Eagle Insight

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Fixed Income

First Quarter | 2018

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Separately Managed Accounts (SMA):

Taxable:
High Quality Taxable
Core Fixed Income
Managed Income Solutions

Tax-free:
High Quality Tax-Free
Special Fixed Income
Managed Income Solutions

Market Overview

The domestic bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, fell 1.46 percent in the first quarter. Treasury yields spiked due in part to market concerns that stronger economic growth will finally spur higher inflation, leading to a faster pace of interest-rate increases by the Federal Reserve. The implications of rapidly rising interest rates finally stifled investor demand for risk assets and increased market volatility mid-quarter.

The yield on the benchmark 10-year U.S. Treasury rose more than half of one percent in less than two months and reached a multi-year high of 2.95 percent in February. In March, however, some of the apprehension over growth and inflation subsided as several important economic measures – along with inflation data – failed to meet market expectations. Government bond prices went up as investors migrated toward their relative safety over growing risks presented by President Donald Trump's proposed tariffs.

Our view for resistance around 3.0 percent held as the yield on the 10-year note declined to finish the quarter at 2.74 percent: 0.33 percentage points higher since December 31 but 0.21 percentage points off its year-to-date high.

Fear of proposed tariffs spiraling into a global trade war weighed heavily on corporate bonds. Corporate-credit spreads continued to widen in March, ending the quarter at 1.09 percent vs. 0.93 percent at the beginning of 2018. The corporate-bond sector was the worst-performing major sector with a negative total return and underperforming duration-matched Treasuries. Government-related securities and structured products fared slightly better than corporate bonds (on a total return basis) but still posted negative total returns.

Corporate Market Review[1,2]

Investment-grade corporate bonds, as measured by the Bloomberg Barclays U.S. Corporate Bond Index, lost 2.32 percent during the first quarter. A strong start to 2018 quickly dissolved as market volatility picked up over fears that the Federal Reserve will raise interest rates faster than expected, increasing the probability of a policy mistake. Proposed tariffs and the potential for retaliation from U.S. trading partners along with Twitter attacks by President Donald Trump added to the weakness in credit.

We believe the focus will now turn to first-quarter earnings. We expect earnings to grow at a healthy pace although they may not meet soaring analyst estimates. Positive earnings should continue to improve credit fundamentals but as we highlighted above, tightening financial conditions are a concern. Domestic and geopolitical risks remain elevated. Mergers and acquisition (M&A) activity was robust in the first quarter with several announced mega-merger-related debt offerings. The historical implications of M&A have been bearish for credit risk, which colors our current credit outlook. Valuations appear more reasonable since corporate-credit spreads have widened; however, downside risks are still a concern. In addition to buying higher-quality corporate bonds, we reduced our overall corporate-bond exposure during the quarter. We also added incrementally to Treasuries and mortgage-backed securities to take advantage of their recent selloff.

Municipal Market Review[1,2]

The domestic municipal-bond market, as measured by the Bloomberg Barclays Municipal Bond Index, was down 1.11 percent for the quarter. The negative performance of previous months softened with a return of 0.37 percent in March. The AAA municipal curve steepened over the quarter with short and intermediate maturities outperforming long maturities. For example: the 1-year index return was up 0.38 percent; the 7-year index was down 1.20 percent; and the 20-year index was down 1.52 percent. Highlights from the first quarter included constrained new-issue supply, a much-anticipated increase in short-term rates and continued uncertainty surrounding how the new tax bill will impact the municipal bond market.

The 10-year municipal AAA yield finished the first quarter 0.47 percentage points higher than it started (2.01 vs. 2.48 percent). Municipal-to-Treasury yield ratios reflect value in the intermediate and longer end of the curve, as ratios have gotten more expensive through the four-year maturity and cheapen thereafter with the 10-year at 90 percent and 20/30-year both at 101 percent. We have taken advantage of these valuations with a barbell approach: buying bonds in those relatively attractive maturity ranges and selling weaker credits at attractive spreads. Cash has been elevated in our municipal programs for most of the quarter but we have begun reinvesting cash as opportunities have arisen, primarily in cheaper longer maturity bonds.

New issuance of municipal bonds remains constrained at $62.8 billion, down roughly 32 percent for the same period last year. We view this as a result of the new tax bill and the elimination of advance refunding bonds. We did see some sporadic negative weekly outflows from municipal bond funds over the quarter; however, overall, the quarter produced positive net inflows of roughly $5.8 billion. Foreign investors still make up a relatively small portion of municipal buyers but demand has risen over the last several years.

In recent headlines, Connecticut has agreed to pay off the city of Hartford's general obligation debt, roughly $550 million or up to $40 million annually over two decades. This will help Hartford to provide some fiscal stability after being on the brink of bankruptcy. We expect a further state rating downgrade, as this additional capital requirement will put pressure on the state's already weaker financial metrics. The state's current pension funding is well below average (roughly 40 percent). We currently have an underweight position in the state and local general obligation sector and will continue to monitor it. We prefer the revenue bond sector as revenue bonds have outperformed the state and local general obligation sector over the trailing 12 months.

Overall credit fundamentals continue to remain strong among the investment-grade universe. Moody's reported that public-finance upgrades have exceeded downgrades for the past three years, indicating continued improvement in credit quality. In total, upgrades exceeded downgrades by 68 percent. We have an overweight position in healthcare; however, we are gradually reducing our exposure to those systems with higher Medicaid and Medicare exposure and/or weakening financials. Currently we have overweight positions in healthcare, education, leasing and special tax sectors.

[1] References to specific securities are intended to illustrate the types of securities Eagle may hold in this portfolio. They are not intended as representations of specific investment recommendations that would have been profitable to an investor. Past performance is not a guarantee of future results. Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice as are statements of financial-market trends, which are based on current market conditions. Investing involves risk, including the possible loss of principle.

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[2] Sources: Investor Tools Perform and Yield Book

Investing in bonds involves risks that may adversely affect the value of your investment such as inflation risk, credit risk, call risk, interest rate risk and liquidity risk, among others. The two most prominent factors are interest rate movements and the credit worthiness of the bond issuer. Investors should pay careful attention to the types of fixed income securities that comprise their portfolios and remember that, as with all investments, there is the risk of loss of capital. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.

Asset-backed securities and mortgage-backed securities are created by pooling loans from a variety of sources and issuing bonds that are backed by these loans. Creditworthiness stems from the credit quality of the underlying loans, as opposed to corporate bonds in which creditworthiness is derived from the earning power of the issuing company. The primary risk of these securities is interest-rate risk. Rising interest rates might cause loan principal prepayments to slow, resulting in less available principal to invest at prevailing higher rates. Conversely, rate decreases might accelerate prepayments, leaving more dollars to invest at lower rates. Investment grade refers to fixed-income securities rated BBB or better by Standard & Poor's or Baa or better by Moody's.

Convertible securities and preferred stock combine the fixed-income characteristics of bonds with some of the potential for capital appreciation of equities and, thus, may be subject to greater risk than pure fixed-income instruments. Unlike bonds, preferred stock and some convertible securities do not have a fixed par value at maturity, and in this respect may be considered riskier than bonds. Convertible securities may include convertible bonds, convertible preferred stocks and other fixed-income instruments that have conversion features.

Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments. The lower rating of high-yield bonds (less than investment grade) reflects a greater possibility that the financial condition of the issuer or adverse changes in general economic conditions may impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Moreover, to the extent that no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

Sovereign debt instruments are subject to the risk that a governmental entity may delay or refuse to pay interest or repay principal on its sovereign debt. A Real Estate Mortgage Investment Conduit (REMIC) is a type of multiclass mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. These classes are distinguished by their sensitivity to the prepayment risk of the underlying mortgage-related collateral. Therefore, they may be more or less sensitive to prepayment risk, bear different interest rates, and have various average lives and final maturities.