



Mary F. Kane, CFA
Partner
Taxable Bond Portfolio Manager

“Patience” is a Virtue

HIGHLIGHTS

- With the government shutdown in the rearview mirror and seasonal factors dissipating, investors are optimistic that Q2 economic growth will resume its above-trend pace.
- Now that the Fed is on hold indefinitely, rates are likely to remain range-bound, barring a significant uptick in inflation.
- Further evidence that the FOMC was willing to be “patient,” combined with signs of easing U.S.-China trade tensions, extended the rally in risk assets.

INTEREST RATES

Interest rates stayed within a fairly narrow trading range. During the first half of the month they were held down by concerns around global growth, weak retail sales numbers, and ongoing trade tensions with China. But sentiment shifted in the closing days and investor anxiety eased on signs of progress on trade, the avoidance of another government shutdown, and the Fed’s solidifying of their dovish tilt. The yield on the 10-year Treasury rose 9 basis points.

The January FOMC minutes, along with Powell’s congressional testimony, highlighted why the Fed was comfortable hitting the pause button at its last meeting. The committee cited “muted” inflationary pressure, slack in the labor market, and concerns around slowing global growth, particularly in Europe and China. They also signaled their expectation to end the balance sheet runoff sometime later this year. The Fed Funds rate sits at 2.25-2.5%, and the market is pricing in virtually no chance of a rate hike in 2019.

U.S. Treasury Market - February 28, 2019

Maturity	2/28/19	Yield Change (bps)			Performance		
	Yield	MTD	QTD	YTD	MTD	QTD	YTD
2-year	2.52%	+6	+3	+3	0.08%	0.35%	0.35%
5-year	2.51%	+7	0	0	-0.15%	0.37%	0.37%
10-year	2.72%	+9	+3	+3	-0.49%	0.24%	0.24%
30-year	3.08%	+8	+6	+6	-1.18%	-0.58%	-0.58%

Source: Bloomberg, FactSet

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

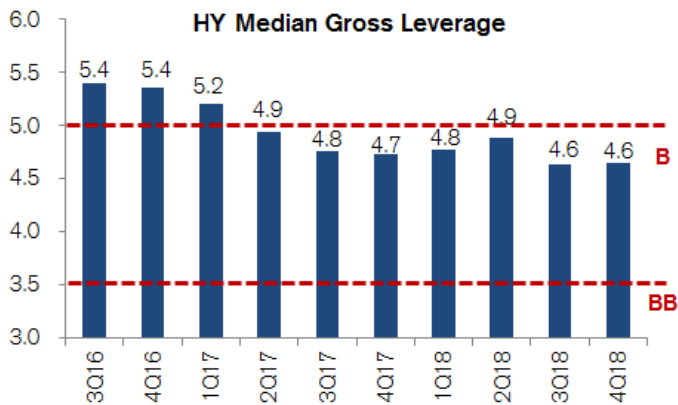
GW&K Investment Management
222 Berkeley Street
Boston, MA 02114

617.236.8900
www.gwkinvest.com

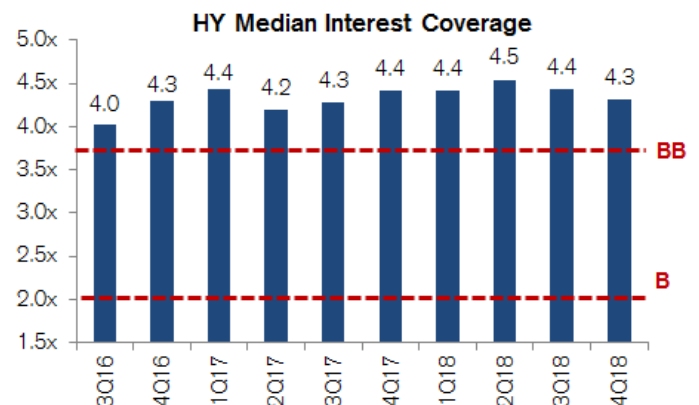
CREDIT

Corporate bonds extended their strong start to the year, reaching their tightest spreads in more than three months amid dovish signals from the Fed and optimism on the trade front. Additionally, a strong rally in commodity prices and an unexpectedly decent earnings season supplied further momentum to the upside. BBBs and cyclicals drove the rally in investment grade, which tightened 7 basis points and sits just 15 basis points wide of its fourth quarter tight. High yield had its third best start to the year ever, behind only 2001 and 1991, as a 1.66% return in February brings year-to-date returns to 6.26%. Preferreds continued to benefit from the risk-on trade, returning 1.73% to bring year-to-date returns to 7.50%.

After a slow start to the year, corporate issuance has picked up dramatically and has been met with a strong appetite from investors. The investment grade primary market had its most active February since 2016 and nearly erased its year-to-date deficit versus last year after experiencing a very slow January. The high yield primary market had its busiest month since last March, with all 30 deals several times oversubscribed and most printing at the lower end of price talk. Underpinning this strong demand for high yield is a generally benign credit environment. Leverage in Q4 remained at its lowest level in several years, interest coverage remains ample and defaults are well below historical averages.



Source: Credit Suisse



Source: Credit Suisse

MORTGAGES

The MBS Index had positive excess returns but continued to lag credit. The low rate volatility environment supported MBS carry over Treasuries. Shorter duration, higher coupon pools were in demand toward the end of the month, benefiting from the bear steepening of the yield curve. The stable rate environment and strong demand, particularly from overseas buyers, should continue to be supportive of valuations. Additionally, the recent compression of investment grade spreads toward MBS, combined with the potential emergence of “end of cycle” concerns, could lead to a rotation toward mortgages. We favor low pay-up, specified pools, which we believe are well positioned to outperform Treasuries in the current economic backdrop.

OUTLOOK

Risk assets should continue to do well as the Fed remains on the sidelines, trade tensions are resolved, and the economy continues to grow on its above-trend pace. We have maintained the defensive positioning in high quality corporate bonds that we established over the course of last year. That said, given that the Fed’s meaningful policy change is likely to extend the current business cycle, we have begun opportunistically adding risk in undervalued, high-quality issuers. On the investment grade front, we see value in select BBB corporates that we believe will better weather a potential downturn in the business cycle. We remain vigilant for signs of overheating in the U.S. that could bring the Fed back into the picture, as well as any indications of significant weakness around the globe that could derail the growth narrative.

INDEX CHARACTERISTICS AND PERFORMANCE

February 28, 2019	CHARACTERISTICS			PERFORMANCE		
Index	Yield to Worst	OAD (Years)	OAS (bps)	MTD	QTD	YTD
Bloomberg Barclays U.S. Aggregate Bond	3.21%	5.91	45	-0.06%	1.00%	1.00%
U.S. Treasury	2.63%	6.10	0	-0.27%	0.20%	0.20%
Bloomberg Barclays U.S. Government Related	3.27%	5.33	63	0.17%	1.16%	1.16%
Bloomberg Barclays U.S. Corporate Investment Grade	3.91%	7.25	121	0.22%	2.57%	2.57%
Bloomberg Barclays U.S. Mortgage-Backed Securities	3.36%	4.74	35	-0.09%	0.70%	0.70%
Bloomberg Barclays U.S. Asset-Backed Securities	2.91%	2.13	37	0.28%	0.76%	0.76%
ICE BofAML Fixed Rate Preferred Securities	4.13%	4.82	105	1.73%	7.50%	7.50%
Bloomberg Barclays High Yield	6.54%	3.52	379	1.66%	6.26%	6.26%
Bloomberg Barclays High Yield - BB	5.00%	3.86	224	1.60%	5.91%	5.91%
Bloomberg Barclays High Yield - B	6.53%	3.28	376	1.71%	6.28%	6.28%
Bloomberg Barclays High Yield - CCC	10.52%	3.13	780	1.59%	6.96%	6.96%
Bloomberg Barclays High Yield BB 1-5 Year	4.31%	2.11	165	1.14%	4.39%	4.39%

Source: FactSet

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