GW&K INVESTMENT MANAGEMENT

TAXABLE BOND MONTHLY COMMENTARY

MARCH 2019

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The End of "Normalization"

HIGHLIGHTS

- The March FOMC meeting took center stage as Fed policymakers signaled no further rate hikes this year, lowered their outlook for growth and announced an early end to the tapering of the balance sheet run-off.
- Treasury yields declined sharply, driven by renewed global growth concerns.
- The 3-month/10-year yield curve temporarily inverted, portending a potential slowdown in the economy.

INTEREST RATES

Treasury yields tumbled in March on a succession of negative headlines. Demand for safe havens rose following the March FOMC meeting, where policymakers heralded an end to rate hikes and an accelerated conclusion to their balance sheet run-off. The committee also provided a more pessimistic growth outlook. As if on cue, these concerns were confirmed by signs of a notable slowdown in the manufacturing sector of several major economies (Germany, China and Japan). Rates around the globe proceeded to fall to fresh lows.

One of the more notable developments was the temporary inversion of the 3-month/10-year Treasury curve, which helped fuel further worries about an impending slowdown. This led to a major repositioning in the rates market that ultimately pushed yields even lower. For the month, the yield on the 10-year Treasury fell 31 basis points, reaching its lowest level in more than a year.

U.S. Treasury Market - March 31, 2019

	3/31/19	Yield Change (bps)			Performance		
Maturity	Yield	MTD	QTD	YTD	MTD	QTD	YTD
2-year	2.27%	-25	-22	-22	0.63%	0.97%	0.97%
5-year	2.24%	-27	-27	-27	1.49%	1.86%	1.86%
10-year	2.41%	-31	-28	-28	2.84%	3.08%	3.08%
30-year	2.82%	-26	-20	-20	5.60%	4.98%	4.98%

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

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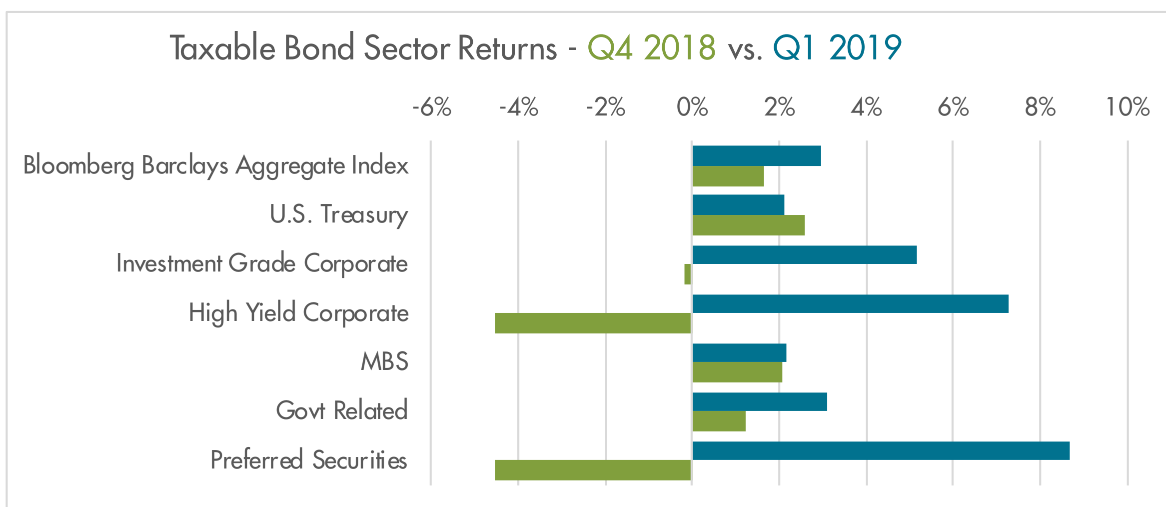
CREDIT

Corporate bonds took a bit of a breather in March after a torrid start to the year, though spreads still sit close to their tightest levels in more than four months. The growth concerns that rattled rates markets had less of an effect on risk assets, which instead cheered the reduced likelihood of a policy mistake from the Fed.

Despite 12 basis points of widening, the high yield market returned 0.9%, benefiting from high carry and the rally in rates. This brings year-to-date returns to 7.3%, its best start to a year since 2003. The investment grade market also had a stellar start, with a 5.1% quarterly return. This snapback in corporate bonds has successfully driven the sector to recover much of its fourth quarter spread widening. Preferreds extended their recent rally, returning 1.1%, to bring year-to-date gains to 8.7%.

The technical backdrop remains highly supportive of spreads as healthy inflows to both investment grade and high yield helped soak up an increase in new issuance. Money moving into investment grade through the first quarter is 39% higher than a year ago though issuance over the same period is 3% lower. High yield supply fell shy of expectations in March and is expected to slow going forward on a light M&A financing calendar and minimal refinancing. High yield sentiment has also been helped by a default rate that remains well below its long-term average.



MORTGAGES

Mortgage-backed securities performed in line with Treasuries, as the benefit of modestly tighter nominal spreads was offset by increasing negative convexity alongside the month long rally in rates. Specified pools outperformed as investors sought out bonds with better call protection characteristics. The duration of the Mortgage Index fell by almost ¾ of a year, or 15%, as prepayment speeds began to ratchet higher. Flows so far this year have been strong, climbing to their highest level in two years. Looking ahead, interest from overseas buyers and a sooner-than-expected end to the Fed's normalization program should provide continued technical support.

OUTLOOK

We continue to believe the odds of a recession in the US over the next 12 months are low. The current backdrop for risk assets remains sound, supported by accommodative monetary policy, low inflation, solid economic momentum, and the robust demand for yield. The dovish shift in Fed policy significantly reduces the likelihood of a policy error and extends the runway for the credit cycle. The eventual resolution of trade tensions and steady economic growth are likely to support favorable conditions for corporate profit growth. As a result, we continue to see opportunities in high quality credit, especially among rate-sensitive and consumer-facing sectors. Within high yield, we expect the growing number of rising stars to continue to support the performance of BB-rated bonds. Nevertheless, we remain alert for any signs of deterioration in global growth that could pose a threat to this outlook.

INDEX CHARACTERISTICS AND PERFORMANCE

March 31, 2019	CHARACTERISTICS			PERFORMANCE		
Index	**Yield to Worst**	**OAD (Years)**	**OAS (bps)**	**MTD**	**QTD**	**YTD**
Bloomberg Barclays U.S. Aggregate Bond	2.93%	5.82	44	1.92%	2.94%	2.94%
U.S. Treasury	2.38%	6.21	0	1.91%	2.11%	2.11%
Bloomberg Barclays U.S. Government Related	3.00%	5.49	62	1.93%	3.11%	3.11%
Bloomberg Barclays U.S. Corporate Investment Grade	3.63%	7.42	119	2.51%	5.14%	5.14%
Bloomberg Barclays U.S. Mortgage-Backed Securities	3.08%	4.03	35	1.46%	2.17%	2.17%
Bloomberg Barclays U.S. Asset-Backed Securities	2.70%	2.15	39	0.72%	1.48%	1.48%
ICE BofAML Fixed Rate Preferred Securities	3.67%	4.45	85	1.11%	8.70%	8.70%
Bloomberg Barclays High Yield	6.43%	3.42	391	0.94%	7.26%	7.26%
Bloomberg Barclays High Yield - BB	4.85%	3.75	235	1.23%	7.21%	7.21%
Bloomberg Barclays High Yield - B	6.42%	3.17	387	0.87%	7.21%	7.21%
Bloomberg Barclays High Yield - CCC	10.52%	3.09	802	0.17%	7.15%	7.15%
Bloomberg Barclays High Yield BB 1-5 Year	4.22%	2.02	182	0.72%	5.15%	5.15%

Source: FactSet

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