Executive summary

Bond funds posted an average gain of 1.24% for the third quarter of 2019. This built on the positive results from Q1 and Q2 and increased the group’s average year-to-date return to 7.11%. The General U.S. Treasury Funds classification had the highest quarterly return among the fixed income peer groups at 4.42%, as 46 of the 51 peer groups posted increases for the quarter. This Treasury fund group was able to benefit from the inverse relationship between bond yields and prices (when yields go down, prices go up) as Treasury yields fell across the spectrum of maturities for the fourth consecutive quarter.

For the third straight quarter, all of Lipper’s fixed income macro-groups posted increases. What was different this quarter is that the World Income Funds group recorded the worst result among the macro groups in Q3 (+0.14%) after having the best in Q2 (+3.40%). A contributing factor to this reversal in fortune is tied to the strength of the U.S. dollar—after decreasing in value (as measured by the Trade Weighted U.S. Dollar Index) in Q2, the U.S. dollar strengthened in Q3, which is a negative for ex-U.S. debt. The poorest performing peer group for Q3 (Alternative Currency Strategies Funds, -1.17%) belongs to the World Income Funds macro-group. Investment Grade Corporate Bond Funds (+1.66%) was the best performing macro group for the quarter, followed by Municipal Debt Funds (+1.46%), Government/Treasury Funds (+1.29%), and General Domestic Taxable Fixed Income Funds (+1.08%).

Following through on its forecast that interest rate cuts were a possibility, the Federal Reserve reduced the Federal Funds rate not once, but twice, in the third quarter. The Fed enacted a 25-basis-point (bps) decrease after both its July and September meetings. Market reaction was somewhat muted to each of these moves, possibly because each cut was telegraphed well in advance (and was therefore already factored in), as well as that Federal Reserve Chairman Jerome Powell indicated after both cuts that they needed to be viewed separately and were not part of a larger interest-rate reduction plan. After trimming 25 bps at the July meeting, Powell stated that the reduction could be a one-off and that Fed officials viewed this action as a “mid-cycle adjustment” and were not committing to additional decreases because they don’t see the economic weakness that would warrant that type of action. Following September’s cut, Powell again talked down any speculation about future action, as he indicated that the Fed did not have any preset course of action for rates and any future rate decreases would be “highly data dependent.” It bears watching if the weak economic data released at the start of Q4 (slowdowns in both manufacturing activity and job creation) is the start of the impetus that the Fed needs to take further action before the end of the year.
FIGURE 1
LIPPER FIXED INCOME MACRO GROUP RETURNS, THIRD QUARTER 2019

Source: Lipper from Refinitiv
Government/Treasury funds summary
Treasury yields declined at all maturities as illustrated in the accompanying table. Treasury spreads also continued to narrow with the two-year/10-year Treasury spread temporarily inverting. The two-year/10-year Treasuries closed inverted for three consecutive trading days (August 27-29) before righting themselves and closing the quarter with a narrow margin of plus 5 bps. The inversion of this spread is important (even if it is only temporary) because it has been a reliable predictor of recessions in the past. The recession typically occurs within one to two years of inversion. The last time the spread inverted was June 2007, and the global financial crisis followed shortly thereafter. For the quarter, the 10-year yield fell 32 basis points while the two-year retreated 12 bps. Longer-term maturities are impacted more by economic expectations, while short-term maturities are more influenced by Fed policy. Therefore, while the yield on the Fed’s two-year note was driven lower by the Fed’s actions this quarter, the 10-year has been hurt by the slowdown in the U.S. economy brought on by the U.S.-China trade war.

The government/Treasury funds macro-group gained 1.29% in Q3, down from its positive performance of 2.26% in Q2. The group is up 6.01% for the year to date. All of the peer groups recorded gains for the quarter led by General U.S. Treasury Funds (+4.42%), which had the highest return among all of the fixed income peer groups. For the remainder of the macro-group, the longer-term maturity peer groups outperformed the short-term maturity ones as General U.S. Government Funds, Intermediate U.S. Government Funds, and Inflation Protected Bond Funds appreciated 2.19%, 1.46%, and 0.80%, respectively, while Short-Intermediate U.S. Government Funds (0.69%), Short U.S. Treasury Funds (0.48%), and Short U.S. Government Funds (0.46%) all trailed those results.

Source: U.S. Department of the Treasury
Investment-grade corporate bond funds summary
The Investment-Grade Corporate Bond Funds group posted an average gain of 1.66% for Q3 and is up 7.30% for the year to date. Like the government/Treasury funds group, the best returns were posted by the longer-term maturity peer groups. The two highest quarterly returns were turned in by peer groups that do not place limits on a fund’s average effective maturity, as Corporate Debt Funds A-Rated Funds and Corporate Debt Funds BBB-Rated were up 2.99% and 2.78%, respectively, for the quarter. Following this pattern, we see that Core Bond Funds, Core Plus Bond Funds, Short-Intermediate Investment Grade Debt Funds, Short Investment Grade Debt Funds, and Ultra-Short Obligations Funds finished the time-period with increases of 2.08%, 1.95%, 0.80%, 0.72%, and 0.65%. Core Bond Funds and Core Plus Bond Funds are intermediate-term peer groups with an average effective maturity range of five to 10 years.

General domestic taxable bond funds summary
This macro-group was up 1.08% for the quarter and has appreciated 7.77% for the year to date. Ten of the group’s 11 peer groups recorded positive results in Q3 led by Flexible Income Funds (+2.34%) and General Bond Funds (+1.91%). Specialty Fixed Income Funds (-0.75%) was the one peer group in the red for the quarter and is down 0.26% for the year to date. Funds in this peer group will typically have more esoteric investment strategies than would be seen in other fixed income classifications including the use of short positions and leverage.

World income funds summary
As mentioned earlier, the U.S. dollar strengthened in Q3. The Trade Weighted U.S. Dollar Index was up 2.23% in Q3 after falling 1.21% in the prior quarter. A stronger dollar is a negative for ex-U.S. debt—this is evidenced by the macro-group’s third quarter performance, as it lagged the other groups with an overall increase of just 0.14%. Four of the six peer groups were under water for the quarter. To put this in perspective, only one other fixed income peer group over the entire universe recorded negative results for Q3. The worst performances for World Income Funds belonged to Alternative Currency Strategies Funds and Emerging Markets Local Currency Debt Funds, which each lost approximately 1.17%. The performances of the Global Income Funds (+1.02%) and Global High Yield Funds (+0.84%) groups enabled the macro-group to post the slight quarterly gain that it did. For the year to date, World Income Funds are up 8.10%.

Municipal debt funds summary
Municipal debt funds appreciated 1.46% for Q3 and have recorded a 6.12% increase for the first three quarters of 2019. The single-state muni peer groups slightly outperformed the national muni groups 1.52% to 1.39%. The largest individual returns belonged to High Yield Municipal Debt Funds (+2.08%) and California Municipal Debt Funds (+1.90%).