# Taxable Fixed Income Strategies

2Q 2017

FIERACAPITAL

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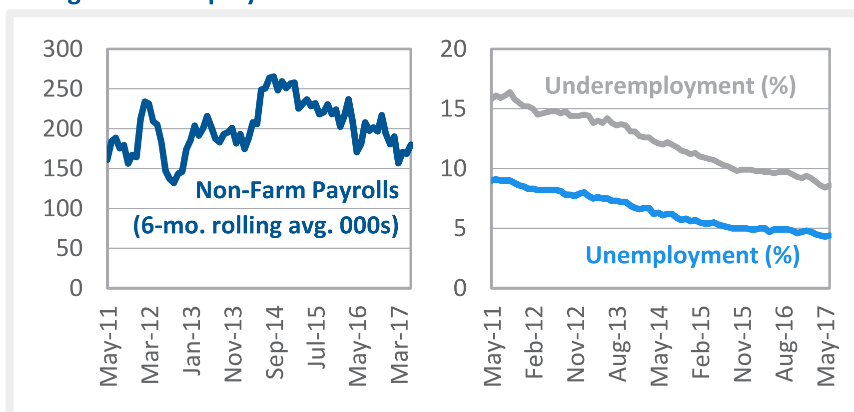
The trend of higher prices for risk assets and low bond yields continued this quarter. Stocks and bonds provided positive returns yet again. Our strategies performed in line with benchmarks excluding the lower quality, volatile sectors we avoid.

Stocks moved to fresh highs on strong profits and rosier global growth expectations. Although US growth slowed in the first quarter, expectations for this quarter and the next have increased. Payroll figures and manufacturing surveys also pointed higher. Fiscal stimulus does not appear on Congress' radar at the moment but supporting the market is the minimum expectation that taxes will not rise and regulation will be more business friendly. Election results in the Netherlands and France put aside risks of Eurozone disintegration.

**Hiring and Unemployment**




Sources: Bloomberg and Bureau of Labor as of 7/7/17

The Federal Reserve increased rates by another quarter point in June. This was well telegraphed and the Fed forecasts one more rate increase this year. Unemployment is now 4.4%, the lowest level seen since 2007. This is evidence that the gradual normalization that began in December 2015 has not choked off the recovery. While the economy shows signs of healing, it has not appeared in the inflation data. The Fed believes the present weakness is "transitory" and expects inflation to drift up to its 2% target in coming months. We think this is reasonable given the decline in labor market slack and the sharp sell-off in commodities appears more related to supply than weakening demand.

The Fed announced plans to reduce the size of its balance sheet. In order to support the economy after the Financial Crisis, the Fed purchased Treasuries and Mortgage Backed Securities (MBS) to ease financial conditions. As the central bank sees it, such extraordinary

**Upcoming Commentaries**

- Corporate Credit, Miriam Legrand
- Relative Value, Lacey Greenwalt
- Policy, Jonathan Lewis

**Market and Strategy Returns***

| | | 2Q17 | YTD |
|---|---|---|---|
| **HGST** | **Gross** | **0.35%** | **0.81%** |
| | Net | 0.26% | 0.63% |
| BBC US Gov/Cred 1-3Y | | 0.31% | 0.72% |
| Ex BBB | | 0.27% | 0.62% |
| **HGCI** | **Gross** | **0.80%** | **1.65%** |
| | Net | 0.72% | 1.48% |
| BBC Int. Agg | | 0.92% | 1.61% |
| Ex. BBB/CMBS/ABS | | 0.82% | 1.40% |
| **Int Gov** | **Gross** | **0.59%** | **1.39%** |
| | Net | 0.50% | 1.21% |
| BBC Int Gov | | 0.66% | 1.20% |
| **Corp 1-5** | **Gross** | **0.85%** | **1.63%** |
| | Net | 0.79% | 1.50% |
| BBC 1-5 Corp | | 0.93% | 1.87% |
| BBC Int. Treasury | | 0.66% | 1.21% |
| BBC Int. TIPS | | -0.40% | 0.65% |
| BBC U.S. MBS | | 0.87% | 1.35% |
| BBC Int. Corp | | 1.50% | 2.67% |
| Industrials | | 1.50% | 2.69% |
| Financials | | 1.50% | 2.71% |
| BBC Muni 5 Year | | 1.25% | 3.17% |
| ML High Yield | | 2.16% | 4.93% |
| S&P 500 | | 3.09% | 9.34% |

*Please see important disclosures at the end of this commentary for strategy and market definitions.
Sources: Bloomberg Barclays (BBC), Bloomberg as of June 30, 2017.

**Past performance is not a guarantee of future results. Inherent in any investment is the potential for loss.**

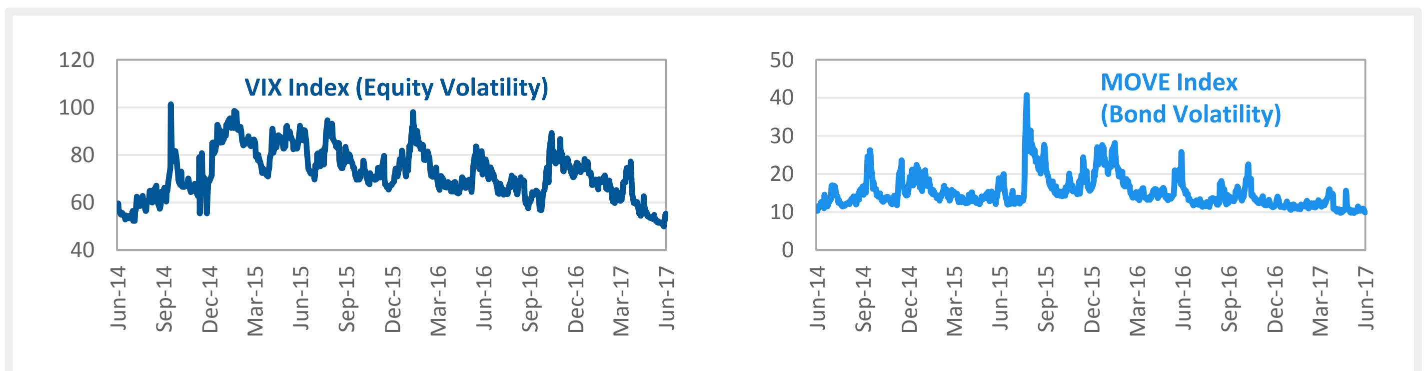
measures are no longer necessary. The current plan does not call for outright sales but rather an incremental reduction in the amount of monthly purchases at a future date.

These moves are not, in our opinion, a signal that central banks are making a hard turn away from policy accommodation. Central banks globally have kept rates low and balance sheets large to ease financial conditions in order to support growth and employment. That work is bearing fruit, but economies do not appear to be overheating. This allows for a slow normalization of policy. This is why we are content to keep durations slightly above target as yields are likely to remain range bound in a slow growth environment.

Our duration position will change if we believe the Fed or other central banks are turning hawkish. We will be watching inflation readings, financial conditions and business activity closely. Another wildcard is who will be next Fed Chair. Janet Yellen’s term expires in February and although she could be reappointed, President Trump could go in a more hawkish direction.

This tapering of MBS purchases was one of the reasons behind our decision to cut exposure to a slight underweight. Agency MBS have historically been a source of stable income along with minimal credit risk for our portfolios. We expect to maintain healthy allocation to mortgages, but wish to tiptoe away before such a large presence like the Fed begins to reduce its purchases. Mortgages tend to struggle as volatility increases. Although this is not our base view, we note the low level of VIX and MOVE and believe it is another reason to pull back slightly.

**Volatility Indicators**




Source: Bloomberg as of 7/13/17

We elected to maintain our holdings of Treasury Inflation Protected Securities. This detracted from performance as inflation expectations declined. Our overweight is based on the view that the fall in inflation is contradicted by a broad range of other measures that indicate growth is positive. It should be noted that inflation follows growth – stated simply, demand outstrips supply and prices rise – and the current low inflation is explained by the slowdown seen at the end of last year. This is not to say our view is for runaway inflation, rather the expectations implied in the market are below the Fed’s target.

Our largest overweight is corporate bonds. Corporates have benefitted from improving labor market and business confidence. The balance sheets are in fine form and tax reform stands to benefit this sector the most. It is difficult to assign probability to what politicians will do, but Republicans are united in lowering taxes and it would be a surprise if they neglected to pass even a modest corporate tax cut while holding a legislative majority and the White House.

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In a period of tightening corporate bond spreads, we are seeking high quality alternatives. We wish to maintain our corporate overweight but supplement that exposure in a risk-managed fashion. We have long used non-corporate credits, like provincials and multilaterals. During the period, we purchased taxable municipal bonds that are attractive relative not only to tax-exempt municipals but also similarly rated corporates. This has the added benefit of diversifying the portfolio into a different sector. Our strategy, because of the separately managed account format, can build positions in such investments more quickly than large funds.

In this low-yielding environment, we believe that an allocation to subordinated securities such as preferred securities may enhance investors' return. We believe that investors can also enhance yield by investing in lower debt seniority levels of high quality companies. Bank credit quality has greatly improved since 2008 with capital ratios at levels not seen in years. Our macroeconomic outlook is for continued slow growth amid accommodative monetary policy which should keep recession risks low and supportive of preferred securities. We think that with high yield spreads at the tighter end of range and positive view of bank fundamentals, preferreds are well-positioned for investment in the current market.

## HIGH GRADE FIXED INCOME INVESTMENT TEAM

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Allocations presented herein are as of the date noted and subject to change.

Strategy Definitions:

Performance presented reflects a composite of all accounts following these strategies. Performance is time-weighted, compounded monthly and may reflect the reinvestment of interest, dividends, and other income.

- High Grade Short Term (HGST) – utilizes the same investment themes and sector rotation methodology as the Core Intermediate strategy but focuses on shorter maturities, limiting the interest rate risk.
- Intermediate Government (Int Gov) – emphasizes government quality bonds, but in a diversified approach that looks beyond Treasuries to include to pre-refunded municipals, Treasury Inflation-Protected Securities and U.S. dollar denominated sovereign-supported issuers.
- High Grade Core Intermediate (HGCI) – relative return focused versus the Barclays Capital Intermediate Aggregate Index, which offers diversification benefits comparable to the Aggregate Index, but with what we believe to be favorable risk/return metrics.
- Corporate Index Replication (Corp 1-5) – seeks to provide the return and risk profile of a selected benchmark with fewer securities through a separately managed account. This is designed for clients interested in a specific asset class, but wishing to avoid the premium/discount issues of exchanged traded funds.

Index Definitions:

It is not possible to invest directly in an index. Investors pursuing a strategy similar to an index may experience higher or lower returns and will bear the cost of fees and expenses that will reduce returns.

- Bloomberg Barclays 1-3 Yr Gov/Credit is the 1-3 Yr component of the U.S. Government/Credit Index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.
- Bloomberg Barclays Intermediate Aggregate Index is the intermediate component of the US Aggregate Index. The Bloomberg Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.
- Bloomberg Barclays U.S. Corporate Investment Grade Index is a rules-based and market value weighted index of publicly issued U.S. corporate bonds. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued.
  - The Bloomberg Barclays 1-5 Corporate Index is the 1-5 year component of the Corporate Index.
  - The Bloomberg Barclays Intermediate Corporate Index is the Intermediate component of the Corporate Index.
  - Bloomberg Barclays Intermediate Corporate Industrial Index is the Intermediate component of the Investment Grade Industrial Index. Bonds in the Index must belong to the Industrial sector.
  - Bloomberg Barclays Intermediate Corporate Financial Institutions Index is the Intermediate component of the Investment Grade Financial Institutions Index. Bonds in the Index must belong to the Finance sector.
- Bloomberg Barclays 5 Year Municipal Index is the 5 Year component of the Municipal Bond Index. The Bloomberg Barclays Municipal Bond Index is a rules-based and market value weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade by at least two of the following ratings agencies: Moody's, S&P, Fitch. They must have an outstanding par value of at least $7 million and be issued as part of transaction of at least $75 million. The bonds must be fixed rate, have a double date after December 31, 1990, and must be at least one year from maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
- Bloomberg Barclays US MBS is a component of the US Aggregate Index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates. In other words, each aggregate is a proxy for the outstanding pools for a given agency, program, issue year, and coupon. The index maturity and liquidity criteria are then applied to these aggregates to determine which qualify for inclusion in the index. About 600 of these generic aggregates meet the criteria. The aggregates included in the index are priced daily using a matrix pricing routine based on trader price quotations by agency, program, coupon, and degree of seasoning.
- The US Intermediate Treasury Index represent the intermediate securities of the U.S. Treasury Index, which represents public obligations of the U.S. Treasury with a remaining maturity of one year or more.
- The Bloomberg Barclays Intermediate TIPS Index consists of securities in the intermediate maturity range of the Inflation-Protection securities issued by the U.S. Treasury.
- The JPMorgan US Liquid Index, or JULI, provides performance comparisons and valuation metrics across a carefully defined universe of investment grade corporate bonds, tracking individual issuers, sectors and sub-sectors by their various ratings and maturities.
- Goldman Sachs Commodity Index (GSCI) is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures
- VIX Index is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.
- MOVE Index is the Merrill Lynch Option Volatility Estimate Index, a yield curve weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2, 5, 10, and 30 year contracts.