To Xi or not to Xi?

With all due credit to Shakespeare, there is no doubt that the very fluid state of the United States’ trading policies and practices with China and other major partners drove both asset price movement and market sentiment in the second quarter, and it is continuing to do so as we head into the year’s third quarter. At times, this evolving, change-on-a-dime dynamic has been unsettling for the markets. It would be less troublesome, however, if it were, indeed, THE question. Unfortunately, many other questions from around the globe will also need to be answered in the coming months, such as: Hard, soft, or no Brexit? Who will be the new British Prime Minister? How will Italy’s elections affect the euro and the country’s relationship with much of Europe, especially given Italy’s economic woes and staggering debt load? How much political uncertainty will the unfolding 2020 US Presidential election cycle create? Can the President and the Chinese Premier ultimately hammer out a trade compromise? And, perhaps most importantly for the bond markets, will we see further global monetary policy accommodations??

What makes this an interesting, albeit unusually difficult time for those of us who try to forecast rates, spreads, and other determinants of bond market performance, is the one common thread these questions share: while their emerging answers may shape fundamentals, they are not, at their core, fundamental economic issues. Rather, they are mainly political or geopolitical issues that are dependent on the statements, decisions, and actions of people and groups. Further, some of these decision makers tend to be fickle and/or impulsive, which leads to an added amount of market volatility in all different directions, especially given the speed with which news travels today.

Some of these answers may be easier to come by. Until the past few days, we would have included the naming of a new European Central Bank (ECB) President in the above list. Last week, however, Christine Lagarde of France was named to succeed Mario Draghi. While she has no prior experience running a Central Bank, her statements while serving as head of the International Monetary Fund suggest that she will be comfortable continuing or even extending Draghi’s accommodative policies. In this particular case, we can understand the Europeans’ ongoing
desire for efforts to spur growth and inflation in any way possible, as the economic backdrop there is clearly not good. Our fear, as has been seen in Japan for nearly three decades, is that there is little the ECB can do that will move the economic needle in any significant way. What it can do, however, is to still at least promote asset price inflation. Score one for the more punch in the punch bowl crowd.

As mentioned above, however, the most pressing question to us is the course of domestic monetary policy over the rest of this year. Clearly, as of this writing, the markets are both insisting on and anticipating a cut in the Fed Funds target to be made at the Federal Open Market Committee’s upcoming, July 30-31 meeting. Certainly, as we have believed would be the case for some time, the inflation picture gives the Fed not just cover but almost a need to cut rates, as price increases continue to run below target. The rest of the US data paints a much more complicated picture. While second quarter growth is appearing to clearly lag the first quarter’s solid 3.1% rate, it should still comfortably be in the 2% range. Employment remains strong, and most other metrics paint a picture of a US economy that is still healthy, even if it has slowed at the margin. That said, the markets are pricing in not only a 100% chance of a 25 basis point cut but a one-in-five chance of a 50 basis point move, which we think is overly aggressive. Such a move would undoubtedly warm the hearts of risk traders, however, we think this would limit the Fed’s flexibility should we actually get into a recessionary environment. Therefore, we think 50 basis points is neither in the cards nor is necessary. We believe instead that rates will be relatively range bound this quarter, the curve may actually resume some modest flattening as the Fed takes a measured approach, and that risk, in the form of spreads, will remain well bid if not occasionally volatile. This phenomenon of lower yields and lower spreads at the same time, a relatively unusual occurrence, will probably continue as both the global economy and global monetary policy hit tipping points.

Tax Exempt Market

The municipal market saw strong returns in the second quarter as the market wrapped up its eighth consecutive month of positive performance in June. Lower US Treasury (UST) yields and strong supply versus demand technicals were supportive of municipal bond prices during the quarter, although munis did underperform Treasuries, especially in shorter maturities. The Bloomberg Barclays Municipal Bond Index posted a total return of +2.14% for the quarter and is up an impressive 5.09% year-to-date (YTD).

Supply and Demand

New issuance totaled $88.7 billion during the quarter, bringing YTD issuance to $167 billion, according to data compiled by The Bond Buyer. Although this YTD figure is right on top of the $166 billion seen at the same point last year, one could argue that last year is not a great comparison due to the unusually low supply we saw during the first quarter of 2018. When compared to the five-year average recorded between 2012 and 2017, YTD 2019 supply is down more than 15%. In fact, the overall municipal market has actually been shrinking over time per Federal Reserve data, which shows outstanding municipal debt hitting a high mark of $3.96 trillion in Q4 2010, before declining to $3.82 trillion today. This is pretty remarkable considering the growth of debt in other areas of the economy, and particularly so when viewed against the backdrop of infrastructure needs at the state and local levels.

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Demand was strong during the quarter as inflows into municipal mutual funds continued unabated. Lipper reported 25 consecutive weeks of net inflows as of 6/26/19. What is even more impressive is that 15 of those weeks saw inflows in excess of $1 billion. Overall, muni funds experienced almost $15 billion in net inflows in 2019.

**Muni-to-Treasury Ratios**

Although munis benefitted from a strong technical environment during the quarter, they underperformed the significant rally in Treasuries which led to wider muni-to-Treasury ratios. Typically when Treasuries rally quickly and absolute yields reach low levels, munis tend to lag the price move higher. This quarter was no exception. While the 10-year Treasury saw yields decline by 40 basis points (bps), yields in 10-year munis fell by just 23 bps. This resulted in the 10-year muni-to-Treasury ratio rising from 77% at the end of the first quarter to 81% at the end of the second quarter. The widening is even more pronounced when you consider that the 10-year muni-to-Treasury ratio had fallen to 71% on May 20th, an all-time low since Bloomberg began keeping track in 2001. Prior to that, munis had benefited from a shortage of bonds, and investors were anxiously preparing for a wave of upcoming redemptions. Once Treasury yields began falling in late May and muni supply picked up in the first half of June, we saw ratios widen out. Going forward, it will be interesting to see if low absolute rates keep ratios near their current levels or if the upcoming supply and demand imbalance will be enough to push them back toward the lows we saw last month. Muni-to-Treasury ratios in 5-year maturities ended the quarter at 74% while ratios in 30-year bonds were 91%.

**Curve Slope**

The muni curve flattened slightly during the quarter as yields in longer maturities fell by more than those in shorter maturities. The slope between 2-year and 30-year AAA tax exempt yields dropped to +106 basis points at the end of June from +111 at the end of March. The spread between 2-year and 30-year bonds still remained wider than the Treasury curve’s +77 basis points, indicating value for longer tax exempt bonds.

**Credit Trends**

At the risk of repeating ourselves: lower-rated bonds outperformed higher-rated bonds during the quarter. Demand remained strong for bonds rated ‘A’ and lower, and credit spreads continued to tighten on pretty much anything that offered additional yield. The AAA Muni Index, which posted a return of +1.83% during the quarter, lagged the performance of the A and BBB Muni Indices by 0.48% and 1.11%, respectively. The High Yield Municipal Index returned 2.73% for the quarter, which was impressive but ‘BBB’ rated bonds were the clear bright spot, returning 2.94% for the second quarter. States with pension funding concerns, such as Illinois and New Jersey, were strong performers in this risk-on environment.

Aggregate credit quality conditions appear to be healthy and, outside of a few areas of weakness, we still believe that overall credit quality is stable. The robust growth in state and local tax revenue has been a significant stabilizing component for municipalities. In fact, total state tax collection is now 13.8% higher than the pre-recession peak which occurred in 3Q 2008. The increased revenue collections, modest spending, and continued rebuilding of reserves have positioned most states very well to withstand the next downturn.

For the most part, credit ratings trends are reflecting the stabilization, as well. According to S&P, finances accounted for 118 upgrades versus 61 downgrades during the first quarter. Although finance-related rating changes have been positive overall, we still view ratings changes related to criteria changes as somewhat of a moving target, but also

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**Muni-to-Treasury Ratios**

12/31/2018 - 6/30/2019; Source: Bloomberg
expect the overall impact to be muted in terms of the universe of names we follow. Recently, Moody’s downgraded a number of credits in response to the First Circuit ruling regarding the treatment of revenue bonds in Puerto Rico’s bankruptcy. You can read more about our opinions regarding this ruling in the attached paper, *Not Your Father’s Revenue Bonds*. Needless to say, this is a story we continue to monitor closely, although we ultimately believe the long-term impact on credit quality will be limited.

**Looking Forward**

With supply and demand technicals expected to stay strong over the next few months, we think that munis should perform well. We believe muni-to-Treasury ratios will remain close to current levels, although they could fall somewhat lower based on upcoming supply and demand imbalances. That said, the Treasury market will likely continue to dictate the overall direction of yields and if low absolute yields persist, we would not be surprised to see ratios hold at levels that are more elevated than where they would be in a higher rate environment with similar supply and demand dynamics. For investors that have engaged in a shorter duration bias, it will be important to monitor the trend in short yields and assess what that means for reinvestment risk. Credit trends appear to be supportive of current valuations in the market, and taxable equivalent yields on ‘A’ and ‘BBB’ rated bonds should continue to draw investors who are looking to enhance their portfolio yields.

**Taxable Market**

At the end of 1Q 2019 we, like many investors, were concerned about the possibility of increased volatility due to a myriad of global issues. Many of those concerns came to fruition in the form of increased tariffs, tensions in Iran, and concerns over a slowing global economy to name a few. While these factors would typically prompt credit spreads to widen—causing risk products to underperform—the Bloomberg Barclays US Corporate Index actually finished the second quarter tighter, reflecting the outperformance of credit relative to US Treasuries. May, in fact, was the only month in 2019 in which the corporate index finished the month wider than it started. The trade war had a greater effect on some sectors—notably technology and semiconductors—than others.

Merger and acquisition activity also was relatively slow, which can be attributed to uncertainty regarding the economy and government policy. A few notable transactions were announced in the second quarter, including AbbVie’s acquisition of Allergan, and Occidental’s purchase of Anadarko Petroleum. This puts potentially large deals in the pipeline as we move forward. Bristol Meyers also came to market with the largest bond deal so far this year to fund its acquisition of Celgene.

From a credit-quality perspective, companies and investors are mindful of the fact that the economy is in a prolonged expansion, and they are cognizant of the consequences that excess leverage can cause should the economy turn. Many of the decisions that have been made recently are reflective of this reality. Moving forward, we expect the accommodative nature of central banks to be supportive of spreads, but given the uncertainties surrounding global trade and the reality that economic and political threats still exist, investors should be prepared for increased volatility and downward price movement.

Taxable municipals again outperformed US Treasuries during the quarter, which is impressive given the decline in Treasury yields. After corporate spreads widened in May, taxable municipals did not look as attractive on a relative basis as they had earlier in the quarter. As a result, investors favored corporates during June, while taxable municipals slightly underperformed US Treasuries. Conversely, corporate spreads tightened in June, causing the relative value between the two sectors to revert back to a more historical level of spreads in certain parts of the curve. In our opinion, maturities eight years and longer offer the most attractive value in taxable municipals. In five-year maturities, however, taxable municipals looked expensive at the end of the quarter because unlike their corporate counterparts, taxable municipal spreads have not adjusted to the flatness of the Treasury curve.

Supply and demand dynamics remain supportive of spreads and from a credit perspective, taxable municipals appear to be in good shape, staying somewhat isolated from the events around the globe. From a value perspective, new issue ‘A’ rated credits have been the most attractive—when they are available—compared to ‘AA’ rated credits, as well as most ‘A’ rated secondary pieces.

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The overall municipal market has actually been shrinking over time per Federal Reserve data. This is pretty remarkable considering the growth of debt in other areas of the economy, and particularly so when viewed against the backdrop of infrastructure needs at the state and local levels.
The mortgage-backed securities (MBS) market underperformed due to its negative convexity during the second quarter. Convexity reflects the adjustment in a bond’s duration when interest rates change, and a bond with negative convexity loses value when interest rates fall. The duration of the MBS index shortened from 4.31 to 3.13 during the course of the quarter, which is considered to be a fairly dramatic move. The sector weighed on performance in strategies that held MBSs, as well as the Barclays Aggregate Index, which is comprised of approximately 30% MBS. This performance is typical when there is a rally in the Treasury market like we saw during the second quarter.

Another development in the MBS market was the introduction of the Uniform Mortgage Backed Security (UMBS) program, which was rolled out in June. UMBSs combine the issuance of FNMA and FHLMC under one program.

As we move forward, we think that much of the upside potential in the taxable markets is tied directly to the results of the trade war and how much support the markets will get from central banks. These are slippery slopes to maneuver when it comes to making investment decisions, and we recommend that investors stay disciplined and focus on high quality assets. It is important to not reach for yield in the low yielding environment that we currently find ourselves in. With all the potential news stories to come during the rest of 2019 and into 2020, we believe there will be a better time to increase risk in portfolios.

**Bloomberg Barclays US MBS Index Option Adjusted Duration**

![Bloomberg Barclays US MBS Index Option Adjusted Duration](chart)

4/1/2019 - 7/1/2019; Source: Bloomberg