SEIX INVESTMENT ADVISORS LLC®
A VIRTUS INVESTMENT PARTNER

Investment Grade: Taxable and Tax-Exempt Fixed Income

> The return of market volatility took its toll on the **investment grade – taxable** market during the first quarter. Leadership changes at the U.S. Federal Reserve and the beginning of the end to excessive global central bank liquidity are under close watch.

> The **tax-exempt municipal bond market** stumbled in the first quarter as a result of the new tax rules as well as rising rates.

INVESTMENT GRADE – TAXABLE

The consensus view of "more of the same" low volatility and easy monetary conditions that rewarded markets in 2017 was challenged in the first quarter. The dominant themes in the early months of 2018 included the return of market volatility, the reappearance of the reflation trade and rising interest rates, and the start of the post-peak era of global central bank liquidity.

Volatility

Absent throughout 2017, volatility spiked in the first quarter. VIX, a measure of equity market volatility, increased 80% from the beginning of the year through the end of the first quarter. To provide some perspective, VIX averaged 11 in 2017 versus a longer-term average of roughly 19. In the first quarter of 2018, VIX averaged slightly over 17 with a range of 9 to 37. Notably, the volatility spike did not carry over to the bond market, where there was minimal movement in the MOVE Index, the bond market equivalent of VIX.

In our view, the popping of the complacency bubble has just begun, led by the volatility-selling strategies that were a highly profitable strategy/trade in 2017, but stumbled dramatically as the VIX spiked. The Bitcoin and tech selloff, major contributors to the spike, are perhaps the precursors of the end to complacency. We regard the low-volatility environment of 2017 as an aberration and believe that a regime change is underway. Markets will return to normal as global central banks become less accommodative and other factors play out such as disappointing or uneven global economic growth. The current trade disputes and fears of a trade war are also likely to keep volatility elevated over the coming months.

The shift in volatility clearly had an impact on risk markets. In this environment, as expected, credit spreads widened. Investment grade corporates widened 16 basis points (bps) from the start of the year, but 25 bps from the cycle tights in early February. Excess returns across the investment grade and "plus" sectors (emerging markets debt and high yield corporates) were uniformly negative over the quarter. The investment grade corporate sector was the largest underperformer with -79 bps of excess return followed by residential mortgage-backed securities (RMBS) and asset-backed securities with excess returns of -39 bps and -19 bps, respectively. CMBS (-6 bps) and government-related sectors (+2 bps), generated little either way in excess return terms. In sharp contrast to 2017, emerging markets and high yield corporates also had negative excess returns. Given that interest rates also rose over the quarter, total returns across both the core spread sectors and plus sectors were uniformly negative. The only outperformer over the quarter was the bank loan sector, which delivered a positive total return. The floating-rate feature of the asset class insulates investors from rising interest rates (but not widening credit spreads).

In other areas, the U.S. dollar continued to weaken, tallying now five consecutive quarters of negative returns. The dollar index was down 2.3% on the quarter, weakening particularly against the yen, which rose due to its safe haven status. Oil prices (WTI) were up 7.5% while copper was down 8.3% over the quarter, the former a function of supply/demand, while the latter a result of a possible peak in global growth.

Interest Rates

As intimated above, U.S. Treasury yields rose over the quarter, led by the short end of the yield curve. The two-year Treasury, fueled by Federal Reserve (Fed) policy, was up 38 bps for the quarter, while the 30-year was up just 23 bps. The curve thus flattened over the quarter, ending at its tightest level since 2008 as measured by the 47 bps spread between the 2- and 10-year Treasury notes. The benchmark 10-year Treasury peaked at 2.95% on February 21 before ending the quarter at 2.74%.

The reflation trade, not seen since the three-month period following the election of President Trump, resurfaced after the passage of tax legislation in December 2017. Additional pressures on the markets that moved rates included expectations of increased Treasury supply given fiscal spending and higher budget deficits as well as the gradual unwind of the Fed's balance sheet.

Despite the upward cyclical pressure on rates over Q1, our secular view of "lower for longer" remains intact for long-term rates. We think that long-term rates will remain range bound and that the 10-year Treasury will not break out of the 2.5%-3.0% trading range. As we reiterated in our year-end review, higher long-term rates are not sustainable given the amount of debt in the U.S. and globally for that matter. When we consider the potential for sustainably higher long-term rates, we focus on the structural forces that have served as a governor on both growth and higher long term rates. The structural dynamics of excessive debt/unfunded liabilities, aging demographics, excess global capacity, and low productivity growth – all of which cannot be reversed through monetary policy or by any tax legislation or fiscal stimulus in the short term – will remain dominant forces keeping long-term rates low.

Central Banks

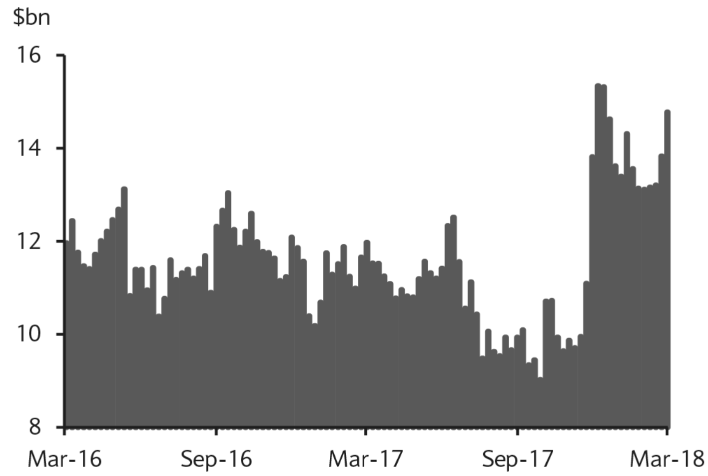
Global central bank liquidity peaked in 2017 as the G3 (U.S., Euro Area, and Japan) central banks moved to tighten monetary conditions or, more appropriately put, to become "less loose." The European Central Bank (ECB) is slated to end its quantitative easing (QE) in September and the Bank of Japan's yield curve control allows for QE in variable and potentially smaller amounts. The Fed is well into its "unloosening cycle" after executing another 25 bps interest rate hike in March (sixth hike of this cycle) with two more hikes anticipated in 2018. Ultra-accommodative monetary policy has been a driving force in markets. It remains to be seen how the riskier asset classes in particular react to less central bank liquidity.

Leadership changes at the Fed are also under close watch. The first quarter saw a new Fed chair with Jerome (Jay) Powell taking over the role from Janet Yellen. As a former Wall Street lawyer, we believe that Powell will be more market savvy than his predecessors and that he will conduct Fed policy somewhat differently than the more academic Yellen or Ben Bernanke. Other changes included the approval of John Williams by the Board of Governors to succeed Bill Dudley as president of the New York Fed, which is noteworthy given that the position holder has a permanent seat on the FOMC and serves as its vice chair. Replacement of the number two official at the Fed, following the retirement of Stanley Fisher, is still pending and three additional Board of Governor chairs also remain vacant.

INVESTMENT GRADE – TAX-EXEMPT

The tax-exempt municipal bond market defied expectations in the first quarter of 2018. Amid uncertainty of pending tax reform, the last two months of 2017 saw record levels of supply as issuers rushed to the market for fear of losing access to the tax-exempt market. Entering 2018, investors thus expected light municipal bond issuance alongside strong demand from higher-tax-bracket individuals still attracted to tax-free investment income, especially given the elimination or limitation of the deduction of the state income tax. Anticipated outperformance by the municipal market in this scenario, however, did not materialize. Indeed, the first quarter saw just $62 billion in issuance, which was down 32% versus the year before. At the same time, demand by retail investors for bonds in high-tax states was consistent but dealers, heavy with inventory overhang, were met with selling pressure from banks and insurance companies. Rising rates and moderate demand were not enough to overcome a favorable technical position. The Bloomberg Barclay's Municipal Bond Index was down 1.1% for the quarter, the largest first-quarter loss in two decades.

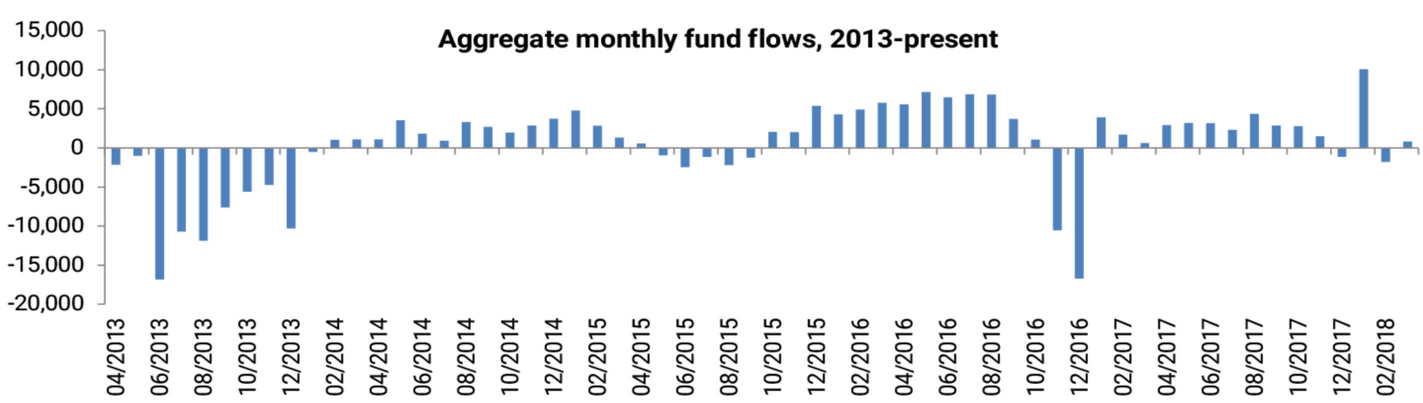
LONG-DATED DEALER INVENTORY (10Y+)



Source: NY Fed

Though the lower corporate tax rate was expected to dampen participation by institutional buyers in the municipal market, notably banks and insurance companies, the level of selling that ensued was unexpected. Banks, based on tax reform as well as the new accounting rules, found it advantageous to sell bonds with short calls and buy longer bonds at a higher coupon.

FUND FLOWS REMAIN MODESTLY POSITIVE, DESPITE MARKET DECLINES ($M)



Source: EPFR, Morgan Stanley Research

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While property & casualty (P&C) insurers historically have been buyers of municipal bonds, they have become relative value investors on the basis of the Municipal/Treasury ratio.

In terms of the yield curve, shorter maturities outperformed intermediate and longer maturities in the first quarter. Despite the Fed hike, which typically puts pressure on the short end of the curve, demand from separately managed accounts (SMAs) propped up prices in January, primarily in the one- to 10-year area, as individuals deployed money they received from maturing bonds and coupon payments. We thus saw a steepening of the municipal yield curve in the first quarter. Given the seasonality factor associated with retail investing, we would expect SMA-sourced demand to decline as has already happened post January. The continued pressure of bank selling is likely to continue throughout the year with a subsequent flattening of the curve.

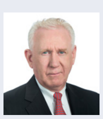
Municipal credit quality spreads remain narrow, not widening nearly as much as other markets such as corporates. The tight spreads are worrisome, especially if GDP growth becomes an area of concern or if pressures in the taxable market spread to the municipal market. For the quarter, AAA-rated paper was down 1.19% and BAAs were down only 1.0%.

Credit issues surrounding state and local governments are still a concern. Revenues have peaked and enormous pressures are on local governments to fund pension and health care liabilities. Many local governments have not adequately tackled the problem, and the strong market environment to help support liabilities may become a thing of the past. Local governments are very dependent on real estate valuations and the taxes they generate. State governments may be in a somewhat better position given that they have different revenue sources and the ability to raise revenues or cut expenditures. Cutting expenditures, however, may be at the cost of aid to local governments.

As we enter the second quarter, we are optimistic on the tax-exempt asset class. Demand is still positive for tax-free bonds. The demand/supply dynamic may change in the second quarter as seasonal factors boost demand as more money comes due to investors. The absence of institutional buyers may increase volatility and credit spreads may widen, both of which play to our strength of identifying and taking advantage of inefficiencies.

Authored by:

Investment Grade – Taxable



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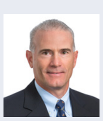

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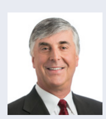
Investment Grade – Tax-Exempt



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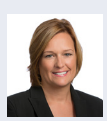

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Seix Investment Advisors is an investment management boutique focused exclusively on managing fixed income securities since 1992. Seix seeks to generate competitive absolute and relative risk-adjusted returns over the full market cycle through a bottom-up focused, top-down aware process. Seix employs multi-dimensional approaches based on strict portfolio construction methodology, sell disciplines, and trading strategies with prudent risk management as a cornerstone.