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Fixed income market overview and outlook

Executive summary

- Both short- and long-term Treasury yields declined during the second quarter, as the Federal Reserve Board ("Fed") indicated it may soon lower interest rates.
- The overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gained 3.08% during the second quarter. The spread sectors also moved higher over the quarter.
- Despite several headwinds, Western Asset Management ("Western") expects global growth to remain resilient on the back of steady U.S. growth, improving domestic conditions in Europe, and signs that sustained monetary and fiscal stimuli across Asia are gaining traction.
- Western acknowledges that trade friction will be an ongoing drag on investor and business confidence, but central banks globally have become much more explicit in their commitment to unleash additional policy accommodation to truncate downside risks.

Market recap

U.S. Treasurys generated a positive return during the second quarter, as both short- and long-term yields declined (yields and prices move in the opposite direction). The spread sectors (non-U.S. Treasurys) also rallied over the quarter. After yields generally moved higher in April, trade concerns dominated May and led to a risk-off environment for much of the month. Yields then moved sharply lower as the Federal Reserve Board ("Fed") indicated it was getting closer to lowering interest rates. Similar accommodative messaging by the European Central Bank (ECB) also contributed to falling global bond yields.

Looking at the U.S. economy, according to the Commerce Department, first quarter 2019 gross domestic product (GDP) annualized growth was 3.1%. In contrast, the economy expanded 2.2% during the fourth quarter of 2018. The acceleration in GDP growth during the first quarter of 2019 was attributed to positive contributions from exports, personal consumption expenditures (PCE), nonresidential fixed investment, private inventory investment, and state and local government spending. These movements were slightly offset by a negative contribution from residential fixed investment. Imports, which are a subtraction in the calculation of GDP, decreased.

The labor market remained tight during the second quarter. The unemployment rate was 3.6% in both April and May—equaling the lowest rate since December 1969. The unemployment rate then ticked up to 3.7%. However, this was partially due to an increase in the workforce participation rate, as it rose from 62.8% in May to 62.9% in June.

The manufacturing sector continued to expand, but the pace moderated during the second quarter. According to the Institute for Supply Management's Purchasing Managers Index (PMI), the manufacturing sector expanded for the 34th consecutive month in June, with a reading of 51.7, versus 52.8 in April. (A reading below 50 indicates a contraction, while a reading above 50 indicates an expansion.) Twelve of the 18 industries measured by the PMI expanded in June.

According to the National Association of Realtors (NAR), existing-home sales rose 2.5% on a seasonally adjusted basis in May versus the previous month's sales. The NAR also reported that the median existing-home price for all housing types was $277,700 in May 2019, up 4.8% from May 2018. Finally, the inventory of homes available for sale in May was at a 4.3-month supply at the current sales pace. In contrast, there was a 4.2-month supply the previous month.

The Fed kept its target rate unchanged in a range between 2.25% and 2.50% during the second quarter. However, at its meeting in June the Fed said, "The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased." In his press conference after the meeting Fed Chair Powell stated, "The case for somewhat more accommodative policy has strengthened."

Both short-term and longer-term Treasury yields fell sharply during the second quarter. When the period began, the yield on the two-year Treasury was 2.27%, and it ended the quarter at 1.75%. Its low for the period of 1.71% occurred on June 25, and it rose as high as 2.41%, on April 16. The yield on the 10-year Treasury began at 2.41% and it ended the quarter at 2.00%,

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equaling its low for the period. Its peak of 2.60 occurred on April 16.

The overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index, gained 3.08% during the second quarter. The spread sectors also moved higher, as the Fed and a number of other central banks leaned toward introducing more accommodative monetary policies. In addition, signs of moderating global growth and uncertainties over U.S.-China trade negotiations triggered several flights to quality. Higher-yielding spread sectors also generated positive results during the quarter. The Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Cap Index returned 2.50%, whereas the emerging market debt asset class, as represented by the JPMorgan Emerging Markets Bond Index Global (EMBI Global), gained 3.76%.

Outlook

Global growth concerns have intensified since last quarter, as an initial trade spat between the U.S. and China has morphed into a broader conflict, with the risk of expanding on new fronts. Markets have also been rattled by the prospect of a U.S. recession, a sustained slowdown in eurozone growth, and higher oil price volatility on escalating tensions in the Middle East. Despite these concerns, we expect global growth to remain resilient on the back of steady U.S. growth, improving domestic conditions in Europe, and signs that sustained monetary and fiscal stimuli across Asia are gaining traction. We acknowledge that trade friction will be an ongoing drag on investor and business confidence, but central banks globally have become much more explicit in their commitment to unleash additional policy accommodation to truncate downside risks.

Investment risks

All investments are subject to risks, including possible loss of principal. Investments in bonds are subject to credit risk, inflation risk, income risk and interest rate risk. As interest rates rise, bond prices fall, reducing the value of an investment. The funds may use leverage, which will increase risk and volatility.

Yields can fluctuate, and they represent past performance, and they are no guarantee of future results.

High-yield bonds involve additional credit and default risk. Mortgage-backed or mortgage-related securities are exposed to prepayment and extension risks that may be greater than the risks involved in investments in other fixed income securities.

Foreign securities are subject to certain risks of overseas investing, including currency fluctuations and changes in political and economic conditions, which could result in significant market fluctuations. These risks are magnified in emerging or developing markets.

Any performance discussed is past performance, and past performance is no guarantee of future results. Unless otherwise stated, all yields and returns discussed are those of indexes or asset classes.

Diversification does not assure a profit or protect against a loss.

Glossary

Please note that an investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges.

The **Bloomberg Barclays U.S. Aggregate Index** is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues rated investment grade or higher and having at least one year to maturity.

The **Bloomberg Barclays U.S. High Yield 2% Issuer Capped Bond Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

The **JPMorgan Emerging Markets Bond Index Global (EMBI Global)** is a U.S. dollar-denominated, investable market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt.

The **Federal Reserve Board ("Fed")** is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

U.S. Treasurys are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasurys when the securities are held to maturity.

The core **personal consumption expenditures (PCE) index** measures the prices paid by consumers for goods and services, without the volatility caused by movements in food and energy prices, to reveal underlying inflation trends.

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