2Q 2019 Commentary

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MARKET COMMENTARY

The first quarter of 2019 proved to be the reemergence of the Federal Reserve's focus on the balance sheet. While Jerome Powell hinted to slowing the pace of run-off of the balance sheet in December, in the first quarter of 2019, he explicitly stated that the Federal Reserve intends to hold the balance sheet steady and stop the increase of fed funds rates unless economic data says otherwise. Powell's confirmation paired with the later stages of a long economic cycle, lower domestic growth projections, and some recent releases of weaker economic data, makes a reversal from lower rates very unlikely in the near future. It helped calm the markets from the increased volatility we saw at the end of 2018 and push both equities and fixed income higher during the first quarter of 2019.

Global stock markets rallied with the S&P 500 Index® up 13.7%, and the MSCI EAFE Index and Emerging Markets Indices both up almost 10%. In the U.S., investors shrugged off news that profit margins had declined from their 2018 record-high levels. Price gains were broad-based, yet most pronounced in the stocks of higher-growing companies, which had been the hardest hit at the end of last year when investors became concerned about their continued ability to grow in a slower-growth environment. The impressive 14.6% return in the small-cap-dominated Russell 2000 Index® was not enough to erase its now 15-year performance deficit against the largest companies found in the Russell Top 200 Index®. With the exception of small cap value stocks, these recent price increases have left the valuations of the broad-based U.S. market indices at or above their 20-year averages.

While stocks grew in the first quarter, the bond market also rallied with the Barclays Aggregate Index moving up almost 3% during the quarter as long-maturity corporates and non-investment grade bonds led the way. Both the Bloomberg Barclays U.S. Aggregate Credit-Long and High Yield Indices were up over 7%, in keeping with their historical pattern of being highly correlated to stocks. Corporate spreads are now back below their median levels of the last 15 years, so similar to stock technicals, there would appear to be very little margin should growth expectations shift even lower. But with more indications that rates may remain lower for longer, cheap access to credit may once again prove to justify lofty valuations in both the credit and stock markets.

Core Fixed Income Composite

PORTFOLIO COMMENTARY

In the second quarter of 2019, the Core Fixed Income Composite ("composite") was up 2.32% (gross of fees) and up 2.25% (net of fees). The Intermediate component of the Bloomberg Barclays Aggregate Bond Index ("benchmark") was up 2.39%.

The composite's largest sector, agency commercial mortgage-backed securities, was also the best performing sector generating a 3.22% total return. On a stand-alone basis, the sector's income contributed 25 basis points to the total return, while the composite generated a total income return of 81 basis points. In addition to the income component, the longer duration profile and swap performance positively impacted returns.

The composite's second largest sector, single family agency mortgage-backed securities, was up 1.83% during the month and underperformed the benchmark's MBS by 13 basis points. The composite's overweight exposure to 30-year MBS vs. the benchmark (the composite currently has no exposure to 15/20-year MBS while the benchmark's sector exposure is 13%), a higher income profile and a superior paydown return all positively contributed to relative returns for the past month. Unfortunately, the composite had an underweight allocation of 3% coupons, which were the best performing coupon during the quarter.

The third largest sector in the composite, taxable municipal bonds, was up 2.45%. In the sector, the price return was 1.50% while the income return was 0.95%. The sector's return was negatively impacted as spreads slightly widened during the month.

The benchmark's performance for the quarter seemed to be helped by its larger position in corporates, which were the best performing major sector in the bond market. The sector generated a 3.13% total return and an excess return of 0.61% as spreads tightened. The other two major sectors in the benchmark, Treasuries and Mortgage-Backed Securities, were up 2.36% and 1.96% respectively.

As of June 30, 2019, the composite's Yield-to-Worst (YTW) is 2.82%, which is higher than the benchmark's YTW of 2.32%; and exhibited 11% longer duration, or interest rate risk, to the benchmark. Overall, the composite's higher income profile contributed slightly higher relative returns. In addition, the higher exposure across the belly and long-end of the curve positively impacted returns given the move in rates.

Going forward, the portfolio management does not anticipate any changes to its asset allocation weightings.

Effective April 1, 2018, the benchmark for the Core Fixed Income Composite changed from Bloomberg Barclays U.S. Aggregate Bond Index to the Bloomberg Barclays Intermediate U.S. Aggregate Index.

Data sources: Barclays Live, Bloomberg PORT, and eVestment Alliance.

As of 06/30/19, the average annual gross returns for the Core Fixed Income Composite for 1-year, 5-year, 10-year and since inception (8/30/99) were 6.42%, 2.95%, 3.61% and 4.93%. As of 06/30/19, the average annual net returns for the Core Fixed Income Composite for the same time periods were 6.08%, 2.63%, 3.30% and 4.54%.