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Third Quarter Fixed Income Letter to Clients

Interest rates remained in a stable range for much of the 3rd quarter until the September employment report highlighted that the economy is creating many new jobs and wage pressure has begun to gain strength. Rates have now broken out to the highest levels in 2018 and indicate the potential for this upside momentum to continue.

Since 2010, the US economy has gained about 19 million jobs. Inflation is running at a relatively firm rate. And although some industries have demonstrated a relatively modest amount of pricing power, key factors such as higher wages, higher input prices, and higher interest rates would suggest that the economy will eventually moderate and inflation will soften as compared to prior strengthening cycles. On the other hand, the possibility that this high-growth cycle will continue with higher inflation, along with higher interest rates, trending even higher must be considered a real possibility.

For now, we believe interest rates can continue on a stable upward progression, with the Federal Reserve boosting rates another 25 basis points at its December meeting following the recent 25 basis point increase last month.

Our outlook for bonds over the next six to twelve months is that there is a 65% probability that the benchmark US Treasury 10-year bond yield will rise to around 3.50%-4.00%. We assign a 15% probability that the 10-year bond yield will simply remain in today's range of around 3.15%. We feel there is a 10% likelihood that rates will run lower to the 2.80%-3.00% area. And given the general nature of markets we always feel that there is a 10% chance that yields will rise or fall much higher or lower than we or anyone can reasonably predict today due to "unknowns". As we have stated time and time again, the key trigger guiding our outlook is inflation. The recent September employment report has finally highlighted a potentially material uptick in wage pressure. So, if this inflationary uptick is confirmed in the next few reports, we expect rates to aggressively trend higher.

Our client's portfolios are designed to earn the highest after-tax return while maintaining a relatively defensive portfolio structure given today's interest rate environment. Of course each client has a unique set of circumstances that we focus on in order to customize the portfolio to meet the specific needs of each client. Tax-free income, preservation of principal and targeted duration management is what makes a municipal bond portfolio an attractive investment for clients in a high tax bracket.

Evan Slater
Fixed Income Portfolio Manager