GW&K INVESTMENT MANAGEMENT

TAXABLE BOND
MONTHLY COMMENTARY

JANUARY 2019

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HIGHLIGHTS

- Risk assets snapped back sharply and safe havens lost their appeal on positive economic data and accommodative language from the Fed.
- Investment grade spreads more than retraced the widening they experienced in December, while high yield saw its best start to a year since 2009.
- "Patience" was the dominant theme in January's Fedspeak, initially with respect to further hikes and then ultimately with the pace of balance sheet run-off.

RATES

Interest rates started the year with a strong rally, as disappointing factory data out of both China and the U.S. compounded fears of a global slowdown. But risk aversion abruptly turned to risk appetite in response to exceptionally strong payroll data, and a steady stream of upbeat news flow further lifted sentiment from there. Haven demand receded as the month progressed, but a more accommodative stance from the Fed drove rates lower in the closing days. The yield on the 10-year Treasury ultimately fell 6 basis points.

The Fed's increasingly dovish posture became clear with the release of the December minutes, which placed heavy emphasis on being patient, and moving gradually. A slew of Fed speakers pushed this narrative further, raising the possibility of a pause in the hiking cycle. Finally, at their January meeting, the FOMC made the dovish pivot official, holding rates steady and indicating a willingness to alter the size and composition of the Fed's balance sheet if conditions warranted. The futures market immediately ruled out any further hikes in 2019 and assigned a roughly 20% probability to a cut.

U.S. Treasury Market - January 31, 2019

	1/31/19	Yield Change (bps)			Performance		
Maturity	Yield	MTD	QTD	YTD	MTD	QTD	YTD
2-year	2.46%	-3	-3	-3	0.27%	0.27%	0.27%
5-year	2.44%	-7	-7	-7	0.52%	0.52%	0.52%
10-year	2.63%	-6	-6	-6	0.73%	0.73%	0.73%
30-year	3.00%	-2	-2	-2	0.61%	0.61%	0.61%

Source: Bloomberg, FactSet

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

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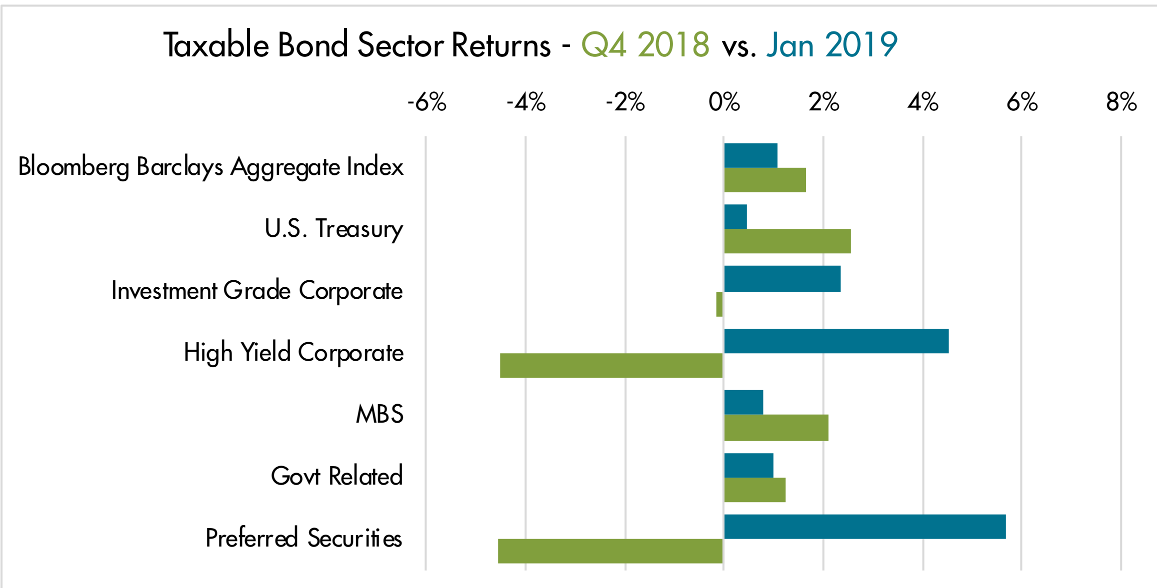
CREDIT

Corporate bonds rebounded dramatically from their December lows. In addition to a dovish Fed, they benefited from signs of a possible resolution to the trade war and a surprisingly decent start to fourth quarter earnings. Oversold conditions at the end of last year set the stage for investment grade's best month since 2016, as spreads tightened 25 basis points to mid-November levels. High yield, which had its best month in more than seven years with a strong 4.5% return, benefited from an 18% surge in crude prices. Preferred securities were the most significant beneficiary of the risk-on trade, returning 5.7%.

In addition to an improved fundamental backdrop, credit markets benefited from a solid technical environment. Investment grade issuance was 24% lower than last year due to a significant decline in issuance from financials, while demand, particularly from overseas buyers, remained robust. The high yield primary market reopened after a complete shutdown in December, and demand from supply-starved investors was so great that most new issues were 3-4 times oversubscribed and priced at the lower end of talk.



Source: FactSet

MORTGAGES

The MBS Index had its best monthly excess return since balance sheet normalization was announced in September 2017. The Fed's dovish pivot triggered a drop in rate volatility to nearly the lowest levels in five years, allowing MBS spreads to continue to retrace much of their fourth quarter widening. Higher overseas demand, combined with range-bound rates and a low volatility environment, aided technicals and improved the sector's outlook versus Treasuries.

OUTLOOK

Our outlook for the U.S. economy has been generally constructive, given that most economic indicators continue to suggest little near-term risk of a recession. The recent softening in the Fed's posture only serves to increase our conviction on this front, now that it seems even less likely the Fed will commit a policy error. We also see attractive value in the corporate space, where even after recent tightening, spreads sit wide of where they spent most of 2018. Recent volatility has created more opportunities than we have seen in some time, and we have been taking advantage of dislocations to swap into high quality names that continue to trade at attractive spreads. Our allocation to MBS is slightly overweight, as we have become more constructive on the space in light of the Fed's recent commentary on its balance sheet. Our bias remains in favor of higher coupon, shorter duration pools, which offer higher carry in the current environment.

INDEX CHARACTERISTICS AND PERFORMANCE

January 31, 2019	CHARACTERISTICS			PERFORMANCE		
Index	**Yield to Worst**	**OAD (Years)**	**OAS (bps)**	**MTD**	**QTD**	**YTD**
Bloomberg Barclays U.S. Aggregate Bond	3.15%	5.86	47	1.06%	1.06%	1.06%
U.S. Treasury	2.57%	6.09	0	0.47%	0.47%	0.47%
Bloomberg Barclays U.S. Government Related	3.25%	5.38	69	1.00%	1.00%	1.00%
Bloomberg Barclays U.S. Corporate Investment Grade	3.91%	7.24	128	2.35%	2.35%	2.35%
Bloomberg Barclays U.S. Mortgage-Backed Securities	3.28%	4.56	32	0.79%	0.79%	0.79%
Bloomberg Barclays U.S. Asset-Backed Securities	2.94%	2.12	46	0.47%	0.47%	0.47%
ICE BofAML Fixed Rate Preferred Securities	4.29%	4.76	127	5.67%	5.67%	5.67%
Bloomberg Barclays High Yield	6.90%	3.67	423	4.52%	4.52%	4.52%
Bloomberg Barclays High Yield - BB	5.32%	4.05	264	4.24%	4.24%	4.24%
Bloomberg Barclays High Yield - B	6.86%	3.41	418	4.49%	4.49%	4.49%
Bloomberg Barclays High Yield - CCC	11.03%	3.24	843	5.29%	5.29%	5.29%
Bloomberg Barclays High Yield BB 1-5 Year	4.71%	2.23	212	3.22%	3.22%	3.22%

Source: FactSet