MANAGER COMMENTARY

FIXED INCOME

GREAT LAKES ADVISORS

A WINTRUST WEALTH MANAGEMENT COMPANY

SECOND QUARTER 2018

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Market Review

Fiscal stimulus and tax cuts nudged inflation higher and with it expectations for continued growth in the second quarter, which served to advance U.S. equities and bond yields across the globe. Interest rates rose early in the quarter, with the yield on the 10-year Treasury note breaching the psychologically important 3% level in April and May before backing off in June, closing the quarter at 2.85%. The Federal Reserve continued on its path of raising the Federal Funds Rate, moving it up one-quarter of a point to 2% in June, and signaled two more such hikes before year end. The yield curve, however, flattened, perhaps suggesting a more challenging economic environment ahead.

In contrast to the "Taper Tantrum" in 2013, the recent rise in real yield and expectations for increasing inflation has been gradual. A further risk to the global economy is the aggressive posture the U.S. has adopted with regard toward trade, imposing trade tariffs on several countries' goods, who in turn, imposed tariffs on U.S. goods.

Sector Highlights

- **Credit:** Credit spreads continue to widen and were a bit more volatile, but still rich to historical spreads. Most of the widening occurred in late May, when global volatility rose due to increased concerns in Italy, and U.S. trade concerns.

- **Treasuries:** With the Fed seemingly committed to two more rate hikes this year, the shape of the yield curve seems destined to flatten, with short rates moving up, while the intermediate and long end of the curve remain somewhat anchored. The two-year and ten-year spread is at the lowest in 11 years at 33 basis points, while ten-year and thirty-year spread closed the quarter at 13 basis points.

Index Returns for Period Ending June 30, 2018

	Q2 2018	YTD
BB Aggregate	-0.16%	-1.62%
Corporate	-0.98%	-3.27%
Treasuries	0.10%	-1.08%
ABS	0.42%	0.03%
Mortgages	0.24%	-0.95%
High Yield	1.03%	0.16%
Municipal	0.87%	-0.25%
2-year Treasury	0.21%	0.09%
10-year Treasury	-0.19%	-2.32%

- **MBS:** Mortgage spreads continue to widen, so far this year widening about 15 basis points, making this asset class a good alternative to credit. We have waited for some time now to re-enter the MBS asset class, and while we are still underweight to historical holdings, we were a buyer of mortgages over the past quarter.

- **CMBS:** Commercial mortgages continue to reduce delinquencies, now near the lowest levels in quite some time. CMBS had a tough time in May as did most asset classes, but held in for the quarter with a return of -0.06%.

- **Yield Curve:** With the Fed signaling its intent to continue to raise short-term rates, the yield curve continues to flatten. The ten-year to thirty-year spread at quarter end is now just 13 basis points, and the two-year to thirty-year spread is 46 bps, with rates higher across the front end of the curve (1-10 year).

- **Municipals:** Muni bonds were a bright spot for the quarter, with the 1-10 Year Index up 81 bps and the 3-15 Year index up 88 basis points. Year-to-date, the 1-10 Year Blend is still positive, up 10 bps, with the 3-15 Year Blend down 20 bps.

Market Outlook

We believe we may be in an environment where the yield curve continues to remain flat, and the Fed will continue to raise short rates. We are mildly concerned that we will continue to see spreads widen. With that scenario as the backdrop, we are keeping durations short to the benchmarks, and will continue our overweight of the short end of the curve, using defensive assets including ABS, munis, and short corporate bonds. Trade tariffs and NATO talks, along with fallout from the ongoing Brexit snags, will likely be the drivers of a market where volatility is commonplace.