

## Fixed Income Insights

# The life-changing magic of tidying up your bond portfolio



The wildly popular book and now television show “The Life Changing Magic of Tidying Up” asks us to sort through our possessions, declutter and decide what to keep. “Does this item spark joy?”

In examining the 2019 fixed income landscape, we try to take this approach as well. There are a large number of economic data points to consider and many potentialities for geopolitical and monetary policy noise. But we must strive to sort through the clutter and focus on what can offer our best insight into the upcoming year...and maybe spark a bit of joy.

### Out with the old year, in with the new



We titled our 2018 outlook, “Something’s Gotta Give” in reference to the seeming disconnect in 2017 between the stock market, which returned in excess of 20%, and the bond market where the 10-year Treasury moved a mere 4 basis points. And give it did! The year began with continued exuberance in the equity markets, but this time Treasuries decided to join in, finally reflecting increased expectations of growth and inflation. But this had other consequences, as the increase in rate volatility proved a major factor in the first equity correction of the year. Stock markets responded skittishly as the 10-year Treasury first broke through 3% in February, with the S&P 500® falling more than 10% mid-month. As risk sentiment faded, flight to quality buying drove Treasury yields again lower. This pattern repeated twice more in the year. The next time was in May as the 10-year Treasury rose to 3.1% and finally in October, when Treasury yields nearly touched 3.25%, triggering the second equity correction, which devolved into a brief bear market. For the year 2018, rates rose somewhat (from 2.41% to 2.68%), while equities declined (S&P -4.4%).



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As we entered the year's last period of volatility in the fourth quarter, we found equity and debt markets striking in a historical context. Every year since the Bloomberg Barclays Aggregate Bond Index began in 1976, when stocks had a negative year, bonds had a positive one. 2018 was poised to be the first to break the trend with bonds delivering negative returns for most of the year as rates rose and stocks moved into negative territory in the fourth quarter. However, the sharp move of equities prompted a flight to quality dramatic enough to push the bond benchmark positive — on the last day of the year!

If 2017 was marked by policy anticipation leading to optimism, primarily in the form of excitement about potential tax reform, 2018 was defined by a foreboding sense of the end of the cycle, magnified by pitfalls of a trade war, even as economic data well exceeded averages of the last decade.

### Keep it! Throw it out! Keep it!

With the pronounced and rapid deterioration of risk sentiment in the fourth quarter of 2018, it is easy to forget the market consensus only a few months earlier. With strong GDP growth, unemployment, corporate profits and the first hints of wage growth, the yields on 10-year Treasuries reached their highest levels in half a dozen years. At that time, big name prognosticators were arguing about just how high rates could go and whether they could be stopped at 4% or perhaps 5%. We were told that smart money was increasingly short Treasuries with the largest short interest ever reported. Record deficits were supposed to exacerbate this situation — as issuance would increase. Equity markets were looking rosy, experiencing some volatility, but continuing to bounce after each dip as the market vacillated between fretting and dismissing trade woes. In this context, the market was pricing in three Fed rate hikes for 2019.

At that time, our outlook was more moderate than consensus expectations. However, only a short time later, our views (which were largely unchanged) became non-consensus in being more positive relative to a newly pessimistic background. The rapidity with which this changed is a healthy reminder of why we need to distill an intermediate view and why reacting to daily headlines can lead to erroneous conclusions and perpetual chasing.

### Beginning to declutter — time to throw out U.S. growth?

We think that growth is something the U.S. will hold onto for another year.

With 2018 GDP expected to exceed 3% for the first time in a decade, even a moderating growth figure relative to tax reform peak levels is far from catastrophic. Current consensus estimates for 2019 are in the 2.4% range, which we note is above the average growth from 2010 — 2017 of 2.2%. Similarly, corporate profits are unlikely to repeat the peak 2018 growth of 25%, but with estimates for 2019 in the 8-10% range, the absolute level of profitability is still quite reasonable. The conference board's leading economic indicators (LEI) measure is near its highest levels, suggesting if accurate, that growth remains on the horizon. A review of past LEI levels suggests significant deterioration is needed before this metric would predict a recession.

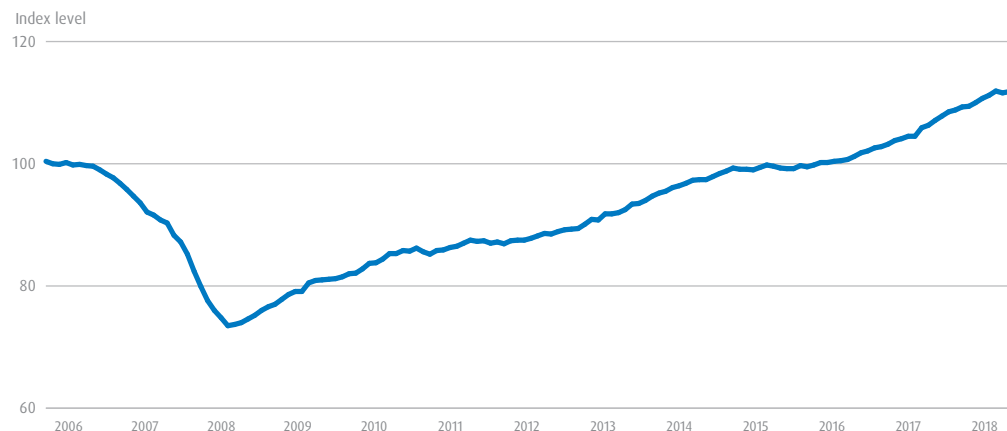
While we can think about this in a broader context, market concerns suggest every data point will be followed closely. The December ISM release illustrated this, where a decline from 59 to 54 caused a market stir, though that level of ISM is generally associated with a robust expansion of growth. January's figure highlighted that there is not yet a one-way trend as ISM rose again to 57. The recent prolonged government shutdown may create additional noise in the accuracy and timeliness of economic data, potentially magnifying the difficulty in distinguishing between one-off data points and emerging patterns.

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In sum, while there are sufficient arguments to suggest a slower growth rate than 2018, we do not foresee growth slowing to the point of recession in 2019. This continuation of a positive economic landscape supports constructive rather than defensive portfolio positioning relative to the market, which seems fixated on what can go wrong, rather than on what is right.

### Leading economic indicators



Source: The Conference Board

### Monetary policy—the Fed is still tidying up from 2008, but policy remains supportive

If we envisioned a 10-year-old economic recovery, with below-trend unemployment, above-trend growth and inflation in line to slightly below target, what should the stance of monetary policy be?

In such a case, inflation is not a problem and thus does not require the Fed to actively constrain monetary policy to battle inflation. But nor would such an economy require monetary policy stimulus. The net result would be a prescription for roughly neutral policy—one neither seeking to constrain inflation, nor promote growth.

Today we find ourselves in an environment where, despite the continued withdrawal of stimulus in the form of four rate hikes in 2018 and the continued wind-down of the Fed balance sheet, overall policy remains accommodative. The balance sheet remains elevated in both size and profile as the holdings continue to include agency mortgage-backed securities and longer-maturity Treasuries. These holdings were not part of the equation prior to the crisis. Recently the Fed has intimated a larger terminal balance for the balance sheet, but that terminal point is still below current levels. We know this since the Fed is permitting the balance sheet run-off to continue.

The Fed Funds rate is closer to neutral than the balance sheets in our view. “Neutral” is a somewhat tricky target as it is only known fully in retrospect. However, in our view, the targeted rate remains slightly below what will be viewed in retrospect as the neutral rate. We therefore see the potential for an additional one to two rate hikes in the current cycle if data remains supportive, acknowledging that a government shutdown, and again-patient fed, may extend the timeline.

If our view is correct, monetary policy will continue to be a net support to the economy in 2019 albeit a less dramatic factor than years passed. Any concerns of the Fed over tightening should be kept in the context of a central bank on the accommodative side of neutral in a landscape that generally speaking should call for neutral policy. At the same time, being closer to neutral and the lack of inflationary pressures allows the Fed to continue carefully calibrating each next step as opposed to acting out of need.

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## The gems you find when you clean up

Monetary policy tightening, if not yet tight in our view, has been held up as a possible cause for the next recession. In the recent American Economic Association's annual meeting, which featured a conversation with current Fed Chairman Powell and his two predecessors Chair Yellen and Chairman Bernanke, this question was addressed. Chair Yellen reiterated her belief that "I don't think that expansions just die of old age. Two things usually end them. One is financial imbalances and the other is the Fed." In discussing the role of the Fed, she highlighted that monetary tightening that ended expansions was typically in response to increasing inflation—a variable noticeably absent in today's environment.

The other variable that has been inextricably linked to recent recessions, in addition to the Fed going too far in tightening policy, is a spike in oil prices. A paper presented to the Fed in 2014 "The Role of Oil Price Shocks in Causing U.S. Recessions," noted that "It has proved difficult historically to separate the role of these two explanations of the business cycle because most recessions are preceded both by higher oil prices and by a tightening of monetary policy and/or of credit markets. One would have expected that over time a recession would have occurred that is unambiguously associated with one explanation only, resolving this identification problem. This has not been the case." Though somewhat forgotten amidst the turmoil of the global financial crisis, that period too, was preceded by a spike in oil prices to \$140/barrel.

While it is difficult to say that a recession could not occur without a rapid increase in oil prices, it is fair to say that in the U.S. it has not. Interestingly, while concerns persist of the Fed going too far too fast, at the current juncture oil is still meaningfully below recent peaks. If a recession were to occur now it would defy this pattern and offer the Fed researchers the case study they are seeking. While not dispositive, this history supports our expectation of more length to the current cycle.

## Corporate debt—are companies hoarding?

Much has been made of the increasing levels of debt since the 2008 crisis. But has this been a healthy re-leveraging after a shock deleveraging or a dangerous repeat of the catalyst for the past downturn? We addressed the health of the consumer in "[What if the Joneses are fiscally responsible neighbors](#)"; (spoiler alert: the consumer is healthy). But how is the corporate sector?

Proving Sun-Tzu's axiom that generals always fight the last war, recent headlines have focused on leverage in the corporate sector as a source of trouble, for example:

- "The Big, Dangerous Bubble in Corporate Debt"—New York Times, August 9, 2018
- "The U.S. is Experiencing a Dangerous Corporate Debt Bubble"—Forbes, August 29, 2018
- "\$9 trillion corporate debt bomb is 'bubbling' in the U.S. economy"—CNBC, November 21, 2018

By nominal measures such as outright debt levels or even adjusted measures such as corporate debt to GDP, corporate debt figures are high in a historical context. However, debt service ratios, which account for the low cost of debt, show corporate debt almost exactly in line with historical debt levels.

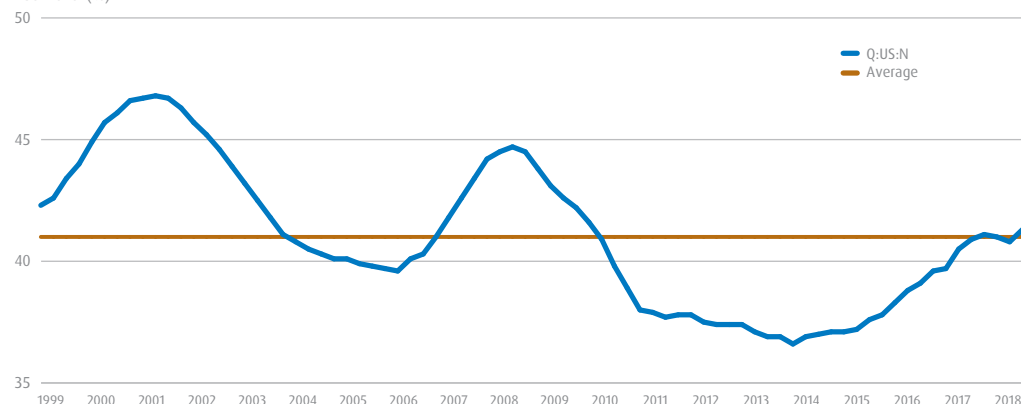
Increasing nominal debt in a period of low interest rates to the point where debt service matches that of prior periods seems like a textbook response to a low rate environment.

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### Debt service ratios of non-financial corporations

Index level (%)



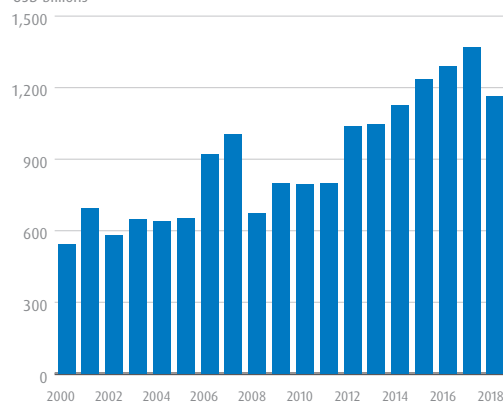
Source: BIS Statistics

Reducing borrowings as interest rates rose this year is in line with this rational behavior. For 2018, investment grade borrowings declined 15% and high yield by 39%. While this response to rising rates is rational, the level to which costs of borrowing have risen are yet to be prohibitive (on a market wide basis) for those requiring funding or refinancing of maturing debt. Further, for 2019, projections of debt issuance are lower than 2018, which suggests the rational behavior continues and corporations are not hoarding debt. Indeed, recent large issuances such as the Anheuser-Busch InBev deal were targeted at increasing financial flexibility and lowered as opposed to raising leverage levels.

As with the health of the consumer and the securitized sector—the reasonable underlying fundamentals are both positive indicators for the economy writ large and supportive of continued investment in the sector. The technical aspect of lower issuance of corporate debt is further supportive absent a meaningful change in demand. Based on the higher level of spreads from the fourth quarter, the breakeven for credit relative to treasuries has increased, providing some cushion in the event of further volatility.

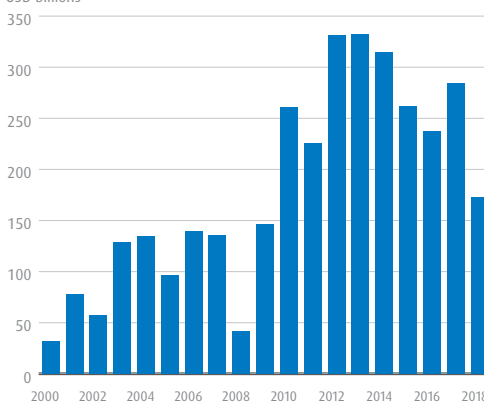
### IG issuance by year

USD billions



### HY issuance by year

USD billions



Source: SIFMA

The largest debt issuer in the U.S., the federal government, has not shown nearly the restraint of the more market-driven participants. However, as the premier risk-off asset in the world (see Q4 2018) we do not anticipate the debt levels becoming a market issue in 2019 or the near future.



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Nonetheless, the levels of debt and the cost to service continue to grow and need to be monitored. This is true internationally as well as global sovereign debt broaches 80% of global GDP—a more highly levered world is a more volatile world.

### Conclusion: The current economic state sparks joy, but could use some tidying

To date, signals of a slowing economy at home are consistent with an economy coming off of a stimulus high, but continuing to grow. However, while in our view, signs point to continued health, we would be remiss in not acknowledging that if slowing momentum were to continue it could result in recessionary conditions, though not in our view in 2019. While we cannot know what surprises this year will bring, we believe that the underpinnings of the U.S. economy remain healthy enough to manage bumps in the road.

While we are broadly optimistic, though more moderately so than in the past, we also have some concerns. It is our view that the American consumer is in a strong condition and the corporate sector, while not as strong, is still in a reasonable condition. This reasonable level of consumer and corporate leverage reduces the risk of forced action from these sectors that has helped turn past slowdowns into full-blown recessions.

However, the evaporation of liquidity in December illustrated just how quickly markets can fall when demand fades. Were persistent negative data to emerge at the same time or leveraged asset owners be forced to liquidate, such a period could have become the next crisis. Trying to predict this in advance however is no easy feat and most negative catalysts are obvious only in retrospect.

While the Fed has taken a prudently cautious stance on monetary policy, the same cannot be said with regards to U.S. fiscal policy. The recent government shutdown, continuing trade tensions and what appears to be the start of the 2020 presidential campaign nearly two years in advance suggest there will be plenty of political noise in the coming year. The Chinese and European economies are showing varying signs of weakness as well as geopolitical tensions that could impact the U.S. economy and markets.

In sum, while U.S. fiscal policy and geopolitics need tidying, the fundamental strength of the consumer and corporate sectors and the cautious prudence of the Fed paired with the yields offered from fixed income should spark joy in 2019.



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## 2019 Outlook summary

### Duration/government securities

- Maintain duration below benchmark at current rates, expecting a moderate increase in rates
- Underweight government securities relative to non-government securities. Deficits suggest increased issuance of Treasuries, while global events and monetary policy divergence continue to limit the rise in rates; similarly, market reactions to increasing rates in 2018 suggest rates may limit their own rise beyond the level of market comfort

### Sectors/quality

- Overweight corporate securities, but monitor for economic and sector data as year progresses; spread widening in non-governmental sectors against a fundamentally sound backdrop increased attractiveness of the sector; lower issuance of credit should provide technical support
- Volatility-driven dislocations have created opportunities in secondary markets, particularly in lower-quality investment grade; structural dislocations across the front end, such as the fixed vs. float relationship may continue to offer opportunities as markets react rapidly to changing expectations of fed policy





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