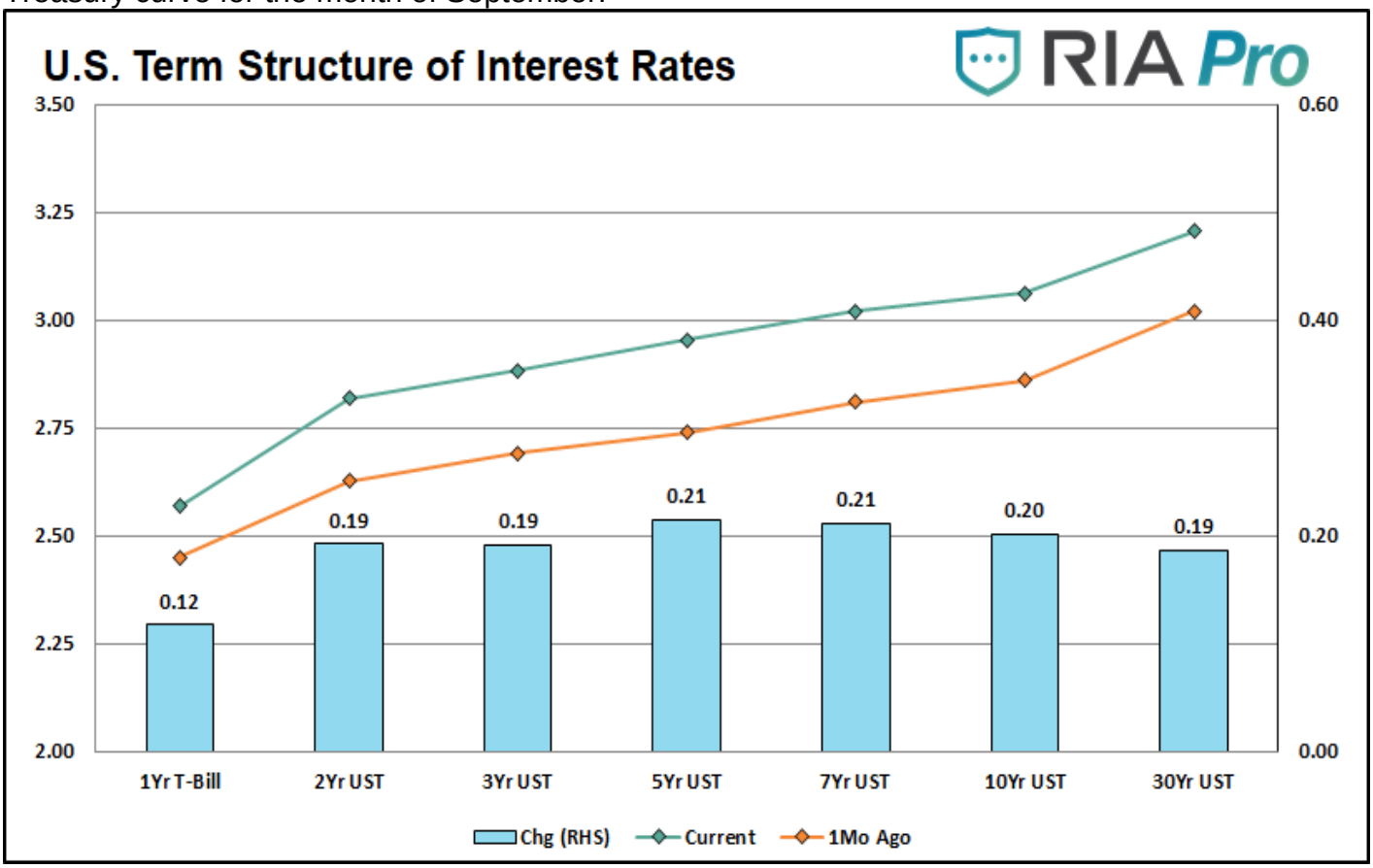
RIA Advice

Monthly Fixed Income Review - September 2018

September?s surge higher in benchmark interest rates set the stage for a challenging month in the fixed-income markets. In our broad asset class categories, as shown below, there were two exceptions as high yield and emerging markets had a solid month of performance. On a year-to-date basis, only the high-yield sector is positive. Similar performance data was observed in the popular ETF?s for these sectors as shown in the second table.

RIA Pro	MTD Total Return	3 Month Total Return	YTD Total Return	12 Month Total Return	Current Yield to Worst
U.S. Aggregate	-0.64	0.02	-1.59	-1.22	3.46
Agg. Treasury	-0.93	-0.59	-1.65	-1.62	2.95
Agg. Investment Grade - Corp.	-0.36	0.97	-2.33	-1.19	4.07
Agg. High Yield - Corp.	0.56	2.40	2.56	3.05	6.24
Agg. Securitized (ABS, MBS, CMBS)	-0.60	-0.07	-1.02	-0.87	3.58

Short term interest rates continue to march higher in response to the hawkish message being telegraphed by the Federal Reserve (Fed). At the same time, the long end of the yield curve remains range-bound although in September yields moved back to the upper end of that range with 10-year U.S. Treasury note yielding 3.06% and the 30-year U.S. Treasury bond at 3.21%. The move across the term structure of interest rates was parallel and for the first time since February, the 2-10s yield curve did not flatten. The chart below illustrates this shift in rates across the Treasury curve for the month of September.



The Federal Open Market Committee (FOMC) meeting at the end of the month produced few surprises and maintains that the Fed Funds target rate will top out between 3.25-3.50% in early 2020. The trajectory of Fed rate hikes suggests another move in December, three rate hikes in 2019 and one more in 2020. If maintained, that path means that interest rates at the short end of the yield curve will continue to rise and argues for an inverted yield curve in the not too distant future. Although an inverted yield curve has in the past implied a looming recession, Fed Chairman Powell and his colleagues on the FOMC are not yet expressing any concerns. With that backdrop, it seems plausible that the outlook for fixed-income remains challenging as rising interest rates will continue to keep pressure on returns. At the same time, the consensus view is that the economy will remain strong which should be supportive of credit markets. Evidence of this dynamic is showing up in the performance differential between high yield credit and most other fixed-income sectors. As discussed in prior months, part of the performance in high yield is due to falling supply, a shorter duration profile and other technical factors. The chart below shows the differential between spreads on BBB-rated credits, the lowest rung of the investment grade universe, and BB-rated credit, the highest rung of junk debt. Amazingly, at a mere 73 basis points, that difference is now very close to the historic low levels observed in the heady months leading up to the financial crisis of 2008. It is also over 100 basis points below the average for the last 12 years.

Emerging market (EM) credit bounced back from a poor August but the rebound seems unlikely to be durable. There remain a multitude of factors which urge caution including tight U.S. dollar funding conditions, on-going trade tensions as well as macro problems in several EM countries. Furthermore, this backdrop is creating the need for counter-measures (rate hikes) by the central banks of affected countries. While that may help matters in the near term as was the case in September, it may also create adverse conditions in terms of the outlook for economic growth. Capital outflows remain a significant risk until some of these issues are meaningfully relieved. *All Data Courtesy Barclays*