Roosevelt Investments

Roosevelt Investments Current Income Portfolio | Second Quarter Commentary

Thoughts from our Domestic Fixed Income Team

Market Overview

Over the course of 2017 and the first half of 2018 the Federal Reserve has raised interest rates. In June, the federal funds rate was adjusted upwards to a 1.75 – 2.00% target range. This has been the seventh 25 basis point increase by the Fed since December of 2015.

A change in leadership at the Federal Reserve Board's FOMC did not appear to alter the committee's long-standing, public commitment to "normalize" US interest rates, especially on the short-end of the yield curve. After nearly a decade of historically aggressive and prolonged accommodative monetary policy to aid recovery from the financial crisis, the time had come to begin a tightening of monetary policy. We believe this shift reflects the Fed's view that our economy has definitively moved off of life support and back to good health.

Longer-term rates, in contrast, have not moved upwards with the same alacrity. After touching 3.11% in mid-April and late-May, the 10-year US Treasury yield ended the quarter at a yield of 2.85%, consistent with its level in February 2018.

This has us questioning the direct impact on market rates and the yield curve, with the Fed's engineered rate increases. We are inclined not to be too focused on interest rate anticipation strategies, as prognostications of higher market rates haven't borne out. Instead, we believe that our more tried and true approach has been effective. That is to remain fully invested, yet well positioned to take advantage of higher yields, should they materialize. Our approach is to build client portfolios with the most attractive levels of internal cash flows while limiting traditional bond market risks as reasonably as possible.

We believe it's possible there will be three, maybe even four, rate hikes a year over the next two years, after which point the federal funds rate may reach 3.25 – 3.50%. Under this scenario, the 2-year US Treasury would likely see 4.00%, and the 10-year US Treasury would trade at 4.00 – 5.00%, possibly higher. This is how we could see the domestic credit market attain "normalcy." US 10-year-note yields have barely nudged higher from a year ago. This market benchmark, rising only slightly with successive Federal Reserve actions in the short-term market, bounced off a temporary flirtation with 3.0%, but quickly returned to about 2.85%, the identical levels seen for 10-year Treasury notes back in 2013. This leaves the possibility of a 4% 10-year note suddenly further away than it may have seemed to most investors, proving how difficult it can be to forecast interest rate changes with much certainty at all, especially in the short-term.

The surprises for interest rate forecasters so far in 2018 reinforce the potential pitfalls that may be created from straying from one's investment philosophy and process in reaction to news cycles or wavering expert opinions. A consistent approach, matching risks to potential rewards, remains especially necessary to maintaining long-term success in fixed income management.

Performance and Outlook

We have not strayed from our core objectives, and have remained fully invested to take advantage of more generous yields on the expected horizon. Our portfolios have continued to produce attractive levels of current income, while maintaining relatively stable market values. We believe we will have to be a bit more patient to see our way through short-term price volatility to the realizations of longer-term planning.

Late last year we opted to select shorter rather than longer maturities for reinvestment operations. This has proven helpful to dampen price volatility relative to the overall market, since bond prices have declined as interest rates have moved higher. In this regard, the first half of 2018 has not been particularly kind to investment grade, intermediate-term US corporate bonds. Corporate bonds underperformed government bonds in the second quarter, continuing the trend experienced in the first quarter this year.

Similarly, we opted for a more defensive investment approach by moving a portion of the portfolio from BBB-rated issuers into similar maturity investments with A-ratings. This approach has helped moderate the price decline of our income portfolio this year as higher rated corporate issues have outperformed lesser quality issues. In fact, since early February the yield spread difference between an index of BBB-rated corporate bonds and the US 10-year note has steadily widened from 1.20% to 1.64% at the end of June.

We maintain a sleeve of investment grade preferred stocks as a key component of our income investment strategy, to an limited allocation of approximately 24%. We continually weigh the risks and rewards of these investments against alternative investment grade sectors. We have elected to increase our portfolio's use of fixed-to-floating rate preferred securities as opposed to fixed rate, traditional preferred stock issues. We believe that the variable rate structures offer flexibility to maximize opportunities afforded by higher nominal interest rates, should they become available. In the meantime, the fixed rate preferred stocks have also added to our portfolio's year-to-date performance.

Federal Reserve Chairman Powell recently re-confirmed the FOMC's present intention to gradually raise the federal funds rate. Economic conditions at present are quite healthy, but may change at any time. We remain committed to implementing our current approach and remaining steadfast to our income–oriented portfolio's long-term strategy. This approach allows us to best preserve capital and retain significant ability to reinvest at higher interest rates should they become available.

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ICE BofA Merrill Lynch 1-10 Year US Corporate Bond Index is a subset of the BofA Merrill Lynch U.S. Corporate Index including all securities with a remaining term to final maturity less than 10 years.

ICE BofA Merrill Lynch 1-10 Year U.S. Treasury & Agency Index is a subset of the BofA Merrill Lynch U.S. Treasury & Agency Index including all securities with a remaining term to final maturity less than 10 years.

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