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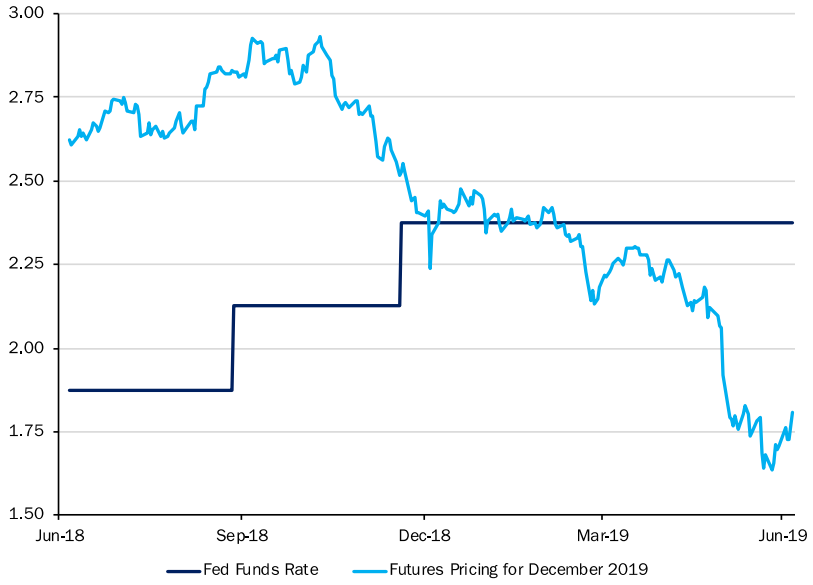
CAUTION OR PRECAUTION?

Fixed Income Outlook – Second Half 2019

Bond market performance in 2019 has been dominated by the theme of central banks pivoting toward easier policy. In particular, the Federal Reserve (Fed) has signaled that interest rate cuts may be coming, marking a meaningful shift compared with the hiking cycle of the past three years (Exhibit 1). This change in messaging has been a driving force behind double-digit returns in many sectors of the bond market in the first half of the year.

Exhibit 1: Rate expectations change from hikes to cuts



Source: Columbia Threadneedle Investment based on Bloomberg data

While interest rate-cutting cycles are often associated with recessions, there is more nuance to the Fed's approach this time around. Recent research has suggested that when interest rates are low, central banks should respond more quickly and forcefully to the early signs of economic weakness in order to prevent a broader downturn to which

they would have limited ability to respond.[1] This supports the idea that the Fed, the European Central Bank and others, should ease policy on a precautionary basis before an actual recession begins in order to prolong economic expansion. Fed Chair Jay Powell recently channeled Ben Franklin by stating that, "an ounce of prevention is worth a pound of cure."

Looking back through history, we can see two somewhat recent examples of precautionary rate cutting cycles by the Fed that allowed for economic soft landings: one in 1995 and again in 1998. A closer look at bond market performance around those cycles could prove instructive as we review the opportunities in the bond market for the remainder of 2019. The table below shows the experience of the bond market in each of these periods compared with today.

Exhibit 2: Performance and yield changes before and after a rate cut

6 Months BEFORE Rate Cut	Yield Change	Excess Returns (%)			
	10-year Treasury	Investment Grade Corporate Bond	High-Yield Corporate Bond	Mortgage-Backed Securities	Emerging Markets Debt
1995	-1.83	0.79	0.51	-0.85	-1.88
1998	-1.14	-3.20	-12.05	-1.12	-31.20
H1 2019	-0.68	5.99	9.63	4.11	9.09

6 Months AFTER Rate Cut	Yield Change	Excess Returns (%)			
	10-year Treasury	Investment Grade Corporate Bond	High-Yield Corporate Bond	Mortgage-Backed Securities	Emerging Markets Debt
1995	-0.36	0.35	0.06	0.41	9.80
1998	0.69	2.32	5.79	0.69	17.51
H2 2019	?	?	?	?	?

Source: Columbia Threadneedle Investment based on Bloomberg data Note -. Indexes used to determine excess returns: Bloomberg Barclays U.S. Corporate Investment Grade (IG Corp.) Index; Bloomberg Barclays U.S. High Yield (HY Corp.) Corporate Bond Index; Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index; Bloomberg Barclays Emerging Markets (EMD) Bond Index; Bloomberg Barclays U.S. Treasury Index (10-year Treasury).

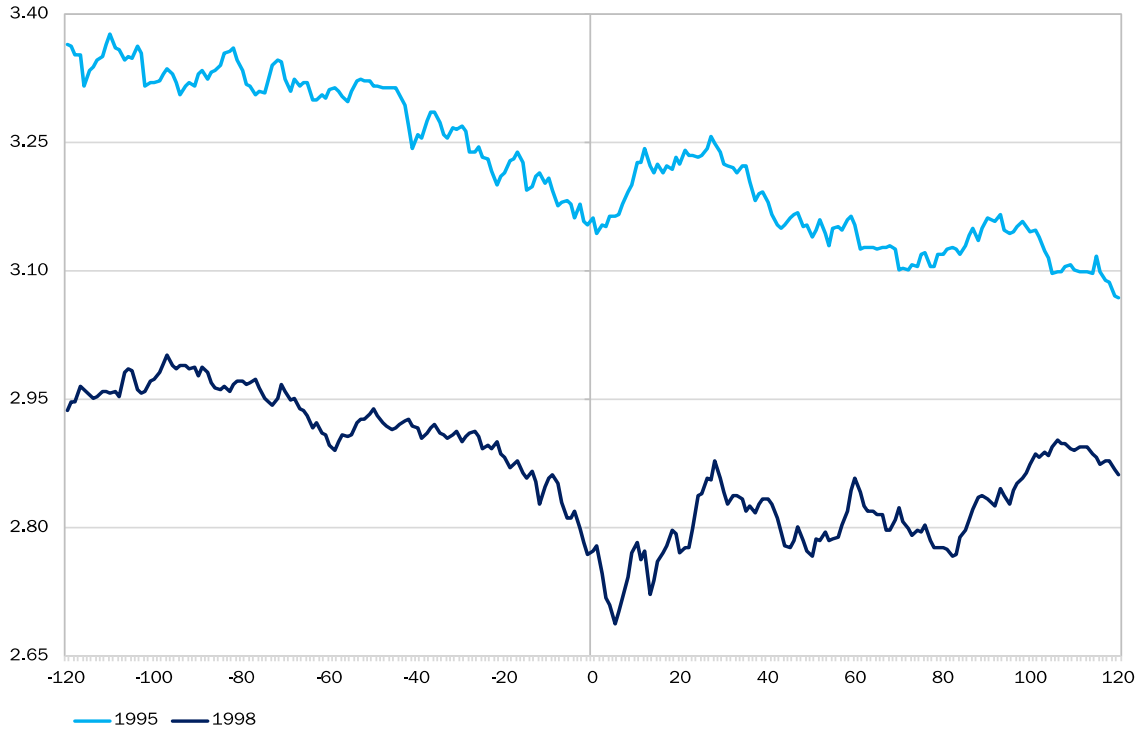
Using these two periods as a guide, we see that the bond market was quite volatile before the rate cut, particularly in 1998, but generally performed well when the Fed began to lower rates. Surprisingly, Treasury yields rose after the Fed started cutting rates in 1998 as in that case the cutting cycle was more modest than market expectations at that time. In the past six months, we have seen both declines in Treasury yields and strong excess returns in credit sectors. It seems that some of the good news may already be in the price as returns were very front-loaded. If the

[1] https://www.federalreserve.gov/econres/feds/files/2019009pap.pdf

Fed delivers the rates cuts that markets expect, we could still see further gains—but that is not a sure thing.

Another motivation behind the Fed's easing is the structural decline in inflation. Chair Powell mentioned this several times recently, including in his semiannual address to Congress. History shows that these cuts do impact inflation expectations, but that gains may be fleeting. Exhibit 3 shows inflation expectations, which saw a much more sustained rise in 1998 than in 1995[2]. We expect inflation expectations to rise this time around, particularly if geopolitical tensions continue to put upward pressure on commodity prices. A more sustained rise, however, will depend on the degree that higher wages pass through to service sector inflation.

Exhibit 3: Inflation expectations around first rate cut



Source: D'Amico, Kim, and Wei (2018), "Tips from TIPS: The Informational Content of Treasury Inflation-Protected Security Prices,"; updated by Kim, Walsh, and Wei (2019), FEDS notes, "Tips from TIPS: Update and Discussions". Data are updated monthly; all rates are in percentage points. This is not an official Federal Reserve statistical release. Because this is a staff research product and not an official statistical release, it is subject to delay, revision, or methodological changes without advance notice.

What happens to the U.S. dollar when the Fed eases? Conventional wisdom suggests that lower short-term interest rates would portend a weaker currency. In these periods of preventative easing, however, that was not the case. In each scenario, the dollar weakened heading into the cut, but strengthened thereafter by about 4%. The dollar has been trading sideways so far in 2019

[2] D'Amico, Kim, and Wei (2018), "Tips from TIPS: The Informational Content of Treasury Inflation-Protected Security Prices,"

but remains at historically strong levels. While it will be hard for the greenback to strengthen meaningfully from its current, lofty starting point, history suggests it will be well supported.

Exhibit 4: Change in U.S. dollar index spot rate (DXY)

Change in DXY Index			
	1995	1998	2019
6 months prior	-8.28%	-5.52%	-0.04%
6 months after	3.73%	4.54%	?

Source: Columbia Threadneedle Investment based on Bloomberg data

The starting point for any forecast matters, too. Clearly, government bond yields are starting at a lower level. The 10-year yield was just above 2% on June 30, compared with 6.2% in 1995 and 4.6% in 1998. However, other valuation measures are more in line with history. Credit spreads—or risk premiums—in most sectors are wider than they were before the initial rate cut in 1995.

In our view, the Fed is likely to cut interest rates three times before year end. That does not, however, guarantee robust returns from the bond market. Following a lackluster period for the market last year, the first half of 2019 was quite rewarding to bond investors. We think that this performance is unlikely to be repeated. An environment of slow growth and easy money is certainly a tailwind, but investors should not throw caution to the wind. We think the high-quality cash flows of the investment grade corporate and mortgage-backed securities markets will provide the best risk-adjusted returns going forward.

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