CARRET Asset Management

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Carret Credit Insight

Inversions, Spreads, and Recessions - What the Market Is Telegraphing

Co-Directors Fixed Income

Jason R. Graybill, CFA
212.207.2339
jgraybill@carret.com

Neil D. Klein
212.207.2340
nklein@carret.com

Firm AUM

$2.7 Billion

We went on record in October of 2018, with our opinion that the FED had reached "neutral" when it raised the Fed Funds Rate to a range of 2.00% to 2.25%. Inflation, as measured by the FED's preferred inflation gauge PCE, was hovering near the FED's 2% target. We define monetary policy at neutral (neither stimulating nor detracting from the economy) when the overnight rate, the Fed Funds Rate, closely mirrors the rate of inflation and the economy (GDP) is growing at a comparable rate. We believe the FED also defines neutral in a similar fashion. Why then did the FED raise rates to a range of 2.25% to 2.50% on December 21, 2018? We believe, that on that date, they anticipated strengthening economic data. It is the FED's job to "forecast" the direction of the economy, unemployment, and inflation – a hard job it is! The markets are a real-time forecaster of all things economic – so let's look at what they are telegraphing today.

As we enter the 2nd quarter, U.S. Treasury yields have ***inverted***, credit ***spreads*** have tightened - both investment grade (IG) and high yield (HY) - and the yield curve is indicating a recession is more probable than not. Let's digest what each of these means in isolation:

- ***Inverted yield curve:*** When short-term interest rates are greater than long-term interest rates, the yield curve is inverted. At quarter end, the 6 month U.S. Treasury was yielding 2.43% and the 10 Yr was yielding 2.42%. While nominal, this is the first time the Treasury yield curve has inverted in the past decade and only the 4th time over the past 30 years. Inversions have historically been a reliable indicator of a pending recession. When the FED maintains an above neutral (tightening) monetary stance and investors believe the economy will slow, long rates fall while the FED holds short rates constant. This is where we ended the quarter. Investors believe the global economy is slowing, inflation is muted, and the FED is more likely to cut rates than raise them.

Key Interest Rates	3.31.19	12.31.18	12.31.17
Prime Rate	5.50%	5.50%	4.50%
Fed Funds Rate	2.25% – 2.50%	2.25% – 2.50%	1.25% – 1.50%
3 Month U.S. T-Bill	2.39%	2.45%	1.39%
5 Yr U.S. Treasury Note	2.24%	2.51%	2.21%
10 Yr U.S. Treasury Bond	2.42%	2.68%	2.41%
10 Yr AAA Municipal Bond	1.86%	2.28%	1.99%
10 Yr A Corporate Bond	3.49%	4.11%	3.25%

Source: Bloomberg, Wall Street Journal, Reuters, Municipal Market Data (MMD), FactSet

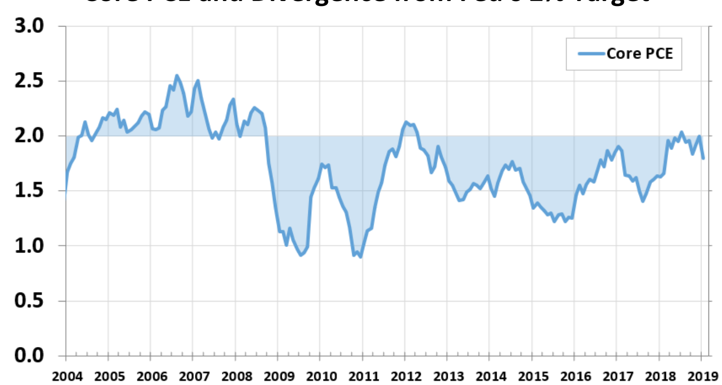
- ***Credit spreads:*** Bond investors demand a return for taking on risk above the return of the "so-called" risk-free rate of U.S. Treasuries. This excess return is referred to as a credit spread. When the economy is soft and corporate profits are declining, investors demand a greater return for taking risk (credit spreads widen). When the economy is robust and profits are rising, investors are willing to get paid less (credit spreads contract). Simply put, we should get paid more to take on risk in times of slow growth and uncertainty and less during the good times (our on-going risk/reward analysis). During the 1st quarter, IG (as measured by 5Yr A rated corporate bonds) spreads contracted by 0.35% and HY (as measured by the iBoxx HY index) contracted by 1.07%.

Today the yield curve is telegraphing an economic slowdown and an increasing probability of a recession. Conversely, credit spreads are telegraphing solid corporate profits and good times ahead. This is certainly unusual; however, we remain in highly unusual times with 31% of all global sovereign debt trading at negative yields.

We have previously discussed our view that the FED would not purposely invert the yield curve – which they haven't. During December, investors were spooked by growing weakness in Europe and fears of a slowing global environment. Investors pushed long-rates down and inverted the curve. In an effort to "calm" investors, the FED tried to telegraph that it ***now*** agrees we are at neutral. FED Chair Powell stated "the most recent economic data is not signaling that the FED needs to move interest rates in one direction or another. We feel our policy rate is in the range of neutral. The economy is growing at about trend. Inflation's close to target. It's a great time for us to be patient and watch and wait and see how things evolve." St. Louis FED President James Bullard said that he "supports being cautious on rates, and wouldn't lean toward moving in either an upward or downward direction". He added, "at the moment, the risks from the downside scenarios loom larger than those from the upside ones. If activity softens more than expected or if inflation and inflation expectations run too low, then policy may have to be left on hold, or perhaps even loosened."

We do not believe that a few days of an inverted yield curve by a few basis points should send a doom and gloom message. While the markets year end reaction to soft data and the yield curve inversion essentially puts the FED on hold, we understand the interpretation of the yield curve and credit spread story: The economy can continue to grow at a subpar rate (below 2.5%) without generating inflation above the FED's 2% target and corporate America can continue to generate record profits which is good for bond investors from a credit perspective.

Core PCE and Divergence from Fed's 2% Target



Source: BEA, Vining Sparks

FED Actions: At the FED's March 21st meeting, they left the Fed Funds Rate unchanged at 2.25% to 2.50% and announced an end date to balance sheet normalization. They acknowledged "economic activity has slowed from its solid rate in the 4th quarter." The FED is now telegraphing no rate increases in 2019, down from two in December. One rate hike is still expected in 2020.

On the balance sheet normalization front, The FED now intends to stop shrinking the balance sheet when it reaches $3.5 Trillion. At year end, the balance sheet stood at $4.1 Trillion down from $4.5 Trillion in October of 2017 when the normalization process was initiated

FED's Economic Outlook: The FOMC's latest *Summary of Economic Projections* lowered the FED's estimate for 2019 GDP from 2.3% to 2.1%. Core CPE inflation estimates for 2019 were unchanged at 2.0%. For 2020, Core PCE inflation estimates are 1.9%. Unemployment estimates increased to 3.7% for 2019 and 3.8% for 2020. We believe the FEDs projections of GDP growth of sub 2.5%, inflation below their 2.0% bogey, and increasing unemployment confirms the FED is on hold.

Economic Highlights: According to FactSet, 4th quarter GDP was reduced from 2.6% to 2.2%, bringing full year 2018 GDP growth to 2.9%, the highest since 2015. Economists' GDP estimates for the 1st quarter of 2019 average 1.8%, and 2.4% for the full year.

The March unemployment rate registered 3.8%. We have had a keen eye on wage growth as full employment typically pulls wages upward and creates inflation. Wage growth for March declined to 3.2% from February's 3.4% rate. The February rate is the high-water mark for this expansion. March consumer confidence came in at 124, missing the 132 consensus and declining from February's 131.

The Core Consumer Price Index (CPI) was softer than expected in March with core prices increasing YoY at 2.0%. This is the first time in 13 months that the Core CPI has not been above 2.0%. The Producer Price Index (PPI) registered its weakest growth in 18 months in March.

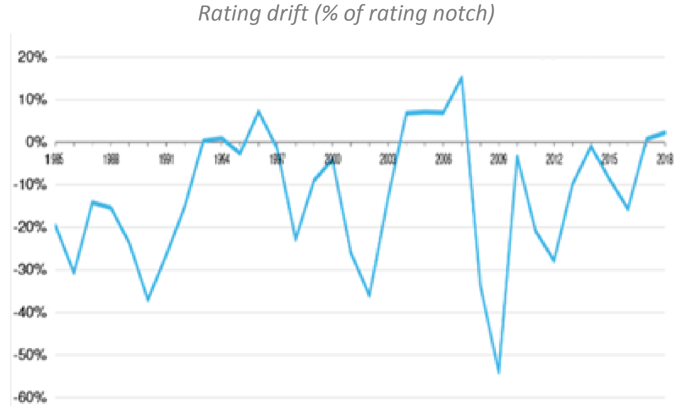
Bottom Line: During the last 2 months of 2018, the equity markets experienced a 15 - 20% pull-back and bonds were not left untouched. The pull-back (risk-off trade), was so quick and sharp that most asset classes, globally, were penalized. IG and HY bond spreads widened materially in 6 weeks, giving up a meaningful portion of the gains generated during the first ten months of the year. Fast forward to 2019… the reversal of trend was powerful. IG and HY spreads have contracted sharply and the gains during the first ninety days of 2019 have been noteworthy. Looking forward, we still recognize that Corporations, Citizens, and our Government are more indebted than ever before and common sense should be used over the long-term. We see no recession on the horizon, but recognize that the global economy appears to be slowing, trade negotiations and Brexit linger, and we are facing the lagged effect of prior monetary tightening. Additionally, we are aware that the elections of 2020 are getting closer and will bring increased volatility. We believe that with yields at low levels and the curve essentially flat, investors should focus on controlling risk. We believe the FED will be on hold for the balance of 2019 and challenged to raise rates until investors let them (long rates creep higher). Our 10 Yr U.S. Treasury forecast for 2019 remains at 2.75% - 3.25% as inflation remains in proximity of 2.0% and the Bank of Japan and the European Central Bank continue to manipulate rates to the downside.

Taxable Bond Strategy

The U.S. investment grade corporate bond market had a strong start to 2019. With investors pouring money into IG debt during the quarter, the lowest rated IG bonds had their best performance in over two decades. Renewed confidence in corporate debt – and more specifically BBB rated corporate debt – comes indirectly from the FED. When they signaled a pause on raising short-term interest rates, investors decided that the current risks of downgrades to junk were minimized enough to boost confidence in BBB rated securities. As we have previously discussed, debt to equity ratios remain near historic lows – a positive for fixed income investors. This credit metric, along with improving balance sheets, paints a positive picture of the corporate bond market. As such, rating upgrades outpaced downgrades in 2018 for the first time since the financial crisis – another encouraging sign for IG corporate bonds.

Upgrades outpaced downgrades in 2018

Rating drift (% of rating notch)



Source: The Wall Street Journal, Moody's Investors Service

The market is finding value in lower rated IG corporate bonds. The rally during the 1st quarter reinforces our view regarding value in BBB rated securities. Specifically, with U.S. Treasury yields falling and the yield curve flattening, investors have two options in their search for yield – either move down in credit or move out in maturity. In the current market environment, it is widely viewed that there is less risk and more reward in buying lower quality positions compared to longer duration ones – the flat treasury curve implies that investors are not getting paid to take on interest rate risk. Since BBB bonds are the lowest rated credits in the IG market, they were affected the most by the flight to quality during the 4th quarter of 2018. With these credits being "oversold", they rebounded in the 1st quarter as the "flight to quality" trade has reversed course.

As of March 31st, we remain overweight corporate bonds with an emphasis on A and BBB credits. During the quarter, 5 Yr A rated yields fell 62 bps (3.62% to 3.00%) and 5 Yr BBB yields fell 76 bps (4.23% to 3.47%). Relative to 5 Yr U.S. Treasuries, corporate spreads tightened during the quarter with A rated spreads falling from +111 bps to +76 bps and BBB rated spreads moving from +172 bps to +123 bps. We find these levels relatively attractive given the low yields on government debt. The 1st quarter saw the 2 - 10 Yr spread continue its fall to +15 bps at quarter end – the tightest quarter-end spread we have experienced during this expansion. Given the flatness of the treasury curve and corporate bond spread tightening, we are comfortable keeping interest rate risk near a 3 Yr duration target; however, we continue to look for opportunities to extend if/when long-term rates move higher or the curve steepens.

Our ***Taxable Bond Strategy*** is focused on high quality IG, intermediate maturity bonds. Portfolios are structured to generate an average yield to maturity (YTM) of 2.94% with a duration of 2.9, and an average credit rating of A-. Relative to our benchmark, we remain overweight corporate bonds although we have increased our exposure to U.S. Treasuries and U.S. Agencies – 19% of the portfolio. During the quarter, we reduced our exposure to BBB rated credits from 45% to 42%, taking advantage of the strength in this segment of the bond market.

Opportunity & Leverage Opportunity Strategies

Last quarter, we highlighted the short-term correlation of HY bonds to equities as it related to the downside (spreads widening). A short 90 days later, we can point to the same correlation to the upside (spreads tightening). Recall, that we like volatility as it creates potential opportunities to either increase portfolio risk or decrease portfolio risk. When we can get "paid' to take risk, we take it and when we are not getting "paid" appropriately, we de-risk portfolios. The 1st quarter brought HY valuations to a level that we deem extended. Accordingly, we have de-risked portfolios. We took advantage of the strength in HY by redeploying capital from calls, tenders, and swaps to shorten portfolios (decreasing interest rate risk) and increase quality (decreasing credit risk). At quarter end, on average, 22% of our Opportunity Strategy was invested in IG bonds while the Leverage Opportunity Strategy had 38% invested in IG bonds. We anticipate having a few additional calls and tenders in the 2nd quarter which will continue to enable us to take advantage of opportunities as they arise.

Barclays U.S. Corp High Yield Index vs 5 Yr U.S. Treasury

(with spread)

Source: Bloomberg, Barrons

As of March 31st, HY spreads, the yield differential between U.S. Treasuries and HY bond yields, tightened sharply, recapturing the sell-off that coincided with the November / December equity sell-off. At quarter end, HY yields sat at 6.39% down from 7.95% at year-end, as measured by the Barclays U.S. HY Index. Spreads, as measured by the Barclays U.S. HY Index vs. the 5 Yr Treasury, tightened to +415bp versus +544bp at the end of the year. Spreads now rest below the 20 year historical average spread of approximately +580bp.

As of March 31st, our ***Opportunity Strategy***, on average, had a YTM of 4.47%, a duration of 2.3, and an average credit rating of BB. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 4.10%, a duration of 1.7, and an average credit rating of BB+. We remain unlevered at quarter end.

Enhanced Cash Strategy

We began 2019 with ultra-short interest rates (3, 6, and 12 month U.S. Treasuries) in a normal (positive) slope. However, as the quarter progressed, ultra-short rates generally flattened, to where these yields were essentially flat, and in some instances, were inverted. Thus, while market conditions didn't offer a dramatic pick-up in yield to purchase slightly longer maturities, we did nominally extend portfolio duration. With the FED strongly indicating that they'd make no additional moves in raising short-term interest rates, we took advantage of locking in some yields out 10 - 12 months.

IG Corporate credit spreads remained compressed; however, we found relatively good value in A and BBB rated companies. We were able to capture, on average, an additional +20 bps spread for A rated credits, and +35 bps for BBB rated credits. That provided incremental, meaningful yield over Treasuries, with ample liquidity.

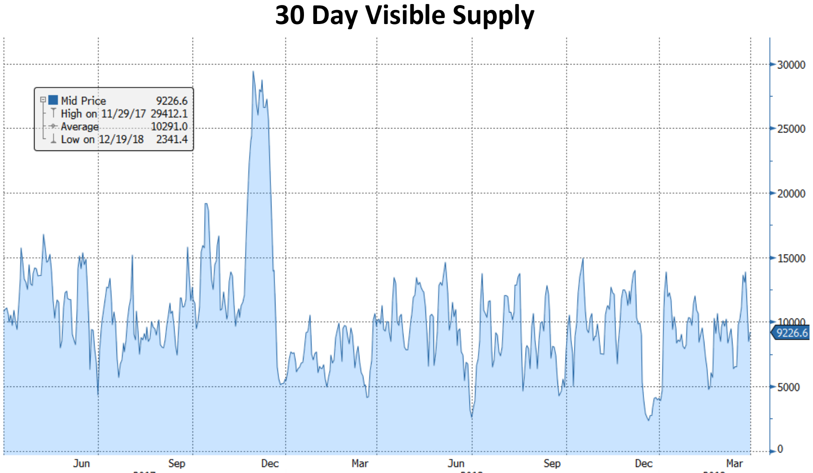
Our ***Enhanced Cash Strategy*** invests in a tactful mix of liquid, ultra-short duration Corporate, U.S. Agency, and U.S. Treasury bonds, adding state specific tax-advantaged Municipal bonds to enhance overall returns when appropriate. At quarter's end, our portfolios averaged a 2.14% YTM, with an average credit rating of A+, and a duration of 5 months.

Municipal Bond Strategy

The municipal market is enjoying its moment in the sun. The market continues to bask in the positive fundamentals that permeated the landscape and ignited a rally in the closing days of 2018. More specifically, subdued supply levels combined with strong market demand helped to provide stability and push prices higher. A slew of supportive market research, during the quarter, provided a welcomed backdrop.

Municipal bond supply, in the form of new issuance, is running slightly ahead of last year's pace. During the quarter, the 30-day visible supply wavered between $2.5 billion and $14 billion with a closing level of roughly $9 billion. This is in line with the 2018 annual averages but well below the year-end 2017's peak of nearly $30 billion. Normally, low relative yields would prompt municipalities to issue more debt at perceived favorable levels. Instead, many municipalities appear to be taking a more austere approach and have been less willing to initiate new project borrowing in today's market. Instead, many are choosing to refinance outstanding / higher-cost debt. Demand, on the other hand, continues to be extremely robust. According to the Investment Company Institute, 1st quarter flows into municipal bond mutual funds posted the strongest 1st quarter on record. Additionally, Lipper reports that all 12 weeks of the 1st quarter saw positive inflows into municipal bond mutual funds. Separately Managed Accounts have also experienced strong inbound flows during the quarter. The demand story goes way beyond the impact of high state-and-local-tax states (SALT states). Municipal investors across the nation continue to find value in the perceived safety of municipal securities combined with attractive relative yields and cash flows. For many investors, the tax reform act of 2017 did not dramatically reduce marginal tax rates. Instead, the new tax rates, along with compelling relative yields, reignited the attractiveness of municipal bonds. Strong demand from the SALT states (Examples: CA, NY, NJ, and MN) served to magnify demand from an already inflated base. Thus, we are finding that taxable equivalent yields (TEY) – across all maturities – are quite attractive on an absolute and relative basis.

30 Day Visible Supply



Source: Bloomberg

During the quarter, market yields (5 Yr AAA) moved sharply lower along with continued flattening of the yield curve. 5 Yr AAA yields fell by 34 basis points in the quarter while the 2-10 Yr segment of the yield curve flattened by 14 basis points. The slope of the yield curve is now at it flattest level since 2008 at 37 basis points.

Over the past 10 years, the average steepness of the municipal 2-10 Yr curve is roughly 150 basis points (including the recent flatness). 10 Yr AAA yields fell by 43 basis points during the quarter. From the recent peak (11/06/18) to bottom (03/31/19), 10 Yr AAA average yields fell by 92 basis points.

Municipal bond yields remain compelling in our preferred segment of the yield curve. At quarter-end, 5 Yr yields (A to AAA) ranged from 1.89% to 1.57% while 7 Yr bonds ranged from 2.01% to 1.67%. Crossover buyers, in mid-to-high tax brackets, continue to realize attractive TEYs versus comparable taxable bonds.

From the credit perspective, even though we do not own Detroit municipal bonds, we follow the credit as a post-bankruptcy litmus test. Detroit's credit rating was raised in March to BB-. S&P noted improvements in government finances along with the city's ability to cover pension and debt costs without incurring budget shortfalls. Detroit emerged from state oversight in April of 2017. On a separate credit topic, S&P issued a report stating that it does not see tax revenues from marijuana sales as having a long-term credit quality impact on states. States that have provided data show that retail marijuana sales were no more than 2.3% of total general reserve fund revenue. Lastly from the credit front, Moodys Sector-in-Depth Report shows that credit rating upgrades outnumbered downgrades in 2018 for the fourth consecutive year. This includes both the actual number of changes as well as the dollar value. The largest upgrade was the State of Florida (GO) and the largest downgrade was South Carolina Public Service Authority.

Our high-quality, intermediate-duration bias continues to seek balance in preservation of principal, total return, and cash flows. We will continue to seek opportunities to add value through credit research and yield curve positioning. Additionally, we will work to identify enhancements in structural and sector diversification. Our municipal bond portfolios are managed as either state-specific or state-focused (general market in approach otherwise). Blending essential service revenue bonds with high quality general obligation bonds continues to be a cornerstone of our municipal bond portfolio strategy. As we alluded to above, we continue to be constructively optimistic in our expectations for the municipal marketplace. Our ***Municipal Bond Strategy*** is focused on high quality investment-grade, intermediate-maturity bonds. Portfolios are structured to generate an average YTM of 2.02% and a Taxable Equivalent Yield (TEY) of 3.91%* with a duration to maturity of 3.9 years, and an average credit rating of AA.

** Assumes 48.3% Combined Effective Tax Bracket*

Separately Managed Account Strategies:

Municipal: Carret's Municipal Bond Strategy is designed to maximize tax efficiency through opportunistic portfolio management while preserving principal through practical portfolio structuring and fundamental credit analysis. We actively manage investment grade portfolios with a diversified blend of issuers, sectors, and maturities aimed at delivering consistent, risk-adjusted returns with an emphasis on tax-efficient cash flows.

Taxable: Carret's Taxable Bond Strategy is designed to achieve above average total returns with an emphasis on preservation of capital and consistent cash flow. We utilize investment-grade fixed income securities and shift across bond sectors based on changing market conditions. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk-adjusted returns.

Opportunity: Carret's Fixed Income Opportunity Strategy is designed to generate a high level of current income with a secondary focus on long term capital appreciation. We utilize higher yielding fixed income securities and shift among various types of fixed income securities based on changing market conditions. We actively manage risk and reward and can respond quickly to market movements. We utilize interest rate hedges to limit duration risk.

Leveraged Opportunity: Carret's Fixed Income Leveraged Opportunity Strategy is designed to utilize low cost leverage and favorably negotiated release rates to potentially enhance our existing Opportunity Strategy returns. We actively manage leverage to augment opportunities within the high yield and investment-grade sectors of the fixed income market.

Enhanced Cash: Carret's Enhanced Cash Strategy seeks to provide excess returns above those offered by cash equivalents, while focusing on capital preservation and liquidity. The strategy invests in ultra-short duration investment grade bonds. Our custom approach opportunistically utilizes tax-advantaged municipal bonds to enhance overall after-tax returns when appropriate.

Mutual Fund Strategy:

Kansas Tax-Exempt: The American Independence Kansas Tax-Exempt Bond Fund's objective is to preserve capital while producing current income that is exempt from both Federal and Kansas state taxes. The Fund seeks to generate monthly income and principally invests in investment-grade bonds of intermediate maturity.