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Capital Management, LLC

Credit Markets: A Historic Quarter

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At the end of March, the benchmark ten-year U.S. Treasury was yielding 2.41%. The second quarter saw yields on the ten-year Treasury fall by a remarkable 40 basis points (0.40%) to end the quarter at 2.01%. This is a historic drop in interest rates.

Many market pundits have continued to fret about an impending recession as U.S. economic activity has slowed from the blistering pace of earnings growth last year, the effect of tax cuts has waned and the trade war with China has escalated and could continue to do so. As a result, bond yields have dropped dramatically in anticipation of slower economic activity in the future and the increasing probability that the U.S. Federal Reserve will begin reducing interest rates to defend against a possible recession.

Bond duration measures the sensitivity of bond prices to changes in interest rates. As interest rates have declined significantly, longer duration bond prices (those most sensitive) have spiked. Over the past six months, higher duration bonds – particularly junk (high-yield) and corporates – have risen in price by nearly 10%.

In the following chart, you can see the yield curves for U.S. Treasury, U.S. Corporate and U.S. Municipal bonds. What's interesting to note is that both the Treasury and Corporate curves are inverted from the 6-month to the two to four year range. The Municipal curve has not inverted. However, the spread between the ten-year Treasury and the two-year Treasury has actually widened over the past quarter. The ten-year to two-year Treasury spread is an important indicator of future economic activity. This is a positive sign for the economy going forward.

While we believe interest rate forecasting is one of the most difficult exercises in finance, the current structure of the yield curve has real-world implications for how to invest in bonds. As of this writing, Fed Funds futures contracts indicate a 100% probability of either a 0.25% or 0.50% cut by the Fed in July, with the market expecting a total of 3-4 cuts over the next 12 months.

As a result, in corporate bonds, we currently prefer a "barbell" approach of owning very short term bonds (less than 1 year) and bonds in the 6-8 year maturity range. In municipals (our largest allocation for clients), we continue to prefer the 4-7 year maturity range as we have for years.

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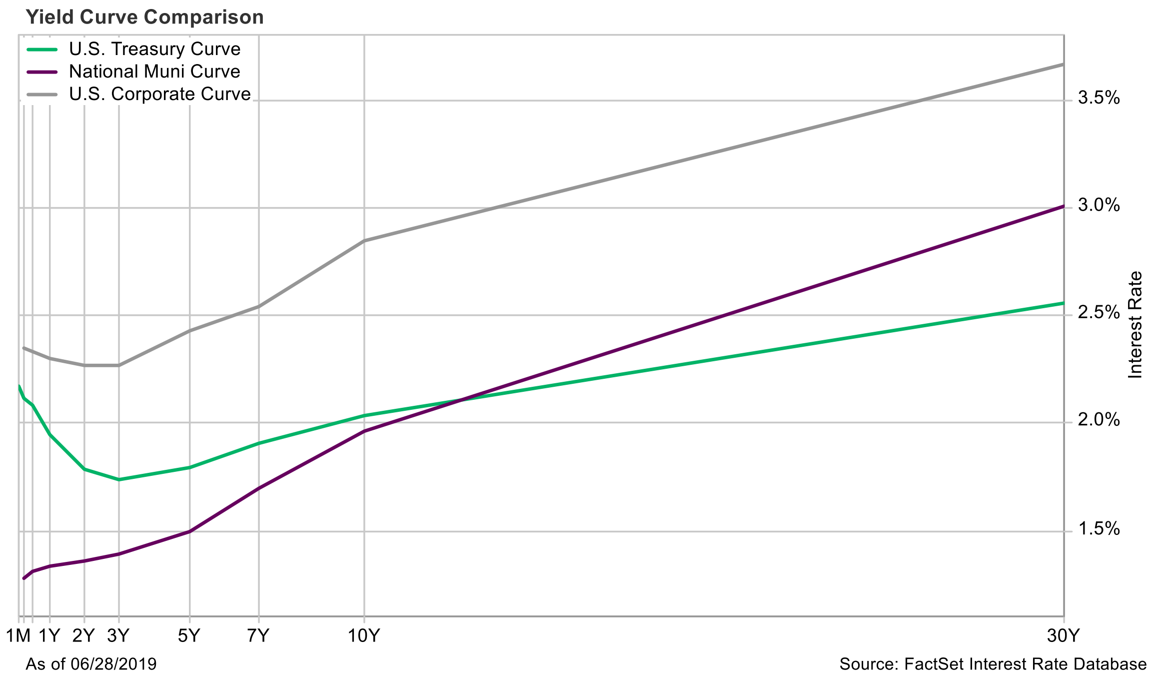

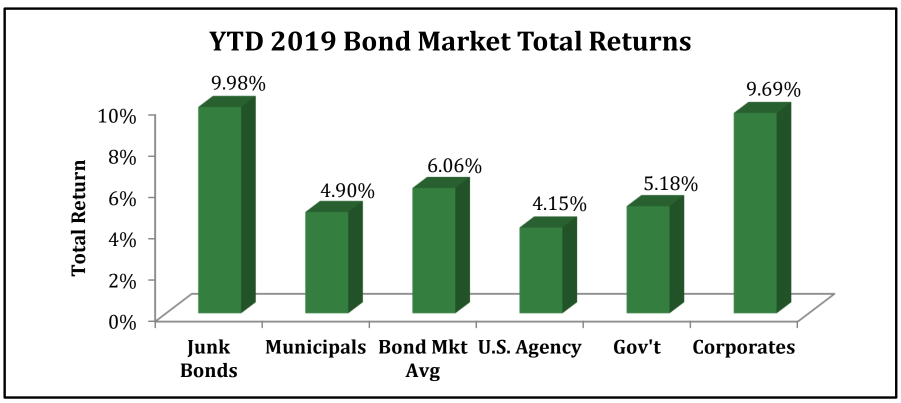

Source: Wall Street Journal

Bond Market Yields 6/30/2019

Average Money Market Fund	0.69%	10 Yr. AAA Muni Bond	1.62%
5 Yr. AAA Muni Bond	1.34%	10 Yr. AA Corporate Bond—Long Term	2.68%
5 Yr. AA Corporate Bond—Intermediate	2.23%	10 Yr. U.S. Treasury	2.01%
		30 Yr. Fixed Rate Mortgage (Conforming)	3.80%

Source: Bankrate.com