"Lower and Longer" Has Legs

Mary Ellen Stanek Provides 2018 Outlook for the Bond Markets

Baird Advisors Managing Director and Chief Investment Officer Mary Ellen Stanek, CFA, recently provided the group's annual investment outlook. Stanek explained that Baird Advisors, which manages $59.1 billion in fixed income assets using a consistent and predictable approach, believes the economy will remain in a period of expansion that is remarkable for its longevity, but not its magnitude. "We believe the same two words continue in prominence," she said. "Lower and longer."

While making the case for sustained, steady growth, Stanek also identified a handful of structural headwinds that have limited the expansion and could create challenges for fixed income market participants. Following are the highlights of her remarks:

The Case for Lower and Longer

At 100 months and counting, the current U.S. economic expansion is already the third longest since World War II. It's also one of the weakest, with average GDP growth of 2.1%, less than half that of U.S. expansions over this post-war period (though it is notable that this growth rate is well above that of Europe, the U.K. and Japan). We think this lower, longer theme has legs and have reason to believe the expansion ultimately could break the post-war record of 120 months set over the course of most of the 1990s.

Consumers Are Feeling It

The most powerful tailwind for the economy may be the buoyant U.S. consumer. Consumer confidence and small business optimism gauges are at or near multidecade peaks. Regardless of one's political leanings, one thing is clear: President Trump's business friendly, pro-growth policy agenda brought U.S. consumers a burst of optimism. And with consumers representing nearly 70% of U.S. economic activity, sentiment matters.

Risk Factor: There are signs – a weakening U.S. dollar and falling 10-year Treasury yields, for example — that the "Trump bump" is fading somewhat, as a new administration that campaigned on regulatory rollback, infrastructure spending, tax reform and repeal of the Affordable Care Act runs into the realities of governing. But, so far consumers show no sign of returning to a pre-Trump state of funk.

Jobs Data Is Solid

U.S. nonfarm payroll employment has seen seven years of solid growth with the unemployment rate falling from a post-recession high of 10% to 4.1%, well under the 6% or so considered "full employment." Just as telling, the high underemployment rate and lower labor force participation — both lingering aftershocks of the 2008 financial collapse and Great Recession— also show signs of improvement. Slowly but steadily, significant slack is being taken out of the jobs market.

Risk Factor: Tight labor markets can spark inflation and investors should be keeping an eye on wage data. However, there are secular forces helping to keep a lid on inflation: i) Baby Boomers are retiring — or better yet from an inflation standpoint, remaining in the workforce, thankful to have a job with benefits and in no hurry to demand wage increases; and ii) technology advances mean that tightness in the jobs market is more likely to be met with investments in robots to make existing workers more productive as opposed to higher wages to attract new workers.

For now, even as wages have firmed slightly, overall consumer inflation remains at a benign 1.6%, safely below the Fed's 2% long-term target.

Housing Has Recovered

By all indications, the U.S. housing market has recuperated from its near-death experience in 2007/2008. Existing home sales are up sharply and the Case-Shiller price index has averaged 3.5% annual increases since 2008. Perhaps more significant for long-term trends, Americans, who had gravitated toward the rental market in the decade since the housing bubble popped in 2007/2008, are potentially expressing a preference for ownership over tenancy. U.S. Census Bureau data confirms this trend with the latest quarterly data showing the second consecutive year-over-year decline in renter households, which follows 8 consecutive year-over-year increases in rental households since the first quarter of 2007.

Risk Factor: One potential drag on housing — and the broad economy — is the massive overhang of student loans. Americans have trimmed consumer credit since the crisis, but student loan debt outstanding has climbed to more than $1.4 trillion and delinquencies continue to rise. Mortgage lenders are creating workarounds to qualify student loan borrowers but, more generally, the student loan burden could weigh down young Americans in what should be their prime years for household formation and consumer spending.

U.S. Banks Look Buff

Balance sheets in the U.S. banking system are currently much stronger than before the Great Recession. Profitability is up, tier 1 capital ratios at the four biggest money center banks are above 11.5% (versus an average of less than 8% in 2007), and the percentage of non-performing loans has declined to pre-crisis levels.

> *Risk Factor:* Loan growth has been solid, if unspectacular, but has trended down over the last two years.

Synchronized Global Growth

With the possible exception of the resurgent American consumer, the most striking shift since a year ago may be the breadth and scope of growth outside of the U.S. For the first time since 2007, preliminary OECD data for 2017 shows no economies in recession and the most significant growth acceleration since 2010. And the biggest driver of growth outside the U.S., the Chinese economy, looks to have stabilized. China's GDP growth, which had been in a long and worrisome decline since 2009, has perked up since the second half of 2015 and today is clocking a healthy and sustainable 6.8%.

> *Risk Factor:* The shift in China's growth trajectory to something slower and more sustainable was brought about in part by concerns over the rapid growth in debt. As of the beginning of 2017, China's nonfinancial debt as a percentage of GDP stood at 258% versus around 150% at the end of 2008.

Central Banks Are Backstopping Growth

Globally, central banks are running generally accommodative monetary policies with the European Central bank (ECB) and the Bank of Japan (BOJ) continuing to purchase large quantities of bonds as part of their quantitative easing (QE) program. Collectively, the Fed, ECB and BOJ own one-third of the global high-grade bond market. For its part, the Fed has begun gradually hiking short-term rates and tapering its reinvestment of QE holdings, but the long end of the U.S. yield curve has barely moved in response, suggesting the market's mantra remains the same as ours — lower and longer — with regards to any sustained, significant move higher in rates. Additionally, while the Fed has begun to slow the process of reducing the size of its balance sheet by tapering reinvestment of principal and interest payments, other major central banks continue their QE bond buying at least for the time being.

> *Risk Factor:* Accommodative monetary policies, including QE's outright bond purchases, have kept interest rates low, but they have also skewed or distorted many historical relationships. Case in point: The 10-year U.S. Treasury yield is 2.35% while the Spanish 10-year government yield is 1.52%. Is the market saying that Spain (with its 17% unemployment) is a better credit than the U.S.? Clearly relentless ECB QE purchases are keeping Spanish yields artificially low. The distortions are also evident in market volatility, where equity and bond volatility remain well below 20-year averages.
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> Adding to the complexity, just as the Fed looks to begin unwinding its portfolio, President Trump has appointed a new chairman, Jerome Powell.
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> All central banks remain in uncharted waters with quantitative easing and the eventual need to normalize their balance sheets. For the Fed, changing the captain and the crew at such a time could be disruptive.

Bond Technicals Are Supportive

The Fed has kept yields low for an extended period of time and many investors are starved for income. 2017 bond mutual fund and ETF flows have significantly surpassed those of 2016. These numbers reflect mostly demand from individual investors and we believe much of the demand is driven by secular demographic changes, not cyclical factors. Boomers are retiring in large numbers and need fixed income investments to replace the steady cash flow from their paycheck.

Not seen in the fund flows data but also important is demand from pension plans and life insurance companies, two of the most yield-starved investment groups around. Our sense is that if we are correct and some upward pressure in yields develops, strong demand from these groups will keep yields from rising sharply.

While the demand side of the equation is important, so is supply, and an expected 5% decline in net spread sector issuance adds to a very favorable supply/demand technical outlook as we head into 2018.

In summary, given the secular disinflationary forces at work around the world and the strong global demand for bonds, we believe we are going to stay in this lower rate environment for an extended period with the 10-year U.S. Treasury, currently at 2.35%, likely remaining in the post-crisis range of 1.5% to 3.5%.

Corporate Credit Fundamentals Are Healthy

Corporate fundamentals are solid overall. Revenues have been robust, even ticking up in recent quarters. Profits are strong as is free cash flow and cash on corporate balance sheets. While leverage had clearly increased over the past several years, it is showing signs of subsiding and much of the borrowing has been focused in higher-rated sectors such as pharma and technology. Interest coverage has also declined but remains at acceptable levels.

Spreads Are Tight

Demand from yield chasers has pushed spreads to historical tight levels in many sectors, particularly in high-yield and emerging market debt. While spreads in the mortgage-backed security market widened modestly in 2017, we believe they are still artificially tight due to the Fed’s QE buying and don’t think they adequately compensate for the risk, especially as the Fed begins to unwind its massive, MBS-centric balance sheet. Supported by solid credit fundamentals, we do still see selective relative value in investment-grade corporates, financials in particular.

In the **Baird Core Plus Bond Fund,** we are tilted toward quality. Only 7.0% – about a third of what our guidelines allow – is below investment grade. There is also a strong bias toward bonds from the financials sector reflecting our long-held view that these issuers have a structural business imperative to manage their balance sheets to maintain their investment-grade ratings. We are underweight mortgage-backed products given concerns about the Fed unwind and the potential for a pick-up in volatility.

Given the shorter duration of the portfolio, the **Baird Short-Term Bond Fund** is positioned a bit more overweight in the spread products we like relative to its benchmark.

Tax-Exempt Issues Appear Fair Valued

When we look at tax-free valuations relative to Treasuries for the intermediate segment of the curve, we find that it is trading right at its long-term average valuation. Shorter on the curve is a bit richer and, conversely, longer maturities are a bit cheaper. From a credit spread perspective, we find a similar story as in the corporate universe. The spread of BBBs versus AAAs is not as generous as a year ago, but once again remains very near long-term average levels.

Similar to our taxable funds, our two newer muni funds seek a yield advantage over their benchmarks while running duration neutral. Credit overweights are modest in the **Baird Core Intermediate Municipal Bond Fund** and slightly greater in the **Baird Short-Term Municipal Bond Fund.**

We are watching developments on tax reform closely. The lack of progress on healthcare reform leaves tax reform as the major policy focus between now and next year’s midterm elections. Yet despite the strong desire to get something done, accomplishing tax reform will be difficult. Municipals have enjoyed strong performance in part because of market skepticism that meaningful reform will occur, though even if it is successful, the top marginal tax rate is not likely to move significantly lower which will keep municipals attractive to higher earners. Stay tuned!

About Baird Advisors

Baird Advisors is Baird’s fixed income asset management division and advisor to the Baird bond funds. The group manages more than $59 billion in taxable and tax-exempt fixed income portfolios including the Baird Ultra Short Bond Fund, Baird Short-Term Bond Fund, Baird Intermediate Bond Fund, Baird Aggregate Bond Fund, Baird Core Plus Bond Fund, Baird Short-Term Municipal Bond Fund, Baird Core Intermediate Municipal Bond Fund and Baird Quality Intermediate Municipal Bond Fund. For more information, visit www.bairdfunds.com.

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For a complete list of the holdings as of the current month end for the Baird Core Plus Bond Fund, Baird Short-Term Bond Fund, Baird Core Intermediate Municipal Bond Fund and Baird Short-Term Municipal Fund, please visit the Baird Bond Funds website.

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