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First Quarter Fixed Income Letter to Clients

The municipal bond market has begun to recover from the January sell-off which was responsible for the first quarter loss of around -1.50% on the Bloomberg Barclays Municipal Bond Index which is an investment grade, tax-free portfolio spanning the entire yield curve. First-quarter bond market weakness was the result of concern that the Federal Reserve would raise interest rates more aggressively than previously expected in conjunction with inflation worries. But with the market having since stabilized in March, many bond market analysts think the worst may be over for the time being.

Our outlook for bonds over the next six to twelve months is that there is a 55% probability that the benchmark US Treasury 10-year bond yield will rise from today's 2.75%-2.90% range to around 3.25%-3.40%. We assign a 35% probability that the 10-year bond yield will simply remain in today's range. And given the general nature of markets we always feel that there is a 10% chance that yields will rise or fall much higher or lower than we or anyone can reasonably predict today due to "unknowns". The key trigger guiding this outlook is inflation driven by wage pressures (average hourly earnings). Until wage pressures materialize more forcefully, Federal Reserve policy makers are unlikely to deviate from the course of three to four rate increases that they have laid out for this year.

Despite the bond market's weakness at the start of the year, demand has been strong for municipal bonds as evidenced by constant inflows to municipal-bond funds. Congress' overhaul of the tax code left individual tax rates high for the top income brackets, which will keep individual investors attracted to tax-exempt municipal bonds.

Our current strategy for municipal-bond investors is to own a diversified portfolio of high-quality, investment grade bonds primarily maturing in one to five years; a smaller portion of the portfolio maturing in six to ten years; and less than 8% of the portfolio reserved for uniquely attractive longer term opportunities if they present themselves. For clients who reside in high income tax states, we focus on buying bonds issued in their state in order to benefit from the state tax exemption. At the same time, we also include some attractive out-of-state bonds for the purpose of credit diversification.

The conventional wisdom at this time is that rates are "going higher". And if this plays out then a short-term portfolio would be ideal since investors can reinvest their proceeds at tomorrow's higher rates. The problem with this strategy is if the higher interest rate scenario doesn't materialize too soon, then the opportunity cost (i.e. the loss of potential gain from other alternatives when one alternative is chosen) of a short-term bond portfolio will outweigh the benefit of being ultra-defensive. Given the current bond market environment, our client's portfolios are designed to earn the highest after-tax return while maintaining a relatively defensive portfolio structure.

Evan Slater
Fixed Income Portfolio Manager