Eagle Insight

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Fixed Income

Second Quarter | 2019

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Separately Managed Accounts (SMA):

Taxable:
High Quality Taxable
Core Fixed Income
Managed Income Solutions

Tax-free:
High Quality Tax-Free
Special Fixed Income
Managed Income Solutions

Market Overview[1,2]

The domestic bond market, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, gained 3.08% in the second quarter for a total return of 6.11% year-to-date. The second quarter was marked by the continued drop in yields as demand grew for U.S. government bonds amid weak global economic and inflation data, escalating geopolitical tensions, and the rising probability the U.S. Federal Reserve (Fed) will cut interest rates in coming months.

Economic data, especially manufacturing reports, both in the United States and abroad have rolled over just when it seemed like the bottom of the global economic slowdown was at hand. Meanwhile, inflation expectations hit a multi-year low as the 10-year breakeven inflation rate sank by 0.17 percentage points during the quarter to 1.7%. Moderate and slowing growth along with little fear of rising inflation drove the yield on the benchmark 10-year U.S. Treasury note to its lowest level since the 2016 U.S. presidential election at 2.01%, compared to 2.41% at the end of March. Although interest rates fell broadly, the steeper decline on the longer end caused the yield curve, as measured by the 3-month U.S. Treasury bill and the 10-year note, to invert to -0.09% at quarter-end.

With the "bad news is good news" reaction function in full effect, investors remained constructive on risk assets, and corporate bonds were the best-performing sector for the second consecutive quarter on both a total return and excess return basis (over duration-matched Treasuries). Government-related securities also posted positive returns and outperformed Treasuries while structured products were the worst-performing sector, ending up 2.04% but adding no value relative to Treasuries.

Fed Update and Outlook[1]

The Fed has moved in a decidedly more dovish direction at each meeting this year. The post-meeting statement, new forecasts and dot plot, plus Chairman Jerome Powell's press conference, all imply that the probability of a future rate cut (or cuts) is getting higher, even though Fed officials voted to keep the federal funds target range unchanged at the June 18-19 Federal Open Market Committee (FOMC) meeting. The Fed appears to have set itself a high hurdle for not cutting rates at the next meeting by focusing on both the "more sustained shortfall of inflation" as well as concerns over economic growth due to the uncertainties of trade disputes. This stance means Fed officials are likely to cut the federal funds rate due to soft inflation even if there is a positive and definitive resolution to the U.S.-China trade negotiations and vice-versa. Market odds of the Fed cutting rates at least once in 2019 have generally been above 50% since late March, and above 80% since late May. The Fed's latest messaging is simply a drift toward what traders have been pricing in for some time.

Our cautious stance has benefited us regarding the move in rates. However, it's hard not to acknowledge the strong rally in risk assets this year despite weakening economic conditions. Maybe risk markets have priced in all the negative economic and earnings growth numbers and are now discounting brighter skies ahead. The problem with that, however, is that economic data have generally continued to trend in the wrong direction and consistently disappointed consensus while earnings estimates for the second quarter have been steadily cut all the way until companies have started reporting them. Labor market strength is a bright spot with wages still improving; however, decelerating capital expenditure plans at the company level due to trade uncertainty may hurt recent productivity gains, putting further pressure on company profit margins as wages continue to trend higher. It appears at least part of the rally hinges on the promise of supportive monetary policies, and the promise of supportive monetary policies hinges on sluggish-to-poor economic data.

Trying to game the "bad news is good news" market can be dangerous since it's hard to determine how bad the news must get before it becomes actual bad news again. We prefer looking at the fundamentals of the economy and the market as they are (i.e., slowing, accelerating, trending sideways, etc.). Nothing in our process suggests we should change our near-term outlook from cautious. Slowing economic growth (both domestically and abroad), decelerating corporate sales and profits, and no signs of inflation anchor this view. None of this information suggests we are destined for a recession, but we believe that risks are elevated. Investors should be mindful about their positioning and discriminatory toward their investment holdings. We remain positioned with limited or select exposure to more cyclical industries and still favorable on parts of the economy such as housing and real estate or healthcare.

Corporate Market Review[1,2]

Investment-grade corporate bonds, as measured by the Bloomberg Barclays U.S. Corporate Bond Index, gained 4.48% in the second quarter and are up 9.85% for the year. The majority of the gain in corporate bonds was due to falling interest rates as corporate credit spreads were only slightly tighter during the period, ending at 1.15% compared to 1.19% at the end of March. Spreads trending flat-to-down is still impressive, considering the reasons that yields on government debt around the world are much lower. Usually corporate credit spreads widen when Treasuries and other relatively safe assets rally. Investors appear to be optimistic about the ability of central banks to orchestrate a reacceleration of economic growth – or at least a decisive bottom – through coordinated easing.

Municipal Market Review[1,2]

The second quarter of 2019 was positive for municipal investors as municipal bonds continued their rally, albeit at a slower pace. The Bloomberg Barclays Municipal Bond Index rose 0.37% for the month of June, resulting in 2.14% gain at quarter-end. Municipals year-to-date are up 5.09%. The AAA general obligation curve experienced a bull flattener over the quarter, with intermediate and long maturities outperforming short maturities. Over the quarter, the 1-year and 5-year Barclay's Municipal indices gained 0.76% and 1.66% respectively, while the 22+ year index was up 2.89%. The first half of the year was characterized by constrained supply, healthy and steady demand including record pace of inflow to tax-free mutual funds. All these factors contributed to strong municipal performance.

Municipal bond supply remains constrained, down 11% quarter-over-quarter from the first quarter of 2018 to the first quarter of 2019 (1Q19). However, year-to-date new issue supply is up 0.8%: $166.8 billion as of June 28. Investors are putting cash to work in municipal mutual funds at a record pace this year, with inflows of $21.3 billion in the second quarter, bringing total inflows to $43.7 billion this year. As a result, many of the larger investment-grade new issue deals this quarter were oversubscribed and often re-priced with lower yields and higher prices. Separately Managed Accounts (SMAs) continue to gain popularity. In a study done by Bank of America Merrill Lynch, SMA accounts averaged 2.2 percent quarter-over-quarter growth from the first quarter of 2017 (1Q17) to 1Q19 – a period where total municipal holdings' growth was mainly negative. The asset class grew from 33% in 1Q17 to 40% in 1Q19 as a total share of individual municipal holdings.

While municipal bonds remain expensive across the curve compared to historical levels, the front of the curve cheapened while 10-years and out became richer. The 10-year Municipal to Treasury ratio is currently 77%, down one percentage point from the end of March. While still relatively expensive, we are actively monitoring both the primary and secondary markets for value adding bonds on the longer end of curve (15+ year) where the Municipal to Treasury ratio is in the low 90s. Our barbell strategy – buying bonds on the longer end of the curve, and rebalancing them with shorter maturity bonds to maintain our target duration and quality characteristics of our portfolio – remains accretive to performance. Our credit research team is actively monitoring the credit fundamentals of our holdings and recommending credit names to sell in an effort to take advantage of these higher prices. We expect cash levels to remain low.

Headlines this quarter going into the summer months were relatively quiet. In April, President Trump and Democratic congressional leaders agreed to a $2 trillion infrastructure plan that would include funds to repair roads and bridges, along with water projects, broadband, and power grid. As of quarter end, there is still no indication of how this plan will be funded. In the later part of the quarter, the hot headline was how the state of Illinois finally passed a budget plan prior to the new fiscal year. This $1 billion plan is earmarked primarily for education and would be funded in part through sales taxes from more online sellers, a new tax on insurance companies, and a measure decoupling the state income tax from a federal tax break for companies that return foreign profits to the United States. Along with a budget, the Illinois House passed a bill that will allow voters on the November 2020 ballot to decide if they want to eliminate the state's flat tax rate. If approved, this would be replaced with a graduated income tax structure that will impose increasingly higher tax rates on higher-earning individuals or businesses, a positive for the state's credit quality. Lastly, the governor of Illinois signed H.B. 1438 into law, which legalizes adult-use recreational marijuana. A portion of this additional revenue stream will go toward the state's general fund, and paying down the state's unpaid bill backlog. States in general, like Illinois, continue to evaluate and make adjustments to their budgets and pension plans as well as create other revenue streams resulting in improving credit fundamentals.

Credit fundamentals remain strong among the municipal investment grade universe, with extremely low default rates. We remain overweight revenue bonds and underweight state and local general obligations bonds. Recently, we have begun adding to the state and local government sector as we have seen proactive measures towards funding pension liabilities and addressing overly optimistic benefit assumptions. We are currently overweight the leasing sector, which has been the best performing revenue sector over the last 12 months. We are also overweight the transportation and special tax sectors.

[1] References to specific securities are intended to illustrate the types of securities Eagle may hold in this portfolio. They are not intended as representations of specific investment recommendations that would have been profitable to an investor. Past performance is not a guarantee of future results. Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice as are statements of financial-market trends, which are based on current market conditions. Investing involves risk, including the possible loss of principal.

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[2] Sources: Investor Tools Perform and Yield Book

Investing in bonds involves risks that may adversely affect the value of your investment such as inflation risk, credit risk, call risk, interest rate risk and liquidity risk, among others. The two most prominent factors are interest rate movements and the credit worthiness of the bond issuer. Investors should pay careful attention to the types of fixed income securities that comprise their portfolios and remember that, as with all investments, there is the risk of loss of capital. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.

Asset-backed securities and mortgage-backed securities are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates.

Investment grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's. Convertible securities and preferred stock combine the fixed income characteristics of bonds with some of the potential for capital appreciation of equities and, thus, may be subject to greater risk than pure fixed-income instruments. Unlike bonds, preferred stock and some convertible securities do not have a fixed par value at maturity, and in this respect may be considered riskier than bonds. Convertible securities may include convertible bonds, convertible preferred stocks and other fixed-income instruments that have conversion features.

Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments. The lower rating of high-yield bonds (less than investment grade) reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Moreover, to the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

Sovereign debt instruments are subject to the risk that a governmental entity may delay or refuse to pay interest or repay principal on its sovereign debt. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.