Fall Market Review

11/07/2018

Market Review

Volatile is a perfect descriptor of financial markets over the past two months. Since September, U.S. equities have wiped out their gains for the year. Bond yields continue to trend upward despite solid economic growth and muted inflation figures. Worries about the finale of the second longest growth cycle in history (112 months), paired with trade war headlines, have fueled the financial market turbulence.

The VIX Index, a widely recognized measure of stock market volatility, has taken off over the past six months. At the end of October, the VIX was 42% higher than in June, 30% higher than its average since 2010, and 10% higher than its 10-year average. Likewise, the MOVE Index (Merrill Lynch Option Volatility Estimate), a measure of bond market volatility, has moved from 46.16 at the end of September to 59 as of close yesterday. This index is still over 30% *lower* than the 10-year average.

Historically during uncertain times with equity market sell-offs, fixed income investment prices rally as money is moved into "safer" investments. Despite this historical dynamic, the bond market was not a safe haven over the past two months with the 10-Year Treasury ending yesterday at 3.22%, up from 2.86% at the end of August. As the Fed unwinds both low rates and its balance sheet, and other central banks consider tightening, volatility should continue to increase.

Best Ideas/Strategy

Total Return Portfolios

BAM Strategies: Short-Term Municipal, Tactical Ladder Municipal, Short Taxable, & Intermediate Taxable

Our Total Return strategies performed well in September and October. Remaining short duration versus their respective benchmarks paid off. We continue to remain short duration, but as rates move higher we anticipate strategy durations will move more in-line with their benchmark durations as we look to capture higher yields across the curve. We are targeting the 7-12 year part of the curve and higher coupon bonds within those maturity rungs.

Goals-Based Portfolios

BAM Strategies: Ultra-Short Municipal & High Income Municipal

Many clients employ goals-based investment strategies. For these portfolios, investments are made in accordance with specific goals versus a total return focus. These goals may include: target yield thresholds (ask about our BAM High Income Strategy), specific time period cash flow needs, or ultra-short investing as a cash alternative (ask about our BAM Ultra-Short Strategy). For these strategies, the client/advisor's goal(s) take precedence over relative performance to a benchmark.

Values in the Market

The 7-12 year part of the curve offer attractive yields versus current market averages, in our opinion. The strategies are well laddered in the shorter maturity rungs. During early/mid 2016, as rates hit all-time lows and we grew wary of extending duration, we made a conscious effort to boost exposure to the front end of the curve. As these issues begin to come due over the coming months, we are currently reinvesting in higher yielding and higher coupon issues in the 7-12 year space. This will result in increased portfolio income and overall cash flow which should help drive portfolio returns in the coming years.

For more information on our strategies please ask your Investment Specialist or Portfolio Manager.

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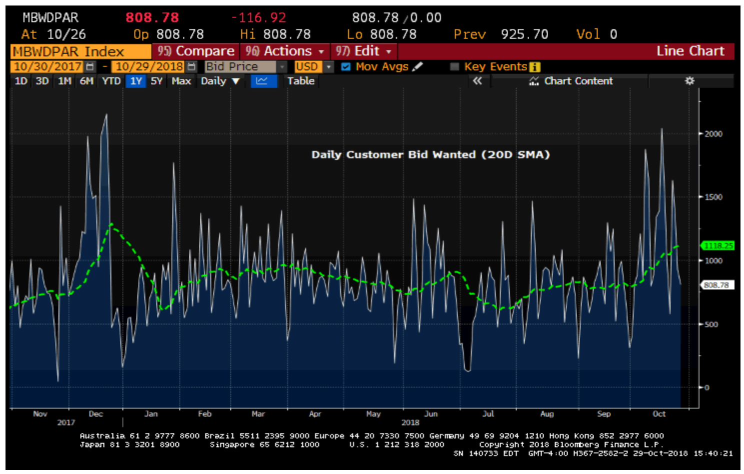
Trader's Corner

Since February of this year, the 10-year Treasury had remained relatively range bound between 2.80% and a 3.05%. During this time, municipals performed mostly in line with taxable counterparts. This dynamic started to change in early October when rates finally escaped this range and peaked as high as 3.25%. During this brief period, bond fund flows saw their first significant outflows since last December and institutional bid lists rose in kind. Accounts looking to raise cash sold heavily on the front end and helped flatten the exempt curve to better reflect Fed hiking and yield curves in general. On the long end of the curve, dealers were forced to cut prices and finally reprice long quality, 4% coupons to par in an effort to drive demand.

Customer Bid Lists

Municipals have underperformed recently, with the 5-year space moving from only 65% of Treasuries in early August to more than 75% today. On the long end, high grade 5% coupons have moved up to 100% of Treasuries and 4% coupons at as high as **130%.** This generally occurs as municipals remain one of the few securities that cannot be shorted. The need to raise cash or perceptions about rate moves can reverse this trend in a hurry.



Source: Bloomberg

Municipal Ratios Showing Price Performance 5/10/30yr (5% coupons)

Source: Bloomberg

As a result, the two most dramatic changes in the municipal space have been on the two extreme ends of the curve. Quality names can finally be purchased inside the first five years at nominal yields affording investors nearly (and in some cases) a 4% taxable equivalent yield. Additionally, on the long end of the curve, solid high grade credits can be bought as 4's at par. The last time we saw these levels was briefly during the Taper Tantrum of 2013.

Recent stock market volatility, however, will probably result in fund flows returning to their modestly positive rate, and if the 10 year bond recaptures its 2.80% – 3.05% range, (currently 3.08%) the opportunity to buy these long quality names at par could be fleeting. For those looking to remain short with their duration, 2023-2025 can offer safe liquid names at taxable equivalent rates of around 4% for the first time in years.

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Higher Coupons, Lower Volatility

On July 5th, 2016, the 10-Year Treasury bond yield hit an all-time low closing the day at 1.37%. Twenty-eight months later, in early October, the 10-year Treasury reached its highest level since June 2011 driven by positive economic data and a shift in Federal Reserve policy from easy to tight. As of close yesterday, the 10-Year Treasury rate stood at 3.22% (+135% from July 2016). Tax-free municipal rates have witnessed similar gains. The AAA-rated, 10-Year municipal rate moved from 1.34% to 2.77% (+107%) over the same timeframe.

As rates have moved higher (bond prices lower), we thought it would be a good idea to discuss price volatility within the municipal bond market. There are a certain techniques we utilize to help reduce price volatility within client portfolios. One such technique is creating a laddered portfolio structure. The ladder allows for a consistent stream of principal redemptions, which allow for reinvestment into higher rates. Overall, it generates a disciplined approach to rates, helping avoid market timing and speculating about the next shape of the yield curve.

A second method we utilize is the separate account structure. This allows clients to control their portfolio holdings and not be directly tied to mutual fund inflow or outflows, which often lead to significant price swings and net asset value (NAV) dislocations.

Another way to reduce volatility in a rising rate environment, and the focus of this article, is allocating more funds to the purchase of higher coupon bonds. Higher coupon bonds provide more cash flow on an annual basis. Back in 2016, investors were purchasing issues with 2.00% coupons. This meant that on an annual basis they would receive $2,000 for purchasing $100,000 par value. Today, issues are coming to market with 4-5% coupons. Investors are receiving 1-1.5x more in annual cash flow versus 2016. Since the investor is recovering their original investment "faster" from a higher coupon bond (more cash flow) than a lower coupon bond (less cash flow), the higher coupon bond will have a lower overall duration and therefore lower price volatility.

Below we have provided a simple price comparison between different coupon issues. It is important to remember the municipal bond market is an extremely idiosyncratic market. No issuer is the same and bonds may act differently based on a variety of factors, such as maturity, structure (callable/puttable), state of issuance, or rating to name a few. In the below example, we assumed the only difference in the bonds being compared pertains to the coupon rate.

Inputs	
Years to Maturity	10
Market Yield	3.00%
Principal Amount	$100,000.00
Coupon Frequency	Semi-Annual

Scenario 1: Market rates move from 3.00% to 4.00%

Market Yield	**Coupon Rate**			
	2.00%	**3.00%**	**4.00%**	**5.00%**
3.00%	$91,415.68	$100,000.00	$108,584.32	$117,168.64
4.00%	$83,648.57	$91,824.28	$100,000.00	$108,175.72
Price Change	($7,767.11)	($8,175.72)	($8,584.32)	($8,992.92)
Percentage Change	**-8.50%**	**-8.18%**	**-7.91%**	**-7.68%**

Scenario 2: Market rates move from 3.00% to 5.00%

Market Yield	Coupon Rate			
	2.00%	**3.00%**	**4.00%**	**5.00%**
3.00%	$91,415.68	$100,000.00	$108,584.32	$117,168.64
5.00%	$76,616.26	$84,410.84	$92,205.42	$100,000.00
Price Change	($14,799.42)	($15,589.16)	($16,378.90)	($17,168.64)
Percentage Change	**-16.19%**	**-15.59%**	**-15.08%**	**-14.65%**

As shown in the examples above, the higher the coupon the better the bond performs in a rising rate environment, all things being equal. Investing comes with risks and as investors we cannot entirely eliminate volatility within portfolios. As bond managers we utilize techniques to minimize this price volatility. Purchasing higher coupon issues in an increasing rate environment is one of these techniques.

Please reach out to your Investment Specialist or Portfolio Manager with any questions.