THIRD QUARTER 2018 SMITH GRAHAM FIXED INCOME COMMENTARY

Is TED Talking?

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Who is TED? And what is TED talking about? The answer depends on who you ask. Some would say that it is a media organization that posts online talks. TED began in 1984 as a conference where Technology, Entertainment and Design came together. Today TED covers a plethora of topics — from the arts to science to business to global issues.

There are fans and followers of the conference, organization and speakers along with a fair share of people who dislike the polished and well-rehearsed lectures from "experts" that have a knack for stating the obvious and attempting to make simple ideas appear complex. There are instructional books to guide you in the TED style. Examples of a few titles are listed below:

- How to design TED-Worthy Presentation Slides
- Talk Like TED
- TED Talks: The Official TED Guide to Public Speaking
- TED Talks Storytelling

The other TED has to do with the Fed (Federal Reserve) and spread. The TED spread has been muted since the financial crisis, but it is not dead. It is a useful indicator, but not sure how very widespread. It's probably not the best thing since sliced bread. It is not a tool used by fools to rush in where investors fear to tread.

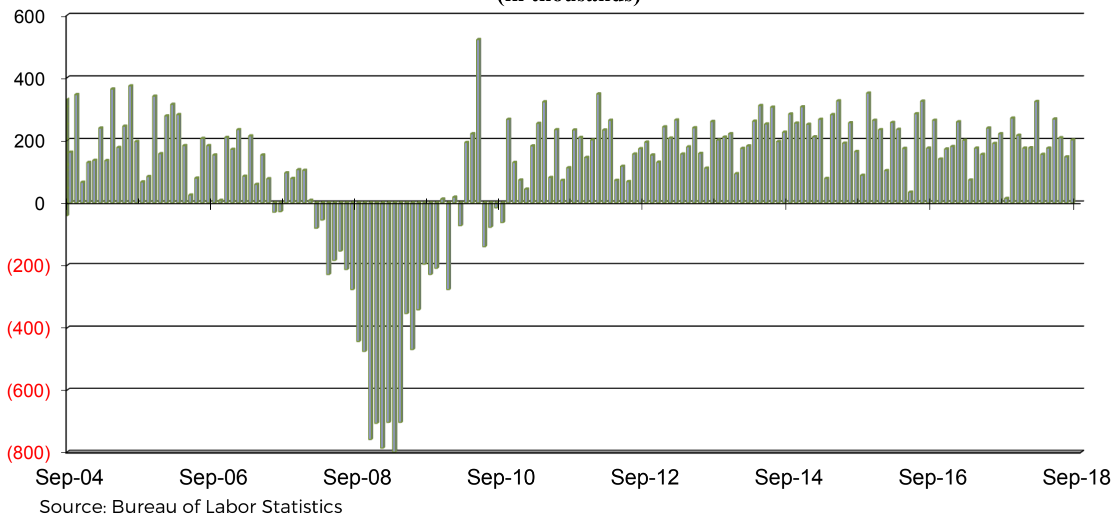
"…..the TED spread is widely viewed as an indicator of the perceived credit risk in the economy and tends to spike in times of crises."

The TED spread got its name from the two financial instruments it compares—the 3-month Treasury Bill (T-bill) and the Eurodollar 3-month London Interbank Offered rate (LIBOR) contract. TED stands for Treasury Bill and Euro-dollar or (LIBOR in US dollars). The Ted spread is the interest rate differential between the 3-month LIBOR in U.S. dollars and the 3-month U.S. T-Bill rate. While it directly reflects default risk in the banking sector, the TED spread is widely viewed as an indicator of the perceived credit risk in the economy and tends to spike in times of crises.

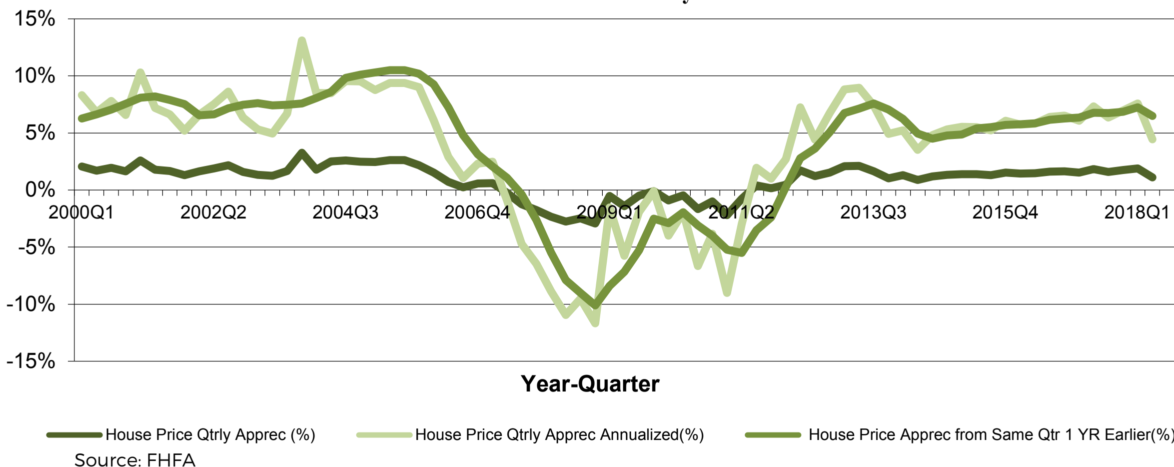
When the TED spread is increasing, it could tell us that banks believe other banks they are lending to have a higher risk of defaulting on loans so they charge a higher interest rate to offset this risk. It could also mean that investors are herding to buy T-bills because they believe the stock market is shakey. It can also suggest that credit markets are not functioning as well as they could. This can be a sign of possible economic contraction.

Conversely, when the TED spread is decreasing, it tells us either that banks believe other banks they are lending to have a lower risk of defaulting on the loans so they charge a lower interest rate to offset this risk. It could also mean that investors are selling T-bills because they believe their money will perform better in the stock market. It also can tell that credit markets are functioning smoothly. This can be a sign of budding economic expansion.

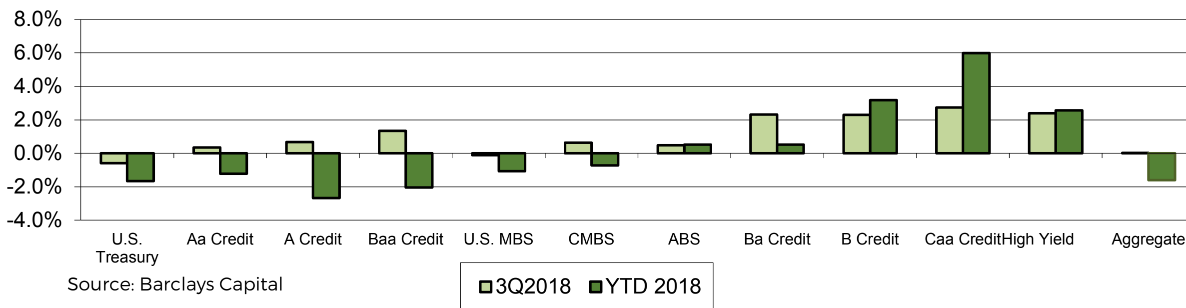
Please see "Spread" on page 5



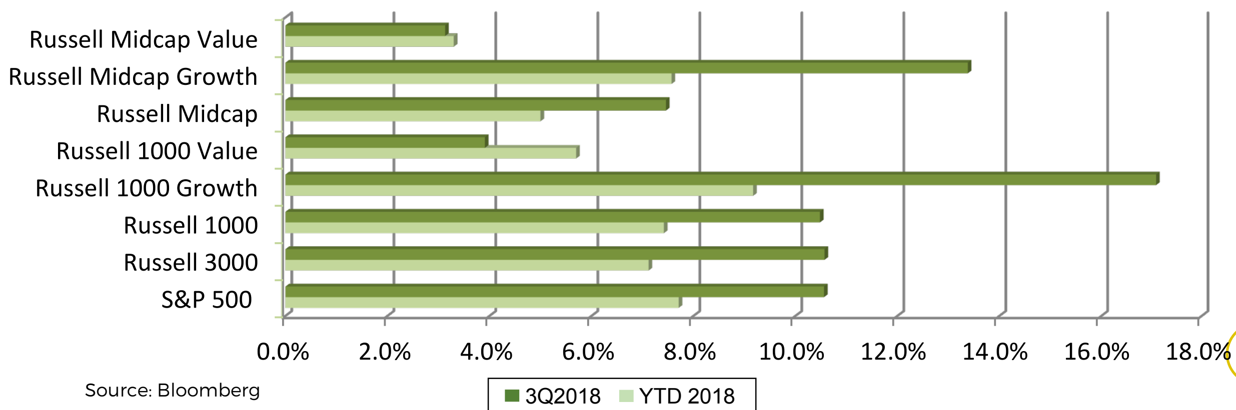
Source: Bureau of Labor Statistics



Source: FHFA



Source: Barclays Capital



Source: Bloomberg

REVIEW AND OUTLOOK

The focus on global trade, the midterm elections and of course the back-up in U.S. interest rates were the primary drivers of market activity for the 3Q2018. The major U.S. stock indexes closed the quarter with their best quarterly performance in five years. Health Care, Communication Services, and Industrials were the sizable S&P 500 sector winners for the period. The Energy sector was the laggard for the quarter while Consumer Staples is the laggard year to date.

The Federal Reserve hiked the federal funds rate by 25 basis points in September. This was the third time this year that the rate was increased and signals one more rate boost in 2018, most likely in December. There is a possibility of three additional hikes in 2019. It was the eighth time the Federal Open Market Committee has raised borrowing costs since late 2015. The Federal Reserve held rates near zero after the Great Recession to help speed up the economic recovery.

The major domestic fixed income indices posted mixed return numbers for 3Q2018, given the 20 basis point increase in yield on the 10-year Treasury. The U.S. Aggregate index increased 0.02% during the quarter. High yield and investment-grade debt produced positive returns during the third quarter, according to Barclays Capital indices. The total returns from corporate high yield were 2.40% for the quarter, while returns from investment-grade corporate debt produced total returns of 0.89%. High yield debt is rated below Baa3 by Moody's Investors Service and lower than BBB- by S&P.

The bull market has been long and strong, but investors may be positioning themselves for an inevitable market correction.

The 2-year Treasury yield climbed 29 basis points while the 10-year Treasury yield increased 20 basis points during the quarter to yield 2.82% and 3.06% for the period, respectively. Industrial and Financial Institutions were the best performing sectors within the U.S. Aggregate index; the two sectors returned 1.07% and 0.93%, respectively, for the quarter. U.S. Treasury bonds came in down 0.59%. Baa bonds were the best-performing investment-grade credit quality during the third quarter, posting a 1.35% gain. Pharmaceuticals, Supermarkets, Wireless and Cable Satellite were the best performing industries within the high yield corporate sector.

The Bloomberg News monthly survey of bond yields – which includes input from more than 60 economists – forecasts that U.S. Treasury 10-year yields will increase to 3.10% in 4Q2018 and then rise to 3.20% in 1Q2019. All the yields are equal to the forecasted yields of the August survey. The U.S. economy can probably handle this less-accommodative stance by the Fed. Recent economic data has been solid, signaling that corporations and businesses remain on course to continue the positive gains in earnings. It is interesting to note that health care stocks have been excellent performers. Also, pharmaceutical high yield bonds have been the leader in that asset class. This sector is viewed as defensive, but also offers some respectable growth opportunities. The bull market has been long and strong, but investors may be positioning themselves for an inevitable market correction. Considering all the moving parts, the financial markets look resilient and the economic picture continues to look reasonably promising.

We will continue to manage portfolios that tend to exhibit less volatility than their relative index and strive to deliver attractive risk-adjusted returns. Our portfolios are designed to perform over a full market cycle with a focus on downside risk, a style we believe will succeed over the long term.

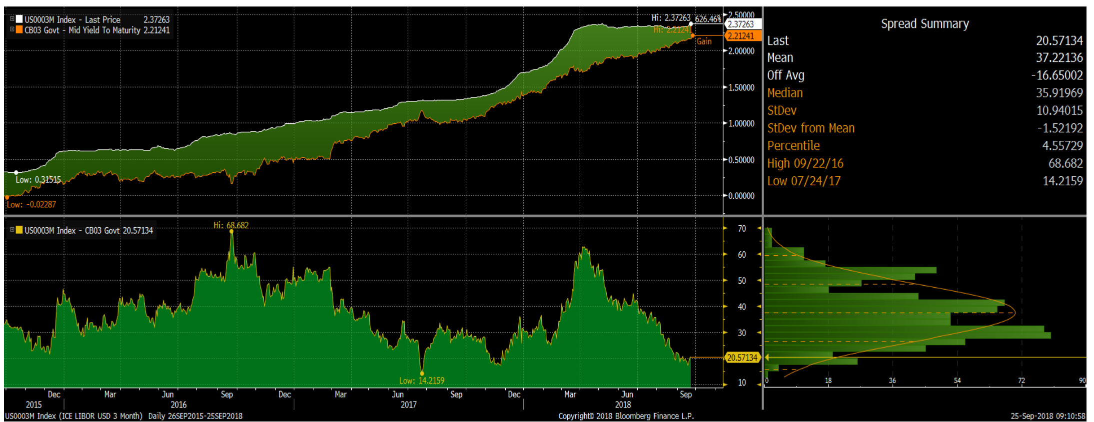
"Spread" from page 2

The bottom line is that the TED spread can be an indicator of economic health. It is a direct measure of the premium investors require for the risk of loaning money to a bank rather than to the U.S. Treasury. TED was talking big-time during the financial crisis but has been quite since the financial crisis. Some investors reduce their risky asset exposure when systemic risk increases. The TED spread is an information variable which can assist in better understanding the behavior of global markets.

If one is unconcerned with the noise in the markets, they can observe this proxy for risk independently with no consensus or following a school of thought. No insight can exist by itself. New ideas and thoughts build on earlier understanding. Good ideas become connected to other relevant concepts. They complete each other as much as they can compete against each other.

Is the TED spread a good sign? How large is an average TED spread? Chart 1 show that the three-year average of the TED spread has been 35.9 basis points with a maximum of 68.6 bps and a minimum of 14.2 bps.

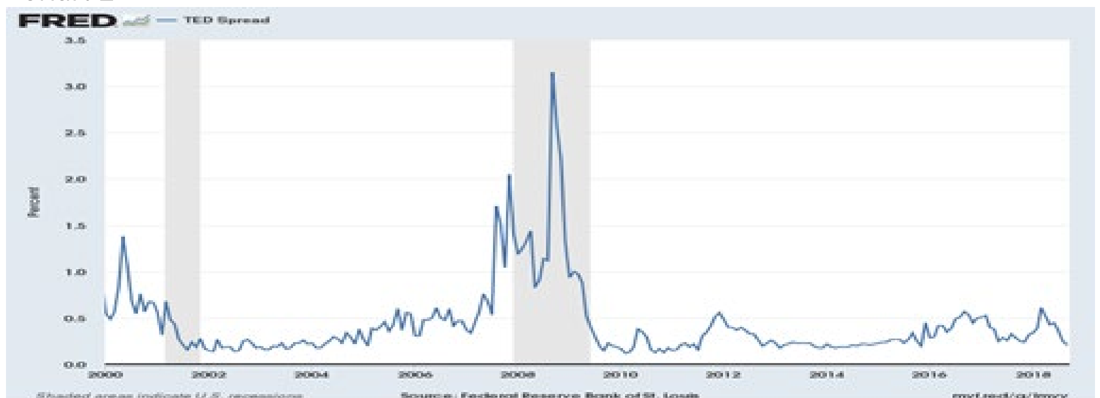
Chart 1



"TED was talking big time during the financial crisis but has been fairly quite recently."

Chart 2 shows that the largest TED spread exceeded 463 bps on October 10, 2008. The most recent low was 9.6; it was achieved on March 16, 2010. The series currently sits at 20.6. A longer historical perspective would show that in times of a crisis, the TED spread really rises. Leading up to the financial crisis this data series tried to tell investors what was going on.

Chart 2



Source: Federal Reserve Bank of St. Louis

The correlation between the TED spread and various sectors of the Bloomberg Barclays U.S. Aggregate Index are not strong over the previous three years. There has been little correlation between investment grade sector option adjusted spreads (OAS) and the TED spread during that period. There has been even less correlation between investment grade sector total returns and the TED spread.

The TED spread and our charts from FRED (Federal Reserve Economic Data) suggest that the financial markets should be fine and that there is little evidence to think otherwise. Corporate bond valuations appear expensive, but the fundamental framework remains intact, particularly as leverage is near post-crisis lows.

But if there was a person on that big TED Talk stage that could impress you using their crystal ball to predict the future, they would probably make these TED-worthy points:

- The Federal Reserve may become too aggressive in controlling inflation
- Global trade clashes, especially with China worry investors
- Mid-term elections and administration concerns in D.C. are an issue
- The yield curve is flattening

There has been even less of a correlation between investment grade sector total returns and the TED spread.

Let's take a look at the yield curve. The yield curve is a curve showing several yields (interest rates) across different bond maturity lengths. Usually the longer bond's maturity, the higher the interst rate. There are exceptions and times when this does not apply. If long-term interest rates fall below short-term rates, this can be an indicator of problems in the credit markets and a looming recession.

Chart 3 shows the spread between 10-year and 2-year U.S. Treasuries. It is trending donwnward. The last time that the yield curve inverted (an inverted yield curve is an interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality) was in 2007. Do you remember what happened just after that?

Chart 3

Source: Federal Reserve Bank of St. Louis

There are various interpretations out there of what the TED spread and an inverted yield curve could mean for the financial markets. There are also those who say that this economy and economic environment are different this time around. The U.S. could have two more fed fund increases before inversion becomes an issue. The financial markets and the global economy are never very cut and dry. There can be a lot of noise and talk in the market that is not reflective of overall market sentiment.

Beware of messengers that are empty vessels with nothing to say and an impressive, bolstering way of saying it. Don't become hypnotized when they talk. Remember that we can get information from to TED to find out what he has to say about the markets. Let's challenge TED. We must adjust the probability of old information to reflect what we have learned. We need to weigh the ideas and evidence that go with what we believe against ideas and evidence that we don't believe. Would it be better explained with some other evidence to go along with it? The TED spread and yield curve are not black and white ideas. They have many shades of gray. They are not going to be 100% reliable. Considering all the moving parts with spreads and curves, in my opinion todays financial markets look resilient and the economic picture continues to look reasonably promising.

Our TED spread talks amongst other economic data can start up rigorous debate and discussion. Our goal at Smith Graham is to navigate the noise and focus on our investment risk-return drivers to navigate the economic environment.

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Contact Us

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Additional Disclosure - A copy of Smith Graham & Co. Form ADV Part 2A, which describes our investment advisory services, fees and operations in more detail, is available upon request.

Investment Risk Disclosure - Fixed income securities are subject to the following investment risks:

– **Interest rate risk**. Interest rate risk is the risk that debt securities will decline in value because of changes in market interest rates. Generally, when market interest rates rise, the value of debt securities declines, and vice versa. An account's investment in such securities means that the value of the account will tend to decline if market interest rates rise. The prices of long-term debt obligations generally fluctuate more than prices of short-term debt obligations as interest rates change.

– **Credit risk**. Credit risk refers to an issuer's ability to make payments of principal and interest when they are due. Bond prices typically decline if the issuer's credit quality deteriorates. Lower grade securities may experience high default rates, which could mean that an account may lose some or all of its investments in such securities. If this occurs, the account's value would be adversely affected.

– **Investment grade bond risk**. Investment grade bonds are considered less risky than bonds whose ratings are below investment grade; however, ratings are no guarantee of quality. The credit quality of these bonds can decline which would normally cause the prices of these bonds to decline.

– **Below investment grade bond risk**. These bonds, commonly known as "junk bonds", involve a higher degree of credit risk. In the event of an unanticipated default, an account would experience a reduction in its income, a decline in the market value of the securities so affected and a decline in the account's value. During an economic downturn or period of rising interest rates, highly leveraged and other below investment grade issuers may experience financial stress that could adversely affect their ability to service principal and interest payment obligations, to meet projected business goals and to obtain additional financing. The market prices of below investment grade bonds are generally less sensitive to interest rate changes than higher-rated investments but are more sensitive to adverse economic or political changes or individual developments specific to the issuer. Periods of economic or political uncertainty and change can be expected to result in volatility of prices of these securities. NRSROs consider these bonds to be speculative in nature.

– **Mortgage-backed securities risk**. Mortgage-backed and securities are subject to prepayment risk. When interest rates decline, unscheduled prepayments can be expected to accelerate, and an account would have to reinvest the proceeds of the prepayments at the lower interest rates then available. Unscheduled prepayments would also limit the potential for capital appreciation on mortgage-backed securities. Conversely, when interest rates rise, the values of mortgage-backed securities generally fall. Since rising interest rates typically result in the decreased prepayments, this could lengthen the average lives of such securities, and cause their value to decline more than traditional fixed-income securities.

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Index Comparison - Barclays Capital indices have been used as comparative benchmarks because the goals are to provide fixed income like returns. These indices are some the world's most recognized indices by investors and the investment industry for fixed income markets. These indices, however, are not managed portfolios and are not subject to advisory fees or trading costs. Investors cannot invest directly in these indices. These indices' returns also reflect the reinvestment of interest. Smith Graham & Co.is aware of the benchmark comparison guidelines set forward in the SEC Clover No-Action Letter (1986) and compares clients' performance results to a benchmark or a combination of benchmarks most closely resembling clients' actual portfolio holdings. However, investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds' ultimate performance results. Therefore, an investor's individual results may vary significantly from the benchmark's performance.

Forward Looking Statements

This newsletter may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct.

Past Performance

Past performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor.

Risk

Investment in securities, including fixed income instruments, involves the risk of loss.

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