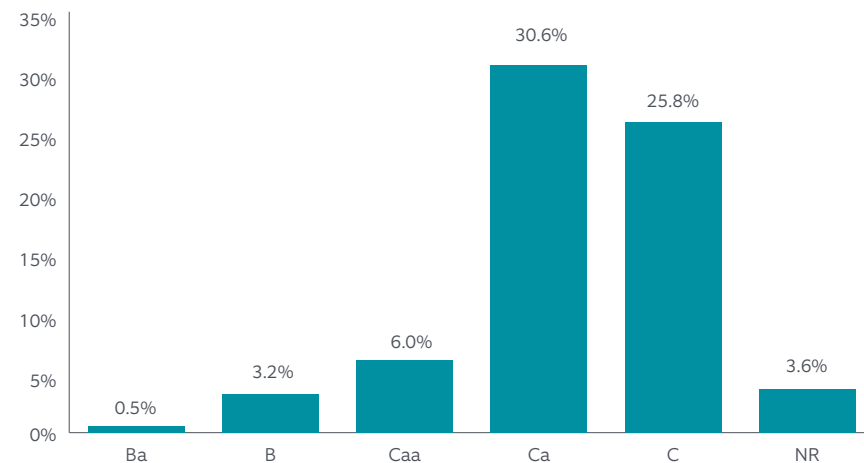
Portfolios continue to be positioned in the mid-range of the credit quality spectrum. With few sector overweights outside of banks and energy, issuer selection is of upmost importance.

**HIGH YIELD ISSUANCE - ANNUAL**



SOURCE: Northern Trust Fixed Income; SIFMA (Securities Industry and Financial Markets Association)

**TOTAL RETURN BY QUALITY – YTD 2018**



SOURCE: Northern Trust Fixed Income; Barclays Live

Higher quality securities have materially under-yielded and underperformed the market. Higher quality securities tend to have more rate beta versus lower quality securities, which exhibit more credit beta. We take a balanced approach and favor credit beta in the current environment.

MUNICIPAL BOND UPDATE

Market Overview:

- The municipal yield curve remains much steeper than Treasuries and offers better value in longer maturities. One- to five-year municipal maturities continue to look particularly expensive.
- New issuance has been very light. We believe new issuance throughout 2018 will be insufficient to meet demand, providing a strong technical assist to the market.

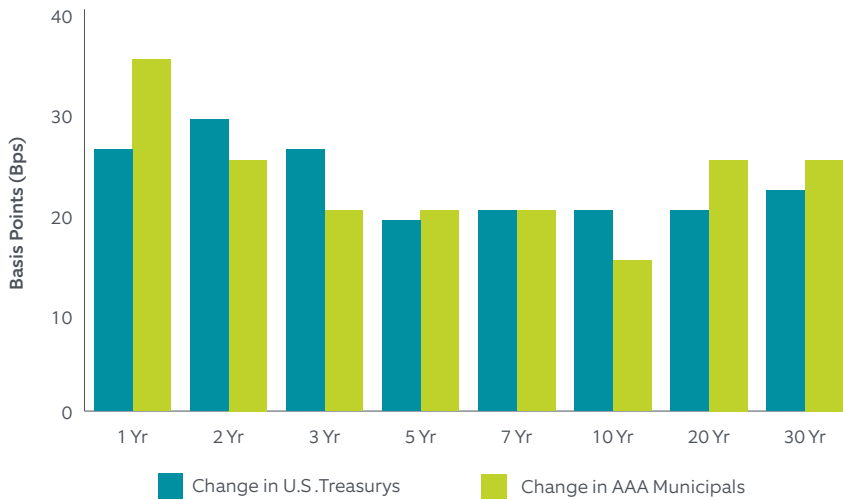
Municipal Performance

- Contributor – Curve Positioning
- Detractor – Quality Bias

Current Positioning:

Interest rate exposure is largely neutral to benchmarks. We favor select general obligation bonds and essential services revenue bonds. Volatility heading into year-end may provide tax swap opportunities.

TREASURYS VS. AAA MUNICIPAL - THIRD QUARTER 2018



SOURCE: Northern Trust Fixed Income; Bloomberg Barclays

RATIO: AAA MUNI YIELD TO TREASURY YIELD



SOURCE: Northern Trust Fixed Income

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