KOVITZ INVESTMENT GROUP
Intrinsic Values®

Fixed Income Commentary
Fall 2018

Interest rates continued their upward trajectory this quarter. The Federal Reserve ("Fed") raised the Fed Funds rate for the third time this year to the 2% to 2.25% range and projects one more rate hike this year. Fed actions are one of the greatest drivers of short-term interest rates, and Treasury Bills reacted accordingly. The yield on one-year Treasuries increased to 2.6% from 2.3% at the start of the quarter. While a 0.3% rate movement might not seem astounding, it's important to remember one-year Treasuries yielded only 0.3% less than three years ago. Longer-term Treasury bonds are influenced by short-term rates, and yields on those climbed higher this quarter as well. Ten-year Treasury bond yields rose 0.2% to 3.1%.

No one knows when the Fed will stop hiking rates, but the Federal Open Market Committee gave a new clue in their most recent policy statement by removing the word "accommodative" to describe their approach. Since the Financial Crisis, the Fed has been holding rates artificially low in attempts to fuel the economy – which they term as accommodative policy. Thus, the Fed believes we're in a neutral rate environment where current rates neither help nor hamper economic and inflationary growth. The Fed will need to start defining future rate increases as restrictive soon, which might be a tall task. The Fed's preferred measure of inflation, Consumption Expenditures Price Index, just recently ticked above their 2% target for the first time in six years. A hiccup in inflation growth, which is all-too-common, wouldn't leave the Fed much ground to stand on.

Rising rates tend to be a short-term negative for long-term bond investors. As rates rise, bond prices fall. When prices decline faster than interest income is realized, bond returns can be negative. As such, the widely quoted U.S. Aggregate Bond Index[1] is down roughly 2% year-to-date. In an environment of rising rates, our goal is primarily two-fold – to posture our clients' portfolios with less interest rate risk than the aggregate market and to focus on municipal and corporate credits which generate more interest income than Treasuries. While each clients' fixed income holdings are unique, we are satisfied with our clients' bond performance in general. Longer-term, rising rates mean upcoming bond maturities can be reinvested into higher rates – increasing the earnings power of a bond portfolio. We believe this patient approach smooths risk in a bond market with many question marks.

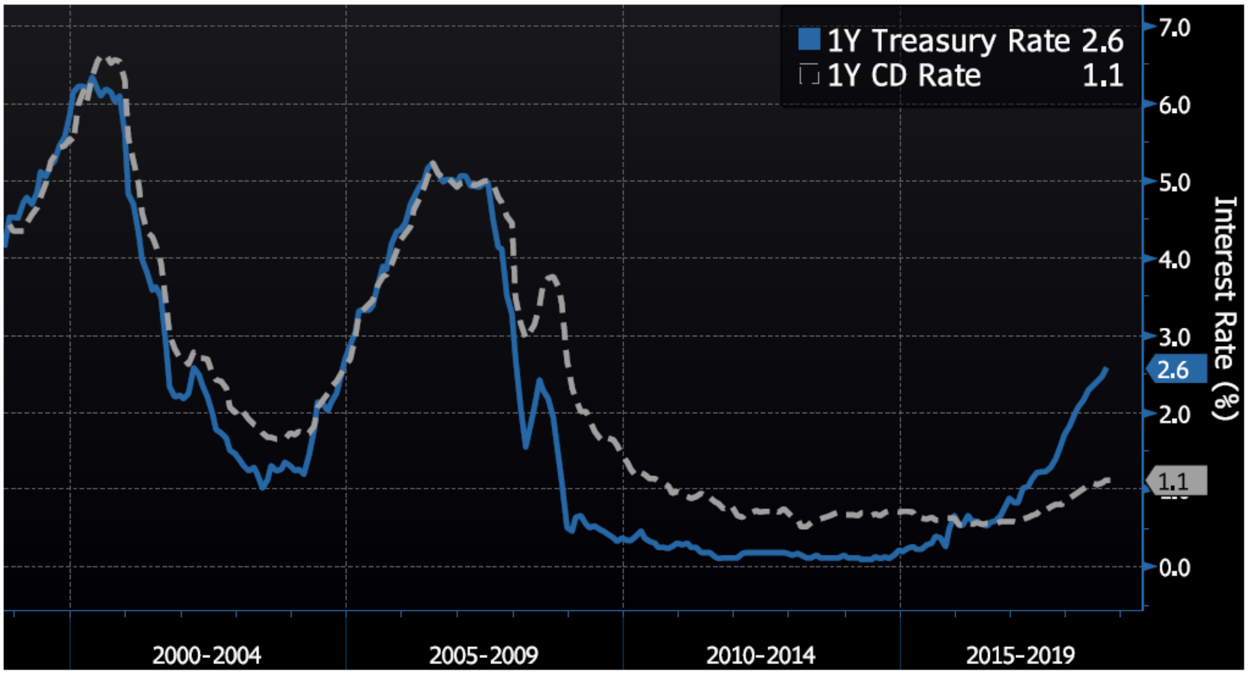
Banks Have Little Interest in Paying Interest

The U.S. banking system has historically offered fair compensation to investors looking for a safe and secure means to park short-term savings. Recently, though, this has not so much been the case. While interest rates are increasing across the rest of the fixed income market, deposit rates at the U.S.'s largest banks are barely budging. As illustrated by the graph on the following page, the rate on Certificates of

[1] *The Bloomberg Barclays U.S. Aggregate Bond Index is a benchmark that broadly measures the U.S. investment grade taxable market.*

Deposits ("CDs") have mostly matched or beat the rate on one-year Treasury bonds over the last twenty years, but over the last couple years that relationship has flipped, meaningfully. One-year Treasury rates now surpass the average national CD rate[2] by 1.5%.

One-Year Rates – Treasuries vs. CDs



Why does a large discrepancy exist? Based solely on the investment merits, it shouldn't. CDs and Treasuries are both very high-quality investments. Treasuries are issued and backed directly by the U.S. government which is unanimously rated AAA, the highest possible credit rating. CDs are guaranteed by the Federal Deposit Insurance Corporation ("FDIC"), up to $250,000 per bank. Since the FDIC is an agency of the U.S. government, CDs are effectively backed by the same credit as Treasuries. Their interest rate risk and liquidity risk differ, slightly, but not enough to explain the yield discrepancy. Treasuries are traded in the secondary market, so prices fluctuate based on rate movements. If forced to sell a Treasury before maturity, the cost is nominal since they're the most actively traded bonds in the market. On the other hand, CDs are not traded in the secondary market, thus they don't have prices that fluctuate based on interest rates. If the owner of a CD needs to redeem it before maturity, banks will charge early withdrawal penalties, which would be equivalent to selling the CD at a discount to its market value.

Peculiarly, the reason for the large discrepancy in yields has more to do with the banking business model than these securities' investment merits. In simple terms, banks make money by borrowing from depositors at a low cost and lending out the deposits for longer periods of time at higher interest rates. The difference between a bank's borrowing costs and lending income is their profit margin. It would be easy to say banks aren't raising interest rates for savers to bolster their bottom line, but it's more simply because they don't need to. Loan-to-deposit ratios for U.S. commercial banks have declined significantly since the Financial Crisis[3]. In 2007, loan-to-deposit ratios peaked at 97% –

[2] *The Bankrate.com U.S. 1 Year CD National Avg Index averages the rates for new CDs offered by major U.S. banks.*
[3] *Sourced from the Federal Reserve.*

meaning banks were loaning out $97 for every $100 in deposits – but the most recent loan-to-deposit ratio was 77%. Due to their relatively inflated deposit levels, banks have little incentive to raise rates on savings accounts and CDs to solicit more of them.

Eventually, enough depositors will catch on, move to greener pastures, and force banks into raising their rates to bring cash back in the door. Investors need to ensure they haven't fallen asleep at the wheel in the meantime. Kovitz offers an array of fixed income solutions for clients. For those with shorter-term liquidity concerns, Treasury bonds can make sense. For those with longer investment "runways" and higher risk tolerance, high-quality, short-term corporate bonds, or tax-exempt municipal bonds may be appropriate. We recommend clients work with their Kovitz Advisor to determine the best solution for their needs.