FUNDMARKET INSIGHT REPORT

THOMSON REUTERS LIPPER RESEARCH SERIES – FIXED INCOME SUMMARY QUARTER-END ANALYSIS

JUNE 30, 2018

Bond Fund Prices Fall for the Second Straight Quarter

EXECUTIVE SUMMARY

Fixed income funds lost ground for the second consecutive quarter, with a return of minus 0.25% on average for Q2 2018 after retreating 0.56% for Q1. The albatross weighing the asset group down this past quarter was the world income funds macro group, which fell 4.65% on average as the group appeared to have been negatively impacted by a bounce in the strength of the U.S. dollar. The only other macro group in the red for the quarter was investment-grade corporate bond funds (-0.12%), which was hurt by the performance of its longer-term-maturity peer groups. The poor performance from the longer-term-maturity bond funds could be expected, considering the increased interest-rate risk in today's economic environment, where we are seeing changes to both the level of interest rates (increase) and in the shape (narrowing) of the yield curve. On the plus side of the ledger were the municipal debt funds (+0.88%), government/ Treasury funds (+0.31%), and general domestic taxable bond funds (+0.07%) macro groups. Somewhat contradictory to the asset group's overall loss for the quarter was the fact that 34 of the 47 fixed income peer groups recorded gains for Q2. Of note, the top 17 quarterly returns belonged to the tax-exempt muni debt fund macro group (ranging from +1.64% to +0.61%). However, the outsized losses from the world income funds macro group outweighed the smaller gains from the muni debt funds group as well as the others.

The Federal Reserve raised interest rates another 25 basis points (bps) at its mid-June policy meeting, to increase the federal funds rate to a range between 1.75% to 2.00%. This marked the second rate hike this year and the seventh since the Fed started moving toward a more restrictive monetary policy in December 2015. It is now believed the Fed will raise rates two more times this year and three times in 2019. The key drivers for this past quarter's rate increase (and the ones forecasted for the next 18 months) were strong economic data related to jobs and inflation. As of the end of May unemployment stood at 3.8%, its lowest level since April 2000. The personal consumption expenditures (PCE) price index hit the Fed's target rate (2.0%) for the first time since 2012. (The PCE price index is the Fed's preferred measure to gauge inflation because it excludes sectors [food and energy] that make it more difficult to identify underlying inflation trends.) The Fed is confident that its judicious use of interest rate hikes over the last two and a half years has kept the economy (and inflation) from overheating, and it is forecasting inflation to remain at 2.0% for the remainder of the year and then increase slightly to 2.1% for the next two years. In a somewhat unusual move Lawrence Kudlow, the top economic advisor to President Trump, stated he hoped the Fed would not accelerate its interest rate hike program. This was unusual, since it has been a quarter of a century since the White House has commented on the Fed's monetary policy. It warrants watching if this was an isolated incident or if there is more to come.

Second Quarter Highlights:

- World income funds (-4.65%) turned in the worst performance among the Thomson Reuters Lipper macro groups.
- The general domestic taxable fixed income funds macro group gained 0.07%, led higher by High Yield Funds (+0.51%) and Loan Participation Funds (+0.45%).
- Municipal debt funds posted a return of 0.88% on average, with both national muni (+0.95%) and single-state muni debt funds (+0.82%) contributing.
- Investment-grade corporate debt funds (-0.12%) were in the red for the quarter as the longer-term maturity peer groups underperformed.
- Government/Treasury funds recorded an increase (+0.31%) for Q2, paced by the Inflation-Protected Bond Funds (+0.59%) peer group.

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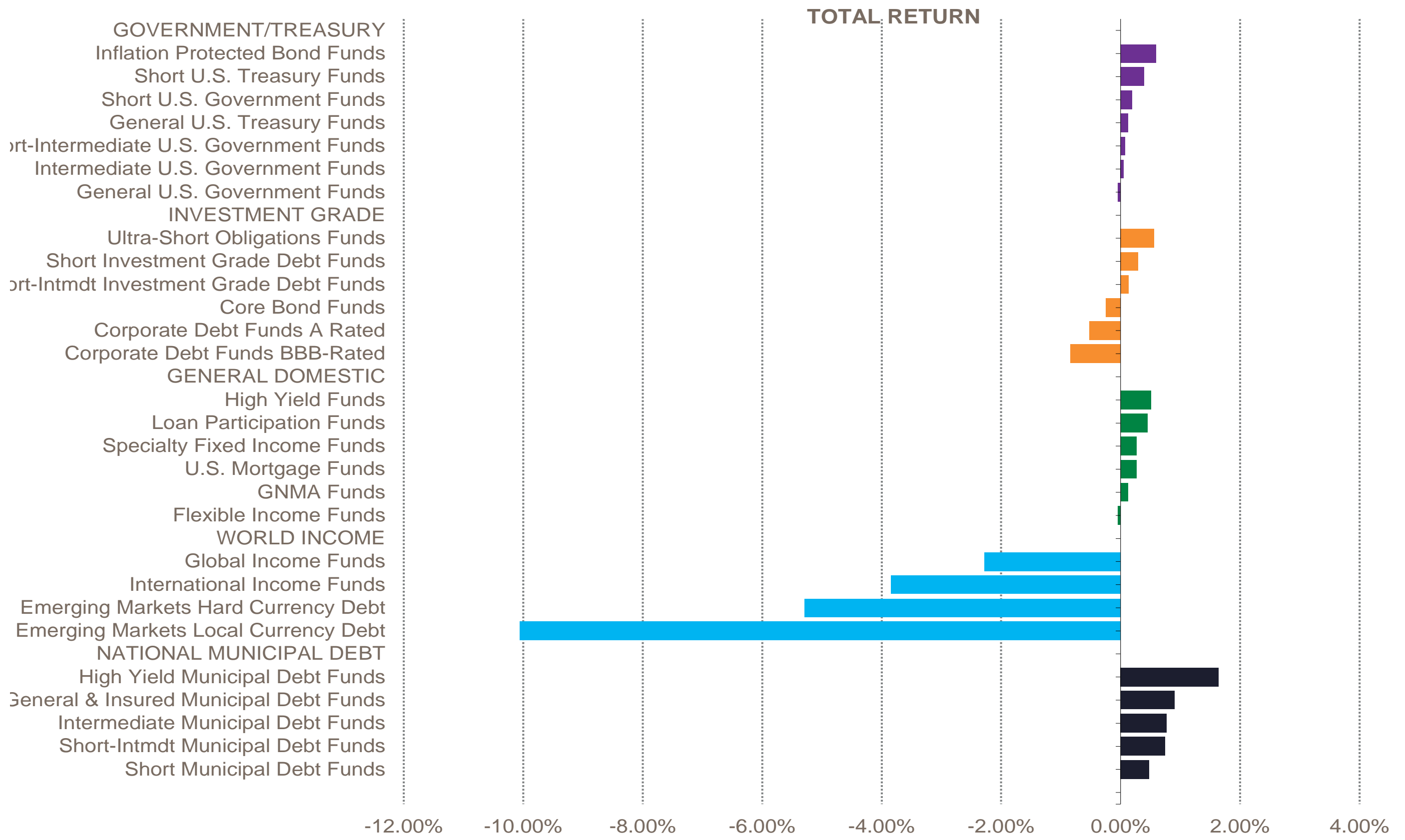
FIGURE 1 LIPPER FIXED INCOME FUND CLASSIFICATION RETURNS, SECOND QUARTER 2018



Source: Thomson Reuters Lipper

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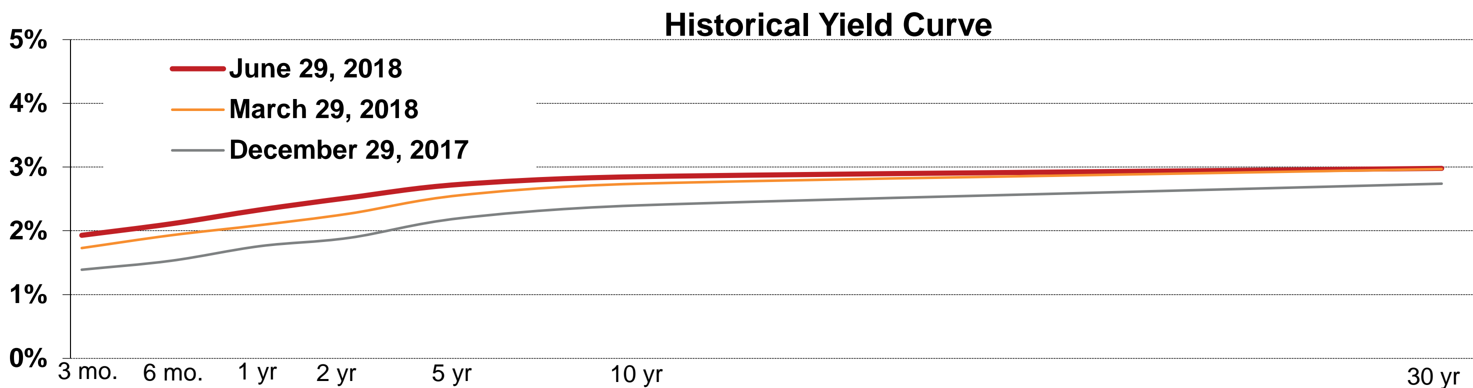
GOVERNMENT/TREASURY FUNDS SUMMARY

The yield curve continued to narrow in Q2. The two-/ten-year spread tightened for the sixth consecutive quarter and closed the quarter at 0.33, its flattest level since August 2007. The yield curve is moving closer to inversion (when short-term interest rates are greater than long-term interest rates); it has tightened 92 bps since the end of 2016. An inverted yield curve does not occur often and has been a reliable indicator of recessions in the past. The last time we consistently experienced an inverted yield curve was Q2 2006 through Q2 2007, directly preceding the global financial crisis. In a recent poll conducted by Reuters approximately 65% of bond market experts believe the yield curve will invert within the next one to two years.

The government/Treasury funds macro group gained 0.31% on average for Q2, rebounding from a 0.84% loss for Q1. As referenced in the Executive Summary, interest-rate risk increased during the quarter and inflation finally reached the Fed's target level. The peer group performances for this macro group reflected those realities; the top-performing peer group was Inflation-Protected Bond Funds (+0.59%), followed closely by Short U.S. Treasury Funds (+0.39%) and Short U.S. Government Funds (+0.19%). (As its name suggests, funds in the Inflation-Protected Bond Funds category invest in fixed income securities designed to provide protection against rising inflation rates, while funds with shorter-term maturities provide greater protection against interest-rate risk than funds with longer-term maturities do.) General U.S. Government Funds (-0.05%) turned in the worst performance for this macro group. (In Lipper methodology "general" in a fixed income peer group's name equates to the peer group not having any maturity constraints. For comparison purposes funds in the General U.S. Government Funds category have an average effective maturity of 14.4 years, and by definition funds in the Short U.S. Treasury Funds and Short U.S. Government Funds peer groups are required to have effective maturities of less than three years.) For the quarter the government/Treasury funds macro group attracted $15.7 billion of net new money, with the Short U.S. Treasury Funds peer group (+$7.9 billion) accounting for over half of that increase.

FIGURE 2 TREASURY YIELD CURVE



Source: U.S. Department of the Treasury

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INVESTMENT-GRADE CORPORATE BOND FUNDS SUMMARY

The investment-grade corporate bond funds macro group retreated 0.12% on average for Q2 after losing 1.04% for Q1. As was referenced in the Executive Summary, this macro group was negatively impacted by the increased interest-rate risk caused by changes to the shape of the yield curve and the level of interest rates. The peer groups with shorter-term maturities all turned in positive quarterly returns: Ultra-Short Obligation Funds, Short Investment-Grade Debt Funds, and Short/Intermediate Investment-Grade Debt Funds recorded increases of 0.56%, 0.29%, and 0.13%, respectively. Conversely, the longer-term maturity peer groups were all in the red: Corporate Debt Funds BBB-Rated (-0.84%), Corporate Debt Funds A-Rated (-0.53%), and Core Bond Funds (-0.25%).

GENERAL DOMESTIC TAXABLE BOND FUNDS SUMMARY

After losing 0.43% for Q1 the general domestic taxable bond funds macro group recorded a small gain (+0.07%) for Q2. The highest returns for the quarter belonged to the High Yield Funds (+0.51%) and Loan Participation Funds (+0.45%) peer groups. These groups were helped by tightening credit spreads and rising interest rates, respectively. (A requirement of the high-yield funds peer group is that the majority of the assets need to be invested in below-investment-grade debt, or risky assets. As credit spreads tighten riskier assets become more attractive, and the BofA Merrill Lynch US High Yield Option-Adjusted Spread shrank 18 bps for Q2. Loan participation funds benefit from rising interest rates because bank loans generally having floating interest rates.)

WORLD INCOME FUNDS SUMMARY

A reversal in the trend of the strength of the U.S. dollar hurt this macro group during Q2. After five straight quarters of the dollar weakening relative to the currencies of the U.S.'s major trading partners (as measured by the trade-weighted U.S. dollar index) the dollar rebounded in Q2. The index rose 3.71 points for the quarter after losing a total of 9.46 points in the previous five quarters. The world income funds macro group lost 4.65% on average as every peer group within this macro group retreated, with the emerging markets debt categories being the hardest hit by the renewed strength in the U.S. dollar. The Emerging Markets Local Currency Debt Funds peer group (-10.06%) suffered a double-digit loss, while Emerging Markets Hard Currency Debt Funds was down 5.29%. Investors also voted with their wallets in respect to these two categories; Emerging Markets Hard Currency Debt Funds and Emerging Markets Local Currency Debt Funds suffered net outflows of $1.1 billion and $829 million, respectively, for the quarter.

MUNICIPAL DEBT FUNDS SUMMARY

The municipal debt funds macro group gained 0.88% on average for Q2, coming off a 0.84% loss for Q1. Both national municipal debt funds (+0.95%) and single-state municipal debt funds (+0.82%) contributed to this past quarter's increase. All 20 of the muni debt fund peer groups recorded positive returns for the quarter, book-ended by High Yield Municipal Debt Funds (+1.64%) and Short Municipal Debt Funds (+0.48%) Despite the overall positive performance by the group, muni debt funds experienced net outflows of $120 million for the quarter. The biggest contributors to these aggregate net outflows were the Short Muni Debt Funds (-$1.3 billion) and Short/Intermediate Muni Debt Funds (-$889 million) groups, while investors did put a significant amount of net new money into funds in the High Yield Muni Debt Funds (+$2.4 billion) category.

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