



# FIXED INCOME UPDATE – THIRD QUARTER 2019

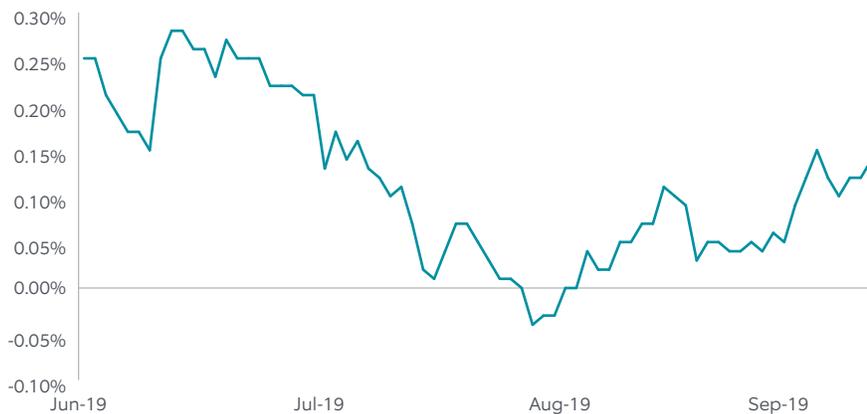
## KEY POINTS

- The mash-up of slowing growth, muted inflation, and easing monetary policy continues to create an atypical investment backdrop for investors.
- While U.S. employment numbers showed only minimal signs of softening, manufacturing data continued to weaken. Mixed data is pointing to a slower growth picture in the U.S.
- The Trump Administration showed a reenergized assertiveness on trade tariffs as the U.S. extends threats to the European Union (EU). Meanwhile, the U.S. and China tensions continue to meander between trade war and trade armistice.

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## YIELD CURVE INVERSION



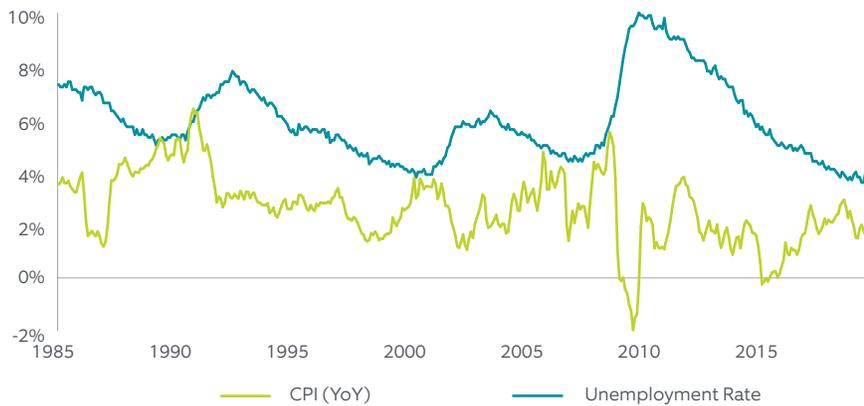
The 2-year and 10-year UST inverted during the quarter, triggering a recession warning.

As of 10/10/19  
SOURCE: Northern Trust Fixed Income; Federal Reserve; Bloomberg Barclays

**MACRO UPDATE**

- Muted inflation and global easing of monetary policy remain supportive of the continued low interest rate environment.
- The underpinnings of the U.S. labor market prove to be sound with only minimal signs of softening, while manufacturing data continues to weaken.
- While more U.S. and China talks are set to take place, the expectation of a wide-scale U.S. China trade agreement remains low as progress on disputes surrounding intellectual property, market access, and human rights is unlikely.

**U.S. INFLATION AND EMPLOYMENT**



As of 9/30/19  
SOURCE: Northern Trust Fixed Income; Bloomberg Barclays

**CENTRAL BANK UPDATE**

- The Federal Reserve moved the policy rate to 1.75% - 2%, the second 25 basis point interest rate cut of 2019.
- While the Bank of England (BOE) remains on hold, the decision to rule Minister Johnson’s proposal to suspend Parliament as illegal has increased Brexit uncertainty and led to higher expectations of near term rate cuts.
- The European Central Bank (ECB) announced new measures designed to stimulate the economy, including restarting their quantitative easing program.

**DECEMBER 2020 FED FUNDS CONTRACT**



As of 10/10/19  
SOURCE: Northern Trust Fixed Income; Bloomberg Barclays

**Long-Term Views**

- We believe growth in the U.S. will continue in a slow-but-positive manner, and a recession is unlikely in the near term horizon.
- We expect the ongoing trade wars, as well as increased geopolitical conflict this year, to serve as a headwind to global growth.
- Global central banks will continue to support easy monetary policy.
- We expect inflation to remain subdued and supportive of the risk asset classes.

The Fed cut rates for the second time in 2019; the market is pricing in 2 more additional cuts by year end.

ULTRA-SHORT/CASH UPDATE

Market Overview:

- Responding to growth and trade uncertainty, the yield of the 2-year Treasury note fell 23 bps, its lowest level in 2 years. This movement provided additional steepness to the yield curve.
- Money market rates moved lower during the quarter. However, less-ample liquidity in the banking system prompted interest rates in the overnight repo market to temporarily spike in mid-September.

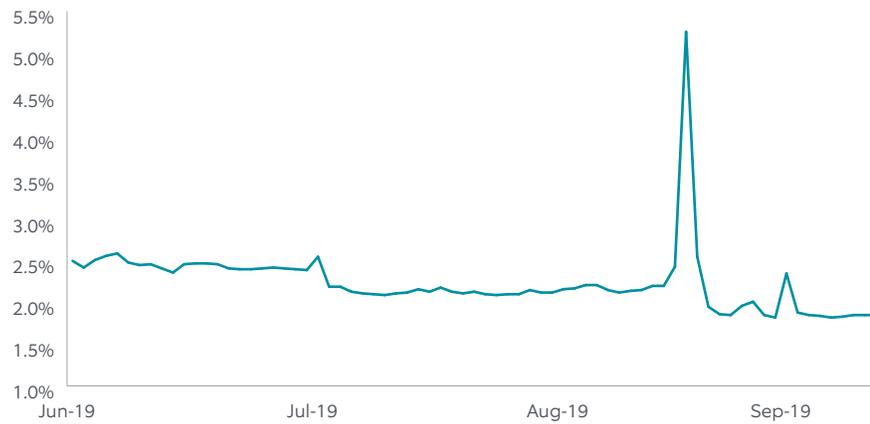
Ultra-Short Performance:

- Contributor – Sector Allocation
- Detractor – Duration

Current Positioning:

We continue to favor corporate credit and remain neutral to long on our duration target.

SECURED OVERNIGHT FINANCING RATE (SOFR)



As of 10/11/19  
SOURCE: Northern Trust Fixed Income; Bloomberg Barclays

SOFR spiked to over 5%, causing market disruption and ultimately Fed intervention.

TREASURYS & TIPS UPDATE

Market Overview:

- The negative yielding bond universe surpassed \$17 trillion over the quarter; negative yielding bonds (as a percentage of total debt issuance) now represent nearly 30% of the total global bond universe.
- The 10-year UST dropped to its lowest level this year with yields hovering around 1.5%; while 10-year yields in Europe and Japan remain negative.

NEGATIVE YIELDING ASSETS



As of 10/10/19  
SOURCE: Northern Trust Fixed Income; Bloomberg Barclays

Rates Performance

- Contributor – Security Selection and Duration
- Detractor – Curve Positioning

Current Positioning:

Portfolios are positioned with a neutral-to-long duration relative to their benchmarks.

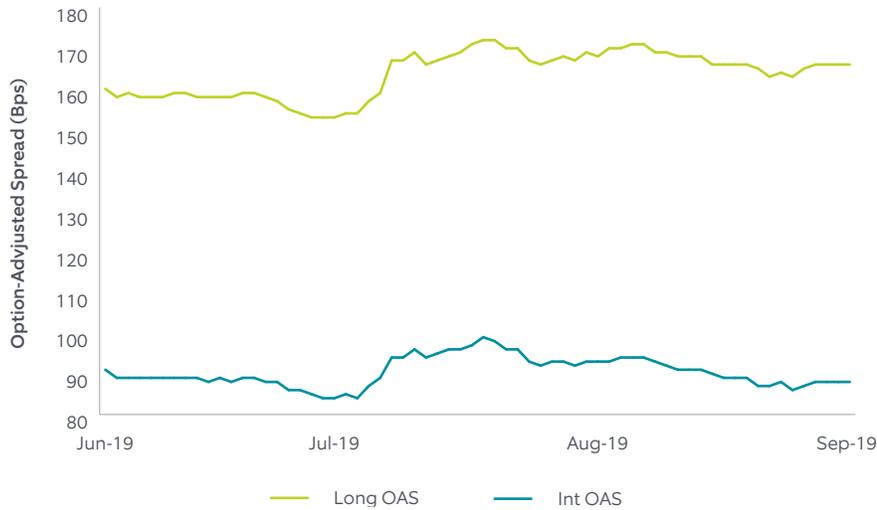
We expect the uncertainty surrounding trade to continue to weigh on global yields.

INVESTMENT-GRADE CREDIT UPDATE

Market Overview:

- A positive technical environment contributed to a total return of 2.27% for the Bloomberg Barclays U.S. Credit Index for the quarter.
- Higher quality investment grade credit outperformed, as investors positioned defensively.

INTERMEDIATE & LONG U.S. CORPORATE SPREADS



As of 9/30/19  
SOURCE: Northern Trust Fixed Income; Bloomberg Barclays

Credit Performance

- Contributor – Security Selection and Duration
- Detractor – Curve Positioning

Current Positioning:

Our overweight to credit has been reduced compared to recent levels, but we remain modestly overweight higher quality, intermediate credit. We expect a volatile 4th quarter.

Investors favor intermediate credit quality and avoided riskier assets with more volatility.

HIGH-YIELD BOND UPDATE

Market Overview:

- Bloomberg Barclays Capital U.S. Corporate High Yield 2% Issuer Capped Index returned 1.39% for the quarter, led by BB rated issuers.
- While trade uncertainty and easing global growth are expected to remain sources of volatility, the high yield market continues to benefit from stable credit fundamentals driven by corporate earnings. A low default rate along with positive technical factors support high yield valuations.

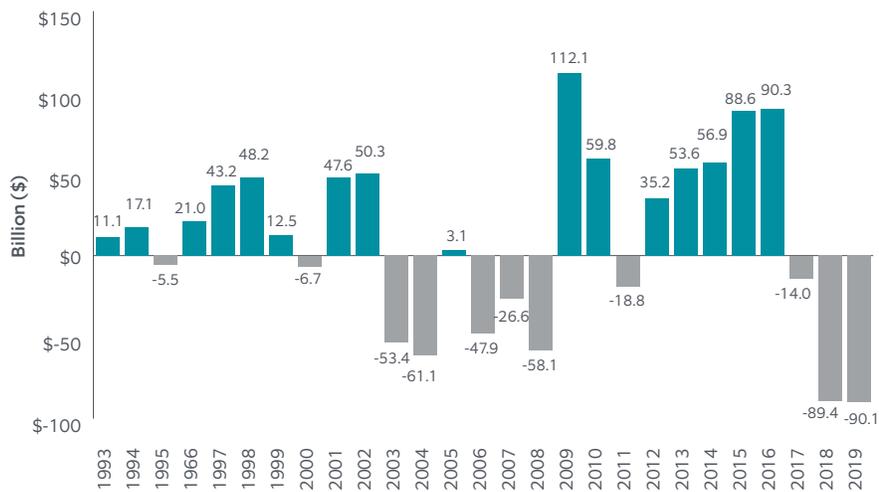
High-Yield Performance

- Contributor – Sector Allocation and Security Selection
- Detractor – Curve Positioning and Duration

Current Positioning:

Portfolios are positioned in the mid-range of the credit quality spectrum. Issuer selection is of utmost importance. We have few sector overweight's outside of financials.

HIGH YIELD BONDS SUPPLY: SURPLUS AND SHORTFALL



As of 9/30/19  
SOURCE: J.P. Morgan

We expect interest rates to remain low. The environment continues to reflect the ongoing search for yield.

MUNICIPAL BOND UPDATE

Market Overview:

- All maturities saw lower yields, with credit spreads continuing to narrow.
- U.S. Treasury rates fell faster than munis across the yield curve.
- Muni-Treasury ratios improved, but remain expensive and below historical averages.

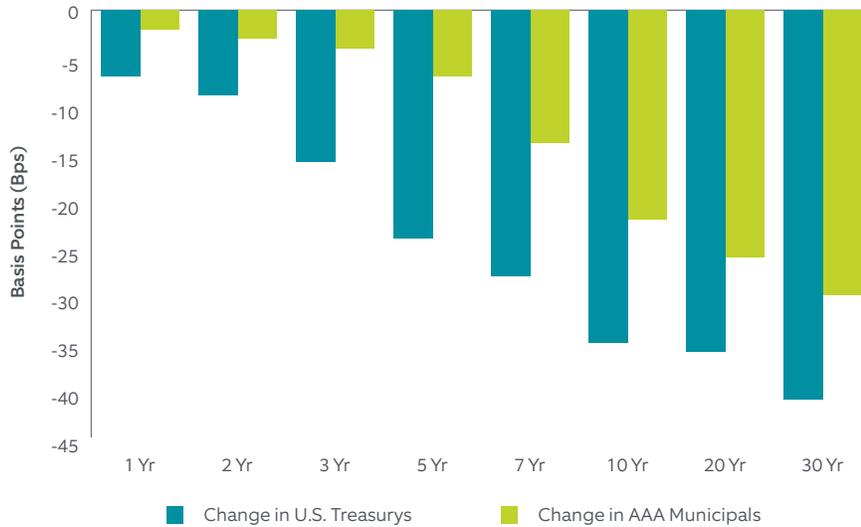
Municipal Performance

- Contributor – Yield Curve Positioning
- Detractor – Quality Bias

Current Positioning:

Interest rate exposure should be slightly defensive, expecting a fall with more balance between demand and supply. Pension funding continues to be a primary credit risk focus. Revenues remain robust, but not all issuers are using that to address funding shortfalls.

TREASURYS VS. AAA MUNICIPALS – CHANGE IN YIELDS 3Q 2019



SOURCE: Northern Trust Fixed Income; Bloomberg

RATIO: AAA MUNI YIELD TO TREASURY YIELD



SOURCE: Northern Trust Fixed Income; Bloomberg Barclays

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