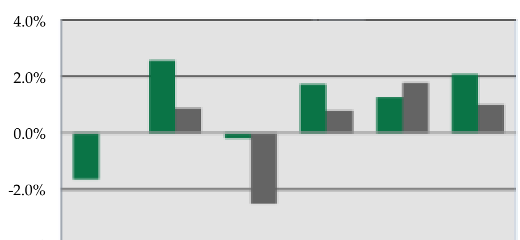
FIXED INCOME OVERVIEW

A risk-off tone dominated the financial markets during the quarter as stock indices tanked and interest rates shifted lower on heightened volatility due to uncertainties in the global economy, political leadership and confusing commentary from the Federal Reserve. The Bloomberg Barclays Aggregate Index gained 1.64% in the quarter to finish 2018 with a return of just 0.01%. U.S. Treasury bonds led the way this quarter in a flight to quality not seen since early 2016 as corporate and high yield bonds found few takers given all the worries. Although our underweighting in U.S. Treasuries cost us a bit in relative performance, our managers are not viewing this as a time to head for the hills, but rather one of potential reward, as a resetting of expectations offers valuations not seen in a while.

Index Sector Performance

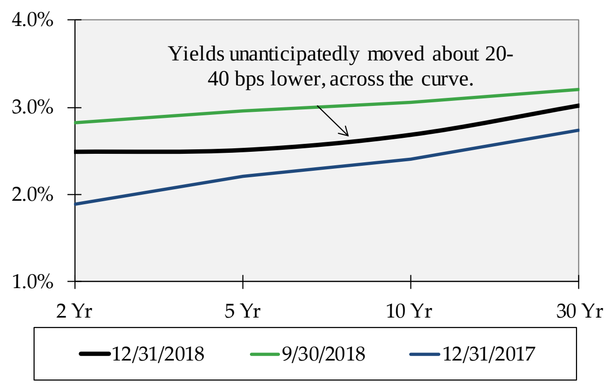


	INDEX	Tsy	Corp	CMBS	ABS	Agency MBS
Q4 '18	-1.64%	2.57%	-0.18%	1.72%	1.25%	2.08%
2018	0.01%	0.86%	-2.51%	0.78%	1.77%	0.99%

Source: Bloomberg

Treasury bond yields rallied sharply in December despite the Federal Reserve delivering another well-telegraphed rate hike. Market participants were hoping for a more dovish tone out of Fed Chair Powell, but they did not get their wish. The ten-year benchmark treasury yield fell 37 basis points to 2.69%, while the two-year note finished the quarter at 2.49%. The often-quoted 2-10's treasury curve finished the year near a low of 20 basis points. We have not seen these levels since the summer of 2007, and most will remember what happened next.

Treasury Yield Curve

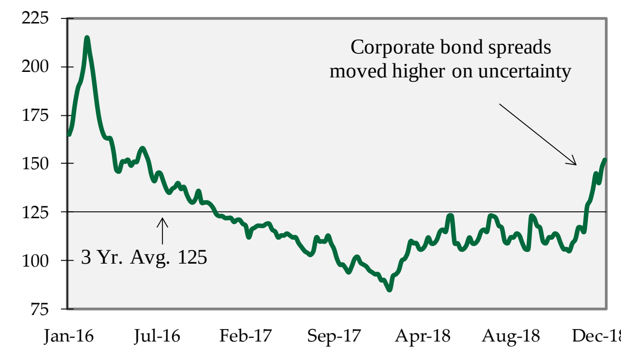


Source: Bloomberg

CREDIT SPREADS

Corporate bonds bore the brunt of the risk sell-off in fixed income as global growth concerns weighed heavily on the price of energy and materials bonds, not to mention the price of oil. Financials were also weak as the aforementioned curve flattening generally pressure banks' margins, and investors were quick to jettison positions. Compounding a more difficult fundamental environment, corporate bond investors faced a challenging liquidity backdrop as the issuance and risk-taking calendar tends to slow near the end of the year. Investment grade corporate bond spreads within the Bloomberg Barclays Aggregate Composite widened 47 basis points, which is 30 basis points wide to a three-year average. Our managers see this as an opportunity to increase allocations to corporate bonds across the spectrum.

U.S. Corp. Investment Grade OAS



Source: Bloomberg

THE ECONOMY

Our view on the U.S. economy remains constructive, but growing concerns of a slowdown are worth keeping an eye on. In our last missive we noted a cooling in trade tensions as the U.S. reached a deal with its North American partners; unfortunately, there has been little movement with China. A U.S. delegation is heading there in early January and positive traction from this meeting would go a long way to easing some of the markets' concerns around global growth. We have probably been too optimistic regarding a deal with China, so we are going to handicap this worry by exercising caution while trading, but not calling for an imminent U.S. recession, and taking the entire yield out of portfolios. Despite many international worries, the domestic backdrop is showing remarkable resiliency. The recent ADP and non-farm payroll data highlights a strong employment picture that continues to show signs of wage growth, even from maligned sectors such as retail. It is also worth mentioning that the U.S. household is nowhere near as leveraged as they were heading into the downturn of 2007-2009. The chart below tracks household debt payments to disposable income and is one measure of the relative health of the U.S. consumer. Current readings are nowhere near the prior two recessions, which fits our thesis of continuing economic growth in 2019.

Source: Bloomberg

THE FED

Rather than delivering a dovish hike that most were anticipating, the Fed added to the markets' confusion in December. Chair Powell's comments on the measured strength in U.S. economy did little to assuage fears as reiteration of an autopilot balance sheet unwind and a seemingly misread of current financial conditions (at least with regard to market sentiment and liquidity) amplified the sell-off in what was already a poor performing month for stocks and corporate bonds. Additionally, inflation readings have remained quite tame throughout the latest rate hikes, which lead people to question whether the Fed is increasing rates now so they have room to lower in the event of a slowdown.

Source: Bloomberg

The futures (red-line) and overnight markets (purple-line) are joining our chorus in being skeptical of additional hikes, even hinting at a possible move lower by year-end 2019.

FIRST QUARTER STRATEGY

We begin the New Year with many unanswered questions. Global and domestic growth appears under pressure while the trade negotiations with China continue. Brexit and the rising tide of nationalism across Europe has us concerned, as do the partisan politics here in the U.S., as the partial shutdown of our government enters its third week. There is some positive news to report as Fed chair Powell pulled a 180-degree turn and highlighted "flexibility" and "patience" around further hikes, while acknowledging a slowing but still growing economy. This echoes our stance as we position portfolios for the year ahead. Interest rates are unlikely to break out on the upside, so we will manage portfolio durations closer to their indices than in past years. Accounts with DFI mandates will remain a bit lower in relative duration, but we might look for a shift into the certain components as recent market volatility has increased the risk/reward opportunity across many asset classes, including high yield and preferred stocks. Corporate bonds across the investment grade spectrum offer appeal, and our managers will use new issue concessions and trading opportunities to focus on this area. We may reduce some of our taxable muni exposure, as names in this space held up quite well last quarter.

Mark R. Anderson, CFA
Chief Strategy Officer

NIS