



## FOURTH QUARTER 2017



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### Market Review

The fixed income market for the last quarter, as measured by the Bloomberg Barclays Aggregate Index, posted a solid gain of 39 basis points, while the intermediate sector posted a 7 basis point loss for the quarter. Short rates rose as the Fed tightened once again in December, with the curve pivoting at the 7 year point and continuing to flatten.

The long end of the curve performed the best, and Treasuries once again outgained credit for the period. The 10 year note gave up ground, and bounced around between a 2.28% and 2.49% yield to maturity. Little or no sign of inflation continues to fuel the rally in long bonds, as economic data shows growth, but with little effect on wages. Tax law changes came into effect on December 22, and confusion still exists about how lower corporate tax rates will affect supply and demand. These concerns have worked to keep rates relatively stable.

Our hallmark underweight to the Treasury sector was a drawback this quarter, but our overweight to Credit and Mortgages kept portfolio returns near those of the benchmarks. We are still short of our duration benchmarks, and continue to believe we will have a better entry point to increase exposure to Mortgages.

### Sector Highlights

- Credit:** Lower rated credit and longer maturity debt again did well. Spreads tightened again, albeit marginally. High Yield lost ground in mid-November and worked its way back to near flat for the quarter. Long BBBs, long Financials, and High Yield were clear winners for the year.
- Treasuries:** The yield curve continues to flatten, with short yields up and the long end just slightly lower than where the quarter started. The Fed hike in December is expected to be followed by three increases in 2018. The 10 year ended up 7 basis points higher in yield, while the 30 year bond finished 4 basis points lower in yield.
- MBS:** Mortgages, like other spread sectors, had a strong quarter compared to their Treasury counterpart. The sector's relative spread declined to the lowest in a number of years. As the quarter began, there were many fears of what the beginning of the end of Quantitative Easing (QE) by the Federal Reserve would mean for Mortgage Backed Securities. These fears were overcome as other spread sectors rallied and the Fed adopted a very gradual approach to trimming its mortgage purchases.
- CMBS:** CMBS had a strong quarter as the sector finished approximately 11 basis points tighter. The market had an easy time of digesting new supply, finishing at the tightest spread for the year. Investors shrugged off concerns about the retail space as well as the prospect of numerous legacy deals that needed to be refinanced. Demand for CMBS was aided by its relative value compared to other fixed income sectors.
- Yield Curve:** A continuation of the Bear Flattening curve continued through the fourth quarter. With the Fed hiking rates again in December, the long end actually rallied, signaling the bond

	Q4	2017
BB Aggregate	0.39%	3.54%
Corporate	1.17%	6.42%
Treasuries	0.05%	2.31%
Mortgages	0.15%	2.47%
High Yield	0.47%	7.50%
Municipal	0.75%	5.45%
2-year Treasury	-0.33%	0.24%
10-year Treasury	-0.04%	3.52%
30-year Treasury	3.43%	15.99%

market's perception that the economy is still not strong enough to lead to higher long term interest rates.

- **Municipals:** With the change in tax laws and the impending change to the municipal bond market, long munis had another excellent quarter, up 223 basis points. The main driver is the perceived demand/supply imbalance, given the changes to refunding rules, and the cap on state and local tax (SALT) deductions.

## Market Outlook

The Fed will likely reduce Quantitative Easing in earnest in 2018, and could hike short rates three times in the coming year. That said, we believe our position with regard to benchmark duration should continue to be shorter than the benchmark, and an opportunity to increase our exposure to mortgages will arrive later in 2018. Our current overweight in Credit will continue, and we will continue to weigh the merits of ABS, CMBS, and both taxable and tax-exempt municipal bonds.

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