



FIRST QUARTER 2018



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Market Review

The yield on the 10-year Treasury Note rose 34 basis points in the quarter. As expected, the Federal Reserve raised the Federal Funds rate by another 25 basis points in March, the sixth such increase since the financial crisis was declared over. Members of the FOMC stated their belief that the outlook for growth in the U.S. economy has “strengthened in recent months”, signaling that at least two more rate hikes are likely before year-end.

In an era where rising interest rates are widely expected, the shape of the yield curve is still bewildering to many. What is curious is the continual flattening of the curve amid ongoing volatility. Drivers of these two moves can be found in monthly economic data, including increases in average hourly earnings, increases in CPI, hawkish FOMC minutes, and comments from new Fed chair Powell regarding faster growth prospects, prospects of a trade war with China, and trust issues with Facebook.

January saw a continued upward movement in treasury rates. The 10-year note increased 30 bps in yield, while the 30 year note advanced 19 bps, a flattening that would continue throughout the quarter. The 25 bps increase in the 2-year note was much like the upward move in 1 month LIBOR rate, which jumped 30 bps, and 3 month LIBOR rate, which jumped 60 bps, a boon to Floating Rate instrument holders.

In February, Investment Grade Credit spreads widened as new issue supply soared. The only bright spot was in Municipals, which finished only marginally lower for the month.

Moving past February volatility, sentiment in March caused more price erosion in virtually all sectors of fixed income. The flight to quality move in Treasuries continued to propel the bull flattening move on the longer end, as Trade War talk spooked the equity markets and sparked treasury buying in volume.

A much expected rate hike in late March helped to bring less certainty to the expected number of interest rate increases in the next 12 months. The short end of the curve saw higher yields, but from the 5 year to the 10 year part of the curve, there was little movement. The long end was the clear winner for the month and quarter, as the 10 year note moved in yield from 2.40% at year end, to a high of 2.94% in late February, settling in at 2.79% at quarter end, with plenty of volatility throughout the period. The 30 year moved from a low of 2.74% at year end, to 3.22% mid-February, and went out at a 2.97% yield.

For the quarter, investment grade credit, particularly intermediate maturity lower-rated debt, fared poorly, as spreads continue to widen. The “winners” included longer duration assets, curve flatteners in each segment, lower coupon 30 year mortgages, and taxable munis.

While most portfolios were short their duration benchmark, as one would usually do in a rising rate environment, the lack of exposure to the longer end of the curve in each category worked against us. Adding long duration exposure at this juncture only increases the likelihood of being whip-sawed, when long rates eventually rise and we return to a more normal, positively sloped yield curve. We expect several more interest rate hikes from the Fed over the year, and we believe that our current approach of being short all-in duration will stand us in good stead for the near future.

Q1 2018

BB Aggregate	-1.46%
Corporate	-2.99%
Treasuries	-1.18%
Mortgages	-1.19%
High Yield	-0.86%
Municipal	-1.11%
2-year Treasury	-0.11%
10-year Treasury	-2.13%
30-year Treasury	-4.01%

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