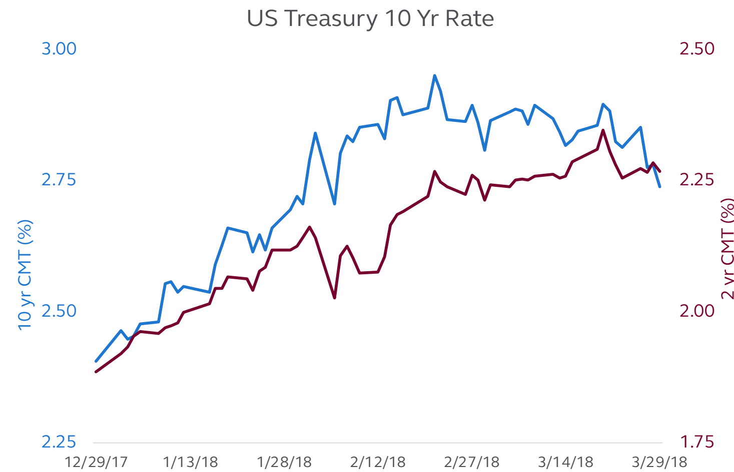
Highlights

Rates moved steadily higher across the yield curve during the 1st quarter with some modest flattening on the long end. The 2-year U.S. Treasury yield finished the quarter at 2.27%, an increase of 38 bps over the quarter. The curve came under pressure from increasing economic strength, expectations of further Federal Open Market Committee (FOMC) policy rate increases, and an increase in the Treasury supply, particularly in Treasury Bill auctions.

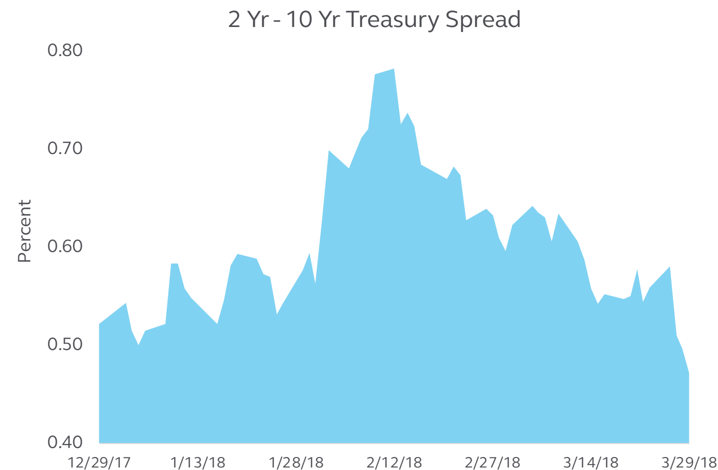
The 10-year Treasury yield finished the quarter up 33 bps at 2.74%. At its highest over the quarter, the 10-year reached 2.95%, threatening the 3% level that is seen by many as a psychological support level having been the peak over the last 7 years. The bellwether seemed headed to that level early in the quarter until the announcement by the Trump Administration that it was placing tariffs on imported steel and aluminum. The prospect of slower economic growth that could result from a trade war impressed equity markets, yet bond markets were undaunted and rates continued moving higher. Stock volatility persisted, though bonds exhibited some flight to quality behavior bringing the 10-year yield down from the peak.

Outlook

We expect a modest continuation of both rising rates and a flattening yield curve. The key drivers will be the momentum of U.S. economic stimulation spurred by tax cuts and government spending and follow through on the Federal Reserve's (Fed) monetary policy. We expect two additional rate hikes this year and continuation of the systematic unwinding of the Fed's balance sheet. U.S. Treasury rates may potentially be more attractive than other global rates which could mute the projected rate rise.



Source: Bloomberg



Source: Bloomberg

Mark Kummerer, CFA
Sr. Portfolio Manager

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Highlights

The Bloomberg Barclays Corporate Investment Grade Credit Index posted total and excess returns of -2.32% and -0.78%, respectively for the quarter compared to similar duration Treasuries. Total return for the 1st quarter was the worst since the 4th quarter of 2016, when Trump's election win caused rates to significantly sell off. Initially, 2018 continued the positive risk-on environment from the prior year; however, after spreads almost reached pre-crisis lows in early February, volatility spiked as inflation and trade war fears became a focus for investors for the remainder of the quarter.

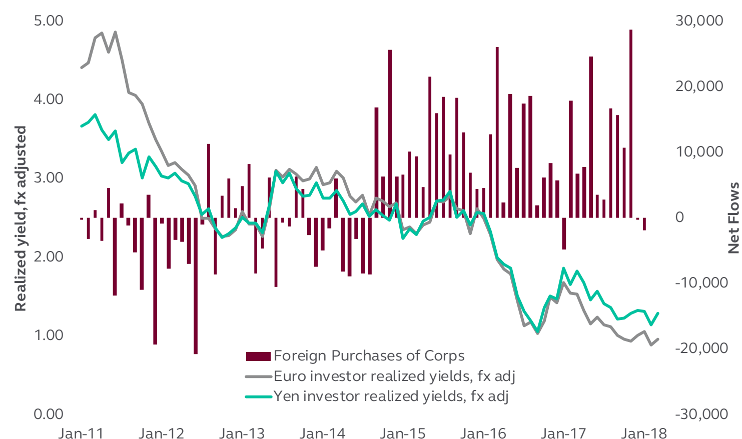
Besides the risk-off environment caused by trade and inflation, credit markets were further negatively impacted by a decline in demand from overseas investors and corporate cash buyers. The notable absence of Asian investors, due to higher foreign exchange hedging costs, plagued liquidity during the 1st quarter. Further, due to tax repatriation, corporate cash buyers were thought to be potential sellers in the front end of the credit space.

Outlook

A trade war with the rest of the world is undeniably negative for corporate credit. With the Trump Administration turning increasingly hawkish on global trade/foreign policy, we share concerns of increased protectionism and an escalation of trade tensions. Despite the large $50B import tariff lists both the U.S. and China have presented, we believe the two sides will have a protracted negotiation that will not provide a significant headwind to the macro environment. We continue to review potential winners and losers in the event trade wars do escalate. Domestic auto manufacturers and agriculture-related credits appear to be the most at risk while overseas competitors may benefit from a shift away from U.S.-based companies. The investment implications are still evolving, however, due to the global footprint of companies and their respective supply-chains, and uncertain path of escalation (tariffs on services or less buying of treasuries).

The tenets of our positive view are mostly intact despite an uptick in recent volatility. As we approach the 1st quarter earnings season, we would expect confirmation of positive corporate fundamentals. We are particularly keen on further details related to use of overseas cash by companies and believe that wholesale selling of securities portfolios will be limited.

Forgeign Purchases of Corps vs. USD IG currency hedged yield



Source: Bloomberg, US Treasury

Top 10 Largest Holders of Overseas Cash

Company	Ticker	Total Cash	Overseas Cash	% Overseas of Total	Exp Earnings Release
Apple Inc	AAPL	285.1	269	94%	5/1/18
Microsoft Corp	MSFT	146.7	132.1	90%	4/26/18
Cisco Systems	CSCO	71.7	71.3	99%	5/16/18
Alphabet Inc.	GOOG	101.9	62.8	62%	4/23/18
Oracle Corp	ORCL	71.6	58.5	82%	6/20/18
Amgen Inc.	AMGN	41.3	38.6	93%	4/26/18
Gilead Sciences	GILD	35.1	31.5	90%	5/1/18
Qualcomm	QCOM	39.3	31.4	80%	4/25/18
General Electric	GE	43.3	29.6	68%	4/20/18
Coca-Cola Co.	KO	20.7	19.6	95%	4/24/18

Source: Bloomber, Bank of America

Dan Kang, CFA
Head of Credit

Please see Disclosures for important information.

Mortgage-Backed Securities (MBS)

Highlights

The Bloomberg Barclays U.S. Agency MBS Index posted total and excess returns of -1.19% and -0.39%, respectively for the quarter, as rates sold off by 35-40 bps and volatility rose from multi-decade lows. While MBS spreads widened along with other risk assets during the quarter, 15-year securities fared better than the broader mortgage market (excess return of -0.23% vs -0.41%) given lower durations/option costs and favorable supply technicals.

Concerns around rising inflation, a more aggressive Fed and potential trade wars dominated market sentiment during the quarter. MBS drew strong support from money managers reallocating from corporate bonds as well as the late quarter rally in Treasuries that kept the 10-year yield within its recent 2.5-3.0% trading range.

Gross and net MBS issuance declined in the 1st quarter by 20-30% versus the prior quarter due to seasonal factors and the marked rise in mortgage rates. 30-year securities comprised over 80% of gross ($277B) supply and all net ($56B) supply. Shorter maturity bonds including 15-year securities contracted by $17B during the quarter following a $31B contraction in 2017. MBS runoff capacity from the Fed's balance sheet ramped up to $8B/month in the 1st quarter and was readily absorbed by private investors given limited origination supply during the period.

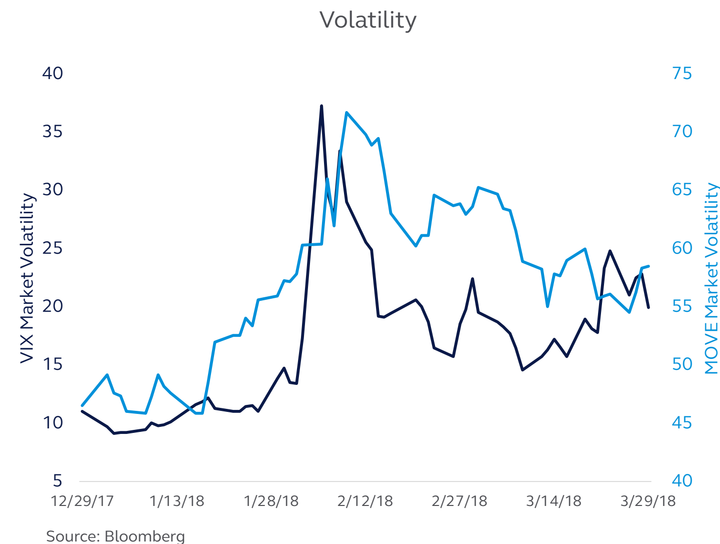
The prepay environment remained supportive as mortgage rates rose 45 bps to 4.70%, rendering 90% of the market out-of-the-money to refinance. Higher coupon Ginnie Mae/Fannie Mae swaps improved following Ginnie Mae's warnings and punitive actions against lenders suspected of loan churning targeted at servicemembers and military veterans that resulted in excessive speeds in Ginnie Mae multi-issuer pools.

Outlook

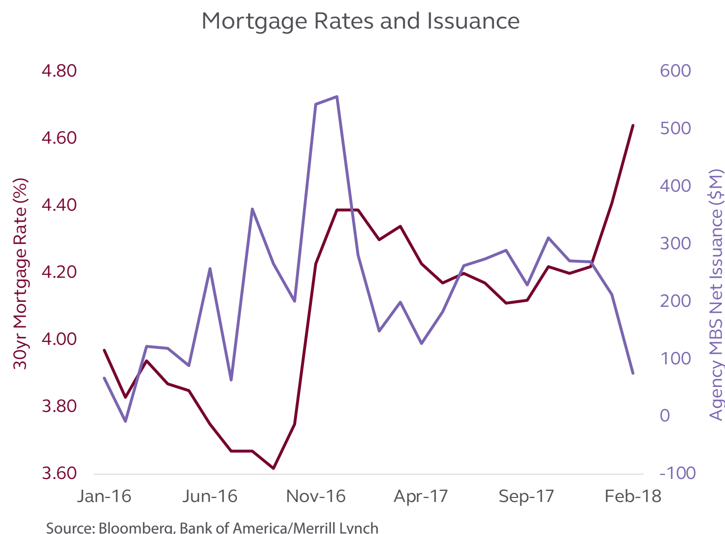
A pullback in global quantitative easing (QE) and associated rise in sovereign debt yields is reversing strong demand technicals that have benefited risk assets over the past few years, including MBS. While money managers were large MBS buyers in the 1st quarter, recent cheapening in investment grade credit makes cross-sector valuations more competitive. In addition, overseas investors, particularly Japan, face higher U.S. currency hedging costs and may opt for EU sovereign debt, which offers higher yields on a currency-hedged basis. Finally, bank demand for MBS was largely absent in the 1st quarter and remains contingent upon deposit growth relative to lending opportunities going forward.

Concurrent with the weakening MBS demand technicals, runoff capacity on the Fed's MBS portfolio are ramping up to $12B, $16B and $20B per month over the course of 2018. However, higher rates are likely to reduce paydowns on the Fed's portfolio while tempering the seasonal increase in MBS origination into the spring and summer months.

Heightened fiscal policy uncertainty at a time when monetary policy accommodation is being scaled back should result in higher market volatility going forward. The Agency MBS sector offers some opportunity to defend against volatility, particularly in shorter maturity product and structured Collateralized Mortgage Obligations (CMOs), which benefit from lower spread durations and option costs along with reduced sensitivity to QE-related monetary policy risks.



Source: Bloomberg



Source: Bloomberg, Bank of America/Merrill Lynch

Perpetua Phillips
Sr. Portfolio Manager

Please see Disclosures for important information.

Highlights

The Bloomberg Barclays AAA Asset Backed (ABS) Securities Index posted total and excess returns of -0.40% and -0.21%, respectively for the 1st quarter. The Bloomberg Barclays Commercial Mortgage Backed Securities (CMBS) Index posted total and excess returns of -.89% and -.28%, respectively for the 1st quarter.

Total ABS issuance was up 12.4% YOY at $67.3B for the quarter. Consumer credit metrics are still strong with unemployment at low rates. Auto ABS continues to dominate the new issue market, with close to $30B in YTD supply. New auto sales returned to a seasonally adjusted annual rate of $17.4M in March, from $16.6M in February. It is expected that 2018 will have a heavy off-lease supply of cars which would likely curtail new auto sales; however, the 1st quarter was not reflective of that impending supply imbalance. Charge-offs in credit card trusts have increased modestly to around 2.35%, as of March. Although increasing, these levels are far below normal charge-off expectations.

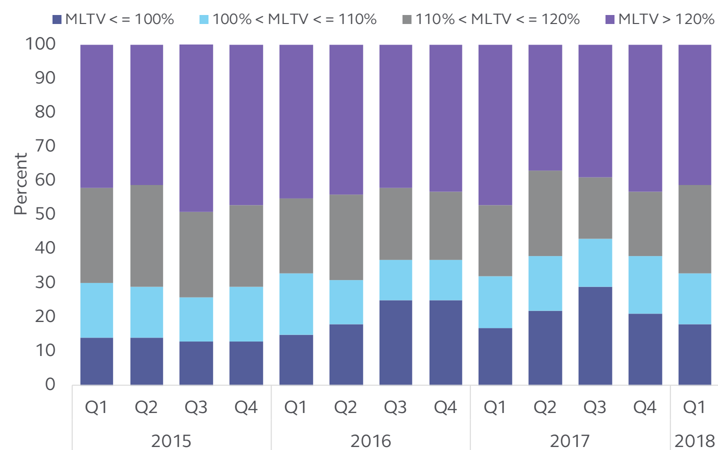
Total CMBS issuance in the 1st quarter was $9.6B, higher than a year ago by $1B though lower than the prior years. Limited supply and additional cross-over investors kept front-pay AAA paper close to 52-week tights. Fundamentals remain strong with continued growth; however, there has been a rational slowdown in transactions and price increases. The 10-year Treasury yield getting close to 3% and 1-month LIBOR hovering above 1.8% have started to change the evaluation of underlying loans. That said, there is still the belief that is predicated on supportive net operating incomes which has kept overall CMBS spreads contained, that cap rates can hold, despite rising interest rates.

Outlook

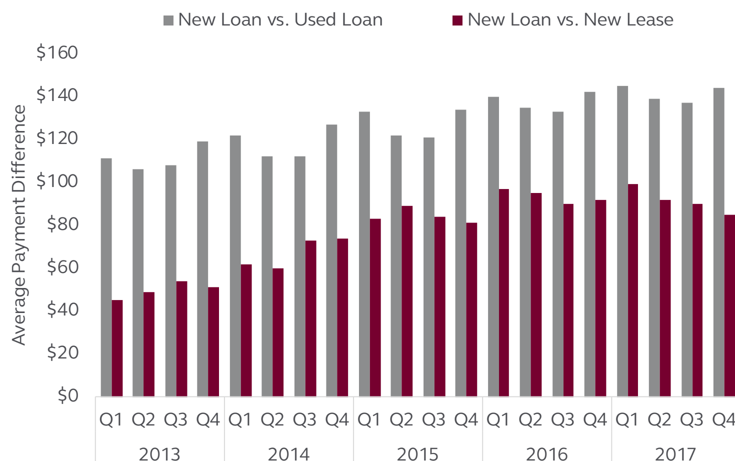
ABS had negative returns in the 1st quarter resulting from both wider credit spreads and a flattening yield curve. Although ABS markets have had good liquidity, the shorter, tighter paper tends to be used as a cash-equivalent, underperforming in a risk-off market where liquidity is in demand. This dynamic has allowed for attractive opportunities in front-end AAA paper that has limited credit risk and potential for spread tightening. Credit curves have been flat providing limited pick-up to go down in risk.

Net operating income growth rates have started to slow with the biggest moves in the hotel and retail segments. Vacancies have also started to move up, although not at an alarming level. The biggest risk seems to be in the single-asset borrower deals with floating rates. As London Inter-bank Offered Rate (LIBOR) has moved up, delinquencies and prepayments are likely to increase. New issue conduit paper has been less attractive, given the strong technical bid for it. Despite expectations for positive net supply of approximately $40B this year, investors in commercial real estate may be moving towards debt versus equity, keeping CMBS spreads contained.

Treasuries, swap spreads, and LIBOR have been the biggest drivers of performance in fixed income during the 1st quarter. The 2-year swap rate moved higher by 50 bps in the 1st quarter, providing a headwind to short tight structured product paper. The 2-year swap spread to Treasuries has increased to over 30 bps translating into an attractive overall spread to Treasuries. The 3-year swap spread is also wide of 25 bps, making 1-3 year ABS paper competitive to short corporates.



Source: CMBS Market Watch, April 2018



Source: ABSolute Value: Auto Lease Residual Value Update, April 2018

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Head of Structured Credit

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The Bloomberg Barclays US Corporate Investment Grade Index is a component of the Bloomberg Barclays US Credit Index which includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements within the Bloomberg Barclays U.S. Aggregate Index.

The Bloomberg Barclays US Agency Mortgage-Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Bloomberg Barclays AAA ABS Index represents the asset-backed securities within the Bloomberg Barclays US Aggregate Index.

The Bloomberg Barclays AAA CMBS Index represents the commercial mortgage-backed securities within the Bloomberg Barclays US Aggregate Index.

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