A Rocky Road Ahead?

Baird Advisors Global Fixed Income and Economic Outlook

Baird Advisors Investment Team

For the 20th straight year, Baird Advisors held its Institutional Investors Conference in Kohler, Wis. Attendees heard a sobering assessment of the breakdown of the post-war global political order and a prescription for repairing it by former Secretary of State Condoleezza Rice. Her formal remarks were followed by a revealing fireside chat-style interview by Baird Advisors CIO Mary Ellen Stanek that explored Secretary Rice's personal story arc, spanning from a childhood in segregated Birmingham, Ala. to the highest levels of government.

Before that, however, Deputy CIO Warren Pierson took a few moments to reflect on Baird's 100th anniversary and the growth of its fixed-income business to $84 billion in assets, then delivered the firm's annual investment outlook. Part market assessment and part economic forecast, the outlook calls for a continuation of the longest economic expansion in modern U.S. history, but highlighting a number of threats that could upend that thesis. "We still say that an imminent recession is unlikely," said Pierson, "but clearly the risks are rising .... The base case is that we will see a continuation of gradual growth in the U.S. economy, but with elevated risks and a wider range of potential outcomes."

Following are highlights of Pierson's remarks:

<u>The Brave New Yield Curve</u>

Interest rates have come down across the entire term structure, but the big economic story of 2019 has been the relentless flattening, and ultimately the inversion in some segments, of the U.S. Treasury curve. Much of the movement has been on the long end, where the 30-year U.S. Treasury recently traded below 2% for the first time ever and the 10-year tested historical lows.

It's fair to say that the sharp decline in rates surprised most market participants—including us. A year ago, most everyone you asked was expecting upward pressure on interest rates, in part because they were already extremely low. Instead, long term yields were cut in half.

Why long-term interest rates are so low

Two secular factors holding rates down are demographics and technology. As the Baby Boomers reach retirement, they continue to have a profound effect on both the economy, because they consume less, thereby dampening growth, and on the financial markets, because they save more, thereby driving down yields. And technology advances, especially in robotics and artificial intelligence, also are keeping a lid on consumer goods inflation and wage pressures.

These two factors are not new—we've highlighted them over the last several years. There are, however, a few new trends that are compounding—or more accurately in some cases, no longer offsetting—the impact of secular shifts in demography and technology:

- The last two years saw a shift from global synchronized growth to a global synchronized slowdown. In 2017, economies all around the world were growing. However, by this time last year it was obvious that growth in Europe and Asia/China was flagging. Still, the U.S. with GDP growth over 3% remained relatively robust, perhaps even strong enough to pull the other developed economies along with it.

  That didn't transpire. Instead, U.S. growth has fallen from 3% to closer to 2%, showing just how interconnected our economies have become. U.S. interest rates are certainly still higher than those in Europe, but that's the exception that proves the interconnectedness rule: European savers earning 0% or less at home are piling into U.S. dollar denominated assets instead. Those inflows, of course, further act to dampen longer-term U.S. interest rates.

- Global manufacturing is in recession and U.S. manufacturing may be following suit, with the Purchasing Managers Index recently falling below 50. To be sure, sub-50 PMI levels don't always mean a general recession—after all, manufacturing is only about 10% of the U.S. economy and U.S. consumption, a much bigger piece of the economy, remains healthy. But manufacturing punches well above its weight in the psychology of C-suites and boardrooms across America and recent signs of manufacturing weakness are hurting business confidence.

- Tariffs have been yet another drag on growth. Over the last 12 months, trade tensions have ratcheted higher and more quickly than many expected causing businesses to reevaluate supply chains and pull back on expansion plans.

  For some sectors and individual companies, the direct impact is hugely disruptive. Apple, for example, has 59 plants making iPhones and 52 of them—representing 1 million workers producing up to 600,000 devices per day—are in China. Few places in the world have the infrastructure to replace that.

  The indirect impacts of the trade conflict, as it spills beyond tariffs to include technology skirmishes (see the dust-up over Huawei) and currency battles (see the devaluation of the Chinese currency) are just as important. On a net basis, global trade represents less than 5% of the U.S. economy but, as with the manufacturing slowdown, we believe the headlines are having an outsized effect on business confidence.

So the growth factors that had to some extent been mitigating the deflationary secular forces of demography and technology weakened considerably in 2019 and the long end of the yield curve responded accordingly. What about the short end?

The formerly flat-footed Fed's pivot

Late last year, the Federal Reserve was still sending signals of increasing short rates, even as equity and credit markets convulsed on every new hawkish statement from Chairman Jerome Powell, the odds of a no-deal Brexit increased, and what had been just talk of tariffs became a reality.

Going into 2019, the Fed looked increasingly out of touch. In January, however, it executed one of the fastest and most dramatic pivots to an accommodative monetary posture ever seen in the absence of a recession. The Fed dropped short term rates by 25 basis points in July and was expected to do so again at the mid-September FOMC meeting. It also suspended the unwind of assets off its massive balance sheet.

In fairness, the Fed has been in a tough position. As the U.S. slowly climbed out of the Great Recession, policymakers clearly wanted to "normalize" interest rates and wean the economy off quantitative easing. But after three years of such normalizing, the Fed's target rates went from among the lowest in the developed world to become the highest. Relatively high short-term rates resulted in an appreciating U.S. dollar that hurt U.S. competitiveness and they contributed to the worrisome inversion of the yield curve.

The Fed is also confronted with a very vocal critic with a very big microphone. Whether one agrees with him or not on the merits, President Trump's regular public browbeating of the Fed to lower rates is creating an environment of uncertainty and volatility around the central bank. You have to go back to President Nixon or Johnson for an historical analog. There is even some speculation that the president's challenges to Fed independence may have had the opposite effect than he intended and tipped the scales toward tightening last December, a decision now widely viewed as a misstep.

But the Fed now appears to have turned down a dovish path. And notwithstanding the laudable impulses to guard its independence and normalize interest rates, we believe the pivot was probably appropriate.

Inversion angst may be misplaced—at least for now

Despite recent Fed easing on the short end, segments of the U.S. yield curve have frequently inverted—where short-term rates are higher than long term rates—in recent months, with the market most keenly focused on the yield spread between the three-month and 10-year Treasury (the spread the Fed watches most closely).

Concern about inversions is understandable, considering that persistently inverted yield curves have historically proven one of the most reliable leading indicators of a recession. We don't think this inversion carries quite so much weight this time around because of all the manipulating by the Fed as it looked to normalize rates and deleverage its balance sheet, but the longer inversions persist, the more significant they become and we are now at 109+ days with this one. Is it different this time in terms of predicting a recession? Time will tell.

Less than zero

Nearly as anxiety inducing for investors as inverted U.S. yields is the phenomenon of negative interest rates in Europe and the prospect they might appear in the U.S. It needs to be stated that negative rates are not normal; they can only occur for a sustained period when central banks are aggressively buying assets in quantitative easing programs, as the European central Bank is doing once again on the Continent.

What negative rates really demonstrate are the limits of the effectiveness of monetary policy and the overreliance on it to combat the secular economic forces acting to inhibit growth (Europe, after all, faces the same technology challenges as we do and its demographic challenges are even greater).

First the ECB made it extremely cheap to borrow money, to little effect. Then it made it free to borrow by taking rates to zero, again to no avail. Finally, with negative rates, it began effectively paying borrowers. Yet European growth remains stuck. Allow us to posit a novel idea: Maybe it's not the level of interest rates that is keeping Europeans from borrowing.

Europe's aging population is clearly more interested in saving, and negative rates are crushing them. In short, maybe instead of the solution to a secular decline in economic growth, negative yields are part of the problem?

The Outlook for the Economy Going Forward

With global growth slowing and central banks seemingly out of bullets, the path ahead is highly uncertain. Unprecedented policies and actions have brought us to an uncertain crossroads where the secular headwinds of an aging population, displacement of labor by technology and a third factor, high government debt levels (which mean capital that could otherwise be put to more productive uses will instead go to paying back the federal debt), may be taking hold and limiting economic growth.

On top of these secular forces, we also foresee cyclical factors—including trade conflicts, Brexit uncertainty, wealth disparities and political/geopolitical upheavals—acting to inhibit U.S. growth in the coming year.

Does that mean a recession is imminent? Probably not. Bank balance sheets are solid and the U.S. consumer, who accounts for 70% of GDP, remains in good shape. Average annual earnings and expenditures are both growing (3.2%% and 2.7%, respectively) and unemployment is near record lows. The wildcard, and the metric we suggest keeping a sharp eye on, is consumer confidence, which is near record levels. All things being equal, so long as the consumer remains confident, we see a continuation of gradual growth in the U.S. economy.

The Market Opportunity

With a backdrop of a potential continuation of the longest ever post-war economic expansion, albeit at a slower pace, where do we see value in the fixed income markets?

Corporate bonds

U.S. investment-grade corporate bond spreads have rallied and stand at 120 basis points over comparable Treasuries, a 33-basis point narrowing on the year. However, that is still well above their 97-basis point spread before the financial crisis, suggesting there is still scope for further narrowing. Moreover, it's also worthwhile to look at bond spreads on a relative basis. Back in June 2007 when spreads were at 97 basis points, that was on top of Treasuries yielding roughly 5%--so the total yield for corporates was about 20% more than Treasuries. Today, however, with Treasuries yielding about 1.5% and corporates offering a 120 basis point spread, the total yield for corporates is almost double that of comparable government bonds.

With the significant yield pick-up relative to Treasuries and with corporate revenue, profits and free cash flow at or near cyclical highs, the Baird Core Plus, Baird Aggregate and Baird Short-Term Bond Funds are overweight investment-grade corporates relative to their benchmarks. In both cases the funds show a sector tilt toward financials, reflecting our long-held view that banks are incentivized even more than other issuers to maintain a healthy balance sheet.

One cloud hanging over many participants in the investment-grade corporate bond market is the continued increase in issuers rated triple-B, the lowest rung in the investment-grade ladder. We, however, believe that the relative growth in triple-B doesn't usually imply an accidental decline in credit quality; rather, it simply means that most such companies are deliberately optimizing their balance sheets by keeping cash reserves and other key financial ratios exactly where they need to be to maintain an investment grade rating, but no higher. It is reasonable to expect such careful stewards of their balance sheets would do everything they can to ensure they don't slip down to junk status and the higher borrowing costs that would result.

That doesn't mean all triple-B issuers would be immune to an economic downturn, but we believe bond investors are well compensated for owning these securities, especially the less risky shorter maturities, which is why we are overweight triple-Bs relative to our benchmark in the Baird Core Plus, Baird Aggregate and Baird Short-Term Bond Funds.

Mortgage-backed securities
Bonds backed by mortgages are a different story. Pass-through MBS are trading at a spread of only 47 basis points over Treasuries, an *increase* of 12 basis points on the year, making MBS one of only two sectors where spreads widened (the other is emerging-markets bonds, which have been rocked by political upheavals in Argentina). The widening has been largely driven by the Fed unwinding its huge MBS portfolio. MBS are also getting hurt by prepayments, as homeowners take advantage of lower rates to refinance. The Baird Core Plus and Baird Aggregate Bond Funds are underweight mortgage-backed securities relative to its benchmark but we have been adding to the position selectively by buying on weakness.

Tax-exempt bonds
As with Treasury's, municipal bond yields have fallen sharply and the yield curve has flattened. But the muni yield curve is still upward sloping, which can be an advantage relative to taxable bonds for wealthy investors. For individuals in high tax brackets the "point of indifference" is about two years, meaning for any maturities beyond that, they will likely do better in tax exempt rather than taxable bonds.

Past performance does not guarantee future results.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

In a rising interest rate environment, the value of fixed income securities generally declines and conversely, in a falling interest rate environment, the value of fixed income securities generally increases. High-yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield. Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment-grade investments are those rated from highest down to BBB- or Baa3.