# Fixed Income Commentary
## Winter 2019

Investors flocked to safety this quarter amidst volatility in the global financial markets. In turn, interest rates reversed course from their upward climb and bond prices rose accordingly. The yield on ten-year Treasury bonds dropped to 2.7% by year-end from over 3.2% in November. The rally in prices was a positive for bond returns, and the U.S. Aggregate Bond Index[1] erased losses from earlier in the year to finish close to breakeven in 2018. While returns close to zero are not typically ideal, investment-grade bonds were some of the best performing assets this year.

Despite investor trepidations, the Federal Reserve ("Fed") continued to tighten the reigns on the economy. They decided to raise short-term interest rates again this quarter, which marked the fourth increase this year. The Fed's benchmark rate now stands at 2.5%, up from 1.5% at the beginning of the year. In comments that contributed to unease in equity markets during December, Jerome Powell, the Fed Chairman, also reiterated the Fed's commitment to reducing the central bank's balance sheet, which applies additional upward pressure on rates by creating an excess supply of bonds in the market. The rising interest rate tide has been met with a wall of backlash recently, and future rate hikes are notably coming under question. As evidence of the disconnect, the Fed is planning to hike rates at least two more times in 2019, but prevailing bond prices are implying greater odds that rates will be cut rather than raised.

Red flags were also raised in the bond market this quarter when the yield curve[2] partially inverted. In a normal interest rate environment, yields on longer-term bonds are greater than those on shorter-term bonds since investors expect to be compensated for the extra risk of locking in yields for longer periods to time. This quarter, the standard relationship was flipped when one-year Treasuries paid higher rates than those with five years left to maturity. Inversions make higher-yielding short-term bonds appear relatively attractive, but, historically, they've signaled the end of economic expansions. If that relationship holds true again, rates could fall and an investor locking in current yields for longer should come out ahead. Regardless, interest rates seem to be approaching a crossroads.

At Kovitz, we don't believe betting on interest rate movements is the best way to make money for our clients, nor have we come across another bond manager that has been able to regularly time the market. We believe laddering a bond portfolio is the best structure to ride out interest rate volatility. If rates rise, maturing bonds take advantage of higher rates. If rates fall, existing holdings produce more income than prevailing rates. The result is more consistent income, liquidity and returns. Core bonds should provide stability within an investment portfolio, which bond ladders are designed for and market timing generally is not. Instead, our goal is to enhance returns by focusing on diligent

[1] *The Bloomberg Barclays U.S. Aggregate Bond Index is a benchmark that broadly measures the U.S. investment grade taxable market.*
[2] *A yield curve plots the yields of similar bonds with differing maturities.*

security selection in bond markets that offer higher yields than prevailing Treasury rates: municipals, corporates, and non-agency mortgage-backed securities.

| BOND YIELDS BY MATURITY AND RATING | | | | |
|---|---|---|---|---|
| | Treasuries | Corporate Bonds[3] | | |
| | AAA | AA | A | BBB |
| *One-Year* | 2.6% | 2.8% | 3.0% | 3.4% |
| *Five-Year* | 2.5% | 3.2% | 3.4% | 4.0% |
| *Ten-Year* | 2.7% | 3.7% | 3.9% | 4.6% |

Looking at corporate bonds, yields are meaningfully higher than Treasuries as illustrated above. Corporate bonds with five years left to maturity offer yields up to 4% for BBB-rated bonds, the lowest rating in the investment-grade category, versus 2.5% yields on five-year Treasury securities. Additionally, unlike treasury bonds, the yields on longer-dated corporates are much higher than those with limited time to maturity. The larger return potential is accompanied by greater risk in that corporate bonds are not free from default risk. Default risk can't be avoided, but we believe it can be significantly mitigated by concentrating on issuers with sustainable competitive advantages, consistently high returns on capital employed, and little reliance on debt financing. It's a formula that we believe has served our clients well for many years.

Strict investment discipline is most important within the BBB rating category since it is only one notch above "junk"[4], where chances of default start increasing exponentially. Triple-B issuers are the ones that will struggle the most to maintain investment-grade status if the end of this economic cycle is on the horizon. We do not take this risk lightly when vetting purchases. For example, for certain clients, we started accumulating a debt position in BBB-rated Starbucks this quarter[5], a financially sound company with an incredibly strong consumer brand and a loyal customer base. Starbucks has almost as much cash on their balance sheet as debt and robust, growing operating profits which cover their interest expense more than eight times over. In other words, the company has the financial flexibility to weather any foreseeable adverse scenarios. On the other hand, Campbell's Soup, an issuer also within the triple-B category but one that we have not purchased for clients, is battling a secular shift away from processed packaged foods and fueling top-line growth through leveraged buyouts. Their debt load recently tripled following the acquisition of Snyder-Lance, best known for making pretzels, and interest expense now eats up over a quarter of their projected operating profit. In this case, the triple-B rating is predicated on the assumption that Campbell's will reduce leverage over time as the acquisition is digested. If not for that assumption, the bonds would be rated junk. Not every triple-B is created equal.

As Graham & Dodd put it, "The soundness of straight bond investment can be demonstrated only by its performance under unfavorable business conditions; if the bondholders needed prosperity to keep them whole, they would have been smarter to have bought the company's stock and made the profits that flow from prosperity."

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[3] *Corporate yields sourced from Bloomberg's BVAL curves.*
[4] *High-yield bonds, also known as junk bonds, are rated BB and below.*
[5] *Please note that bond purchases will vary across accounts, depending on client asset allocation, cash availability, other client-specific circumstances, and the nature of the firm's bidding and portfolio management processes.*