January 2019

Fourth Quarter Fixed Income Letter to Clients

The fourth quarter of 2018 was very strong for the bond market. The 10-year US Treasury yield fell from as high as 3.24% in October, down to around 2.70% in late December. The bond market's strength has been the result of an unambiguous message from the Federal Reserve that they will return to a data driven monetary policy, in conjunction with the market's reduced expectations for multiple rate hikes in 2019.

The Tax-Free Municipal Bond benchmark index ended the year with a positive return of about 1%, which for someone in the 40% tax bracket, that's a 1.67% taxable equivalent yield. The midterm election results are seen as a positive for the municipal bond market since a split Congress will likely be unable to reach any agreements on changes to the tax code (maintaining the current tax exemption) or infrastructure spending ahead of the 2020 Presidential election. The big question is will the economic environment roll over and slow down much more. If so, we can expect a continuation of a strong bond market in 2019.

Our outlook for bonds over the next six to twelve months has changed a bit from last quarter's outlook. We feel that there is a 40% probability that the benchmark US Treasury 10-year bond yield will rise from today's 2.65%-2.80% range to around 3.00%-3.10%. We assign a 25% probability that the 10-year bond yield will simply remain in today's range. We feel there is a 15% likelihood that rates will run lower to the 2.30%-2.50% area. And given the general nature of markets we always feel that there is a 10% chance that yields will rise or fall much higher or lower than we or anyone can reasonably predict today due to "unknowns". Inflation continues to be tame relative to the economies' robust growth that has been seen over much of 2018. Now if inflation were to pick up in a meaningful way, then bonds will have a tough time. But in the meantime, bonds feel firm at this time so it makes sense to invest some portion of one's overall investment portfolio in the bond market.

Our current strategy for municipal-bond investors continues to be to own a diversified portfolio of high-quality, investment grade bonds maturing in one to ten years. For clients who reside in high income tax states, we focus on buying a diversified portfolio of bonds issued in their state (when possible) in order to benefit from the state tax exemption. We also buy out-of-state bonds for the purpose of credit diversification.

Our client's portfolios are designed to earn optimal after-tax return while maintaining a relatively defensive portfolio structure given today's interest rate environment. Of course each client has a unique set of circumstances that we focus on in order to customize the portfolio towards meeting their goals and investment objectives. Tax-free income, preservation of principal and targeted duration management is what makes a municipal bond portfolio an attractive investment for clients in a high tax bracket.

Evan Slater
Fixed Income Portfolio Manager