



# FIXED INCOME UPDATE – FOURTH QUARTER 2018

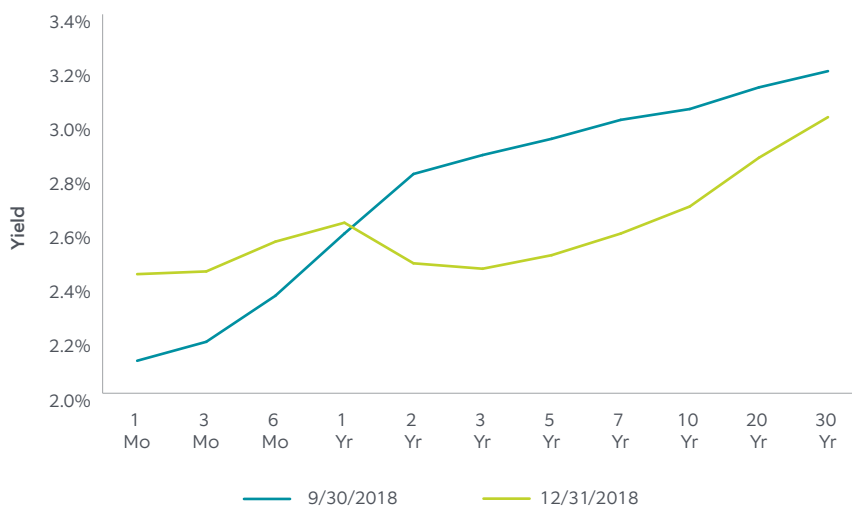
## KEY POINTS

- U.S. economic data remained firm, but signs of a potential slowdown in the U.S./global economy have been growing.
- The yield curve flattened, with the spread between 2 & 10-Year Treasuries reaching its lowest level in over a decade.
- The Federal Reserve delivered a muddled message and increased its target range by 25 basis points at the December Federal Open Market Committee meeting, and implied future rate hikes to come.
- Credit markets were volatile, ending the year at their widest levels both in investment grade and high yield. Markets showed an overly zealous fear of recession moving into 2019.

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## CHANGE IN TREASURY YIELDS – FOURTH QUARTER



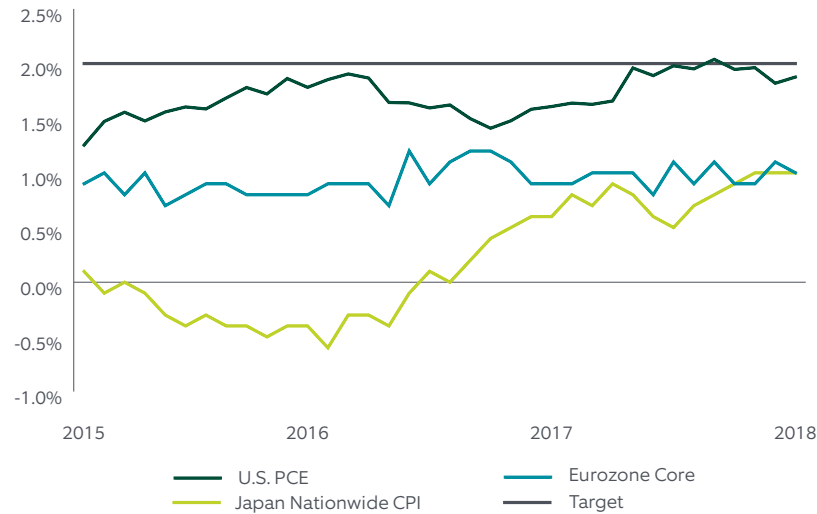
The front end of the curve continued to flatten amid more dovish Fed comments and fears of the Fed overtightening

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

MACRO UPDATE

- Economic growth in the U.S. remained in a higher channel, but is expected to decline in Q4.
- Concerns over the continued trade tariffs and political uncertainty in the eurozone present investors with a murky path forward.

CORE INFLATION

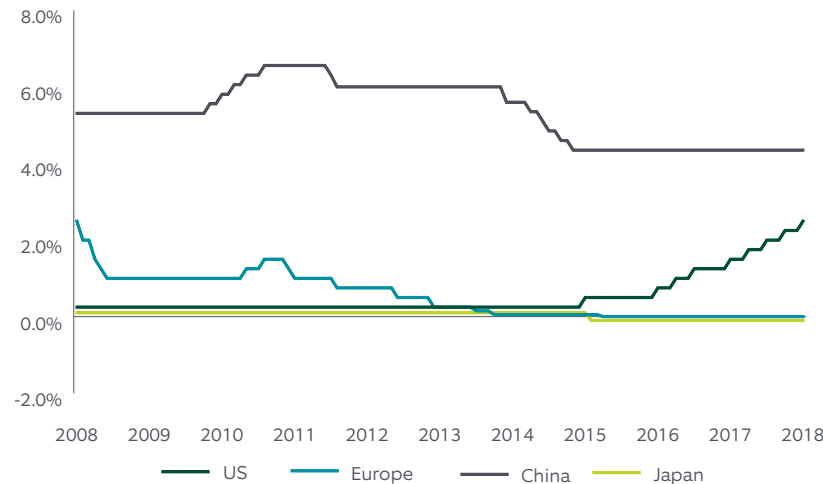


As of 11/30/18  
SOURCE: Northern Trust Fixed Income; Bloomberg

CENTRAL BANK UPDATE

- The Fed raised rates one-fourth of a percentage point to a range of 2.25-2.50% in December, the fourth rate hike this year.
- Federal Reserve Chairman Jerome Powell recalibrated his message and the outlook on Fed Funds to “just below” versus “far from” neutral.
- As previously announced, the European Central Bank has initiated the end of its €2.6 trillion quantitative easing program.

CENTRAL BANK POLICY RATES



SOURCE: Northern Trust Fixed Income; Bloomberg

Long-Term Views

- Despite a slowing global economy, tightening U.S. monetary policy, and ongoing trade tensions, we do not expect a recession to unfold over the next year.
- While the possibility of the Fed overtightening remains a risk case, the market expects it to take a more patient and flexible approach.
- We expect inflation in developed economies to remain challenged. The market has priced out the Fed in 2019, with macroeconomic data driving the path forward.

Slowing growth combined with weakening inflation data have all been attributed with causing the back-end of the curve to bear-flatten.

ULTRA-SHORT/CASH UPDATE

Market Overview:

- After nine rate increases over the past three years, the market has quickly shifted away from expectations of future hikes, while the Fed still forecasts two more in 2019.
- Spread assets (ABS, CMBS, credit) widened throughout the quarter. Recent widening in front-end credit exposure provides opportunity.
- Prime money fund assets steadily increased, marking the 9th straight quarter of net inflows and finished 2018 with ~\$565 billion in total assets, 25% higher than 2017.

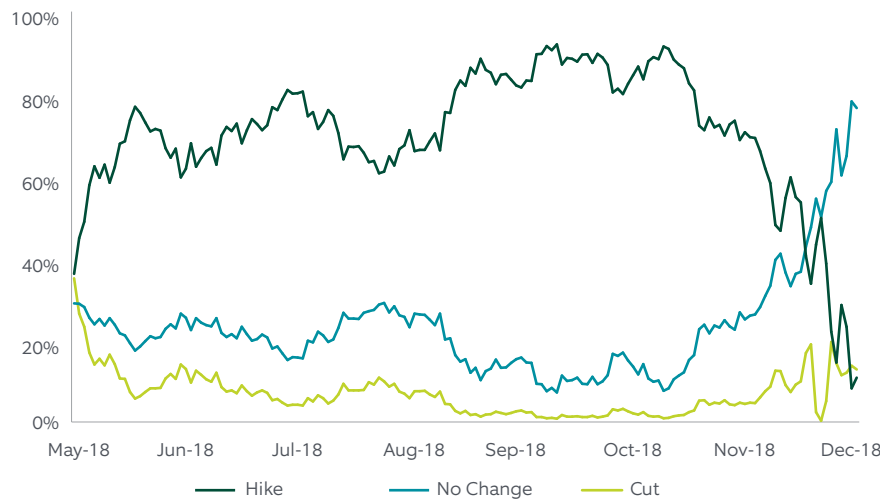
Ultra-Short Performance:

- Contributor - Curve Positioning
- Detractor - Sector Allocation and Duration

Current Positioning:

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

PROBABILITY OF FED ACTIVITY IN 2019



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) widened 38 basis points during the quarter.

TREASURYS & TIPS UPDATE

Market Overview:

- The December Fed hike, coupled with concerns over slowing growth and a lack of inflation, caused the Treasury curve to bear-flatten.
- For the first time since 2007, the spread between the 2- and 5-Year Treasuries dropped below zero, signaling we are likely approaching the end of the Fed's tightening cycle.

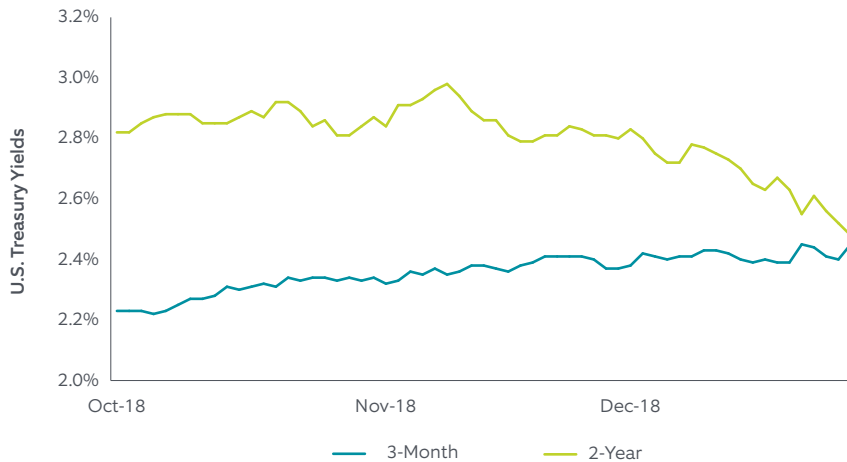
Rates Performance

- Contributor - Duration

Current Positioning:

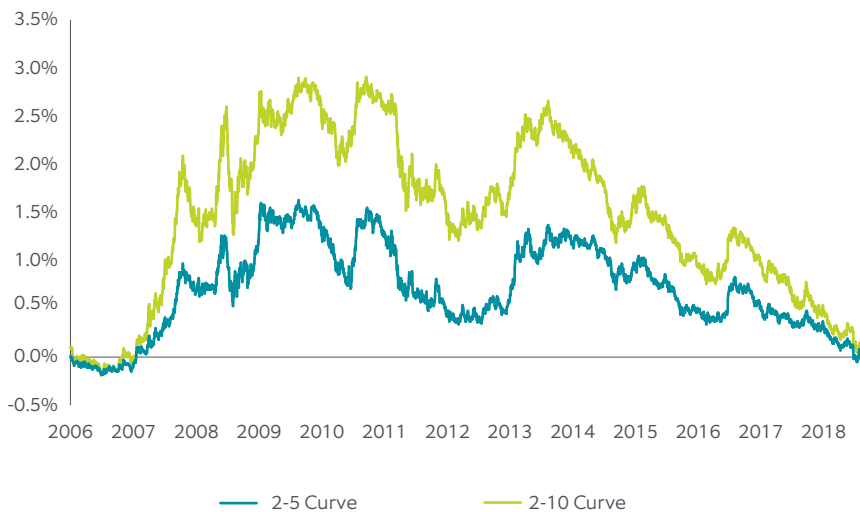
Active portfolios increased Treasury exposure during the quarter and are positioned with a neutral duration.

FRONT-END TREASURY CONVERGENCE



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

CURVE FLATTENS & BRIEFLY INVERTS



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

Often viewed as a precursor to a recession, investors are closely watching for curve inversions.

INVESTMENT-GRADE CREDIT UPDATE

Market Overview:

- Despite reduced supply, credit spread widening accelerated during the fourth quarter, spurred by negative market sentiment, lower oil prices and a variety of idiosyncratic risks.
- Fundamentals remain supportive, and while the percentage of BBB-rated companies in the market has increased, we don't expect a large wave of downgrades on the horizon.

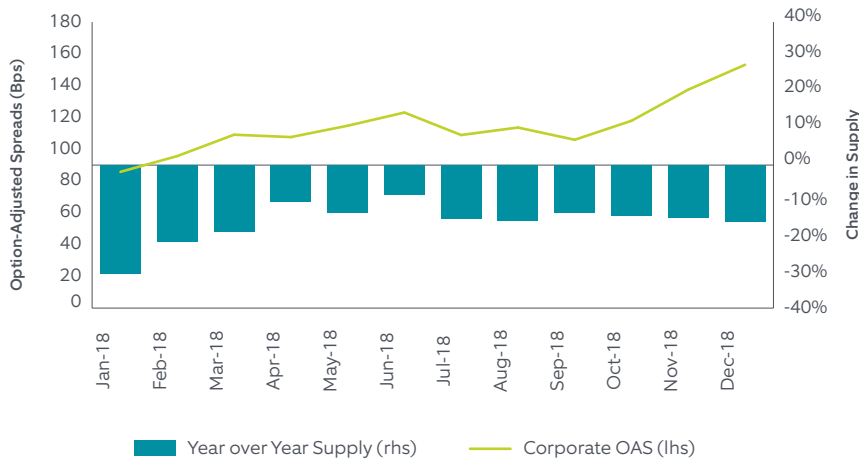
Credit Performance

- Contributor – Duration
- Detractor – Security Selection and Sector Allocation

Current Positioning:

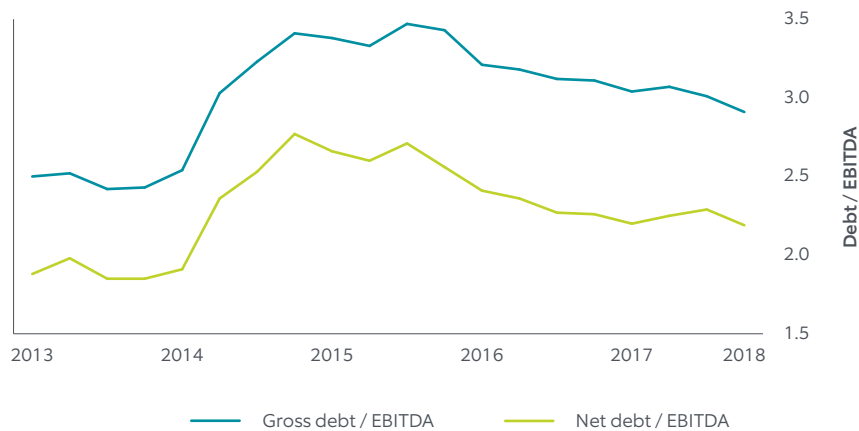
Our overweight to credit has been reduced from historical levels, but we remain modestly overweight relative to benchmarks.

CORPORATE OPTION-ADJUSTED SPREAD & ISSUANCE



SOURCE: Northern Trust Fixed Income; Barclays Live; Bloomberg

CORPORATE LEVERAGE



As of 9/30/18  
SOURCE: Northern Trust Investment Strategy; Bloomberg Barclays

Strong profits combined with reduced issuance have led to deleveraging in the investment grade universe.

HIGH-YIELD BOND UPDATE

Market Overview:

- Relative to other risk assets, high yield performed well in the fourth quarter, benefitted by solid credit fundamentals through stable corporate earnings.
- Positive technical factors and a low and declining default rate support high-yield valuations.

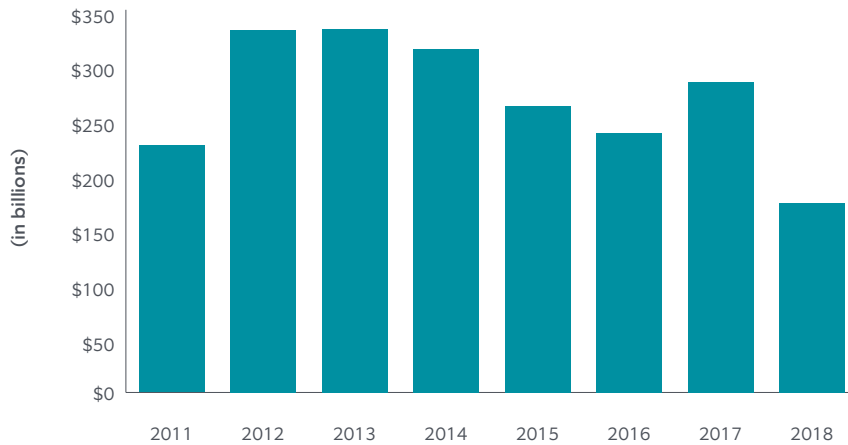
High-Yield Performance

- Contributor - Duration
- Detractor - Security Selection

Current Positioning:

Portfolios are positioned in the mid-range of the credit quality spectrum. Issuer selection is of utmost importance as we have few sector overweights outside of banks and energy.

NEW ISSUANCE



SOURCE: Northern Trust Fixed Income; Bloomberg

MOODY'S DEFAULT RATE



SOURCE: Northern Trust Fixed Income; Moody's

New issuance is down 40% over the last year and the default rate continues to trend lower.

MUNICIPAL BOND UPDATE

Market Overview:

- Municipal buyers continued to favor shorter maturities. This kept valuations expensive on the front end of the yield curve, while the back end remained steep.
- New issuance for the year was 24% lower than 2017. This was a strong technical assist to the market, restraining rate increases despite Fed tightening.

Municipal Performance

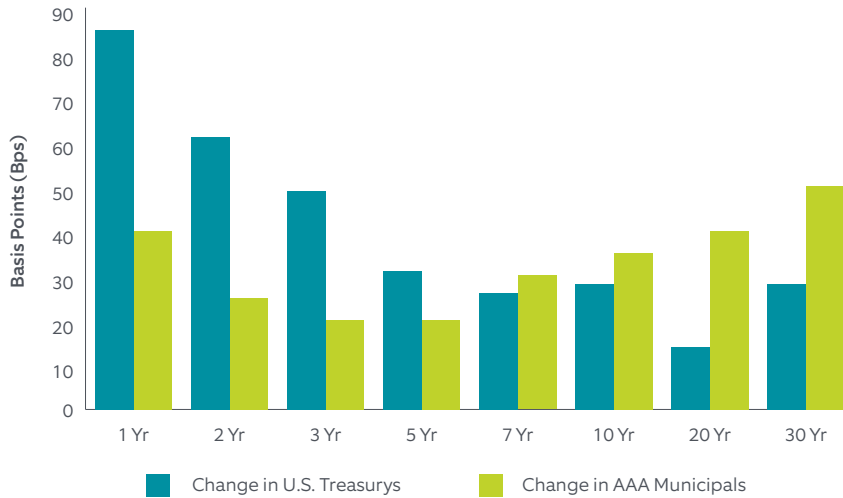
- Contributor – Quality Bias
- Detractor – Curve Positioning

Current Positioning:

Interest rate exposure is largely neutral to benchmarks. We favor select general obligation bonds and essential services revenue bonds.

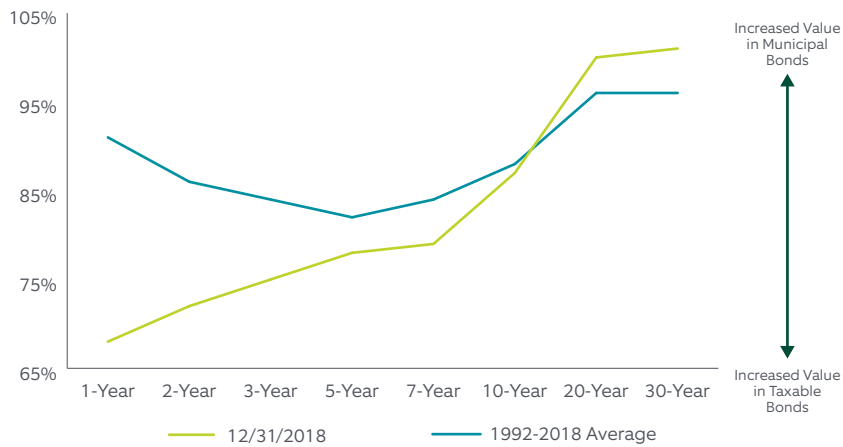
State revenues are strong, supporting rebuilding of reserves and infrastructure projects.

TREASURYS VS. AAA MUNICIPAL - FULL YEAR 2018 (FED FUNDS: +100 BPS)



SOURCE: Northern Trust Fixed Income; Bloomberg Barclays

RATIO: AAA MUNI YIELD TO TREASURY YIELD



SOURCE: Northern Trust Fixed Income

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