January 2019

Cash was king in 2018, but likely won't be in 2019

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- Fed rate hikes led to a flattening U.S. Treasury yield curve.
- Most fixed-income sectors failed to keep pace with cash, as interest rates rose with Fed rate hikes and credit spreads widened.
- A slowing global economy (Europe and China) and the prospect of escalating trade wars have injected a new level of uncertainty about the path of short- and long-term U.S. Treasury rates in 2019.
- Though our base case is for a continuing flat U.S. yield curve, there is a possibility we could see either a steeper or inverted yield curve in 2019. In this uncertain environment, we believe there is a range of income solutions that offer investors potential superior returns to holding cash.

As 2018 wound to a close, some market writers got to dust off a headline that hasn't been on target for a long time: It was a year when "cash was king." The ICE BofAML 3-mo. U.S. Treasury Index returned 1.87% during 2018, while longer-duration and credit risky fixed-income classes were flat to down for the year.

Fixed-income sectors were hurt by the U.S. Federal Reserve's continued hiking of the fed funds target rate, while credit riskier segments of the market like emerging-market debt and corporate bonds were further affected by widening credit spreads, which reflected concerns over a slowing global economy. But as Exhibit A shows, while cash was king, U.S. municipal bonds, mortgage-backed debt and floating-rate loans also had positive returns.

Importantly, the fixed-income losses of 2018 resulted in higher yields for investors, which open up a range of opportunities for 2019 in sectors we believe are likely to outperform cash under various economic scenarios. But before we review those, first we look back at the dynamics that drove the fixed-income market in 2018.

2018: Rate hikes and flattening

At the beginning of 2018, the market (as indicated by fed funds futures) and the Fed were in general agreement with expectations of three to four 25-basis-point (bps) increases in the fed funds target rate in 2018. This was coupled with a slow unwind of quantitative easing (QE), now referred to as quantitative tightening (QT).

This presented a strong case for a flattening U.S. yield curve and a tail wind for the U.S. dollar. We suggested investors consider a range of floating-rate and short-duration assets in this environment.

This prognosis proved to be correct, as the yield curve did indeed flatten. Most shorter-duration and floating-rate sectors eked out positive returns in 2018, while longer-duration sectors like investment-grade and high-yield debt were in negative territory (Exhibit A).

Besides loans, investors have a number of choices in floating-rate assets across the credit-quality spectrum

Exhibit A

Long duration sectors fared poorly in 2018.

Annual Returns (%)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Higher	Treasury 13.74	High Yield 57.51	EM (Local Currency) 15.68	Municipal 10.7	EM (Local Currency) 16.76	High Yield 7.42	Municipal 9.05	Municipal 3.3	High Yield 17.49	EM (Local Currency) 15.21	Cash 1.87
	MBS 8.34	Bank Loan 51.62	High Yield 15.19	Treasury 9.81	High Yield 15.58	Bank Loan 5.29	Investment Grade 7.46	MBS 1.51	Bank Loan 10.16	Global Agg Ex-U.S. 10.51	Municipal 1.28
	Global Agg Ex-U.S. 4.4	EM (Local Currency) 21.98	Bank Loan 10.13	Investment Grade 8.15	Investment Grade 9.82	Cash 0.07	MBS 6.08	Treasury 0.84	EM (Local Currency) 9.94	High Yield 7.48	MBS 0.99
	Cash 2.06	Investment Grade 18.68	Investment Grade 9	MBS 6.23	Bank Loan 9.66	MBS -1.41	Treasury 5.05	Cash 0.05	Investment Grade 6.11	Investment Grade 6.42	Treasury 0.86
	Municipal -2.47	Municipal 12.91	Treasury 5.87	High Yield 4.38	Municipal 6.78	Investment Grade -1.53	High Yield 2.5	Investment Grade -0.68	MBS 1.67	Municipal 5.45	Bank Loan .44
	Investment Grade -4.94	Global Agg Ex-U.S. 7.53	MBS 5.37	Global Agg Ex-U.S. 4.36	Global Agg Ex-U.S. 4.09	Municipal -2.55	Bank Loan 1.6	Bank Loan -0.69	Global Agg Ex-U.S. 1.49	Bank Loan 4.12	Global Agg Ex-U.S. -2.15
	EM (Local Currency) -5.22	MBS 5.89	Global Agg Ex-U.S. 4.95	Bank Loan 1.52	MBS 2.59	Treasury -2.75	Cash 0.03	High Yield -4.64	Treasury 1.04	MBS 2.47	High Yield -2.26
	High Yield -26.39	Cash 0.21	Municipal 2.38	Cash 0.10	Treasury 1.99	Global Agg Ex-U.S. -3.08	Global Agg Ex-U.S. -3.08	Global Agg Ex-U.S. -6.02	Cash 0.33	Treasury 2.31	Investment Grade -2.51
Lower	Bank Loan -29.1	Treasury -3.57	Cash 0.13	EM (Local Currency) -1.75	Cash 0.11	EM (Local Currency) -8.98	EM (Local Currency) -5.72	EM (Local Currency) -14.92	Municipal 0.25	Cash 0.86	EM (Local Currency) -6.21

Sources: Morningstar, S&P/LSTA as of 12/31/18. Data provided is for informational use only. Past performance is not a reliable indicator of future results. See end of report for important additional information. Investment Grade represented by Bloomberg Barclays U.S. Corporate Index. MBS represented by Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index. Treasury represented by Bloomberg Barclays U.S. Treasury Index. High Yield represented by ICE BofAML US High Yield Index. Municipal represented by Bloomberg Barclays Municipal Bond Index. Bank Loan represented by S&P/LSTA Leveraged Loan Index. Global Agg Ex-U.S. represented by Bloomberg Barclays Global Aggregate Ex-USD Index. EM (Local Currency) represented by JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified. Cash is represented by the ICE BofAML 3-Yr. US Treasury Index. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds.

to help position their fixed-income portfolios in a rising or flattening U.S. yield curve environment. For example, municipal floating-rate notes (FRN) are rated AA+, with a yield that adjusts with the Securities Industry and Financial Markets Association (SIFMA) Index, and returned 1.70% in 2018. Floating-rate agency collateralized mortgage obligations (CMOs) are backed by single-family residences, are rated AAA, and returned 2.46% in 2018. Further out the risk spectrum, there are floating-rate collateralized loan obligations (CLOs). These are structured products invested in floating-rate loans, and are offered in different tranches of varying credit quality. For example, a B-rated CLO returned 2.93% in 2018. The yields on CMOs and CLOs both adjust with Libor.[1]

Considering slower growth

Toward year end, we experienced large bouts of market volatility, as a number of concerns appeared to take hold with investors, including fears of slower future global growth and an out-of-control trade war. Late in 2018, the U.S. yield curve (10-year U.S. Treasury yields minus 2 year U.S. Treasury yields) nearly inverted – an historical leading indicator of recession. Federal funds futures began to reflect speculation that the Fed might pause in its rate hikes and deliver no target fed funds increases in 2019.

There's no doubt we face a number of global economic crosscurrents. Exhibit B compares Purchasing Managers' Index (PMI) levels for the U.S., Europe and China over the past year. When the PMI is below 50 the economy is considered to be in a contractionary phase. The U.S. PMI remained at 59.3, while Europe and China have slowed markedly, and both are in or close to contraction.

The near inversion of the U.S. yield curve would seem to imply that the U.S. may follow the rest of the world in slower economic growth. That could be true, but even then the indicator is notoriously imprecise in terms of how soon a recession may follow – two years is the average. The U.S. economy could cool, for example, to 2% GDP growth without entering recession. The U.S. economy grew 3.5% in the third quarter and 4.2% in the second quarter, and is on pace for its strongest year of growth since 2004. If trade wars abate and employment remains strong, it's easy to imagine an environment conducive to the Fed continuing some level of QT.

Exhibit B

Outside of the US, growth has slowed.

Purchasing Managers' Index (PMI)	12/31/17	12/31/18
US	59.3	59.3
Europe	60.6	51.3
China	51.6	49.4

Source: Bloomberg LLC, as of 12/31/18.

The bottom line is that fixed-income investors are facing a higher level of uncertainty for the interest-rate and credit environment compared with a year ago, when the Fed's course seemed relatively clear and the global growth outlook was solid. Thus, it makes sense to focus on a combination of debt investments that could do well under several economic scenarios.

The good news is that the elevated yields available in today's fixed-income market may have a twofold positive impact: investors can have higher income, which also works as a bigger "cushion" that can reduce potential volatility (losses) due to rising rates and/or additional credit spread widening. Exhibit C shows how absolute yield levels have increased over the past year. For example, the yield on U.S. investment-grade corporate bonds increased 82 basis points (bps) to 3.81% over the past year and the yield on U.S. high yield increased from 5.84% to 7.95%. Year-end yields in these sectors have not been this high since 2009 for investment grade and 2015 for high yield.

[1]**Source:** Eaton Vance, December 2018. Credit ratings are categorized using S&P Ratings, which are subject to change. Credit ratings measure the quality of a bond based on the issuer's creditworthiness, with ratings ranging from AAA, being the highest, to D, being the lowest based on S&P's measures. Ratings of BBB- or higher by S&P are considered to be investment-grade quality. Credit ratings are based largely on the ratings agency's analysis at the time of rating. The rating assigned to any particular security is not necessarily a reflection of the issuer's current financial condition and does not necessarily reflect its assessment of the volatility of a security's market value or of the liquidity of an investment in the security. SIFMA refers to the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index, a common benchmark for floating-rate municipal issues. Libor, or London Interbank Offered Rate, is a common benchmark for floating-rate taxable and tax-exempt issues.

Exhibit C

Yields increased markedly in 2018.

	YTW (%)		Change (%)
	12/31/17	12/31/18	
3-Mo. US TSY	1.36	2.38	1.02
2-Yr. US TSY	1.88	2.50	0.62
10-Yr. US. TSY	2.41	2.69	0.28
Agency MBS	2.84	3.38	0.54
ABS	2.46	3.30	0.84
Barclays Agg	2.71	3.28	0.57
Muni	2.33	2.78	0.45
CMBS	3.07	3.58	0.51
Inv. Grade Corp.	2.99	3.81	0.82
Floating-Rate Loans	5.19	7.23	2.04
High Yield	5.84	7.95	2.11
EM Sovereign	4.64	5.99	1.35

Sources: ICE BofAML, Bloomberg Barclays, S&P/LSATA, as of 12/31/18. Data provided is for informational use only. Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. See end of report for important additional information. The 3-Mo. US TSY is represented by the ICE BofAML US 3-Month Treasury Bill Index. The 2-Yr. US TSY is represented by the ICE BofAML US 2-Yr. Index. The 10-Yr. US TSY is represented by the ICE BofAML US 10-Yr. Index. Agency MBS is represented by the ICE BofAML Mortgage Backed Securities Index. CMBS is represented by the ICE BofAML US Fixed Rate CMBS Index. Inv. Grade Corp. is represented by the ICE BofAML AAA-A US Corporate Index. High Yield is represented by the ICE BofAML US High Yield Index. EM Sovereign is represented by the ICE BofAML US Emerging Markets External Sovereign Index. Bank loans are represented by the S&P/LSTA Leveraged Loan Index. Barclays Agg is represented by Bloomberg Barclays U.S. Aggregate Bond Index.

Differing potential future yield scenarios

Exhibit D illustrates how a range of fixed-income investments are likely to fare, under a variety of yield change assumptions, based on starting yields as of December 31, 2018.

The 3-month U.S. Treasury bill is shown in the top line as the reference level for total return, in keeping with the theme of "will cash be king?" in 2019. Listed below the 3-month U.S. Treasury bill is a range of debt investments, roughly ordered from lower to higher yields. Reading the values in the rows from left to right indicates the expected total return over the course of 2019 for the assumed yield change noted at the top of the column, which reflects the sum of interest-rate increases (decreases) and credit spread widening (tightening). The shaded boxes indicate yield change scenarios in which the investment would outperform cash — 3-month U.S. Treasury bills. Here are some examples, in flat, rising and falling yield environments.

Flat market yields. In this scenario, where yield change equals zero, bonds "earn their coupon," with nothing added or subtracted. As might be expected, all sectors outperform cash, given that bonds pay investors a premium in yield for any interest-rate or credit risk assumed when they forgo cash.

Rising market yields. The cash proxy — 3-month U.S. Treasury bills — gains from rising rates (and no credit risk), as it is issued at the market rate every quarter. If we go to the third column, indicating a rise of 100 bps, the return for 3-month U.S. Treasury bills is 2.88%, compared to its initial yield of 2.38% (we assume rates rise on a straight line basis throughout the year). In comparison, high-yield bonds are hurt by rising yields — their total return of 3.68%, assuming the same 100-bps rise in rates, is lower than the initial yield of 7.95%. Nevertheless, high-yield outperforms cash, in every yield change scenario except the two highest we have assumed, at 125 bps and 150 bps. The same observation applies to floating-rate loans, which outperformed cash in every yield change scenario up to and including a 150 bps rise (and we are assuming that 100% of the yield increase is due to credit spread widening). These are examples of how initial yields can provide a cushion for total return when market yields rise.

Exhibit D

Potential yield scenarios favor high-yield and floating-rate loans ahead of cash.

In many potential yield scenarios (various combinations of interest rate and credit spread change scenarios), floating-rate loans and high yield outperform cash. In flat or declining yield scenarios, all sectors outperform cash.

[shaded cell] = **Sector outperforms cash**

Assumed Yield Change (basis points)

	Duration	YTW	150 bps	125 bps	100 bps	75 bps	50 bps	25 bps	0 bps	-25 bps	-50 bps
			Estimated Annual Return[1] (%)								
3-Mo. US TSY	0.24	2.38	3.13	3.00	2.88	2.75	2.63	2.50	2.38	2.25	2.13
2-Yr. US TSY	1.94	2.50	-0.40	0.08	0.57	1.05	1.53	2.02	2.50	2.99	3.47
10-Yr. US. TSY	8.45	2.69	-9.98	-7.87	-5.76	-3.65	-1.53	0.58	2.69	4.80	6.92
Agency MBS	5.29	3.38	-4.55	-3.23	-1.91	-0.59	0.73	2.06	3.38	4.70	6.02
ABS	1.97	3.30	0.35	0.84	1.33	1.82	2.32	2.81	3.30	3.79	4.28
Barclays Agg	6.19	3.28	-6.01	-4.46	-2.91	-1.36	0.18	1.73	3.28	4.83	6.38
Muni	5.09	2.78	-4.87	-3.59	-2.32	-1.05	0.23	1.50	2.78	4.05	5.32
CMBS	4.96	3.58	-3.86	-2.62	-1.38	-0.14	1.10	2.34	3.58	4.82	6.06
Inv. Grade Corp.	6.80	3.81	-6.39	-4.69	-2.99	-1.29	0.41	2.11	3.81	5.51	7.22
Floating-Rate Loans	2.50	7.23	3.48	4.10	4.73	5.35	5.98	6.60	7.23	7.85	8.48
High Yield	4.27	7.95	1.54	2.61	3.68	4.75	5.81	6.88	7.95	9.02	10.08
EM Sovereign	7.08	5.99	-4.64	-2.87	-1.10	0.67	2.45	4.22	5.99	7.76	9.53

Source: ICE BofAML, Bloomberg Barclays, S&P/LSTA, as of 12/31/18. Data provided are for informational use only. Past performance is not a reliable indicator of future results. See end of report for important additional information. It is not possible to invest directly in an index. See Exhibit C for asset class indexes. Return calculations are based on standard duration formula, assuming parallel shifts in the yield curve, and continuous rises in interest rates and adjustments of benchmark yields over a one-year period. Chart represents projections based on various interest-rate scenarios, but is not intended to predict any particular scenario.

*The duration specified for floating-rate loans is spread duration rather than interest-rate duration. Spread duration measures the sensitivity of a bond's price to changes in credit spreads rather than the absolute level of interest rates. While loan prices have very low sensitivity to interest-rate moves, they do respond to changes in credit spreads. We use spread duration here to give loans a "headwind" that is comparable to other fixed-income sectors in a rising-rate environment.

[1]Credit risk is assumed to be captured by credit spreads. Estimated losses due to credit are not included.

Falling market yields. This is the scenario in which most traditional high-quality, fixed-income investments do well, including those embedded in the broad taxable bond benchmark Bloomberg Barclays U.S. Aggregate Bond Index — or high-quality U.S. municipal bonds. In a falling-yield environment, prices on higher quality, longer-duration fixed-income investments rise as their stable coupons became move valuable to investors. In fact, many fixed-income sectors outperform cash in falling yield environments, as the benefit from declining interest rates more than offsets the negative impact from credit spread widening.

Our base-case scenario for 2019 is that the U.S. yield curve remains relatively flat and there is some, but limited, additional credit spread widening in credit risky sectors. The Fed is not likely to raise short-term rates to the extent that it promotes an inversion of the Treasury curve. And with the Fed's preferred inflation measure, the core Personal Consumption Expenditures Price Index (PCE), and the market's long-term annual inflation expectations both just below the target 2% level, as well as the possibility of a continuing slowing in global economic growth, we believe that long-term rates will be range bound. We expect U.S. corporate bond default rates to remain at relatively low levels, given the expected overall positive growth in the U.S. We believe alternative scenarios — a steepening or inversion of the U.S. yield curve — are less likely in 2019, though more probable than 12 months ago.

Positioning for the current environment

Under our base-case scenario (a flat yield curve with marginal credit spread widening), we continue to believe that floating-rate and relatively short duration taxable and tax-exempt assets across the credit spectrum have attractive risk/return profiles relative to both cash and long-duration assets. Notably, with limited additional credit spread widening (e.g., up to 100 bps) and higher starting yields, we believe both the floating-rate and high-yield sectors are well-positioned to outperform cash in 2019.

That said, investors should also consider additional fixed-income solutions for other possible scenarios. Each of the strategies mentioned above would likely perform well in a steepening U.S. yield curve scenario, which could materialize due to a rise in long-term U.S. inflation expectations stemming from increasing wage pressure and an escalating trade war, among other factors.

Traditional high-quality, longer-duration taxable and tax-exempt strategies may work best (and beat cash) in an inverted yield curve scenario. Finally, investors looking for more aggressive positioning may find that a slowdown in the pace of fed funds rate increases (and any U.S. dollar weakness) could create an attractive entry point in sectors that sold off the most in 2018, including emerging-market local debt.

Whatever the coming year brings, we stand ready to assist our clients in identifying specific strategies that are positioned to beat cash in 2019. We wish you a very healthy and prosperous new year.

Index Definitions

Bloomberg Barclays Global Aggregate Ex-USD Index is a broad-based measure of global investment-grade fixed-rate debt investments, excluding USD-denominated debt

Bloomberg Barclays Municipal Bond Index is an unmanaged index of Municipal bonds traded in the U.S.

Bloomberg Barclays U.S. Mortgage-Backed Securities (MBS) Index measures agency mortgage-backed pass-through securities issued by GNMA, FNMA, and FHLMC.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market

Bloomberg Barclays U.S. Treasury Index measures public debt instruments issued by the U.S. Treasury.

Bloomberg Barclays U.S. Agency Index measures agency securities issued by U.S government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. government

Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities

Bloomberg Barclays U.S. Asset-Backed Securities (ABS) Index measures ABS with the following collateral type: credit and charge card, auto, and utility loans

Bloomberg Barclays U.S. CMBS Index measures the market of conduit and fusion CMBS deals with a minimum current deal size of $300mn

Bloomberg Barclays U.S. Corporate Investment-Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Barclays U.S. Aggregate Bond Index

JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified is an unmanaged index of USD-denominated bonds with maturities of more than one year issued by emerging-market governments.

ICE BofAML US 3-Month Treasury Index is an unmanaged index of 3-month U.S. Treasury bills.

ICE BofAML Current 2-Year US Treasury Index is an unmanaged index of current two-year U.S. Treasury bills.

ICE BofAML US Fixed-Rate Asset-Backed Securities Index is an unmanaged index of U.S. fixed-rate asset-backed securities.

ICE BofAML Mortgage-Backed Securities Index Is an unmanaged index of mortgagebacked securities.

ICE BofAML AAA-A US Corporate Index is an unmanaged index of U.S. investment-grade debt.

ICE BofAML US Municipal Securities Index is an unmanaged index of U.S. municipal securities.

ICE BofAML US Emerging Markets External Sovereign Index is an unmanaged index of external sovereign debt.

ICE BofAML US High-Yield Index is an unmanaged index of U.S. high-yield debt.

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