Economic & Market Overview

as of September 30, 2018

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The U.S. economy continued to remain strong during the most recent quarter. The early estimate from the Atlanta Federal Reserve Bank showed a 4.1 percent GDP growth rate for third quarter. Fiscal spending was a factor for the strong growth. In addition, an uptick in consumer spending also helped. The positive feedback of the economy continued to work. Strong consumer spending is sustained by a healthy labor market and a steady rise in earnings. However, one of the negative side effects of the current labor market is a growing inability for employers to hire qualified employees. Certain pundits believe this will eventually lead to a spike in wages and, ultimately, inflation.

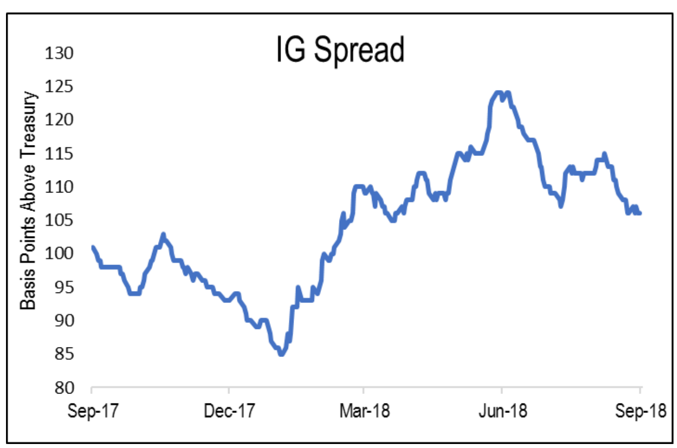
The Fed has maintained an optimistic viewpoint on the economy. With respect to its price stability mandate, they have a tough task at hand. To keep inflation in check, the Fed understands this requires raising interest rates and with that, the possibility of a higher unemployment rate. The result might be a slowdown in the economy but just enough to see a reciprocal decline in inflation. Ideally, this will happen without setting off a recession.

At Washington Capital, we believe our domestic economy is strong enough to withstand the Fed's rate hikes. The bigger question is whether the emerging economies can sustain their growth in the face of a global drain on dollar liquidity. Recent emerging economy currency volatility is a telltale sign on what can happen in the global economy during such a period.

Investment Grade Credit

For the quarter and nine months ended September 30, 2018, investment grade credit returned 0.97 percent and a negative 2.33 percent, respectively, as measured by the Bloomberg Barclays U.S. Corporate Total Return Index. Spreads on investment grade corporate credit continued their march tighter during the quarter, not surprising, given positive investor reaction to the latest round of corporate earnings. Assisting with the general good mood in the market, a lack of new supply is creating a technical bias tighter. As the quarter closed, the spread on the Bloomberg Barclays US Aggregate corporate bond index was +106 basis points, fully retracing all the widening of this index since April and flirting with another trip below 100 basis points and well below its post-crisis average of 174 basis points. Front and center for most of this year has been events around trade and tariffs. We are watching carefully for signs that uncertainty around trade will harm the U.S. economy, but so far, investors and most corporate management teams are showing few ill effects from this risk factor.

No shortage of pundits in our space have described the current era as a "Goldilocks" moment in time. Described as a period of strong economic growth, low employment and low inflation, it is certainly worth noting that periods such as these are rare and rarely last. Low unemployment typically leads to faster wage growth, which typically leads to a more confident consumer, which typically leads to higher inflation. The Fed wants to remove the accommodative policy stance without harming the U.S. economy. How well the Fed navigates through this moment in time will play a big part in which direction spreads turn. It isn't impossible to imagine a scenario where the Fed plays it right, and the current low spread environment sticks around for a while.



Bloomberg Barclays US Corporate Total Return Index (LUACTRUU)

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High Yield Credit

For the quarter and nine months ended September 30, 2018, the high yield market returned 2.30 percent and 1.80 percent, respectively, as measured by the Bloomberg Barclays BB to B Index. We believe the high yield market's strong performance is attributable to several factors present throughout 2018. To begin with, the strong economic backdrop and good corporate earnings have given investors confidence in the ability of lower rated companies to perform on their obligations. This is also reflected in the low and declining default rate this year which was 3.4 percent at the end of the second quarter versus 4.0 percent at the end of the first. In addition, new corporate debt continues to be issued at a slow pace, pushing up pricing for already-issued debt. Finally, still low interest rates encourage investors to both move out the yield curve and down in credit quality to obtain better yields.

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