KOVITZ INVESTMENT GROUP
Intrinsic Values®

Fixed Income Commentary
Summer 2018

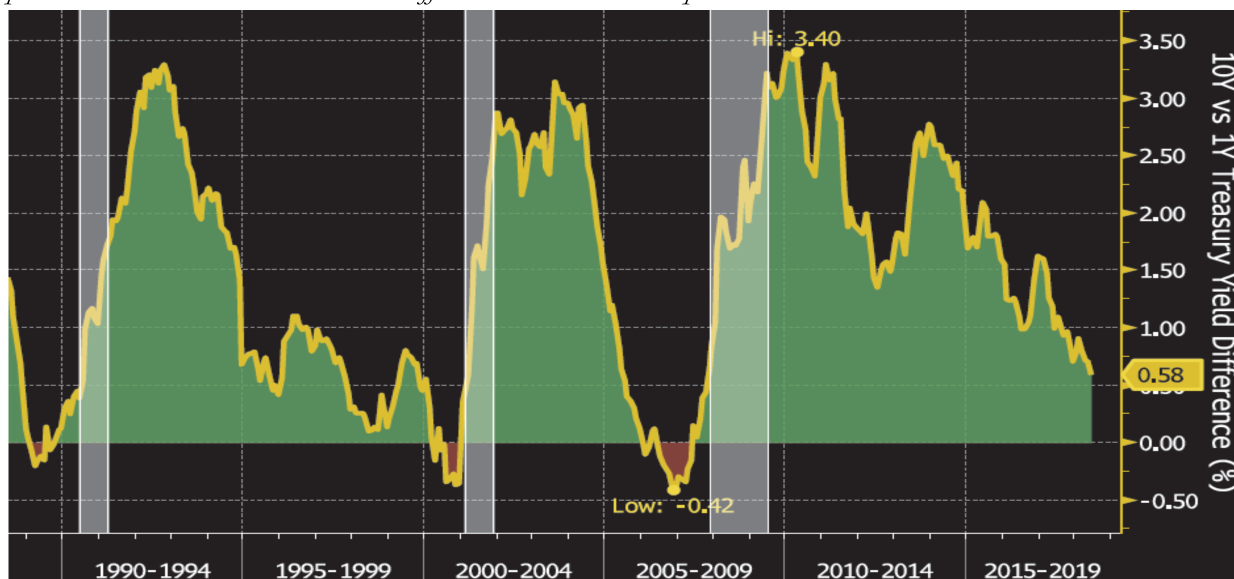
In a widely predicted move, the Fed increased its policy rate by another 0.25% in June to the 1.75% to 2% range. Less expected, the Fed slightly accelerated their forward rate guidance, citing their confidence in the strength of the economy. The Fed's policy has been accommodative since the 2008 Financial Crisis to stimulate employment and economic growth, but their policy may soon become restrictive. With two more rate hikes planned this year and three more in 2019, short-term rates could surpass 3% as early as next year – higher than the ten-year Treasury yield of 2.9% at quarter-end. It appears the Fed is more concerned about the risk of overheating the economy than overtightening policy.

The Fed did not comment on the shape of the yield curve in their most recent statement, but it is likely on the forefront of their minds. A yield curve plots the yields of similar bonds with differing maturities. In a normal interest rate environment, yields on longer-term bonds are greater than those on shorter-term bonds, but, occasionally, short-term yields can be greater, thus inverting the curve. The Fed's policy for short-term rates could be described as full steam ahead, which is leading many market commentators to believe an inverted yield curve may be on the horizon. Inverted curves matter for several reasons, but most notably, they have an amazing track record of forecasting recessions. In the last 30 years, inverted curves have preceded the recessions in 1990 and 2001 and 2008.

Inversions tend to be swift, and reversions to steeper curves can be fierce. The average inversion between one-year and ten-year Treasury yields over the last 30 years has lasted less than a year. In the year following an inversion, the difference in the same yield curve has climbed to an average of 2%. In a word, inversions have historically meant one thing for bond markets, volatility.

Is A Yield Curve Inversion on the Horizon?

The chart plots the difference between ten-year and one-year Treasury yields over the last 30 years, and shades recessionary periods in white. The current 0.58% difference is the narrowest spread since November 2007.



At a time when the economy and interest rates appear relatively healthy, it's important to remind bond investors to never let their guard down – risks are pervasive. At Kovitz, our investors have a dedicated team of experienced fixed income professionals who manage risks on their behalf. We build high-quality bond portfolios with limited interest rate sensitivity to be a ballast for investment accounts – built with the goal of weathering any storm. We tend to welcome volatility as a chance to scour the fragmented, inefficient bond market for opportunities to enhance yields without sacrificing the safety of investor principal.

Illinois Pension Woes Continue

Illinois pension problems were back in the headlines this quarter. Harvey, a city just a stone's throw from Chicago's southern border, was forced to lay off nearly half of its police and fire department in April. Harvey has been plagued with financial mismanagement for decades, but the Illinois Comptroller recently rendered the city nearly insolvent by diverting state-shared revenues to Harvey's underfunded pension liabilities instead of the city's general coffers. The move was the first use of a new statue enacted in Illinois in 2016, coined the pension intercept law.

The new law aims to shore up city pension funds across the state. Cash-strapped cities in Illinois have chronically underfunded pension obligations by redirecting state tax contributions to benefit current city employees and bondholders. It seems Illinois will no longer give these city governments discretion over vital state funds. For obvious reasons, this has sounded alarms around the municipal bond market since bondholders rely on the same sources of revenue for principal and interest payments.

While we don't believe Harvey to be an isolated incident, we've found most concerned bond investors have painted Illinois' municipalities with a very broad brush. Prices and yields of bonds associated with the state of Illinois trade cheaper, sometimes significantly, than other states' municipal bonds of

similar credit risk. The general market's disregard for Illinois bonds extends even to the state's most prosperous cities with wealthy citizens, growing populations, and strong municipal balance sheets. For investors willing to do their homework, bargain bin prices – and accompanying higher yields – can be had without added risk in our opinion.

For example, the City of Hinsdale, Illinois issued a series of general obligation bonds in June, backed by the full credit and taxing power of the city. The issuance was assigned the highest possible rating of AAA by both S&P and Fitch. Despite the rating agencies' confidence, the series of bonds priced much closer to out-of-state A-rated municipalities than AAA. The Hinsdale bonds maturing December 2026 were priced to yield 2.75% at issuance. According to the MMD Scale[1] that same day, AAA-rated municipal bonds maturing in 2026 broadly traded at yields of 2.35%, while A-rated municipal bonds (two categories lower) yielded 2.82%.

Hinsdale and Harvey both have underfunded pensions, but stand in stark contrast to each other in every other financial measure. Hinsdale is an affluent suburb located about 20 miles west of Chicago. The city has a median family income of $207,000 and an unemployment rate of 3.7% as of year-end 2017, compared with nationwide stats of $73,000[2] and 4.1%[3], respectively. The city's management has historically practiced conservative financial planning with consistent budget surpluses and available cash comprising a sizable portion of annual expenditures. When analyzing the credit, Hinsdale's pension obligations are the sole detractor. Even so, the required pension contributions comprise a manageable 10% of the city's annual expenditures, and Hinsdale has plenty of financial flexibility to handle any adverse changes.

At Kovitz, we like to utilize our unique familiarity with Illinois municipalities to find value in situations like this recent Hinsdale bond issue. Over an eight-year investment horizon, we are not concerned with Hinsdale's ability to repay debt, and our goal is to obtain excess yield over the Scale as an enhancement to clients' bond portfolios. Most pension funds within Illinois are a cause for concern, but there are many municipalities insulated from the problems, if you know where to look. This is another time we prefer to be greedy when others are fearful.

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[1] *Thomson Reuters Municipal Market Data (MMD) Scale is a yield curve that represents the average rates of general obligation municipal bonds (trading in blocks of $2+ million) of a range of credit qualities and maturity dates. The MMD Scale is widely uses as a benchmark rate for municipal securities.*

[2] *The US Median Family Income reported by the US Census Bureau as of 12/31/16 (the most recent data).*

[3] *The US Unemployment Rate reported by the Bureau of Labor Statistics as of 12/31/17.*

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