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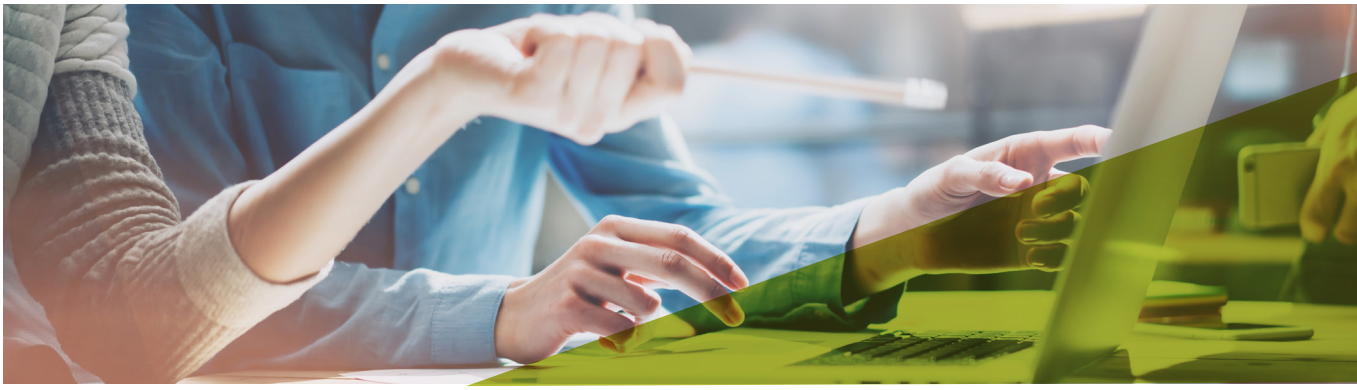
Quarterly Market Commentary 2019



Third Quarter in the Rearview Mirror

U.S. Financial markets had a mostly sunny summer with the Dow, S&P 500 and Treasury, corporate and municipal bonds posting positive returns during the quarter ended September 30. Several new records were set while storm clouds in the form of central bank, trade and political uncertainties as well as oil terrorism, brought some heavy downpours on each of these asset classes over the course of the three months. Risk investors dashed in and out from under the umbrella havens of bonds, and new records were set in stock and bond markets. But, there were some very unsettling aberrations in Treasury yields and the money markets.

The graph below displays the price volatility in the S&P 500 Index between June 28 and September 30. Despite the decline in August, this benchmark Index gained 1.2% by the end of the quarter and was up 18.7% on the year – the strongest first three quarters since 1997.

Table 1.
Source:
Bloomberg

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The chart below shows the swings in the 30-year U.S. Treasury yield during the quarter. The sharp decline in mid-summer reflected heavy demand from investors who sought out these assets for their relative safety as well as yield. International clamor drove up prices such that, by August 27, benchmark yields hit a record low of 1.95%. After a two-week sell-off and late-month rally in September, the yield on the long bond settled at 2.11%, down 41 basis points for the period.

Table 2
Source:
Bloomberg

U.S. bond yields fell dramatically in late July primarily due to interest rates set by central bank policies that produced $17 trillion of negative yielding sovereign and corporate debt in Germany, France, Switzerland, the Netherlands, and Japan. Prices for world's safest sovereign debt rose along with demand for most any U.S. paper. In addition, the lack of progress in our trade talks with China, economic data confirming continued weakness overseas, and indications of certain slowdowns here at home sparked global concerns and drove investors to safe havens. The Federal Reserve cut rates for the first time in more than 10 years. The July 31 rate cut of a quarter point was widely anticipated, but reference to the reduction as a "mid-cycle adjustment" rather than the start of an easing process was not well received and sent some markets into a tailspin. The September 18 rate cut came with more of a hawkish stand than expected and raised some doubt that further reductions would be made this year.

The difference between the shortest and longest dated U.S. government bonds and corporate debt had been tightening over the summer as investors paid higher and higher prices for liquid securities with the most yield. The municipal curve was the flattest since 2007 as the difference in rates on the top-rated 2- and 30-year maturities declined from 106 basis points to 79 basis points. Worldwide attention was given to the brief inversion of one section of the Treasury curve, an uncommon situation – said to signal a

coming recession – wherein the yield on shorter two-year government bonds exceeded that of the longer 10-year maturities for the first time since 2007. The inversion lasted for five days in August and dominated headlines, while little heed was paid to the spread most closely studied by economists: three-month and 10-year Treasury yields. That relationship has been upside down by as much as 50 basis points most every day since May.

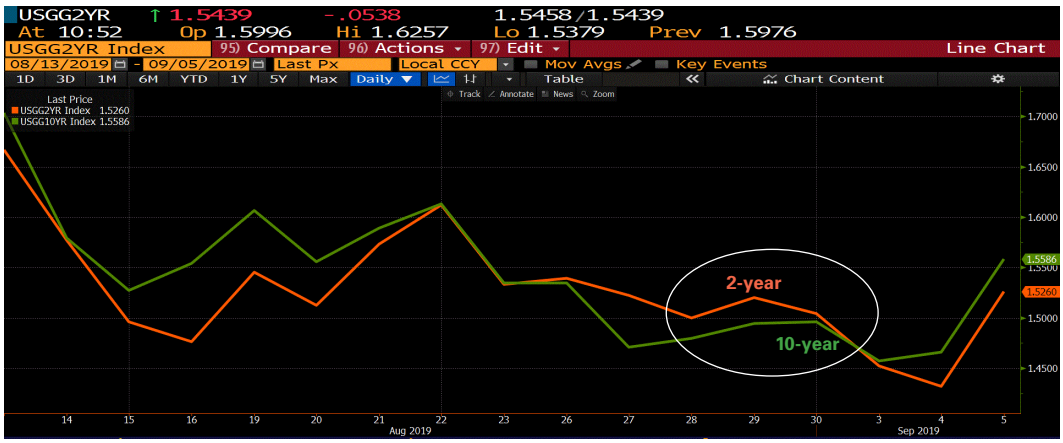

Table 3
Source:
Bloomberg

Investors continued to seek out the highest yields among the safest havens until Labor Day. Strong U.S. data put a damper on the media hype over growing risks of a U.S. recession and bond prices pulled back for two weeks. In addition, short-term funding rates ballooned higher for the first time since the financial crisis, signaling a cash shortage and causing the Fed to jump into action. The central bank has since been injecting tens of billions of liquidity daily via repurchase transactions to increase the quantity of reserve balances in the banking system. Bondholders recovered some of their losses during the last fortnight of the quarter after the rate cut, and threat of restricting U.S. investments in China caused another flight to quality.

From an historical perspective, both stocks and bonds have rallied for 40 years. The Nasdaq, Dow Industrials and S&P 500 indices all hit record highs in July of 2019 while the 30-year Treasury yield fell to a record low in August.

Source: Bloomberg. 10-year Treasury yield declines and S&P 500 Index gains since 1979. Bond prices and yields move in opposite directions.

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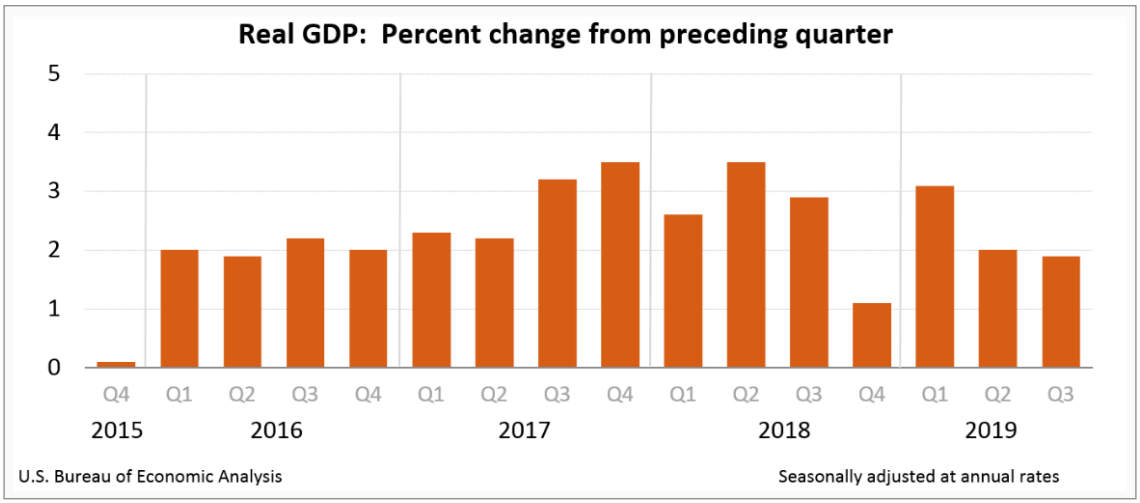
3Q19 and YTD 2019 Returns.

The Morningstar Core Bond Index, a broad measure of the fixed income universe, rose by 2.28% during the quarter. The Bloomberg Barclays U.S. Aggregate Bond Index returned 2.3%, and is up 8.5% on the year. The Bloomberg Commodity Index lost 1.3%, dropping year-to-date returns to 3.1%. Crude oil futures dropped $4.40 or 7.5% while gold spot prices increased by nearly $61 an ounce or 4.3%

	3Q19	YTD 2019
U.S. Treasury	2.40%	7.71%
Treasury Inflation-Protected Securities	1.35%	7.58%
Municipal Bond Index	1.58%	6.75%
U.S. Corporate Investment Grade	3.05%	13.20%
U.S. High-Yield Corporate Bonds	1.33%	11.41%
Emerging Market Debt	-2.11%	7.15%
U.S. Aggregate Bond	2.27%	8.52%
U.S. Agency Pass-Throughs	1.37%	5.60%
Asset-Backed Securities	0.92%	4.13%

Select Bloomberg Barclays Indices: Third Quarter and YTD 2019

U.S. Real GDP grew by 1.7% in the third quarter according to the latest estimates of the Federal Reserve Bank of Atlanta based on consumer spending, residential investment, net exports, non-residential fixed investment, change in private inventories and government spending data. The U.S. is still experiencing the longest economic expansion on record going back to 1854.



U.S. GDP Growth Rate. Source: https://www.bea.gov/news/glance

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Technical and fundamental factors influenced the performance of individual bond markets last quarter. However, central bank intervention, as well as the 2017 U.S. tax reforms, have unquestionably led to some historically unusual behavior. U.S. Treasury, corporate and municipal bonds all met with new foreign demand and yields fell to multi-decade lows. The low-rate environment spurred record high corporate debt issuance. SIFMA reports that $405.3 billion of investment grade and high-yield corporate bonds came to market, bringing the year-to-date total to $1.1 trillion. Investors in high tax states seeking exemptions after the 2017 tax reform law capped the federal deduction on state and local taxes pushed prices on municipal bonds issued in states including California and New York, to nosebleed levels. Households concerned with the volatility and risk in the stock market pulled more than $78 billion from equity funds and added $62 billion to taxable fixed income funds; municipal bond mutual funds saw a record-setting 40 consecutive weeks of positive inflows, with $25.5 billion of net investment during the third quarter. State and local issuers brought $121.8 billion of municipal bonds to the primary market and this was all quickly absorbed by investors heavy in cash from liquidations, coupons and $120 billion of redemptions from tendered, called and maturing bonds. Municipal taxable issuance surged to levels not seen since the Build America Bond era as issuers looked to achieve savings by refinancing debt that can no longer be refunded on a tax-exempt basis. In the face of negative overseas yields, non-traditional buyers, including foreign entities and insurance/pension funds continued to diversify the base of muni holders.

Investors waded through the onslaught of headline news and commentary that has become the new norm in Twitterworld. While traders closely tracked all the words and body language of trade negotiators and Fed speakers, many developments which would otherwise be considered major news were filtered out or downplayed over the summer. The massive power outage in New York City. The Capital One hack affecting 106 million users. China's currency devaluation. The drone and missile attacks against Saudi Arabia's oil processing facilities. The Mueller testimony. The resignation of Theresa May. The political upheaval in Puerto Rico. The launch of North Korean missiles. Iran's seizure of a British-flagged oil tanker. Reports that the combined balance sheets of the four largest central banks (the Fed, European Central Bank, Bank of Japan and People's Bank of China) totaled $19.7 trillion. The U.S. Treasury's announcement that it was considering ultra-long bond issuance. The annual threat of a federal government shutdown and approach of the debt limit cap. The Congressional Budget Office announcement of a $960 billion deficit. More than $430 billion of third quarter Treasury borrowing. $22.7 trillion of outstanding federal debt. The unusually large number of Democrat presidential candidates. The unprecedented, acerbic nature of the public exchanges between House leaders and the President during the past three years that has descended into the extraordinarily rare talk of impeachment.

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Positioning for the Fourth Quarter and Year End. October is typically the most volatile month of the year and wild swings in stocks and bonds often occur, with 1929 and 1987 being the most extreme cases. We try to look beyond the drama and discount the hype, stay alert, stay diversified and carefully monitor our credits. This year, the start of the fourth quarter is still ripe with geopolitical risks ranging from U.S.-China and U.S.-European trade issues, to Brexit, Iran, North Korea, Hong Kong and Northern Syria. Central bank policy action is being closely watched for desired easing and stimulus. The Federal Open Market Committee meets twice more this year, and futures trading reflects a 70% probability that there will be a rate cut on October 30, but only an 18% chance on December 11. The next European Central Bank monetary policy meetings are on October 24 and December 12. The 2020 election cycle continues to heat up, and Congress faces a Thanksgiving deadline to come to an agreement with the President on Fiscal Year 2020 spending. Third quarter earnings season is upon us and is expected to produce the third consecutive year-over-year decline. Economic data, consumer and business spending in particular, will be closely monitored for signs of recession, however, we see the U.S. economy continuing to expand and inflation remaining in check, all good signs for fixed income.

There is bound to be some seasonal volatility given the coming holidays, pressure to reduce dealer inventories and tax loss selling. Absent unexpected headline risk, we still anticipate steady demand for bonds from aging investors adjusting portfolio allocations for income, those seeking havens from risk and foreign buyers searching for positive yields. We do not foresee big returns in fixed income this quarter, but we are primarily focused on the income. In the municipal bond space, the fourth quarter tends to produce a heavy primary calendar with lower investment grade and below investment grade credits, so there may be good opportunities for some investors who are able to go out on the risk spectrum. We encourage you to contact your HJ Sims advisor to review the offerings along with your portfolio, investment objectives and risk tolerance, and make any necessary adjustments in your allocations before year-end.

Prepared by **Gayl Mileszko**, Senior Vice President