Bond Case Briefs

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Fed Policy Boosts Bond Funds in the First Quarter.

Heading into 2019, the Federal Open Market Committee (FOMC) adopted a more dovish stance than some market participants had expected. In December, the committee held the federal-funds target rate within the 2.25%-2.50% range after it had previously signaled the likelihood of more increases, and it maintained that position in March. The majority of FOMC members expect rates to remain unchanged the rest of 2019. This was the first quarter without a rate hike since the third quarter of 2017.

In March, the Fed also announced a plan for ending its balance-sheet unwinding process by September 2019, not the end of the year as investors previously expected. This accelerated timeline implies that the Fed will maintain a larger balance sheet than initially signaled, which should provide additional liquidity to the market.

Overall, bond market participants reacted positively to the Fed's more dovish tone, as U.S. Treasury yields fell and credit spreads tightened throughout the first quarter. The Bloomberg Barclays U.S. Aggregate Bond Index, a proxy for the U.S. investment-grade market, gained 2.9% during the quarter–a strong start after a seesawing 2018 in which the index ended the year roughly flat. The index's main sectors–agency mortgages, investment-grade corporates, and U.S. Treasuries–all experienced gains. Investment-grade corporate credit was the index's key driver for the period, returning 5.1%, while agency mortgages and U.S. Treasuries each gained just over 2%.

The Yield Curve Inverts

U.S. Treasury yields have remained low in 2019, and the yield curve inverted at the end of the quarter. The three-month U.S. Treasury yield, which is heavily influenced by the federal-funds target rate, remained roughly stable, ending the quarter at 2.4%. Meanwhile, the 10-year U.S. Treasury note's yield declined to 2.4% from 2.7%, slightly lower than the six-month yield. That modest yield-curve inversion temporarily spooked the markets, as pundits were quick to point out that inverted yield curves have often preceded recessions. But the market ultimately shrugged off these concerns.

Credit Rallies Following a Tough Fourth Quarter
Following a credit sell-off in late 2018, corporate credit was buoyed in early 2019 as credit spreads tightened, supported by the Fed's dovish stance. Risk-taking generally rewarded strategies that had larger stakes in lower-quality credit over their more conservative peers. Energy-related debt, in particular, benefited as the West Texas Intermediate crude-oil price rose to just over $60 per barrel from $45 to start the year, representing one of the largest quarterly increases in recent years. Energy's large presence in the high-yield bond space fueled gains.

Within the high-yield bond Morningstar Category, Fidelity Advisor High Income Advantage (FAHCX), one of the more aggressive strategies in the peer group, generated a 10.3% gain for the first quarter. This fund, which has a Morningstar Analyst Rating of Silver, benefited from its flexible mandate that can carry up to 20% in common stock, as the S&P 500 rose 13.6% during the period. More-conservative high-yield strategies, such as Bronze-rated Diamond Hill Corporate Credit (DHSTX) (up 5.6%), still performed well in absolute terms, even if they didn't rise to the top of their peer group rankings.

Convertible securities, which combine corporate bonds and an equity call option, also posted strong returns for the period.

Strong Technicals Fuel Munis

Municipal-bond market technicals remained supportive throughout the first three months of 2019, as demand outstripped supply. Tax reform that passed in late 2017 continued to impact the muni landscape. With a lower corporate tax rate, many traditional long-term municipal buyers such as insurance companies and banks have shifted away from the sector, propping up the long end of the muni yield curve. The muni curve's upward slope and relatively high yields added to the sector's attractiveness versus U.S. Treasuries.

While the distribution of returns in muni categories was narrow during the quarter, strategies with longer durations generally outperformed their shorter peers, and funds holding lower-rated issues also benefited from the market's risk-on mentality. For example, Silver-rated BlackRock National Municipal (MANLX) delivered a 3.0% gain, beating more than three fourths of its muni-national intermediate category peers, thanks to its longer duration and allocation to lower-quality issuers–notably Illinois, Puerto Rico, and tobacco bonds. The more conservative Bronze-rated Franklin Federal Intermediate-Term Tax-Free Income (FITZX), which focuses primarily on AA rated issues and avoids junk-rated bonds, gained 1.9%, trailing the majority of its competitors.

Puerto Rican credit got a boost from a federal-court-approved deal between the commonwealth and creditors. Puerto Rico's Cofina bonds, which are backed by the territory's sales tax, were exchanged for new non-investment-grade Cofina debt.

Going Global

Similar themes played out in fixed-income markets outside the United States. Hard-currency emerging-markets debt, which comes with credit risk, rallied almost as much as U.S. high-yield, with indexes gaining nearly 7.0%. Yields on developed-markets government debt dropped during the quarter, resulting in a 2.2% gain for the U.S.-dollar-hedged Bloomberg Barclays Global Aggregate Bond Index. As a result, the total of negative-yielding debt globally grew above $10 trillion during the quarter.

Exchange-rate fluctuations versus the U.S. dollar–for both developed-markets and emerging-markets currencies–were mixed in early 2019. The dollar appreciated versus the euro and yen, which created a modest headwind for unhedged world-bond category funds. But despite Brexit uncertainty, the British pound appreciated against the dollar during the quarter. After recovering somewhat in the second half of 2018, the Argentine peso depreciated sharply versus the dollar in 2019's first quarter, a position that continued to cause indigestion for a number of actively managed funds over the past year.

But overall, credit risk and emerging-markets exposure was likely a bigger differentiator for world-bond funds. Bronze-rated Dodge & Cox Global Bond (DODLX), which has a sizable corporate and emerging-markets debt stake, returned just under 5.0%, while the higher-quality Hartford World Bond (HWDIX) (also Bronze rated) gained 1.4%.

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Zachary Patzik, CFA does not own shares in any of the securities mentioned above. Find out about Morningstar’s editorial policies.