CLS's WEEKLY 3

What You Need To Know About the Markets

MAY 15, 2018

1. A diversified portfolio should have some fixed income positions.
2. Now is not the time to worry about rising rates.
3. The many benefits of muni bonds.

Market Performance

Equities	LAST WEEK	QTD	YTD '18
Total U.S. Market[1]	+2.48	+3.60	+2.94
Domestic Large-Cap Equity[2]	+2.49	+3.51	+2.72
Domestic Small-Cap Equity[3]	+2.65	+5.15	+5.06
International Equity[4]	+1.88	+2.55	+1.33
Developed International Equity[5]	+1.60	+3.38	+1.80
Emerging Market Equity[6]	+2.52	-0.38	+1.03
Fixed Income	**LAST WEEK**	**QTD**	**YTD '18**
U.S. Investment Grade Bonds[7]	-0.01	-0.83	-2.28
Cash Equivalent[8]	+0.03	+0.19	+0.52
Commodities	**LAST WEEK**	**QTD**	**YTD '18**
Commodity[9]	+0.09	+3.15	+2.74

[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]MSCI Emerging Markets Index [7]Bloomberg Barclays Capital U.S. Aggregate Bond Index [8]Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index[9]Bloomberg Commodity Index

As of 5/11/2018

Week in Review

So much for sell in May and go away! Stocks rallied sharply last week, both in the U.S. and overseas.

The Russell 3000 Index and the S&P 500 Index were both up nearly 2.48% and 2.49% respectively. Small-caps did even better, up 2.65%. Overseas, the MSCI EFA Index was up 1.60%. Emerging market stocks did even better, up 2.52%.

In bonds, despite supply coming, the Bloomberg Barclays U.S. AGG bond index was essentially flat on the week. The 10-year U.S. Treasury moved higher by two basis points to yield 2.97%.

Money Continues to Pour Into Fixed Income ETFs

Although Warren Buffett reiterated that he is not a fan of fixed income investments (specifically, government securities) at the recent Berkshire Hathaway shareholders meeting, money continues to flow into fixed income ETFs. As our team has frequently attested, fixed income is an important asset class and belongs in diversified, balanced portfolios. Owning Apple or Bitcoin alone is not a strategy I would advise — no matter the returns!

According to data from the Investment Company Institute, year over year as of the end of March, 2018, assets into bond funds increased by approximately 20%. Bond ETFs have been around for more than 15 years, but only in the past few years have they seen growth in assets. Today, there are more than 300 bond ETFs, quadruple the amount available in 2008.

Fixed income ETFs are more liquid than underlying bonds. Most are liquid to trade and typically easier to trade, too. Bonds trade less frequently than equities, and their true price is harder to gauge.

With rates rising, many investors are looking for ways to control their interest rate risk exposure. Bond ETFs offer a more efficient way to control interest rate and credit risk exposures. One example, MINT, is an active ETF (a CLS theme) with the objective of providing maximum income consistent with the preservation of capital. Several holdings are floating-rate securities that adjust based on changes in short-term interest rates.

Bond ETFs allow investors to achieve fixed income exposure at a low cost. As demand has increased, liquidity and bid-ask spreads also continue to improve. Lastly, bond ETFs do a better job at price discovery than underlying bonds and adjust quicker to market conditions than less frequently traded underlying securities.

Marc Pfeffer

Managing Director, Institutional Fixed Income

Marc Pfeffer specializes in fixed income strategies. He is a Portfolio Manager on the CLS Flexible Income Fund team and manages the CLS Active Income X Strategy and CLS's ETF strategies. He also manages individual municipal bond portfolios for the CLS Master Manager Strategy and is a senior member of the CLS Investment Committee.

Mr. Pfeffer joined CLS in 2011, continuing as Senior Portfolio Manager for the Milestone Treasury Obligations Fund. The Fund was incorporated into CLS's fund family in January 2012. Mr. Pfeffer has more than 30 years of investment management experience, including time spent as the Chief Investment Officer at Milestone. He also worked previously at Goldman Sachs and Bear Stearns.

Mr. Pfeffer graduated from the State University of New York with a Bachelor of Science degree, and from Fordham University with a Master of Business Administration degree. He holds his FINRA Series 7, 63, and 65 licenses.

Did you know? Marc is also an avid poker player.

Interest rates continue to be a major topic of conversation as market pundits endlessly debate the arrival of the long-awaited bear market in bonds. When will the Federal Reserve (Fed) hike next? How high will the 10-year yield go? Where can investors hide from the carnage? It appears to be a foregone conclusion that a) rates are rising, and b) that is a bad thing.

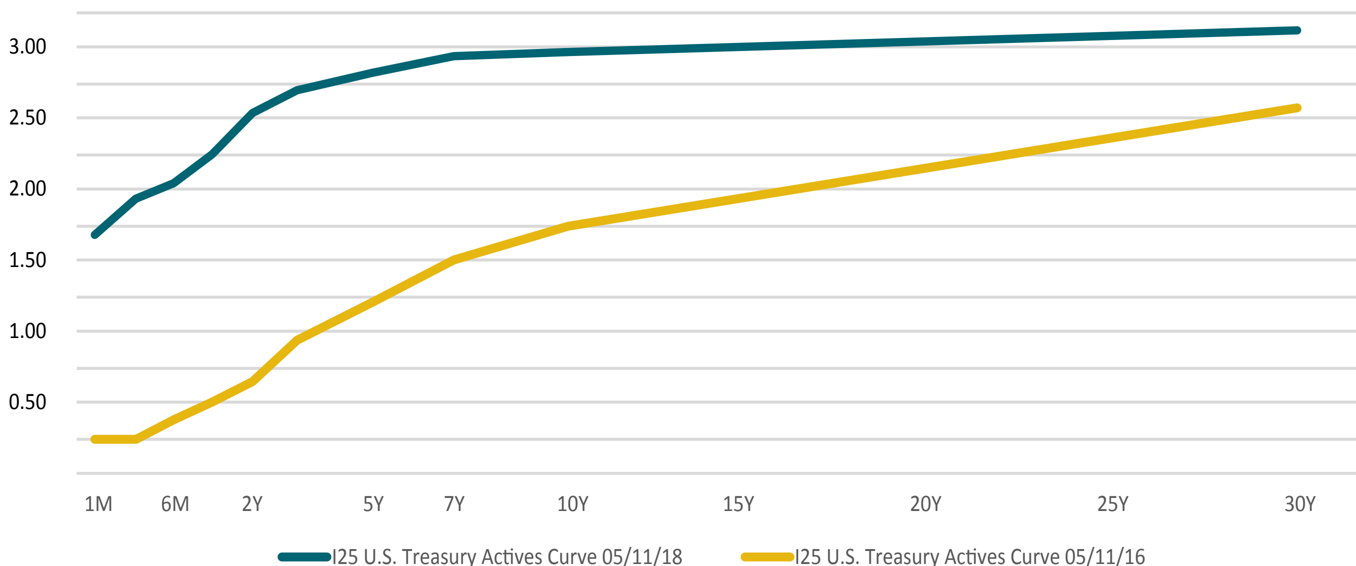
This conversation misses the point entirely. While it is true that both short- and long-term rates have been increasing, they're up from historically low levels. The Fed applied an unprecedented level of monetary policy accommodation during the 2008 financial crisis. Years later, the economy is in dramatically better condition and continues to grow at a steady pace. Today's rising rates reflect normalization. This is a positive. Maintaining crisis-era policy implies we are still in a crisis, or we fear one on the horizon. Since neither seems to be the case, I give you three reasons not to fear rising rates.

1. Higher Yields are Not Guaranteed

There are strong fundamental reasons behind the rising level of rates over the last two years. The Fed has hiked six times, lifting the short end of the curve, while the long end has increased on the back of rising growth and inflation expectations. Additionally, the reduction of the Fed's balance sheet and increased Treasury supply from widening budget deficits have applied upward pressure along the curve.

The upward tick in rates already experienced has been sharp, and it is very possible these factors have already been priced into the market or may even be overdone. Recent economic data seems to have moderated, while sentiment in the bond market remains very bearish. Historically, negative sentiment has been a contrarian indicator, often signaling strong performance moving forward. Short positioning within Treasury bond futures, for example, has hit the highest level on record. When there is no one left to turn bearish on bonds, their price tends to rise.

U.S. Treasury Actives Curve



Source: Bloomberg Finance L.P.

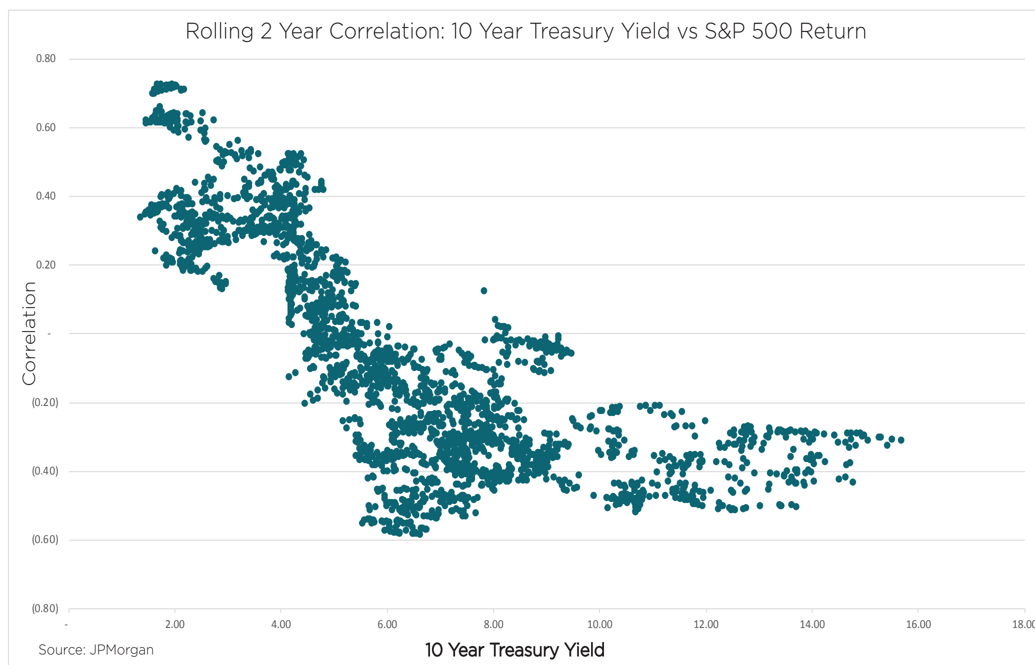
2. If They Do Climb Higher, It's Not a Big Deal

A balanced investor who fears losing money in bonds risks missing the forest for the trees. It is true that a high-quality bond is dominated by interest rate risk. When rates rise, the bond will experience a decline in price — a reality on full display in today's environment. The Bloomberg Barclays Aggregate Bond Index has returned -2.19% in the first four months of this year. That makes 2018 the worst start to a year for the bond market since 1996. To put things into perspective, this year alone the stock market has lost that amount or more in a single day five times!

Investors must remember that a balanced portfolio's risk is dominated by stocks. Bonds are there to diversify that risk and dampen portfolio volatility. No investor likes to see red on his or her investor statement, and that may be doubly true coming from the bond allocation. Before investors run away from bonds, they should remember a) high-quality duration is among the best defenses against the larger risk lurking in portfolios, and b) the starting yield is one of the best predictors of a bond's future return. When yields rise, the long-term expected return does too.

3. Rising Yields are Not Necessarily Bad for Stocks or the Economy

Aside from the impact on their fixed income allocations, some investors fear what rising yields may mean for the stock market or the economy. Fears of this kind could have merit if interest rates reach a certain point, but we are quite far from those levels today. If the return potential for risk-free assets rises with rates to a meaningfully high level, the need to take risk to generate investment returns would diminish. This, in turn, would put downward pressure on risky assets, such as stocks. The chart below, recreated from JP Morgan's Guide to the Markets, provides an illustration of how interest rate changes relate to stock prices.



According to the analysis, when the 10-year yield is below 4.5-5%, yield moves and stock returns are positively correlated. So, when interest rates are rising, stocks tend to have positive returns. As interest rates move above that level, the relationship changes and becomes negative. At that point, rising yields are typically accompanied by falling stock prices. With the 10-year yield currently below 3%, there is a long way to go before interest rates become a headwind. Further increases from here (especially on the long end) are much more likely to be a function of improving economic growth, a positive for stocks, rather than a warning sign for the economy.

The Case for Municipal Bonds

Although the new tax code has reduced marginal tax rates, municipal bonds remain a viable and relatively attractive investment for many high net worth investors. Of special note are those investors who live in high-tax states, such as New York, Massachusetts, and California, and will be looking to maximize deductions and minimize taxable income.

Muni bonds are not taxed at the federal level, and depending on the state you live in, many are issued with exemptions from state and local taxes, too. So, investors get to keep more of their income. Additionally, muni bonds have historically been safer investments than debt issued by corporations. While there are exceptions, of course, default rates are much lower for municipal bonds when compared to corporate bonds with similar credit ratings.

Many municipalities can raise taxes or cut services in order to make payments. Furthermore, municipal bonds have followed Treasury rates upward in 2018. For example, although 10-year Treasuries have reached their highest level in several years, the municipal ratio has remained attractive with yields approximately 82% of Treasuries.

As rates continue to rise as a result of a stronger domestic economy, revenues from municipal issuers will also rise, making them a stronger credit. I believe they will continue to be a good source of income for investors going forward. I write from experience as I manage several individual, customized municipal portfolios as part of CLS's Master Manager Strategy. Additionally, they have been held for several years in other CLS strategies.

If you are interested in learning more about fixed-income options, please reach out. Thanks for reading.

The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The S&P 500 Index is an unmanaged index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 2000 Index is an index comprised of the 2,000 smallest companies on the Russell 3000 Index and offers investors a benchmark for small-cap stocks. The MSCI ACWI ex U.S. Index (MSCI All-Countries World Index, excluding U.S.) is an index considered representative of stock markets of developed and emerging markets, excluding those of the U.S. The MSCI EAFE Index is an index which tracks performance of international equity securities in developed countries in Europe, Australia, Asia, and the Far East, excluding the U.S. and Canada. The MSCI Emerging Markets Index is an index which tracks performance of large and mid-cap firms across countries classified as emerging market countries. The Bloomberg Barclays Capital U.S. Aggregate Bond Index measures performance of the U.S. investment-grade bond market. The Bloomberg Barclays Capital 1-3 Month U.S. Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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