MANAGER COMMENTARY

FIXED INCOME

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

MANAGER COMMENTARY

Fourth Quarter 2019

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MARKET REVIEW

The bond market saw a significant reshaping of the yield curve over the past three months. The short end of the curve reacted to Fed easing, while rates rose from 3 to 30 years as trade uncertainty faded with the U.S. and China's Phase 1 trade deal announcement and economic data remaining stable. The Phase 1 deal, which is due to be signed in mid-January, means the planned new tariffs will not be imposed, while U.S. tariffs imposed in September on $120 billion Chinese goods will be reduced by one half. The 25% tariffs on $250 billion of Chinese goods will remain. China has also agreed to increase purchases of U.S. goods, with a highlight on agricultural produce.

The Fed cut interest rates once in the quarter before indicating that "the current stance of monetary policy is appropriate". The GDP expanded by an annualized rate of 2.1% in the third quarter, better than was expected and stronger than was reported in the second quarter. Further, the unemployment data released in early December showed that unemployment declined to 3.5% - its lowest rate in 50 years- with better than expected wage inflation. Other economic data, such as the purchasing managers' indices, which survey the manufacturing and services sectors, continue to indicate a modest expansion.

The U.S. 10-year yield rose 26 bps from 1.66% to 1.92%, while the two-year yield dropped 5 bps from 1.62% to 1.57%, steepening the yield curve as the market took a more optimistic view on the economy.

Corporate bonds performed exceedingly well to cap a strong year. High yield outperformed, but U.S. investment grade was also strong relative to government bonds and across various sectors. Credit spreads continue to tighten to near record lows.

SECTOR HIGHLIGHTS

Credit: Corporate spreads were tighter by 22 basis points during the 4th quarter. Spreads started the quarter at 115 basis points and ended at 93 basis points. Longer Corporates performed better than short-dated, and Industrials, specifically Basic Materials and Communications, had the best excess return for the quarter. The Bloomberg Barclays Aggregate Index returned 18 basis points for the quarter, the Bloomberg Barclays Intermediate Govt/Credit Index returned 37 basis points, and the Bloomberg Barclays Corporate Investment Grade index returned 118 basis points for the quarter. Although the economy seems to be growing at a slower pace than in years past, risk assets could continue to perform as the Fed has cut rates to help alleviate a weaker underlying market.

Municipals: The muni market performed strongly yet again in 2019. High Grade Municipal-to-U.S. Treasury yield ratios declined steadily in the first half of the year, but regressed in September due to a huge increase in supply of new issuance. Ratios now sit around more normal long-term averages. Credit fundamentals are still extremely stable and marginally improving year to date. Credit spreads have been stable in the aggregate, and overall municipal credit quality remains sound. Defaults remain low and are dominated by idiosyncratic project risks rather than systemic risk. In addition, credit upgrades consistently exceed downgrades. Aside from fundamental factors, muni bonds look attractive from a technical perspective: demand is strong and supply is tight. Municipal Bond fund inflows have been at record highs this year. We expect net negative new issuance in 2020, which should further benefit municipals from a technical perspective. One quarter and one year returns for the benchmarks we follow are impressive as the table below details:

	Q4	2019 YTD
Bloomberg Barclays 1-5 Year Muni	0.87%	4.03%
Bloomberg Barclays 1-10 Year Muni	0.86%	5.63%
Bloomberg Barclays 3-15 Year Muni	0.83%	6.83%

Asset-Backed Securities: Given the short duration of the ABS sector, the asset class as a whole outperformed its risk-free counterparts as the sector returned 92 basis points for the 4th quarter and 453 basis points for the year. However, some esoteric ABS sub-sectors did underperform their risk-free counterparts— namely aircraft, railcar, and containers. Our portfolios maintained an overweight to subprime auto and consumer sectors which outperformed.

We maintain a positive view on the U.S. consumer who accounts for the bulk of the spending in the economy. U.S. households continue to benefit from a decade-long run of low unemployment, moderate wage growth, and low interest rates. As we look forward to 2020, consumer strength is the underpinning of our investment allocations to the ABS sector. We will continue to invest in the higher quality part of the capital structure in consumer-based sectors that provide the best risk vs. return profiles.

Mortgage-Backed Securities: Mortgages generated nearly a point of excess returns versus comparable treasuries in 2019, with most of the performance generated in the 4th quarter. For the last quarter of the year the sector returned 39 basis points, for the year 560 basis points of total return. While total returns were strong, agency MBS readily underperformed other spread product asset classes such as investment grade corporates which returned 14.54% for the year.

2019 was an eventful year for agency MBS as mortgage rates rallied 100 basis points, which in turn rapidly increased mortgage prepayments. As we enter 2020, mortgage technicals appear cumbersome with low mortgage rates, a pickup in housing activity, and the Fed continuing to reduce its MBS balance sheet. Prepayments being the bane of the sector's existence, we continue to invest in strong prepayment stories and well-structured cash flow securities, and continue to look for strong cash flow profiles on the short end of the curve.

Yield Curve: The Yield Curve reversed course and steepened in the fourth quarter. The curve pivoted at the 2 year point with the front end coming down 21 bps in the 3 month and 6 month part of the curve and 14 bps in the 1 year part of the curve. The long end was certainly different with the 5 year part of the curve increasing 20 bps and the 10-30 year part of the curve increasing about 29 bps. This was a significant reversal for a yield curve that was flattening most of 2019.

Indeed, there are two main reasons for this reversal. One is that after the Fed lowered rates by 25 bps in October, they signaled a rate pause for the near future until data significantly changed enough to warrant a change one way or the other. Basically, the Fed is on hold until they see more clarity about whether the expansion will continue or if the economy will slow further. Also, along with the Fed being on hold, they will continue to support the repo market and will increase their balance sheet through treasury purchases. The other reason for the steepening was the Phase 1 trade agreement between the U.S. and China. Most importantly, this agreement averted more tariff escalation by the U.S. in early December. The agreement is expected to reduce tariffs going forward if China buys a certain amount of agriculture products from the U.S. More details on the specifics are expected once this is signed on January 15th, 2020.

Treasuries: Treasury returns were mixed on the back of yield curve steepening. The curve's pivot point was the 2 year part of the curve. Therefore, the front end experienced positive returns for the quarter and the back end saw negative returns. 1m to 2yr treasuries gained around .45% for the quarter, while the 10 year and 30 year lost 1.77% and 4.88% respectively. The closely watched 2/10yr spread increased significantly in the quarter after going on a bit of a rollercoaster. The spread started the quarter at 8 bps, going up to 27 bps in November, before backing up to 14 bps and then ending the year on a rally to 34 bps. The steepening of the curve indicates that the market believes that along with the rate cuts by the Fed, their repo support and planned treasury purchases will do enough to turn around a slowing economy and keep the expansion plugging along. Going forward, volatility is the name of the game as uncertainties around geo-politics continue to persist.

INDEX RETURNS FOR THE PERIOD ENDING DEC 31, 2019

	Q4	2019 YTD
BB Aggregate	0.18%	8.72%
Corporates	1.18%	14.54%
Treasuries	-0.79%	6.86%
ABS	0.92%	4.53%
Mortgages	0.39%	5.60%
High Yield	2.61%	14.32%
Municipal	0.74%	7.54%
2-year Treasury	0.41%	3.31%
10-year Treasury	-1.77%	8.90%
30-year Treasury	-4.88%	16.43%

MARKET OUTLOOK

We see a continued gradual slowdown in global economic growth over the next few years. Although a full economic recession is not likely near-term, we believe that the slowdown will increase, as measured by GDP, and we believe further that the Fed will need to stimulate the economy by any means deemed needed to avoid a recession.

That said, we continue to de-risk portfolios by reducing the contribution to duration (CTD) of credit to benchmark CTD. We feel the risks outweigh the benefits in credit with spreads at cycle tights, and that we should protect our clients from the potential credit deterioration. We will, for now, maintain our overweight to credit vis-à-vis the Intermediate and Aggregate benchmarks, but will scrub lower rated credits that we see to have greater spread widening potential than higher grade credits, and will maintain a higher than usual exposure to Treasury, Agency, MBS, and ABS assets.

Business spending has been subdued by uncertainty about trade deals, elections, and geopolitical risks. However, with U.S. unemployment at decade long lows, consumers remain the strong underpinning of the U.S. economy. A healthy consumer coupled with an accommodative central bank will support the economy.

We also continue to move portfolio duration versus the benchmark to near 100%, in keeping with the thesis that longer rates will be lower for the next several quarters. We began this process in the latter part of 3Q2019, and will continue to fine tune the mix as the market changes.

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