MANAGER COMMENTARY
FIXED INCOME

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY
Fourth Quarter 2018

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MARKET REVIEW

The last quarter in the bond markets left the yield curve drastically changed with regard to shape and yields. An assortment of global political developments garnered headlines in November and December, resulting in a sell-off in equities and a rally in the bond market. Continued trade tension between the U.S. and China, and a plunge in oil prices led to the bond market believing that the Fed would not only NOT hike rates in 2019, but rather, likely will have to LOWER rates to stave off a slowdown in growth in the economy.

The yield curve is now inverted from 1 to 7 years, but with yields on 2 to 10 year treasury notes nearly 40 basis points lower than where they began the quarter. The spread in yield from 10s to 30s was about 15 bps at the end of September, but is now steeper with the spread at about 33bps. Corporate spreads continue to widen, as concern about the massive increase in BBB rated bonds has the bond market concerned that leverage in lower investment grade bonds will lead to downgrades if the economy sours.

SECTOR HIGHLIGHTS

Credit: The corporate market was softer during the quarter with an increase in risk premium due to softer global economic expectations. While Treasury yields were lower, which drove returns, credit spreads were wider. Lower quality corporates underperformed higher quality corporates with the Bloomberg Barclays BBB U.S. Credit widening 61 basis points and the Barclays U.S. Credit A rated widening 33 basis points. The Bloomberg Barclays Aggregate Index was up 164 basis points for the quarter, while the Intermediate Govt/Credit was up 165 basis points. The Bloomberg Barclays Corporate Investment Grade Index was down by 18 basis points for the quarter.

Treasuries: The Fed raised rates in December as expected and indicated it would raise rates two additional times in 2019. With the global economy slowing somewhat, plus a China trade war, the Treasury market is not pricing in a Fed hike in 2019. The curve remains extremely flat with 2 year / 10 year at 19 basis points at year-end, slightly flatter than at September 30 when it was 24 basis points. Overall during the quarter, rates fell but the Treasury curve became flatter. This indicates a lower probability of additional Fed rate hikes in the future, and an increased probability of a slower economic environment. The 2-year note was 2.49% at year-end, a decrease in yield of 33 basis points during the quarter.

MBS: Agency MBS is a safe haven asset class among spread sectors and MBS delivered solid returns over the last two months of the year. Fourth quarter returns were 2.08%, and 0.99% for all of 2018. The risk-off rally at year-end, and curve inversion on the front end caused lower coupons to outperform the current and premium coupons.

ABS: 2018 ABS supply ended at $229bn, including $6bn in December. Auto issuance was the largest ABS asset class booking $104bn followed by credit card issuance at $36bn and other issuance rounding out total ABS issuance. While overall ABS spreads widened to 2 year wides, the sector provided positive returns of 1.25% for Q4 and 1.77% YTD. Lower volatility and consistent monthly positive returns continue to support ABS as a defensive sector with spread pick up to both short corporates and treasuries.

Municipals: Munis finished the year with strength, despite outflows from funds and some tax-loss selling as interest rates moved lower into year-end. Technical factors improved greatly, as lower rates may actually improve demand versus a very manageable forward supply calendar. Richer valuations relative to treasury and corporate bonds was the main driver for out-performance. Given the shape of the treasury yield curve, and the widening of corporate spreads on the short end of the curve, munis definitely appear rich at this time. The Bloomberg Barclays 1-10 year Index gained .99% in December to generate a return for the quarter of 16.61%, which makes the 12 month return 1.64%.

Yield Curve: A major shift in the yield curve occurred in the fourth quarter of 2018. After the Fed raised rates in December for the fourth time in 2018, it changed course from a gradual rate hike path to a potential pause/more data dependent path in 2019. The Fed's dot-plot signals two rate hikes in 2019, but the market is essentially pricing in no new rate hikes, which has caused tension in the market. The Fed

continues to see a strong labor market, wage growth, and overall somewhat solid economic data; the market has focused on the likelihood of little to no tariff relief from the trade wars, continued chaos in Washington, and global growth slowing – especially in China. This tension has brought rates down significantly, flattening the curve further and even inverting portions of the front end of the curve. The 2yr treasury yield dropped 34 bps to 2.45%, while the 10 year part of the curve dropped 38bps to 2.68% as of year-end. The 2/10's spread has gone from a high of 34bps in October to a low of 10bps in December before ending the year at 15bps. We look for Fed/market tensions to continue in 2019, causing uncertainty throughout the yield curve.

INDEX RETURNS FOR THE PERIOD ENDING DECEMBER 31, 2018

	Q4 2018	YTD
BB Aggregate	1.64%	0.01%
Corporate	-0.18%	-2.51%
Treasuries	2.57%	0.86%
ABS	1.25%	1.77%
Mortgages	2.08%	0.99%
High Yield	-4.53%	-2.08%
Municipal	1.69%	1.28%
2-year Treasury	1.28%	1.40%
10-year Treasury	3.87%	-0.01%
30-year Treasury	4.10%	-2.72%

MARKET OUTLOOK

The move in the treasury market over the last quarter of 2018 was not anticipated, and as a result, leaves us in a quandary over just how to position portfolios versus their benchmarks over the next year. We have concluded that while we do need to have exposure in longer duration assets, significantly increasing that exposure now could lead to being whip-sawed by rising rates should things in the economy and in the geopolitical arena change sentiment and reverse the plunge in rates, and with it the drop in longer duration asset prices. For now, we intend to cautiously add to longer duration assets to maintain a defensive posture versus portfolio benchmarks, while scrubbing the portfolios of lower investment grade, shorter duration assets that we deem at risk for credit downgrades.

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