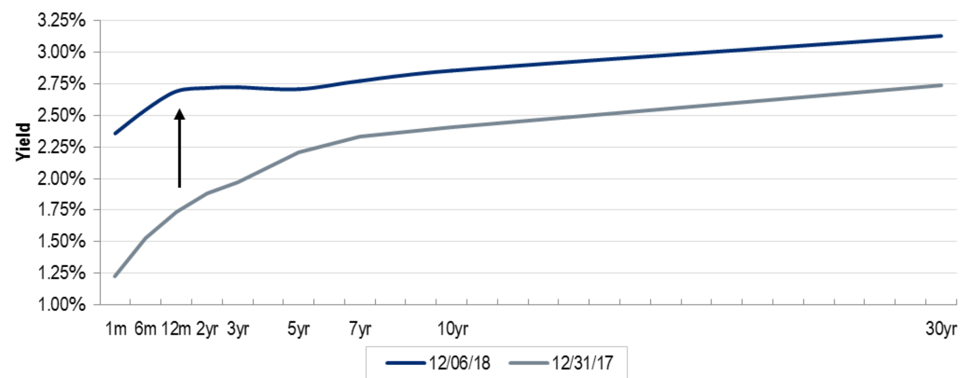
Global Asset Management

December 2018

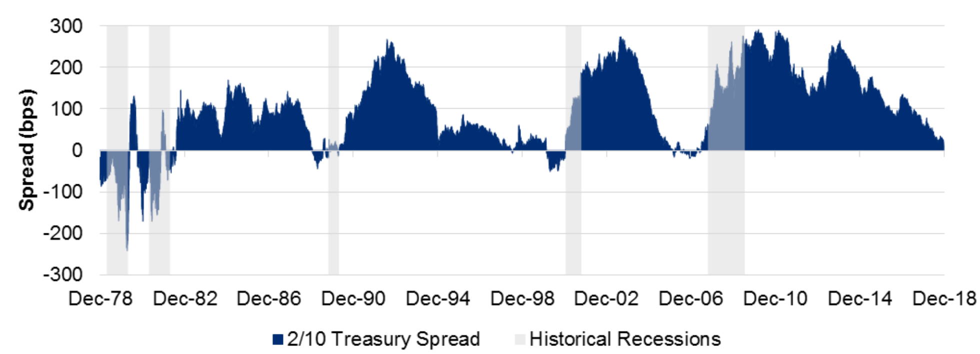
Inflection Point: A Bond Market Update

U.S. Treasury Curve



Source: Bloomberg, as of Dec 6, 2018

2-Year/10-Year U.S. Treasury Spreads



Source: Bloomberg, as of Dec 6, 2018

Overview

The current US Treasury yield curve is at its flattest level since 2007. In recent days, the yield curve has partially inverted (the 2-year and 3-year Treasury yield rose above the 5-year Treasury yield). The 10-year US Treasury Note is now yielding below its 200-day moving average, causing the widely watched "2s-10s" spread (the difference between the 10-year yield and 2-year yield) to also reach 11 year lows and move closer to inversion territory. Historically, when the 2s-10s invert, it has been an accurate predictor of recessions. It's important to note that this inversion has not yet happened, but as of early December the 2s-10s steepness has diminished and traded to within 11 basis points. Forward curves are also flat showing no spread 12 months from now, further suggesting that we are at an inflection point.

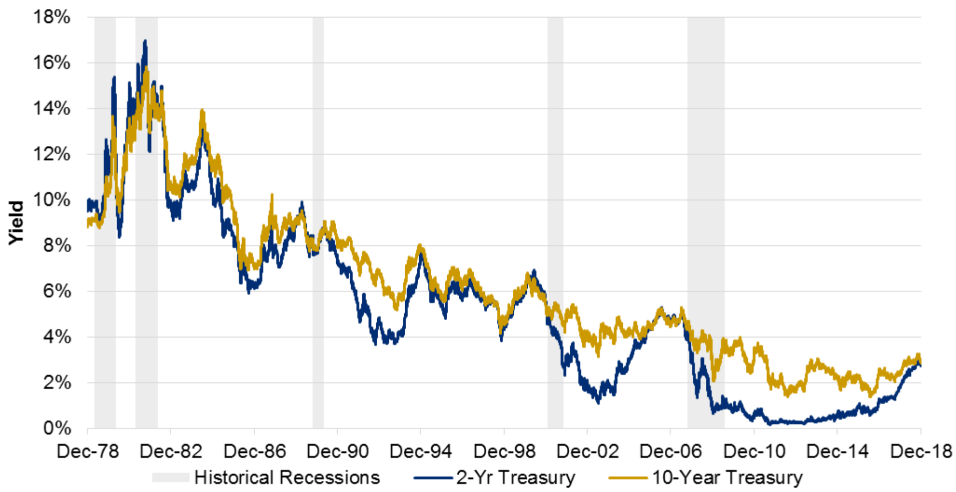
Yield Curve Implying Lack of Confidence in GDP Growth:

- Today's flat yield curve is viewed as a reflection of lack of confidence in future GDP growth and inflation
- Flatter yield curves tend to occur during and preceding periods of slowing economic growth, including recessions. Curve inversions are driven by:
  - Rising short rates – increasingly restrictive overnight rates can be viewed as limiting credit and future growth
  - Falling longer rates – the market is pricing in a slowing economy which will result in lower inflation expectations

Market and Strategy Implications:

- Market yields are pricing in slower growth. In addition, further weakness in equities could see investors flocking to the relative safety of Treasuries, pushing up bond prices and causing long rates to fall further relative to short rates which are anchored by the current/expected Fed Funds Rate
- Recent rate movements and volatility in equity markets have discounted the 2019 path for Fed Funds Rates, making it more difficult for the Fed to reach its projection of three rate hikes for next year. The Fed acknowledges we could be closer to the peak in the Fed's rates cycle
- The latest rate rally is a prime example of the difficulty in using duration to add alpha. The direction of interest rates can be difficult to predict. Markets can turn suddenly which only increases the volatility from making duration bets. We continue to stay fully invested with a focus on adding income through our bottom up security selection while avoiding duration calls

2-Year & 10-Year U.S. Treasury Yields



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