GW&K
INVESTMENT MANAGEMENT

TAXABLE BOND
MONTHLY COMMENTARY

DECEMBER 2018

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HIGHLIGHTS

- Investor sentiment deteriorated significantly due to heightened concerns about slowing growth, restrictive Fed policy and rising trade tensions.
- As expected, the Fed hiked rates and tilted in a dovish direction, but not nearly enough for investors, who were looking for a pause.
- In a decisive rebuke of Fed policy, volatility surged and investors sought safe havens by sending rates and risk assets down sharply.

RATES

The Treasury market enjoyed its best month since June 2016. Rates were driven lower by worries that the synchronized global growth narrative was coming to an end and that the Fed was on the verge of making a policy mistake. On top of that, signs began to emerge that the trade war was weighing on China's economy. The yield on the 10-year Treasury fell 30 basis points, reversing much of its increase over the prior 11 months. The yield curve ended near its flattest level in a decade.

The disconnect between FOMC guidance and market expectations grew sharper following Chairman Powell's post-meeting press conference. Heading into the Fed meeting, markets were expecting a pause. Instead, the FOMC merely reduced forward guidance to two hikes from three while leaving the pace of balance sheet run-off unchanged. This decision was widely viewed as a policy mistake and an uptick in volatility promptly ensued.

U.S. Treasury Market - December 31, 2018

	12/31/18	Yield Change (bps)			Performance		
Maturity	Yield	MTD	QTD	YTD	MTD	QTD	YTD
2-year	2.49%	-30	-33	+60	0.81%	1.28%	1.40%
5-year	2.51%	-30	-45	+30	1.86%	2.81%	1.42%
10-year	2.69%	-30	-37	+28	3.01%	3.87%	0.00%
30-year	3.02%	-27	-19	+28	5.94%	4.10%	-2.72%

Source: Bloomberg, FactSet
Performance represents total returns of the Bloomberg Barclays U.S. Treasury Bellwethers Index for the maturities shown

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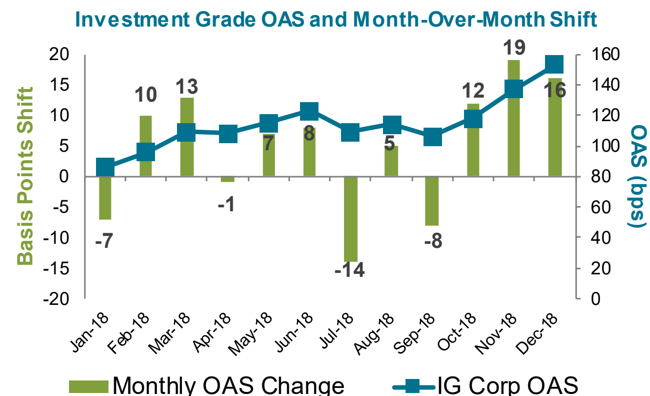
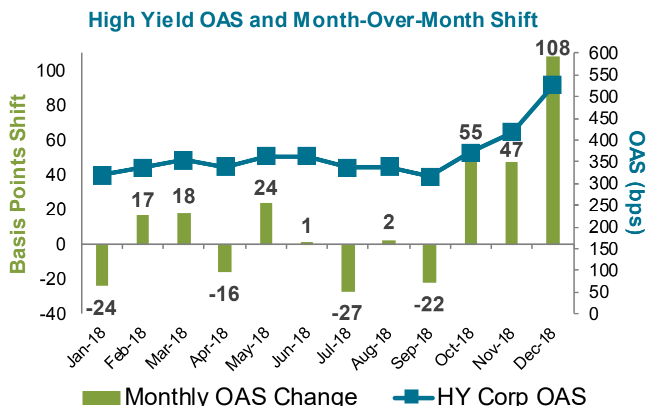
CREDIT

Credit spreads widened significantly along with plunging equity and crude oil prices. The selloff was exacerbated by thin year-end liquidity and a rising chorus of commentators predicting an imminent recession. End of cycle concerns led to worries that earnings had peaked and that default rates were about to rise from historical lows. High yield spreads experienced their worst month in more than seven years, with lower-quality CCC spreads approaching distressed levels. Investment grade spreads ended the month at their widest level since 2016, as BBBs in particular suffered from the prospect of wide scale rating agency downgrades.

The high volatility environment had a significant effect on technicals in the high yield market, which saw broad-based outflows, partially offset by a sharp decline in new issuance. High yield saw its first month of zero supply since the height of the financial crisis, leaving full year issuance 41% lower than the prior year. Investment grade also had its lightest month since the crisis, bringing full year issuance down 12% from last year's record level. December was a weak month for preferreds, which struggled due to their junior position in the capital structure as well as weakness across the financials space.



Source: FactSet



Source: FactSet

MORTGAGES

Mortgage-backed securities (MBS), like Treasuries, were a beneficiary of the risk-off trade. The rally in rates helped drive a positive return, and real money buying in the final days drove spreads tighter. There were few coupon- or maturity-specific themes during the month, though lower-coupon had a slight edge due their longer duration. Going forward, the technical backdrop for MBS remains unsettled as the Fed balance sheet continues to run off. However, we believe recent spread widening has largely priced in this uncertainty.

OUTLOOK

The U.S. economy has so far shown scant evidence of a downturn. In fact, economic indicators still point to an above-trend pace of expansion in 2019. Following recent market volatility, valuations appear increasingly attractive and thus more supportive of an overweight to corporates. That said, we recognize the possibility that the cycle may be approaching its end and continue to have a preference for higher quality corporates. Our allocation to MBS remains neutral, though we are becoming more constructive on an improving demand outlook. We continue to favor seasoned mortgage pools that should better withstand the continued run-off in the Fed's balance sheet next year.

INDEX CHARACTERISTICS AND PERFORMANCE

December 31, 2018	CHARACTERISTICS			PERFORMANCE		
Index	**Yield to Worst**	**OAD (Years)**	**OAS (bps)**	**MTD**	**QTD**	**YTD**
Bloomberg Barclays U.S. Aggregate Bond	3.28%	5.87	54	1.84%	1.64%	0.01%
U.S. Treasury	2.61%	6.10	0	2.15%	2.57%	0.86%
Bloomberg Barclays U.S. Government Related	3.34%	5.29	73	1.62%	1.22%	0.27%
Bloomberg Barclays U.S. Corporate Investment Grade	4.20%	7.10	153	1.47%	-0.18%	-2.51%
Bloomberg Barclays U.S. Mortgage-Backed Securities	3.39%	4.73	35	1.81%	2.08%	0.99%
Bloomberg Barclays U.S. Asset-Backed Securities	3.06%	2.15	53	0.79%	1.25%	1.77%
ICE BofAML Fixed Rate Preferred Securities	5.67%	5.88	242	-0.92%	-4.56%	-4.34%
Bloomberg Barclays High Yield	7.95%	3.96	526	-2.14%	-4.53%	-2.08%
Bloomberg Barclays High Yield - BB	6.24%	4.35	354	-1.31%	-2.91%	-2.41%
Bloomberg Barclays High Yield - B	8.00%	3.73	531	-2.19%	-4.35%	-1.31%
Bloomberg Barclays High Yield - CCC	12.55%	3.39	989	-4.27%	-9.28%	-3.84%
Bloomberg Barclays High Yield BB 1-5 Year	5.86%	2.52	322	-1.09%	-1.85%	0.03%

Source: FactSet

Disclosures

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