

Economic Insight: Expectations of an insurance cut

Second-Quarter 2019 Recap

Vishal Khanduja, CFA

Calvert Fixed Income
Portfolio Manager

Brian Ellis, CFA

Calvert Fixed Income
Portfolio Manager

Risk assets delivered another strong performance in the second quarter. The S&P 500® was volatile in May but still rose 4.30% for the full three months, capping its best first-half performance in 22 years. Led by investment-grade indexes, domestic bond markets also generated healthy gains. And the positive returns were not confined to the United States: international debt and equity markets climbed higher as well.

From our perspective, the main story of the quarter was the downdraft in rates. Global bond yields moved substantially lower, driven by renewed U.S.-China trade tensions, weaker U.S. and global economic data, and dovish central banks. In the U.S., yields declined across the Treasury curve, with the 10-year trading below 2% for the first time since 2016. Two-year rates fell more than 10-year rates, resulting in a modest curve steepening. Overseas, Japanese sovereign debt yields sank deeper into negative territory, and rates fell to record lows across much of Europe — which, in several countries, meant they also became more negative. The global value of negative-yielding bonds topped \$13 trillion in June, an all-time high according to Bloomberg.

The quarter began with optimism that the U.S. and China were close to reaching a trade agreement. However, negotiations broke down in early May and a series of retaliatory actions soon followed. The U.S. increased tariffs on \$200 billion of Chinese imports and threatened new tariffs on another \$300 billion. The U.S. also added Huawei, China's largest telecom company, to its list of entities considered to be security risks, effectively banning American companies from selling to Huawei without government approval. China responded by raising tariffs on \$60 billion of U.S. goods and readying its own "unreliable entities" list. Trade tensions festered until late June, when the two countries called a tentative truce ahead of the G20 summit.

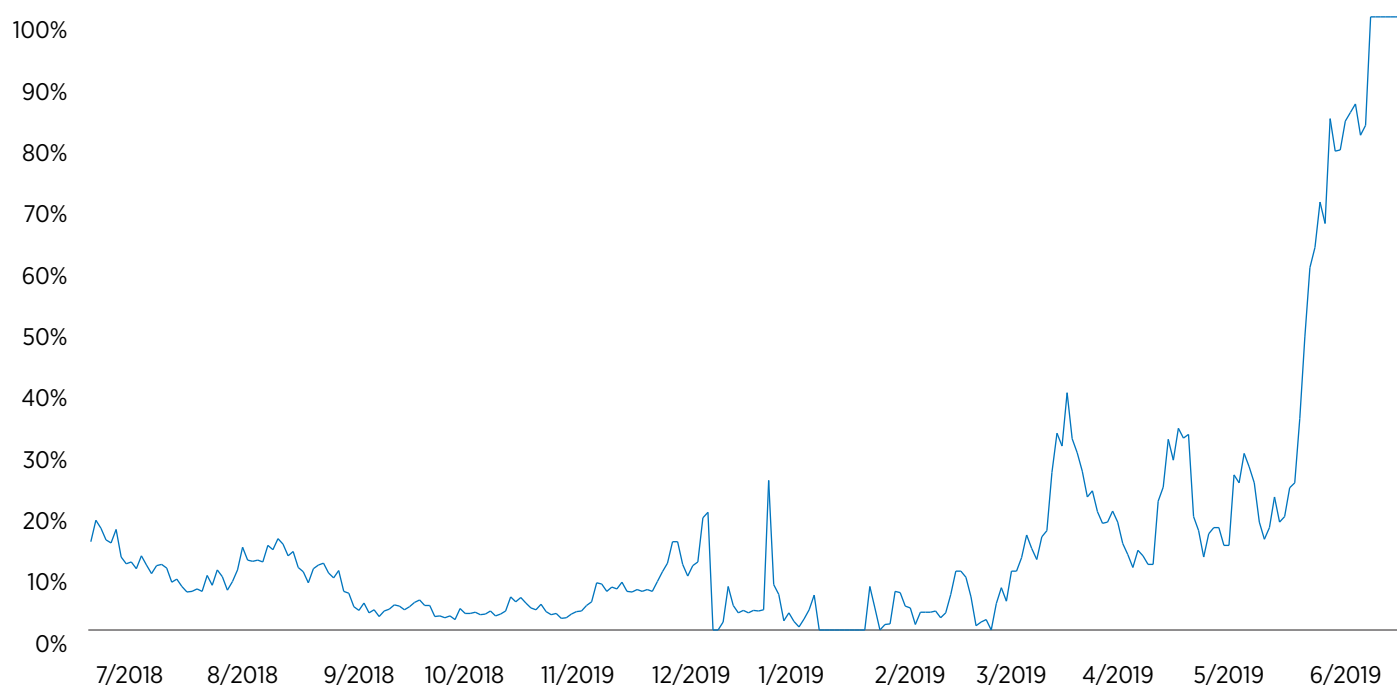
The U.S. economy, which expanded at a 3.1% annual rate in the first quarter, showed signs of slowing in the second quarter. Growth in non-farm payrolls decelerated, with the six-month average falling from 234,000 in January to 172,000 in June. Consumer confidence declined, durable goods orders softened and the Institute for Supply Management's purchasing managers index, a key gauge of manufacturing activity, fell to its lowest level since 2016. Signs of weaker growth were also evident overseas, including the steepest quarterly drop in eurozone manufacturing in six years and the largest monthly decline in Chinese imports in almost three years. On the domestic inflation front, price pressures remained muted, with both annual headline and core Consumer Price Index (CPI) hovering around 2%.

As trade tensions escalated and economic data weakened, markets began to anticipate an "insurance cut" from the Federal Reserve (Fed) — i.e., a cut in the fed funds rate aimed at pre-empting a more pronounced U.S. slowdown. Although the Federal Open Market Committee (FOMC) held policy steady throughout the quarter, it signaled a willingness to cut rates to extend the expansion. Similar to the Fed, the European Central Bank (ECB) did not take any new action but communicated a more dovish stance, suggesting it might cut rates and potentially restart bond purchases. Central banks in several countries, including Australia and India, lowered rates in an effort to bolster their economies.

In this environment, the Bloomberg Barclays U.S. Aggregate Bond Index and the Bloomberg Barclays U.S. Corporate Investment Grade Index returned 3.08% and 4.48%, respectively, for the quarter. Returns were largely driven by falling Treasury yields, as credit spreads finished the quarter close to where they had started. Worries about increased leverage and weakening fundamentals at this point in the credit cycle were headwinds; however, robust investor inflows supported spreads. Foreign demand was particularly strong given the yield advantage of U.S. bonds and because lower LIBOR rates have made currency hedging less expensive. Returns were also positive in the high-yield markets, albeit more subdued. The ICE BofAML U.S. High Yield returned 2.57%, and the S&P/LSTA Leveraged Loan Index advanced 1.68%.

Exhibit A

Probability of a July Rate Cut



Source: Bloomberg

Outlook

On July 1, the U.S. expansion that began in mid-2009 became the longest on record, surpassing the previous record expansion that occurred from March 1991 to March 2001. Leading up to this historic milestone, the U.S. economy posted several quarters of very healthy growth, boosted by fiscal stimulus. But now the effects of fiscal stimulus are fading and, after three years of Fed tightening and over a year of trade uncertainty, economic data has become more mixed.

Signs the U.S. economy may be losing some of its positive momentum —combined with ongoing trade uncertainty, weaker global growth and dovish Fed rhetoric — have led many market participants to anticipate a new easing cycle. At quarter-end, markets were pricing in four rate cuts by April 2020, with the first happening at the FOMC's July 30-31 meeting. We agree that the Fed's next move will likely be an easing. However, we think what markets are expecting in terms of the timing and magnitude of future cuts is too aggressive.

In our opinion, economic indicators point to continued U.S. growth in the coming quarters — the data doesn't seem to warrant a near-term rate cut. Unemployment is low, consumer spending remains solid and consumer confidence, despite falling recently, is still high. That said, if the data weakens materially from here, we believe the Fed would be hard-pressed to overcome market expectations and do nothing. One potential positive for the U.S. economy would be a trade deal with China. However, it remains to be seen if and when any such agreement will be reached given the tenor of the negotiations up to this point.

In addition to thinking that markets are expecting too much from the Fed, we think they may be overestimating the efficacy of Fed policy in the current environment. Inflation certainly has room to move higher, but unemployment is at its lowest level in about 50 years. It's also difficult for policy to move asset prices higher with U.S. stocks hitting record highs and corporate credit spreads at very tight levels. So even if the economy takes a turn for the worse and the Fed gives markets what they want, it's our view that rate cuts will not be as economically stimulative as they have been in the past.

Expectations for easy monetary policy should provide near-term technical support for bond valuations. However, we don't believe it's prudent to be investing in risk assets over the next six to 12 months thinking that the Fed can halt an eventual economic downturn. We think inflation assets continue to look attractive because of where we are in the cycle and because of the possible inflationary effects of trade tariffs and any Fed easing. Consequently, we favor Treasury Inflation-Protected Security (TIPS).

Low unemployment should continue and wage growth has improved. For that reason, we view asset-backed securities tied to consumers as providing attractive spreads and potential stability for portfolios.

Important Additional Information and Disclosures

Source of all data: Eaton Vance Management, as at June 30, 2019, unless otherwise specified.

This material is presented for informational and illustrative purposes only. This material should not be construed as investment advice, a recommendation to purchase or sell specific securities, or to adopt any particular investment strategy; it has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and Eaton Vance has not sought to independently verify information taken from public and third-party sources. Investment views, opinions, and/or analysis expressed constitute judgments as of the date of this material and are subject to change at any time without notice. Different views may be expressed based on different investment styles, objectives, opinions or philosophies. This material may contain statements that are not historical facts, referred to as forward-looking statements. Future results may differ significantly from those stated in forward-looking statements, depending on factors such as changes in securities or financial markets or general economic conditions.

This material is for the benefit of persons whom Eaton Vance reasonably believes it is permitted to communicate to and should not be forwarded to any other person without the consent of Eaton Vance. It is not addressed to any other person and may not be used by them for any purpose whatsoever. It expresses no views as to the suitability of the investments described herein to the individual circumstances of any recipient or otherwise. It is the responsibility of every person reading this document to satisfy himself as to the full observance of the laws of any relevant country, including obtaining any governmental or other consent which may be required or observing any other formality which needs to be observed in that country. Unless otherwise stated, returns and market values contained herein are presented in US Dollars.

In the United Kingdom, this material is issued by Eaton Vance Management (International) Limited ("EVM"), 125 Old Broad Street, London, EC2N 1AR, UK, and is authorised and regulated by the Financial Conduct Authority. EVM markets the services of the following strategic affiliates: Parametric Portfolio Associates® LLC ("PPA"), an investment advisor registered with the SEC. Hexavest Inc. ("Hexavest") is an investment advisor based in Montreal, Canada and registered with the SEC in the United States, and has a strategic partnership with Eaton Vance, and Calvert Research and Management ("CRM") is an investment advisor registered with the SEC. This material is issued by EVM and is for Professional Clients/Accredited Investors only.

This material does not constitute an offer to sell or the solicitation of an offer to buy any services referred to expressly or impliedly in the material in the People's Republic of China (excluding Hong Kong, Macau and Taiwan, the "PRC") to any person to whom it is unlawful to make the offer or solicitation in the PRC.

The material may not be provided, sold, distributed or delivered, or provided or sold or distributed or delivered to any person for forwarding or resale or redelivery, in any such case directly or indirectly, in the People's Republic of China (the PRC, excluding Hong Kong, Macau and Taiwan) in contravention of any applicable laws.

Eaton Vance Asia Pacific Ltd. is a company incorporated in the Cayman Islands with its Japan branch registered as a financial instruments business operator

in Japan (Registration Number: Director General of the Kanto Local Finance Bureau (Kinsho) No. 3068) and conducting the Investment Advisory and Agency Business as defined in Article 28(3) of the Financial Instruments and Exchange Act (as amended) ("FIEA"). Eaton Vance Asia Pacific Ltd. is acting as an intermediary to promote asset management capabilities of Eaton Vance Management (International) Limited and other Eaton Vance group affiliates to registered financial instruments business operators conducting the Investment Management Business, as defined in the FIEA.

In Singapore, Eaton Vance Management International (Asia) Pte. Ltd. ("EVMIA") holds a Capital Markets Licence under the Securities and Futures Act of Singapore ("SFA") to conduct, among others, fund management, is an exempt Financial Adviser pursuant to the Financial Adviser Act Section 23(1)(d) and is regulated by the Monetary Authority of Singapore ("MAS"). Eaton Vance Management, Eaton Vance Management (International) Limited and Parametric Portfolio Associates® LLC holds an exemption under Paragraph 9, 3rd Schedule to the SFA in Singapore to conduct fund management activities under an arrangement with EVMIA and subject to certain conditions. None of the other Eaton Vance group entities or affiliates holds any licences, approvals or authorisations in Singapore to conduct any regulated or licensable activities and nothing in this material shall constitute or be construed as these entities or affiliates holding themselves out to be licensed, approved, authorised or regulated in Singapore, or offering or marketing their services or products.

In Australia, EVM is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of the provision of financial services to wholesale clients as defined in the Corporations Act 2001 (Cth) and as per the ASIC Corporations (Repeal and Transitional) Instrument 2016/396.

EVM is registered as a Discretionary Investment Manager in South Korea pursuant to Article 18 of Financial Investment Services and Capital Markets Act of South Korea.

EVM utilises a third-party organisation in the Middle East, Wise Capital (Middle East) Limited ("Wise Capital"), to promote the investment capabilities of Eaton Vance to institutional investors. For these services, Wise Capital is paid a fee based upon the assets that Eaton Vance provides investment advice to following these introductions.

In Germany, Eaton Vance Management (International) Limited, Deutschland ("EVMID") is a branch office of EVM. EVMID has been approved as a branch of EVM by BaFin.

Mutual Funds are distributed by Eaton Vance Distributors, Inc. ("EVD"). Two International Place, Boston, MA 02110, (800) 225-6265. Member FINRA/ SIPC.

Eaton Vance Investment Counsel. Two International Place, Boston, MA 02110. Eaton Vance Investment Counsel is a wholly-owned subsidiary of EVC and is registered with the SEC as an investment adviser under the Advisers Act.

Investing entails risks and there can be no assurance that Eaton Vance, or its affiliates, will achieve profits or avoid incurring losses. It is not possible to invest directly in an index. Past performance is not a reliable indicator of future results.

About Risk

Bank Loans – There can be no assurance that the liquidation of collateral securing an investment will satisfy the issuer’s obligation in the event of non-payment or that collateral can be readily liquidated. The ability to realize the benefits of any collateral may be delayed or limited.

Credit – Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer’s ability to make principal and interest payments.

Foreign – Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, or other conditions. In emerging countries, these risks may be more significant.

Gov’t Agency – While certain U.S. Government-sponsored agencies may be chartered or sponsored by acts of Congress, their securities are neither issued nor guaranteed by the U.S. Treasury.

Income Market – An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about Municipal issuers.

Inflation-Linked – Interest payments on inflation-linked securities may vary widely and will fluctuate as principal and interest are adjusted for inflation. Investments in inflation-linked securities may lose value in the event that the actual rate of inflation is different than the rate of the inflation index.

Interest Rate – As interest rates rise, the value of certain income investments is likely to decline.

Lower-Rated – Investments rated below Investment Grade (typically referred to as “junk”) are generally subject to greater price volatility and illiquidity than higher rated investments.

Standard & Poor’s 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance,

Bloomberg Barclays U.S. Aggregate Index is an unmanaged index of domestic investment-grade bonds, including corporate, government and mortgage-backed securities.

Bloomberg Barclays U.S. Corporate Investment Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Barclays U.S. Aggregate Index.

ICE BofAML U.S. High Yield Index is an unmanaged index of belowinvestment grade U.S. corporate bonds.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market. S&P Dow Jones Indices are a product of S&P Dow Jones Indices LLC (“S&P DJI”) and have been licensed for use. S&P® and S&P 500® are registered trademarks of S&P DJI; Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC (“Dow Jones”); S&P DJI, Dow Jones and their respective affiliates do not sponsor, endorse, sell or promote the Fund, will not have any liability with respect thereto and do not have any liability for any errors, omissions, or interruptions of the S&P Dow Jones Indices. ICE® BofAML® indices are not for redistribution or other uses; provided “as is”, without warranties, and with no liability. Eaton Vance has prepared this report and ICE Data Indices, LLC does not endorse it, or guarantee, review, or endorse Eaton Vance’s products. BofAML® is a licensed registered trademark of Bank of America Corporation in the United States and other countries. It is not possible to invest directly in an index. Historical performance of an index illustrates market trends and does not represent the past or future performance of a fund. Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable.

About Eaton Vance

Eaton Vance provides advanced investment strategies and wealth management solutions to forward-thinking investors around the world. Through principal investment affiliates Eaton Vance Management, Parametric, Atlanta Capital, Hexavest and Calvert, the Company offers a diversity of investment approaches, encompassing bottom-up and top-down fundamental active management, responsible investing, systematic investing and customized implementation of client-specified portfolio exposures. Exemplary service, timely innovation and attractive returns across market cycles have been hallmarks of Eaton Vance since 1924. For more information, visit eatonvance.com.

