Cashing In on the Short End of the Curve

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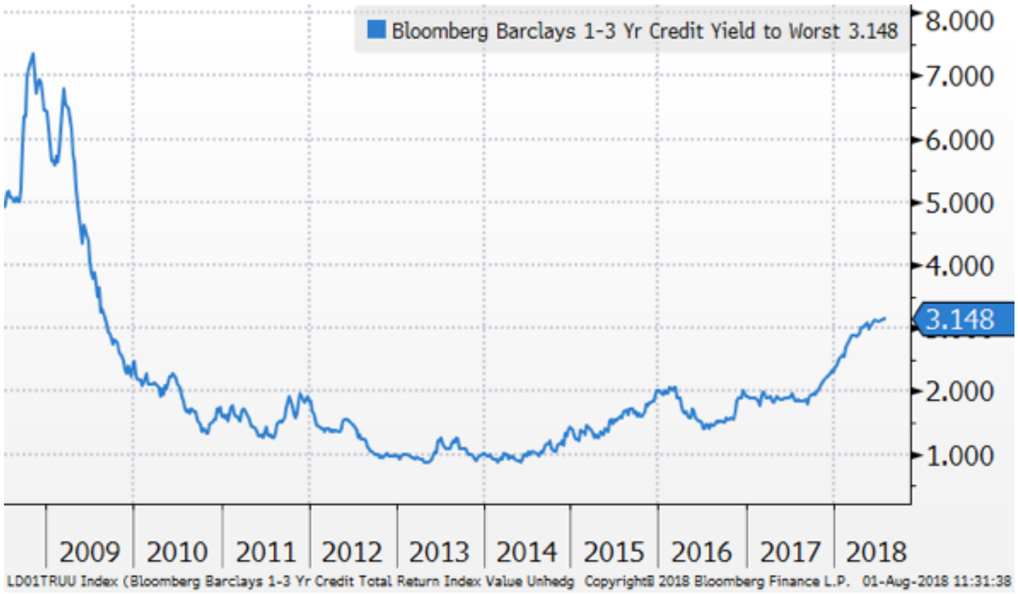
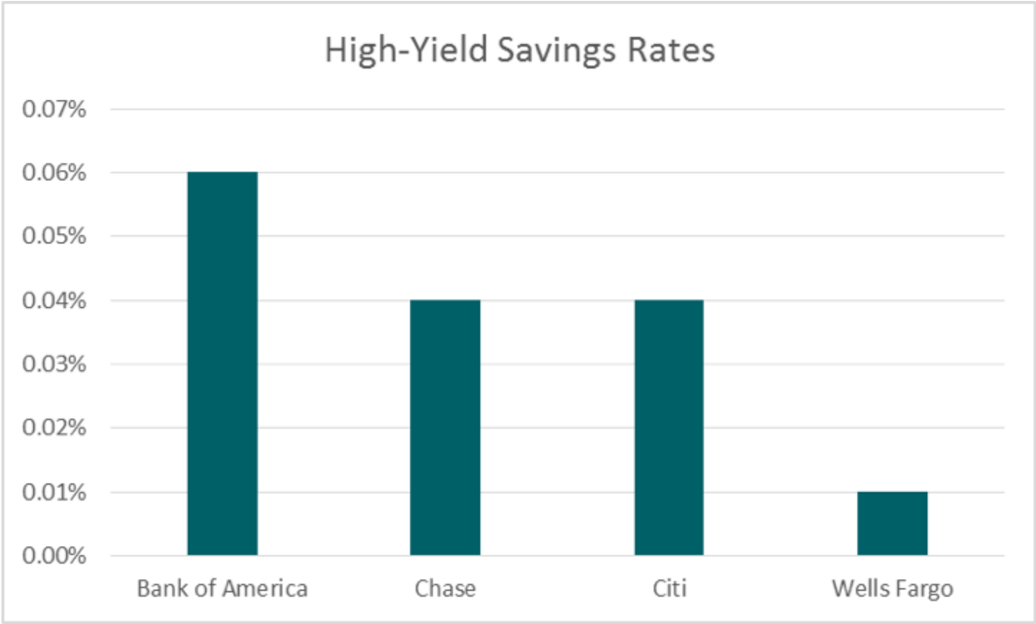
In the fallout from the global financial crisis, the U.S. Federal Reserve cut interest rates to near zero and began an unprecedented quantitative easing program, buying U.S. Treasury bonds as well as mortgages. Globally, other central banks followed suit, with the European Central Bank, Swiss National Bank, and the Bank of Japan all pushing short-term rates *negative*. The reasoning behind these policies was to help spur economic growth. However, it had a secondary effect. Investors and savers earned virtually zero on products which were tied to short-term interest rates - such as bank deposits, certificates of deposit (CDs), and short-term government and corporate bonds.

As economic growth has returned, some central banks have slowly started to discuss – and in a few cases have started the process of – 'normalizing' interest rates. The Federal Reserve was the first major central bank to do so, increasing the Federal funds rate in December 2015 for the first time since the 2007-08 financial crisis. They have subsequently raised the funds rate six additional times to its current target range of 1.75% - 2.00%. Currently, the market and the Fed expect an additional one-to-two rate hikes over the remainder of 2018.

The recent sharp increase in short-term interest rates has created exciting opportunities in short-term U.S. treasuries, investment grade corporate bonds, and commercial paper. Today, the yield on the 2-year U.S. Treasury is over 2.60%, its highest level since July 2008 - well above the low yield of 0.17% in September 2011. As the graph below shows, buyers of investment grade corporate bonds with less than 3 years to maturity can now obtain yields of over 3%. Meanwhile, investors in short-term commercial paper are receiving yields over 2% for terms longer than 60 days.



However, many people may be unaware of this opportunity, as the rates on bank deposits and certificates of deposit (CDs) have yet to reset higher. Historically, higher short-term Treasury rates would have translated into higher yields on bank checking and savings accounts, as well as on CDs. However, this relationship has broken down as banks have been reluctant to pass on higher rates to customers as they seek to maximize profits. In addition, banks have a lot of cash on reserve and don't need additional deposits and are, therefore, not competing with higher rates to attract new customers. The chart below highlights the high-yield savings rates offered by the largest U.S. banks.



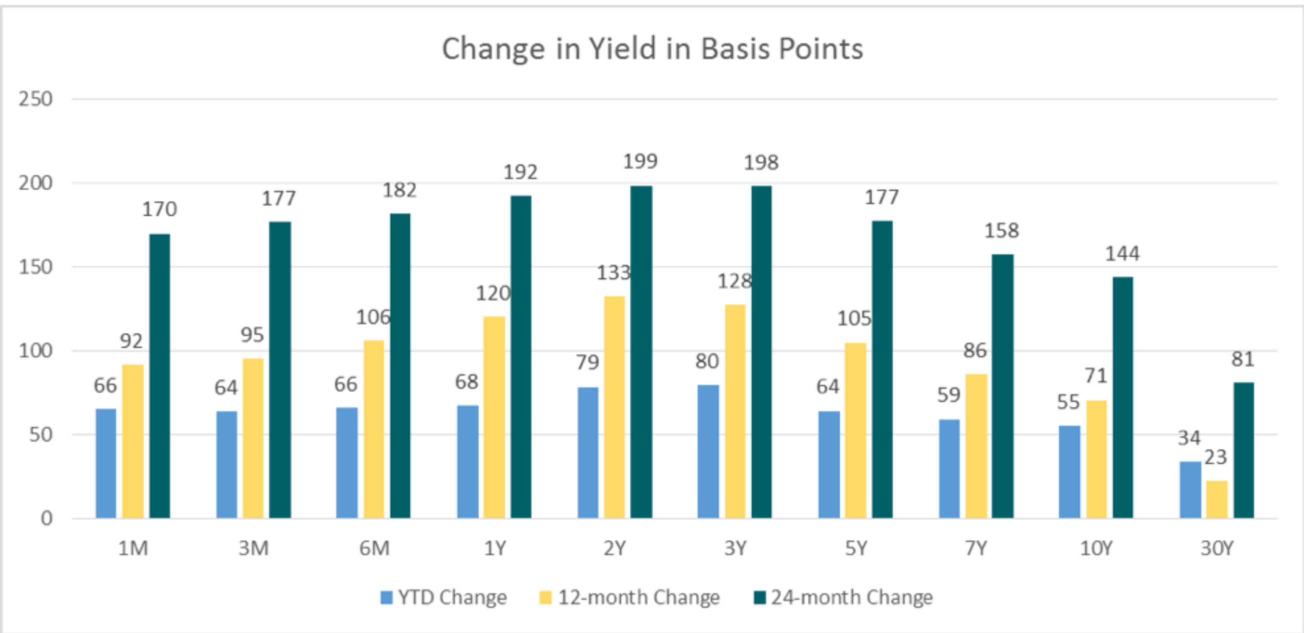
Source: Informa Research Services. Rates reflect high yield savings rates for products offered at the select banks with a minimum balance of at least $2,500. As of 07.31.2018.

In this paper, we highlight some of the opportunities available to investors today in the short-term fixed income markets. These strategies generally offer a significant pick-up in yields and, in some cases, improved liquidity relative to traditional bank savings products. Investing in short-term fixed income portfolios can also help to provide some risk mitigation against more interest-rate-sensitive fixed income portfolios as well as from investments in risk assets such as stocks.

Treasury Bonds:

Over the past 12 and 24 months, short-end Treasury yields have increased substantially with the 2-year Treasury note yielding 1.26% and 1.67% more than it was one year and two years ago, respectively.

The graph below shows the changes in yields for different maturities of the yield curve over the respective time periods.



Source: Bloomberg. As of 07.31.2018

The U.S. Treasury department will have to issue an estimated $955 billion in 2018, which is significantly higher than issuance of $519 billion last year, to finance the deficit created in large part by tax reform and the $1.3 trillion spending bill passed to increase the debt ceiling. The increase in financing needs led to a record $330 billion of net new Treasury issuance in the first quarter, much of which was financed by issuance of short-maturity Treasury Bills with less than 12 months to maturity.

The Federal Reserve is also expected to buy $200 billion less Treasuries and mortgage-backed securities (MBS) in 2018 than it did in 2017, in essence removing a large buyer and source of demand from the market. The combination of higher supply and lower demand has been one of the major factors, along with the potential for future rate hikes, which has pushed yields higher. As the previous graph illustrates, interest rates for Treasury securities with maturities of 1 year or less have increased substantially year-to-date, especially when the increase in yields is compared to the absolute yield of the security.

The chart below looks at the current yields on U.S. Treasury securities and the date that these yield levels (or higher) were last available for the respective maturities. As the table highlights, short-term U.S. Treasuries yields are as attractive as they have been in nearly a decade.

Maturity	Current Yield	Last Time Rates Were at This Level
3 months	2.02%	June 2008
6 months	2.19%	July 2008
1 year	2.41%	July 2008
2 year	2.68%	July 2008
3 year	2.77%	September 2008
5 year	2.85%	September 2008
7 year	2.92%	April 2010
10 year	2.96%	May 2011
30 year	3.08%	July 2014

Source: Bloomberg. As of 07.31.2018

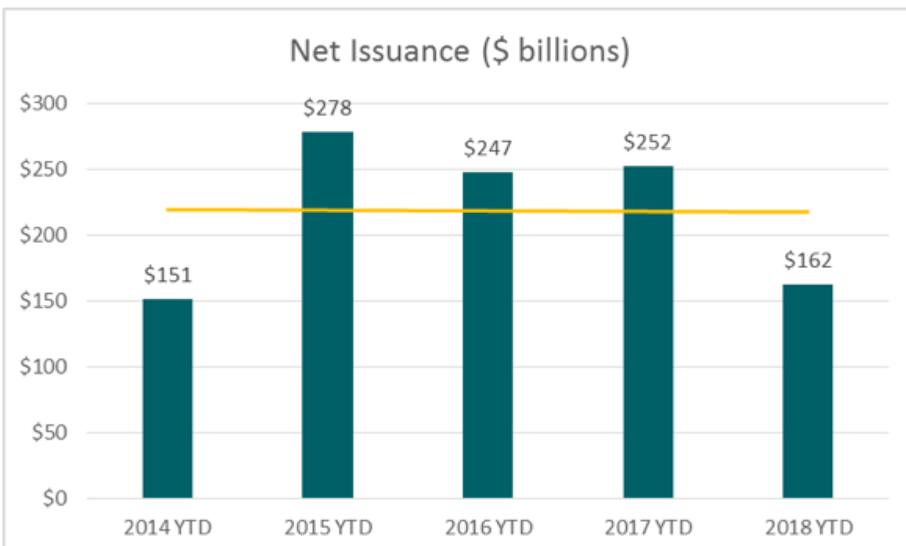
Corporate Bonds:

A combination of higher U.S. Treasury yields and wider credit spreads has provided investors the opportunity to buy investment grade bonds with yields exceeding 3%, while maintaining limited interest rate, or duration, sensitivity.

The widening of credit spread in the 1-3 year area of the corporate bond market was driven in large part by concerns over the effects of tax repatriation. For the past six years, U.S. corporations have been among the largest buyers of short-dated corporate bonds. Prior to the passage of the Tax Cuts and Jobs Act (TCJA) in December, U.S. corporations were incentivized to leave foreign earnings overseas, which resulted in a large stockpile of cash. It is estimated that U.S. corporations invested around $400 billion of this cash in short-term investment grade corporate bonds. With the passage of TCJA, companies now have the opportunity to repatriate overseas cash at a favorable tax rate. Entering the year, investors were worried that not only would the short-term investment grade corporate bond market lose a large buyer, but that these corporations may actually sell their portfolios into the secondary market. This led some investors to avoid buying short-dated corporate bonds for fear of less demand and a large amount of secondary market supply.

While we acknowledge that corporations are no longer the powerful buying source that they have been over the past several years, we don't believe that there will be large amounts of sales from this investor base and therefore think that the spread widening has been overdone. Instead, we believe that most corporations will reduce their bond portfolios by allowing them to mature and not reinvest the proceeds, rather than sales in the secondary market. First, most of their corporate bond positions are short term, and many will be trading below par due to the sharp rise in interest rates; therefore, by allowing their holdings to mature they can avoid mark-to-market losses. Second, the market liquidity in short-maturity investment grade bonds is not sufficient to handle large sales without moving prices. Lastly, we expect the increase in CAPEX, share buybacks, and dividends to be gradual, such that there isn't a need to raise funds quickly. The data contained within first quarter earnings reports appears to confirm that companies have not been selling large amounts of bonds. At the end of the first quarter, aggregate holdings for corporate bonds by these companies was down only around 10%. This is a rather modest decline and suggests that positions are indeed declining due to maturities rather than sales in the secondary market.

The most dramatic fallout from tax reform for the corporate bond market has actually been the lack of new issuance. The investment grade market has had $162 billion of net new issuance year-to-date, which is around $70 billion less than the average net issuance over the same time frame for the past four years. Furthermore, the sectors with the most overseas cash – technology and healthcare – have had net negative supply year-to-date.



Source: Wells Fargo. As of 05.18.18

Another benefit for short-term corporate bond investors is the trend of companies focusing their new issue supply in longer maturities. Given the flatness of both the Treasury and credit curve, this makes sense as companies can extend the maturity of their bonds without having to pay significantly higher interest rates.

In addition to the better than expected technical backdrop, corporate fundamentals and the macroeconomic environment have been strong. During the first quarter, companies reported strong earnings growth and an increase in free cash flows due to tax reform. The outlook for the U.S. economy over the remainder of the year continues to remain solid, with the consensus forecast for above-trend real-GDP growth of 2.8%. We anticipate that these trends will be supportive of spreads.

We believe that the current set-up presents an attractive entry point into the short maturity investment grade corporate bond space. The investment grade bond market is made up of a deep and diverse investor base, and yields of greater than 3% should attract investors into the market. In addition, investors with flexible mandates, who may not be traditional buyers of corporate bonds, are also candidates to move assets to take advantage of this dislocation.

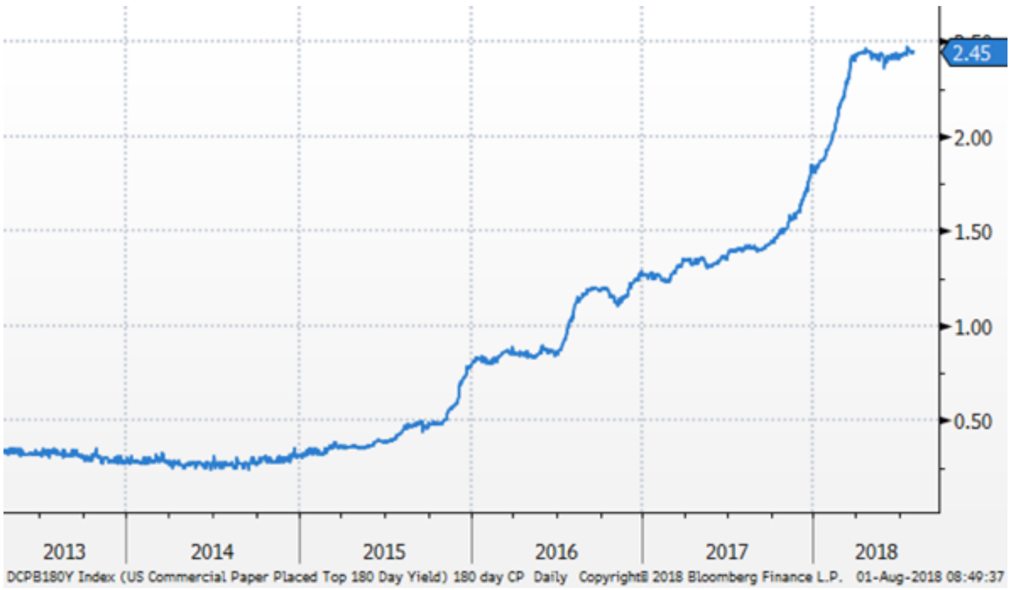
Within the investment grade market, we are focused on non-cyclical, defensive sectors which are less likely (due to regulation or other factors) to participate in releveraging their balance sheet. At an issuer level, we are focusing on companies with ample liquidity, strong free-cash-flow generation and management teams who are committed to strong balance sheets.

Commercial Paper:

Commercial paper ("CP") is a short-term promissory note issued by a corporation for a specific amount and with a fixed maturity date, which is not to exceed a final maturity of 270 days in order to stay exempt from SEC registration rules.

Since November, the difference between Libor and the Overnight Index Swap (OIS) rate has widened to almost 50 basis points due in large part to the sizable amount of Treasury bill issuance and the passage of tax reform. The TJCA included a new base erosion and anti-abuse tax (BEAT) which has resulted in pushing Libor higher. Leaving aside the many technicalities of the provision (a detailed discussion of the BEAT is beyond the scope of this whitepaper), BEAT imposes a minimum tax to limit a corporation's ability to reduce its normal U.S. taxes through payments to related foreign parties. This change has impacted U.S. branches of foreign banks, who previously relied on short-term borrowing from their headquarters overseas, by making those debt payments taxable. At the end of 2017, data from the Federal Reserve shows that the U.S. branches of large European and Japanese banks received an aggregate of over $400 billion in dollar funding from their overseas headquarters. These same institutions will now have to turn to the unsecured borrowing markets in the U.S. to fill this funding need, which in turn has pushed Libor rates higher.

Libor rates have an impact on all asset prices, but particularly those with shorter maturities and credit exposure. The spread widening between Libor and OIS has translated one-for-one into higher three-month commercial paper rates and, by extension, into higher yields for longer-dated CP. The chart below shows the interest rate offered by 90-day CP over the past 5 years. CP currently offers a very attractive opportunity for investors to earn a sizeable increase in yield over most traditional bank offerings such as certificates of deposit.



The Benefits of Active Management:

As with other fixed income offerings, we believe that active management, combined with risk controls, can produce superior risk-adjusted returns in fixed income in general. This is certainly the case for opportunities in the short-term markets. Strategies which are actively managed can take advantage of market dislocations as they occur, while managing the strategy to meet an investor's liquidity and current income objectives.

Overall, we believe that the front-end of the bond market currently offers an attractive investment opportunity, offering investors diversification from risk markets which are trading at higher valuations or an opportunity to earn higher yields relative to traditional bank products.