Fixed Income Outlook 2019

Key Takeaways

- We believe U.S. Treasury (UST) yields will continue to rise as a host of factors point towards higher interest rates including: increased UST supply as a result of quantitative tightening, a historically large current account deficit in the U.S. with rising costs to finance the debt due to higher rates, and reduction of global quantitative easing
- We continue to believe that U.S. Corporate Bond investors are not being adequately compensated for the combination of interest rate risk, liquidity risk and credit risk
- UST securities and credit sensitive sectors with attractive yield per unit of duration profiles should remain cornerstones in multi-sector portfolios

The strong performance of risk assets to start 2018 was driven by continued improvement in corporate earnings, increased global growth expectations, highly accommodative monetary policy from global central banks and a benign inflation environment. As a result credit spreads, specifically in investment grade corporate and high yield corporate bonds, also approached near cycle tights. Volatility increased in January and persisted at elevated levels throughout February and March, however global markets remained synchronized throughout the later stages of 1Q. In 2Q and 3Q, however, a significant divergence between the U.S. markets and the rest of the world occurred. Ex-U.S. developed markets and emerging markets faltered as trade concerns and less accommodative global central bank monetary policies came to the forefront.

At the beginning of 2018, Mr. Gundlach coined 2018 a "don't lose money year." His expectation was for UST yields to rise, volatility to increase and equities to have a down year as quantitative tightening continued ramping up in the United States and the Federal Reserve looked to forge ahead with its rate hike agenda. Despite making these proclamations when most experts were calling for a "melt up" given strong global growth data, Mr. Gundlach was correct. UST yields across the curve reached levels that have not been breached in years. The global equity market, as measured by the MSCI ACWI Index, finished the year down 8.95%, despite being up more than 7% just 18 business days into January. U.S. stock market volatility, as measured by the VIX Index, hit a level in February that was more than triple where it started the year and still remains well above its January level today.

As we enter 2019, we believe UST yields will continue to rise. However, we believe UST securities, especially on the front end of the curve, should remain a cornerstone in any multi-sector portfolio due to the high quality and liquidity they provide. We continue to be underweight U.S. investment grade corporate bonds due to their long duration profile and the large amount of issuance that has occurred in the space since the financial crisis. Since 2008, corporate CEOs have taken advantage of the market opportunity and increased their companies' leverage by issuing long dated debt at low rates. Alarmingly, nearly half of this issuance has been in the BBB-rated space, only one downgrade away from being considered below-investment grade (i.e. junk bonds). As a result, from a credit perspective, we favor securities with more attractive yield per unit of risk profiles, which can be found in certain areas of the structured products market. In addition, while we do not anticipate recession over the near-term and the majority of our internal indicators signaling a continued expansion, we remain biased towards higher credit quality within assets that have a shorter duration than the Bloomberg Barclays U.S. Aggregate Bond Index. One rationale for this is the flattening of the yield curve that has taken place throughout 2018, making longer duration assets less attractive since there is not significant yield pickup to move out the curve. Historically, as the economic environment starts to deteriorate, spreads narrow and the curve flattens. As of December 31, 2018, the spread between the 10Y UST and 2YT UST has narrowed to 19 basis points.

Emerging market debt has become more attractive as we enter 2019. Trade tensions between the United States and China, a stronger USD, and the threat of slowing growth in China has caused spreads to widen significantly within the asset class throughout the course of the year. While DoubleLine has not added to the sector within multi sector portfolios, active management allowed us to use the volatility as an opportunity to selectively add risk at more attractive valuations. We remain bearish on European government bonds due to their long duration, lack of yield and less accommodating monetary policy outlook.

Moving forward, we continue to keep an eye out for market moving events and catalysts that could create disruption within the markets. We believe volatility will persist as investors await clarity around key policy decisions from central banks and monitor trade negotiations between China and the United States. Globally, idiosyncratic risks such as a China slowdown, Brexit uncertainty, and high debt levels in Italy are likely to remain a concern for investors heading into 2019. Given increased volatility and a global economy that appears to be in the late stage of the cycle, we continue to favor fixed income portfolios that are well diversified, actively managed and have a bias to higher credit quality heading into 2019.