How Low Can Rates Go? Total Return Market
Outlook
October 18, 2019
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The fixed income market benefited in the third quarter as both global growth fears and the trade
dispute continued to drive uncertainty in financial markets. With Europe remaining in an economic rut
and China showing signs of slowing from the protracted trade conflict, investors sought the safety of
U.S. Treasuries, pushing up prices and reducing yields. The effect was most pronounced at the long
end, with 30-year Treasury yields down 41.9 basis points (bps) and 2-year yields down only 13.3 bps.
Much of this move took place in concert with European yields as they were driven further into negative
territory in anticipation of a dovish September European Central Bank (ECB) meeting. Yet as flows
continued to move into risk-free assets, credit remained stable as spreads were unchanged during the
quarter, thus resulting in the continuing rally across investment grade fixed income.

Overall the domestic economy has been resilient this year despite the ongoing trade war, but the
manufacturing sector has been hit hardest and is beginning to show signs of weakness. The Institute
for Supply Management (ISM) and Purchasing Managers Index (PMI) manufacturing surveys are both
hovering around 50 (anything less than 50 is signaling contraction), which is keeping the markets on
edge. In the latest September release, the ISM survey posted 47.8, which surprised markets and
suggests an increased possibility of a recession. The September PMI survey was a little stronger,
remaining above 50 at 51.1.

Away from manufacturing, consumer-driven indicators suggest a more stable environment, as low
unemployment and wage growth have supported retail sales and other consumer services. Indicators
such as the Citi Economic Surprise Index, which measures data surprises relative to market
expectations, rose from -68.30 to +43.00 during the quarter (positive numbers suggest positive
surprises, and vice-versa). The move from negative to positive was definitely a good sign, but the index
backslid a little to +23.20 in October due to the weaker manufacturing survey data.

Our portfolio remains defensive as the trade war endures and could potentially bring the economy to
the brink of recession, but we believe such an outcome will be contained as it is in the best interest of
both parties to come to a resolution prior to a complete meltdown.

During the quarter, several defensive central banks around the world cut rates in an effort to stimulate
their respective economies. Accordingly, the Federal Reserve (the Fed) cut 25 bps during the quarter
as inflation remained under control with trade uncertainty muddling the economic outlook. The market continues to price-in another 25 bps cut before the end of the year, which seems reasonable based on the Fed’s recent actions. The quarter was also marked by the Fed resolving funding pressures in the overnight repurchasing (repo) market by initiating a temporary open market operation. The Fed acknowledged the cause of the dislocation was a technical issue as the reserve cushion was reduced and resulted in the overnight rate being set as high as 10% from rates hovering around 2%. Such a move in the repo rate was alarming for market participants but posed little risk to the financial system. The Fed’s initial reluctance to carry out temporary operations (which were common pre-crisis of 2008) could have been driven by concerns of the action being misperceived as additional quantitative easing, which could have created more of a confidence issue in the Fed than an actual problem.

Credit spreads remained well-contained even as uncertainties persisted during the quarter. The record amount of new issuance hitting the investment grade corporate market was a potential headwind, yet credit spreads were unchanged over the quarter at 115 bps over Treasuries. Companies flush with cash hit the market to opportunistically issue debt at historically low rates. Corporations such as Coca-Cola and Apple were among the 130 issuers to hit the market with over $158 billion in issuance over just the month of September, which was the third busiest month on record. The first week of September marked the busiest week ever for investment grade new issuance at $75 billion! Given all the new supply, spreads remained steady as investment grade bond funds saw new inflows and investors continued to reach for yield through investments into corporates.

We also continue to monitor corporations in the BBB cohort, as much attention has been given to the risks of owning the group. Although we see many positive actions as these companies remain vigilant to protect their investment grade rating, Ford Motor Company (one of the largest issuers of investment grade debt) was downgraded by Moody’s to a junk rating of BA1 during the quarter.

Going forward, we remain constructive on the economy, but we are taking a more defensive posture as trade tensions are still unresolved and investors are preparing for the end of 2019. As we enter the final quarter of the year, investors are cautiously approaching the period as memories of the sharp technical selloff in risk assets linger from the fourth quarter of 2018. In addition, investment grade assets have returned robust performances thus far this year, so we will watch to see if investors start to lock in their 2019 returns and call it a year. This could result in the selling of investment grade assets at a discount, and we stand ready to act if signs of such activities emerge. Much has been discounted into this market given the fears of slower growth and the ongoing trade issues, but we continue to believe there are many opportunities across rates, mortgages and credit to take advantage of. We actively monitor these markets for such prospects.

As always, we thank you for your continued support and welcome any questions.

Best Regards,
Eddy Vataru John Sheehan Daniel Oh

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A basis point (bp) is a unit that is equal to 1/100th of 1%.

The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. The Index is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management (ISM).

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

The Citi Economic Surprise Index measures the pace at which economic indicators are coming in ahead of or below consensus forecasts.

Bond ratings are grades given to bonds that indicate their credit quality as determined by private independent rating services such as S&P, Moody’s and Fitch. These firms evaluate a bond issuer’s financial strength, or its ability to pay a bond’s principal and interest in a timely fashion. For example, S&P ratings are expressed as letters ranging from ‘AAA’, which is the highest grade, to ’D’, which is the lowest grade.

As of 9/30/19, the Osterweis Total Return Fund held Coca-Cola (0.0%) and Apple (0.9%).

Holdings and sector allocations may change at any time due to ongoing portfolio management. References to specific investments should not be construed as a recommendation to buy or sell the securities by the Osterweis Fund or Osterweis Capital Management.

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