WASMER SCHROEDER

Strategy Road Maps: 1st Half of 2020

December 31, 2019

Economic Commentary

- The global economy, taken as a whole, continues to grow slowly. The good news is that many of the countries whose activity caused global GDP growth to slow markedly in 2019 – mainly several European nations and, to a lesser extent, China—seem to have bottomed and, at a minimum, should be flat year-over-year in the coming months. One major caveat is the ultimate scope and severity of the current virus outbreak centered in one of China's largest cities which could alter the global growth landscape if not contained effectively.
- Of note, the US economy continues to be one of the strongest in the developed world. Bolstered by continuing strong consumer confidence and spending (owing to low unemployment, rising wages, and a very strong equity market), but tempered by continuing sluggish business investment (owing to political and geopolitical uncertainties), domestic GDP growth should be solid once again over the next couple of quarters.
- Central bankers around the world continue to support economic growth through aggressively accommodative monetary policies. We expect little in the way of policy change during the first half of this year, and communication from each of the main Banks should remain quite dovish, as strongly accelerating growth seems a remote possibility, and inflation in most jurisdictions remains below announced targets.
- Against this fundamental backdrop, we don't expect much movement in either global interest rates or Treasury rates in the US. Our base case scenario for Treasuries is for steady rates in shorter maturities, slightly higher rates in longer tenors, and, as such, a slightly steeper curve. Ultimately, we think rates are quite 'comfortable' at current levels, and think rangebound is a good way to view the market.
- Agility is always important to bond investors, but perhaps never more so than today. News flows ever more quickly, and market moving, volatility inducing headlines seem to occur ever more frequently. While we don't believe these headlines viewed over slightly longer timeframes will trump the fundamentals discussed above, every investor needs to be able to adjust their base case scenario, and reposition as necessary, if certain events turn out to be more than transitory.

Tax Exempt Municipal Market/Strategies

- As we enter 2020, our thematic bright lines for municipal bond investors continue to be strong supply/demand tailwinds, stable credit quality conditions and relative value opportunities in longer dated maturities. We discuss each of these inputs in the paragraphs below.
- A critical variable for the municipal market this year will be investor demand. The market spent much of 2018 fretting about the impact that lower corporate tax rates would have on demand from banks and insurance companies. Those concerns washed away quickly, however, as 2019 was a record year for municipal fund flows and that trend has continued into 2020. Aging demographics, shifting risk tolerance profiles and painful caps on state and local tax (SALT) deductions are not short-term inputs, so our baseline expectation is that retail participation in the municipal market will remain at elevated levels.
- A key ballast to the muni market's demand profile will be new issuance volume. While the 4th quarter of 2019 was a record for municipal issuance, almost 30% of the supply came as taxable. This shift was driven by a dramatic drop in short-term interest rates which provided municipal bond issuers the opportunity to advance refund their existing

tax-exempt debt into taxable structures. This trend in taxable issuance has continued into the 1st quarter of 2020, however, if we were to see Treasury yields revert back to their levels in early/mid-2019, the volume of taxable issuance would likely slow due to the mechanics of advanced refundings. Yet, given our outlook for US Treasury yields to remain range bound, we would expect that additional taxable muni issuance will further limit the supply of tax-exempt bonds in 2020 and perhaps even 2021.

- Credit quality conditions in the municipal market remain stable as economic trends across the country have been supportive of sales and personal income tax receipts. State and local government general fund balances are well positioned at this stage of the economic expansion, and fiscal 3rd quarter tax revenues have come in approximately 7% higher than the prior year. The housing and labor markets continue to show surprising resilience which bodes well for credit quality as we look out over the next 12-24 months. Credit spreads have compressed, however, meaning investors are getting paid less for moving down in credit quality. These low rate, tight spread environments suggest that investors should be diligent in their underwriting standards, however pockets of value still exist for credit savvy investors.
- Finally, the influx of new assets into the municipal market has placed a significant strain on the short end of the yield curve, compounded by the loss of new pre-refunded bonds to help soak up the additional demand. This has resulted in a recent bull steepening in munis, with the yields on maturities inside of 5 years compressing significantly. The long-end of the yield curve has been relatively stable, however, which we think offers value for investors that are seeking to enhance income within portfolios that have longer dedicated time horizons.

Taxable Market/Strategies

- The resilience of the economic expansion, bolstered by the corporate tax cuts and reduced regulation, has extended the cycle of corporate credit. While we may be late in the cycle, corporate spreads seem fair given the current risks in the economy, despite their historically tight levels against US Treasuries.
- While overall corporate credit is solid, there are pockets of weakness in M&A related names that bear watching. As always, corporate credit surveillance is key to anticipating adverse credit performance, as ratings generally lag reality. We maintain a slight overweight to the sector with higher-than-benchmark quality. Demand will remain strong and supply will fall.
- 2019 taxable municipal issuance hit the highest level since the Build America program ended in 2010. This supply added depth and liquidity to the market and brought in a number of non-traditional players. We view this as a long term positive for this sector.
- Supply in the taxable municipal market is set to be high again this year at +/-100 billion. So far, new deals have been priced relatively aggressively, but still offer value against many corporate credit alternatives without the inherent event risks. We maintain our full allocation to the sector and expect demand to rise.
- The agency mortgage-backed market continues to provide us value in high coupon, burned out cohorts. However, given the low volatility backdrop, current coupons look moderately attractive, especially compared with agency debentures. We like the space in the near term with specific pool characteristics and have added exposure to this area.
- ESG concerns continue to move through the markets. This is a secular trend and one that needs to be monitored at the issuer level across multiple markets. There is no question that entities that fall short of expectations will take a valuation hit at some level and we are looking to avoid these names over longer time horizons