To quote from last month?s FI Review, ?*The performance for the rest of the year no doubt depends more on coupon than price appreciation as spreads are tight and headwinds are becoming more obvious...*?

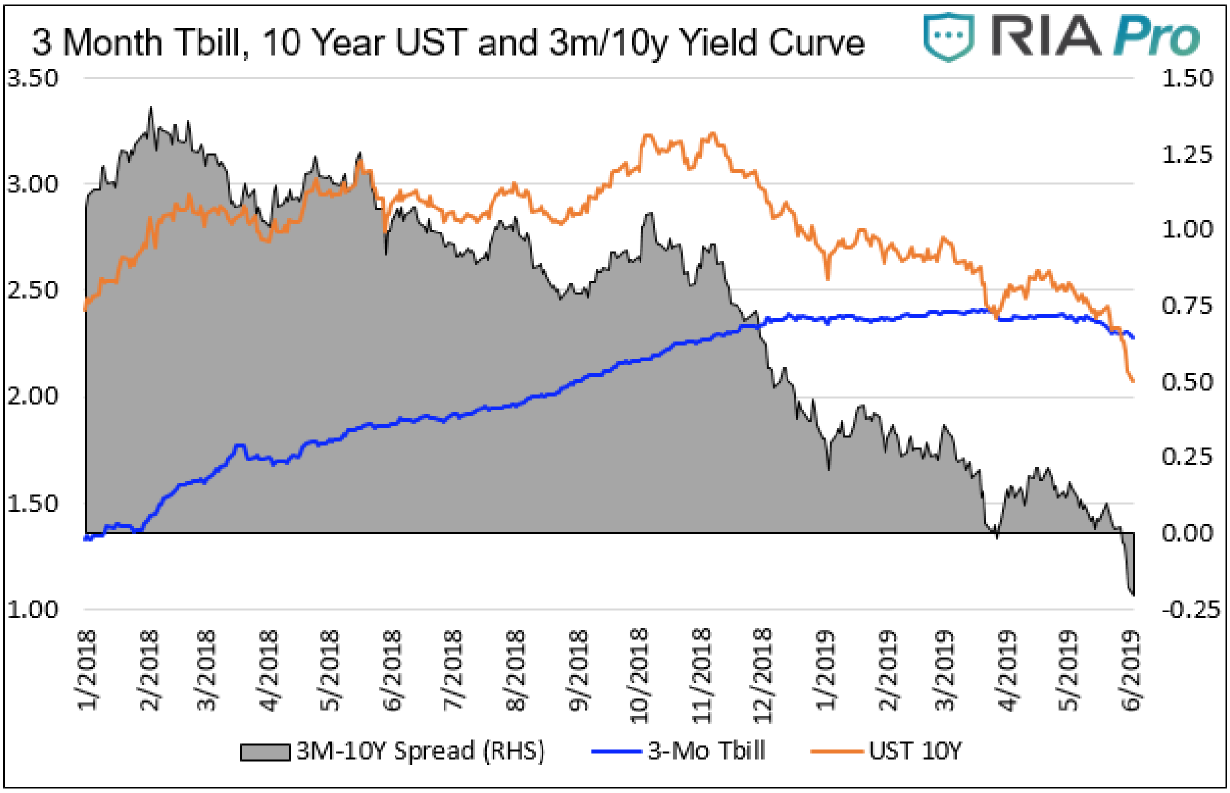
On the surface, it looks as though fixed income had another excellent month with the exception of the high yield (junk) sector. Year-to-date, total return gains range from between 3.5% (MBS, ABS, CMBS) to 7.3% (junk). With equity markets up 9-10% through May, bonds are, to use horse racing vernacular, holding pace and stalking. But the monthly total return data does not tell the whole story as we shall see.

RIA Pro	MTD Total Return	3 Month Total Return	YTD Total Return	12 Month Total Return	Current Yield to Worst
U.S. Aggregate	1.78	3.72	4.73	6.27	2.97
Agg. Treasury	2.35	4.01	4.18	6.28	2.41
Agg. Investment Grade - Corp.	1.43	4.54	7.05	7.45	3.60
Agg. High Yield - Corp.	-1.19	1.16	7.36	5.51	6.12
Agg. Securitized (ABS, MBS, CMBS)	1.34	2.78	3.51	5.63	3.17
Agg. Investment Grade - Muni.	1.38	3.37	4.63	6.40	2.30
Agg. Emerging Markets	0.62	2.39	6.37	7.31	5.32
Data as of 05/31/2019					

To start with an important backdrop for all asset classes, the decline in yields during May was eye-catching and most notable was the sharp inversion of the 3-month to 10-year curve spread. The table below highlights yield changes for May and the curve inversion.

Maturity/Curve	April 30	May 31	Change (BPs)
3-Mo T-Bills	2.38	2.30	-7.76
2-Yr UST	2.27	1.92	-34.40
5-Yr UST	2.28	1.91	-36.73
10-Yr UST	2.50	2.12	-37.72
30-Yr UST	2.93	2.57	-36.03
3M-10Y Curve	0.12	-0.18	-29.96

The graph below shows the yields on the 3-month T-bill and the 10-year Treasury note as well as the yield spread between the two. Past inversions of this curve have tended to signal the eventuality of a recession, so this is a meaningful gauge to watch.

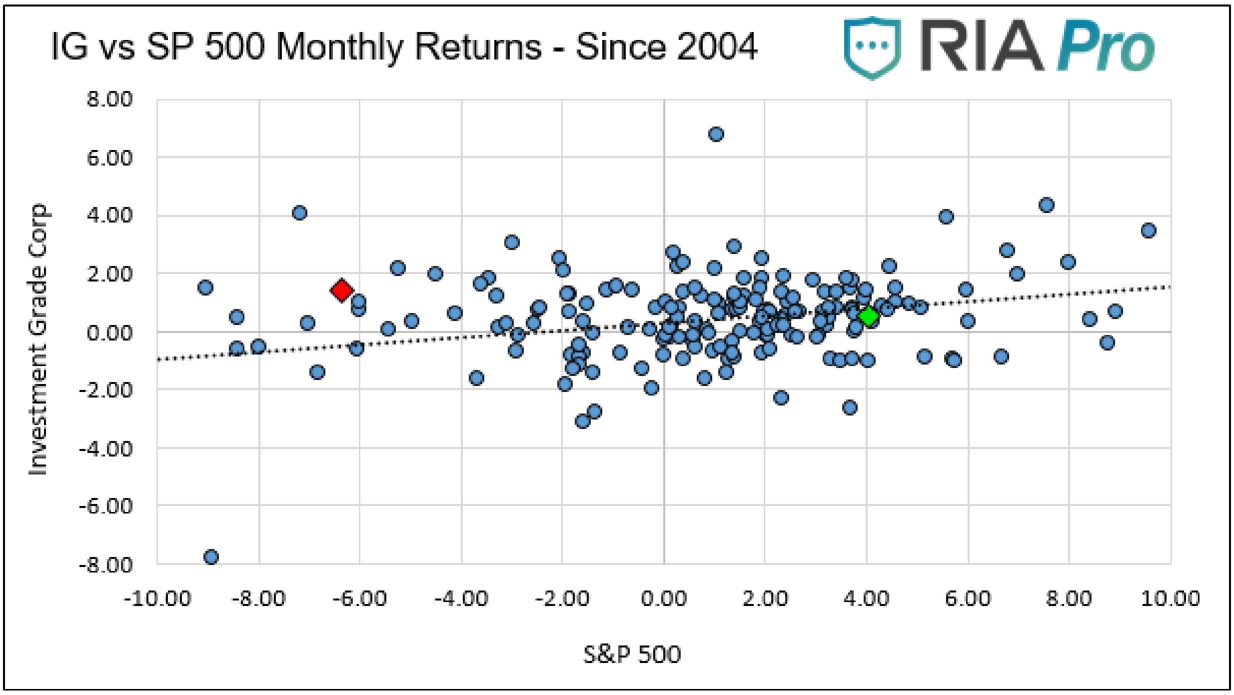


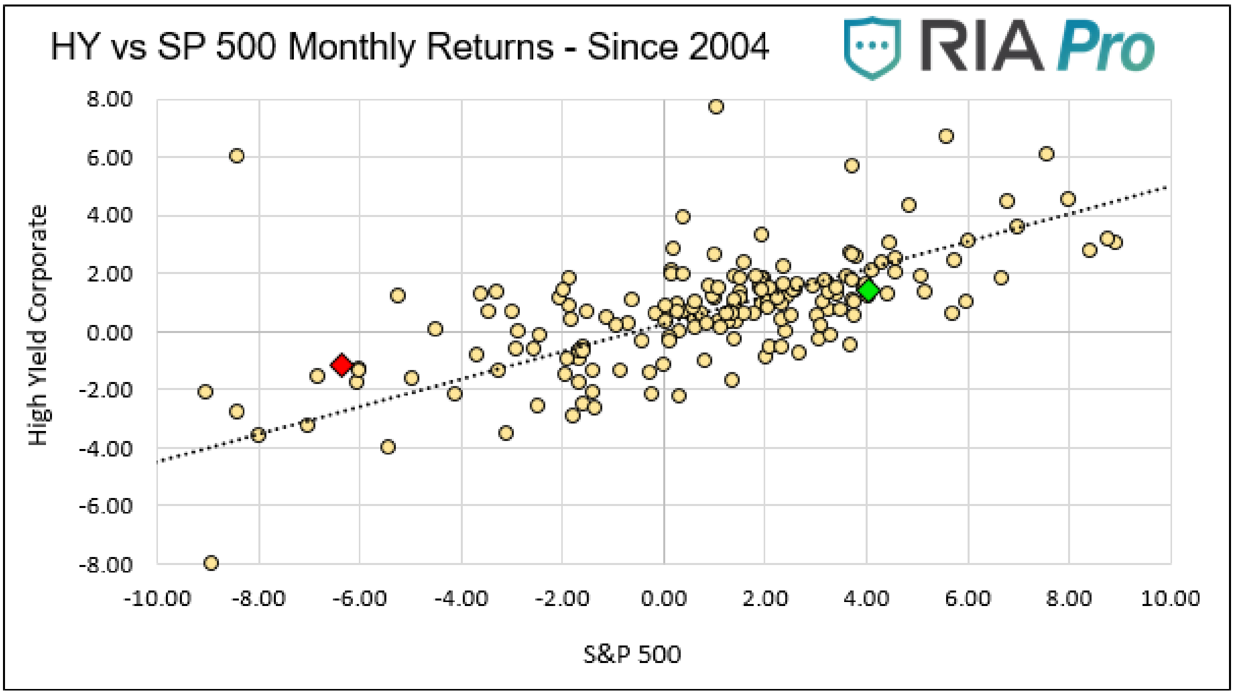
To reference the lead quote above, we maintain that spread tightening has most likely run its full course for this cycle and performance will largely be driven by carry. That said, we offer caution as the risk of spread widening across all credit sectors is high, and May might be offering clues about what may yet come.

The first four months of the year highlighted excellent risk-on opportunities. However, with Treasury yields now falling dramatically, they seem to signal bigger problems for the global and domestic economy than had previously been considered. The Treasury sector handily outperformed all others in May and higher risk categories (Junk and EM) were the worst performers. This is a reversal from what we have seen thus far in 2019.

Summer winds are blowing in trouble from the obvious U.S.-China trade dispute but also from Italy, Brexit, Iran, and Deutsche Bank woes.

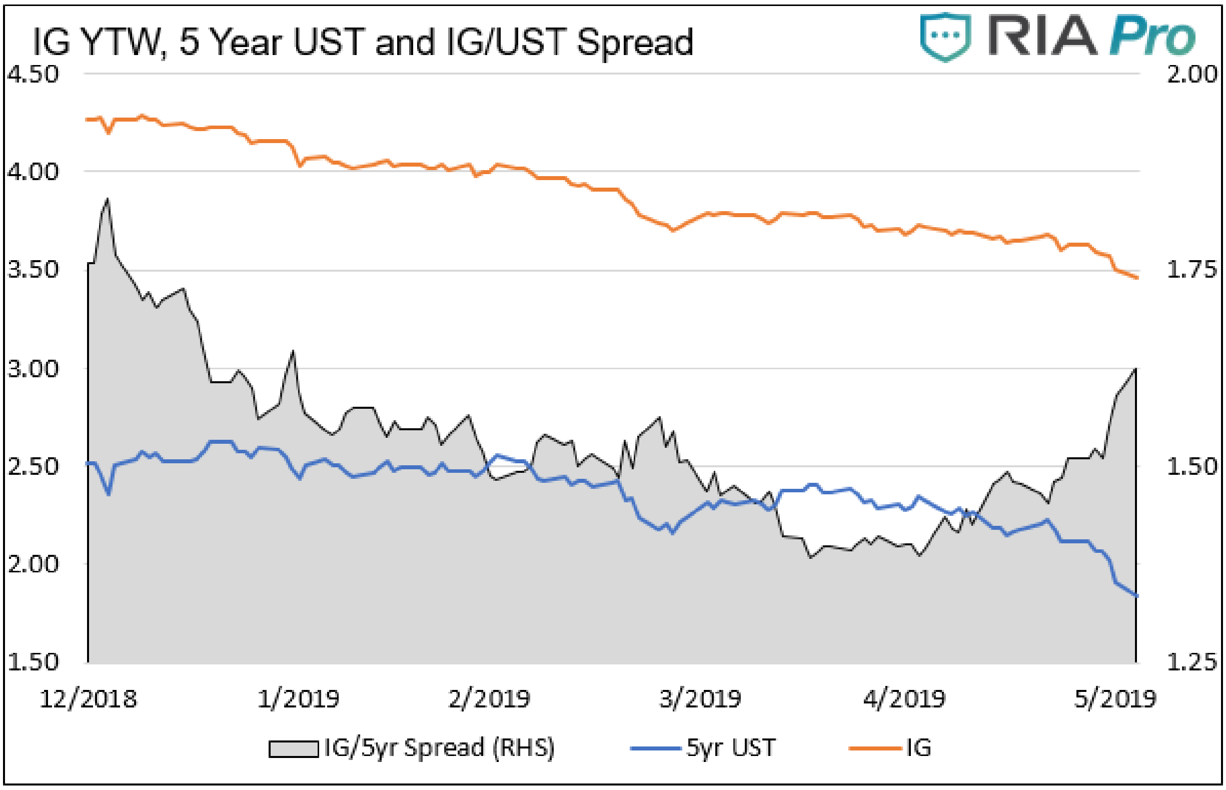
To highlight the relationship between the historical and recent month-over-month moves in the S&P 500 returns and those of investment grade and high yield bonds, the scatter chart below offers some compelling insight. The green marker on each graph is the month of April, and the red marker is May.

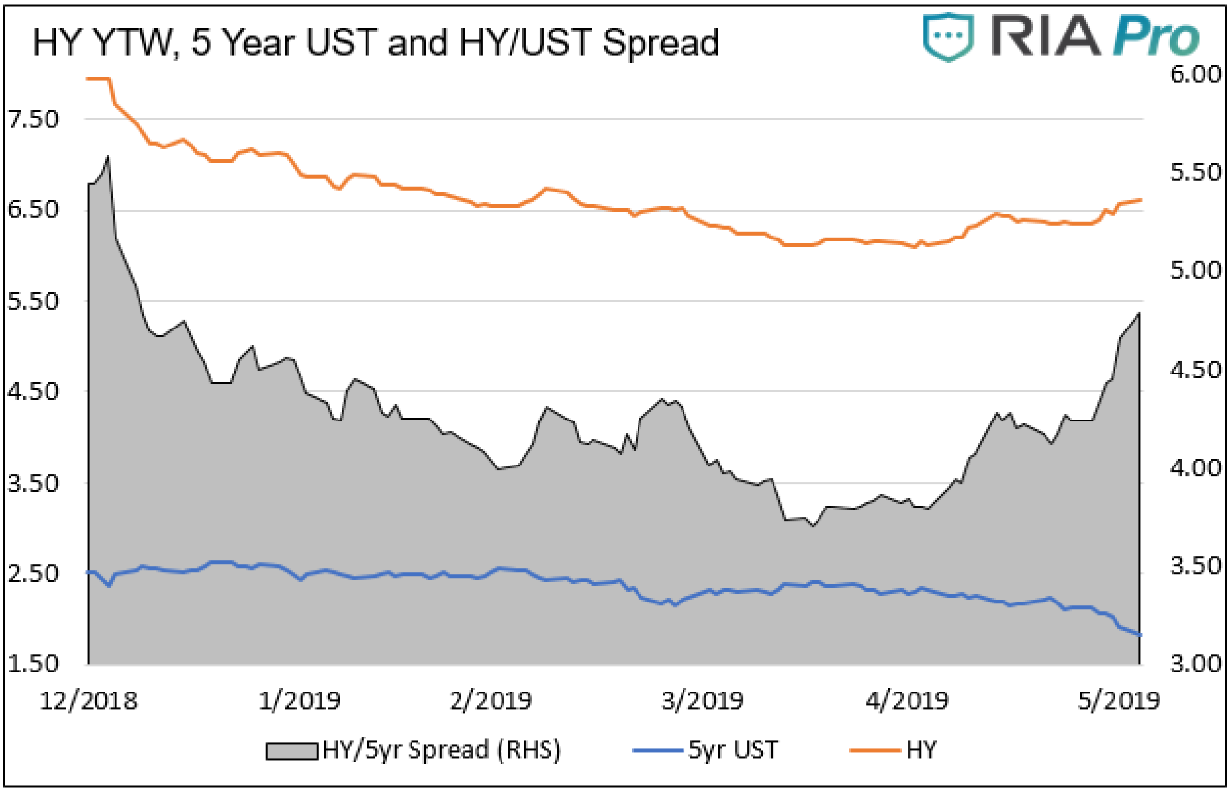




Investment grade bonds have less sensitivity to equity market moves (trendline slope 0.124) and, as we should expect, high yield bonds have return characteristics that closer mimics that of the stock market (trendline slope 0.474). The scales on the two graphs are identical to further stress the differences in return sensitivity.

Finally, when looking at the spread between 5-year Treasuries and investment-grade bonds (similar duration securities) versus the spread between 5-year Treasuries and high-yield bonds, the spread widening since the end of April has been telling.





The investment grade spread to Treasuries widened by .019% (19 bps) and .82% (82 bps) against junk. Netting the risk-free interest rate move in Treasuries for May reveals that the pure excess return for the investment grade sector was -1.39% and for high yield it was -2.49%.

The month of May offered a lot of new information for investors. Most of it is highly cautionary.

All Data Courtesy Bloomberg and Barclays