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Avoiding the minefields: Why being nimble in 2019 will be key

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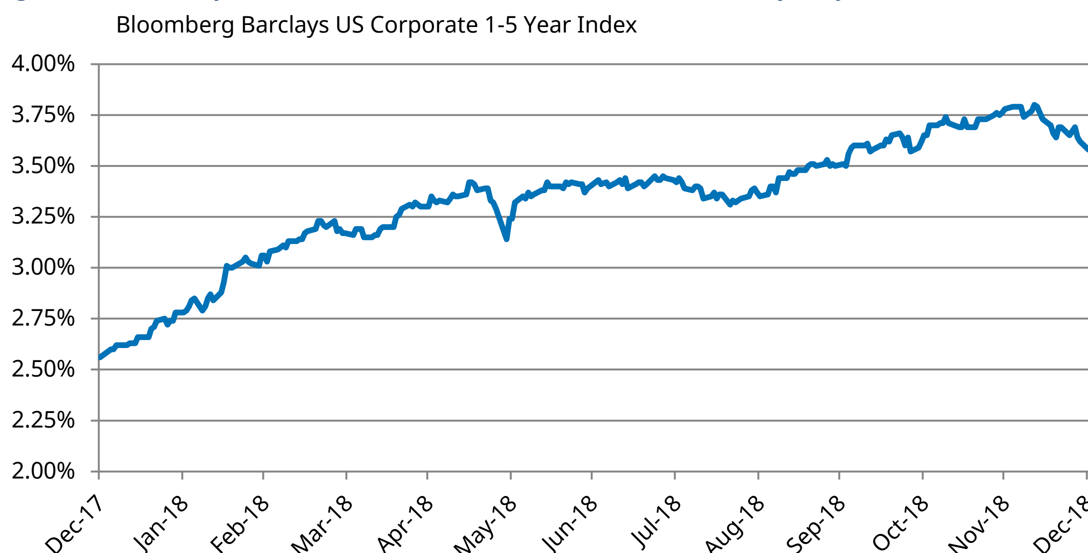
In our current outlook presentation, we refer to the 'potential minefields of debt, liquidity and politics'. We think it nicely sums up the hurdles risky assets have to navigate as we head into 2019. While we feel that we should whisper this rather than shout it, we do think it might soon be time to buy bonds…you read that correctly! US fixed income should be a bigger part of your future allocation in 2019.

To be clear we don't think it's time to rush blindly to buy risk. In fact, given the performance year to date 2019, it might be time to trim a bit of your equity-like fixed income allocations. Fortunately with short-dated, high-quality fixed income offering return potential that hasn't been seen in nearly a decade and corporate spreads off the historical tights, the opportunity cost of de-risking at this time is favorably low for investors. Whatever your view on today's market, it is certainly time to start having the conversation about good old-fashioned fixed income.

Figure 1: Short corporates have become more attractive over the past year

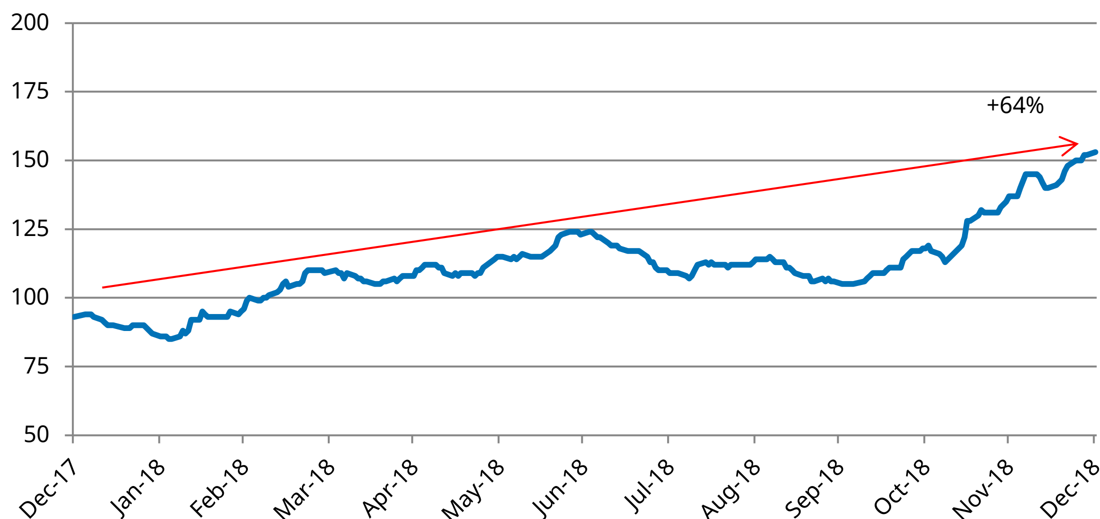


Source: Bloomberg as of December 31, 2018. Past performance is no guarantee of future results.

Our recently authored paper "Late-cycle investing: Are investors in for a Dickens of a time?" was a fairly negative piece offering little hope. If you haven't read it, we encourage you to do so. The challenges faced by fixed income assets are not insignificant. The narrative of synchronized global growth has shifted downwards towards an expectation of a slowdown. The decade long support provided by central banks' quantitative easing (QE) is behind us, and with it, the zero-cost financing that inflated risk assets across the board. Corporate borrowing has increased significantly, the share of BBBs has ballooned and credit investors need to be paid more to take on those risks. Oftentimes in markets, patience and price are your strongest allies. This sentiment certainly has rung true recently as market volatility has increased significantly, resulting in sharply lower valuations across the risk spectrum. It also rung true on portfolio positioning, as we began the de-risking process over a year ago based upon the view that valuations were stretched, fundamentals were peaking and the technical environment was turning less favorable. With investment-grade corporate spreads more than 50% wider last year, it is fair to say that having patience and conviction has been a virtue.

However, something material has changed since we wrote that piece—namely price. Corporate credit spreads widened throughout 2018 and the move in October and November was the largest two month increase since the commodity-related downdraft in early 2016.

Figure 2: US Investment Grade Corporate Spread (in bps)



Source: Bloomberg as of December 31, 2018. Yields and spreads fluctuate over time.

Fixed income assets cheapened throughout 2018 and as a result, investment grade corporate spreads are now above their long-term median levels. Following the sell-off in the fourth quarter, valuations are more attractive than they have been in recent years. While we are cognizant that the correction could continue, we are re-evaluating our corporate allocations and starting to shop. The recent volatility has led to more interesting relative value decisions within the corporate market as we have seen a wider degree of sector and issuer dispersion and new issue premiums. Another area that we have become more favorable on is mortgage-backed securities, which offer higher liquidity and credit quality than corporates and a higher yield than Treasuries.

Toeing the minefield: Where do we go from here?

Despite conflicting indicators, the US economy remains healthy. However the combined impact of higher rates, a strong dollar and the move from QE to quantitative tightening (QT) policies proved to be a toxic combination for risk assets late last year. While markets continue to grapple with questions regarding the global growth outlook, the impact of tighter financial conditions and the end of the easy liquidity regime, we remain steadfast in our focus on valuations. The strategies that have served investors well in the QE era, in our view, are unlikely to succeed as we move further into an era of QT. The final move in the last couple of weeks of the year took valuations into cheap territory so we have spent some liquidity. But given the technical and fundamental headwinds, this was not a significant enough move to increase our risk stance materially…yet. The technical environment remains challenged as the Treasury continues to expand supply of the risk-free asset and non-domestic investors increasingly look away from the US due to the prohibitively high hedging costs. We are especially concerned given the environment where corporate debt is close to a record high as a proportion of GDP and balance sheet leverage remains elevated.

What about rates?

Markets love a topic du jour and the current market focus is related to the yield curve, specifically the inversion that has occurred between the two-year Treasury yield and the five-year Treasury yield. The spread between these two interest rates is currently trading at a negative level, meaning that one could buy a two-year Treasury at a higher yield than a five-year Treasury. This is unusual behavior as one would expect longer maturities to yield more than shorter maturities (e.g., an upward sloping yield curve). Yield curves historically have been a reliable indicator of when the economy has passed its peak growth phase; however, the timing of when an actual downturn occurs is somewhat less illuminating. Although it should not be ignored, a yield curve inversion doesn't necessarily portend an imminent recession. Observing 40 years of history suggests that peak S&P levels occur

22 months after the first curve inversion between the 2-year and the 10-year Treasury, and recession occurs on average 27 months after the first inversion.[1]

Will we go into recession in the future? Absolutely. Is it going to happen soon? Not necessarily.

Part of our view is informed by the fact that very few economic metrics are indicating a recession any time soon. While the leading economic indicators look to have peaked, they remain elevated in any historical context. Job creation remains robust and business sentiment indicators suggest continuing optimism.

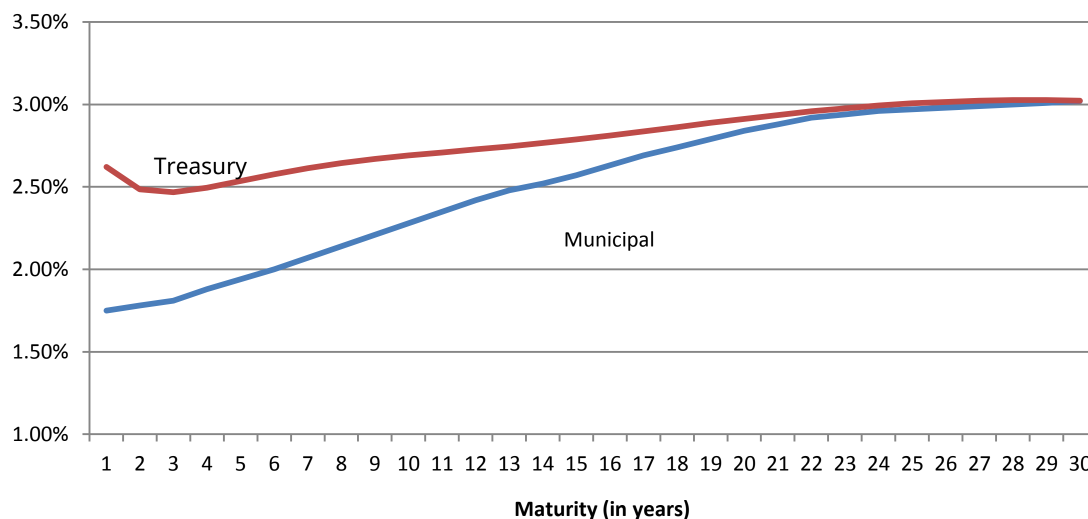
Despite this economic backdrop, rates markets now believe the rate hiking cycle will conclude in the middle of next year at a terminal rate of approximately 2.625% (approximately 1.5 more rate hikes from today). While we expect the Fed will be more data-dependent as the cycle continues, rather than automatically hiking rates 25bps per quarter, we currently believe that data is sufficiently strong to warrant more hikes than the market is currently discounting. This sentiment was echoed recently by Fed Vice Chairman Richard Clarida, who cautioned investors against thinking that the Fed would act to halt a decline in risk assets. This is all to say that while we believe the rate of growth in the US is slowing, this cycle is far from over and moves to price an imminent end of the rate hiking cycle should be faded. It has been amazing how volatile the rate expectations have been recently, from rate hikes to cuts and back to hikes in a couple of weeks. While it gives people plenty to talk about, bear in mind that at this time last year, the market probability of four rate hikes for 2018 was just 8%! And the Fed delivered four rates hikes, so clearly, markets are not always correct.

And Municipals?

The municipal bond market posted another positive year in 2018, making it the fifth consecutive year of positive returns. While it wasn't a smooth ride for investors, tax-exempt municipals proved to be one of the top performing asset classes as most fixed income and equity indices were in negative territory for the year. Municipals were pulled higher by strong US growth and rising Treasury yields. Through year end, the short end of the curve reported strong returns while the longer end was lower, but still positive.

Unfortunately, as ever in the municipal world, things are not quite so simple. Unlike the taxable world where the yield curve has flattened and even inverted at certain maturities, the municipal yield curve remains steep, especially when compared to the Treasury curve.

Figure 3: Yield curve comparison as of December 2018



Source: Bloomberg and MMD, December 31, 2018. Yields fluctuate over time.

[1] Source: Schroders, Bloomberg

We believe that this is the result of retail municipal investors 'hiding' at the short end to escape the volatility in markets. This phenomenon, combined with our proprietary measure called the NIT (Net Implied Tax rate)[2] which captures the changing relationship between tax-exempt bonds relative to both treasuries and high quality corporates, was signaling that municipals were expensive. This led us to start allocating away from short municipal bonds and into high quality short and intermediate duration corporates, as well as also increasing our mortgage-backed holdings in tax-aware accounts.

Conclusion

We continue to monitor markets for the opportunity to materially add risk. There is no doubt in our minds that we will have an entry point. In our view, the potential catalysts for our entry point are plentiful. Will it be an exogenous crisis in Europe or a homegrown event? Whatever causes a dramatic shift in valuations, we have plenty of dry powder ready to deploy across the US fixed-income universe, whether it be Treasuries and taxable, or municipals. Warren Buffet once said that as an investor, it is wise to be "Fearful when others are greedy and greedy when others are fearful". We couldn't agree more, being nimble will be key in 2019.

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[2] The NIT is a relative value comparator, using high-grade long-maturity municipals versus high-grade long-maturity govt/credit spreads.