IR+M

INCOME RESEARCH + MANAGEMENT

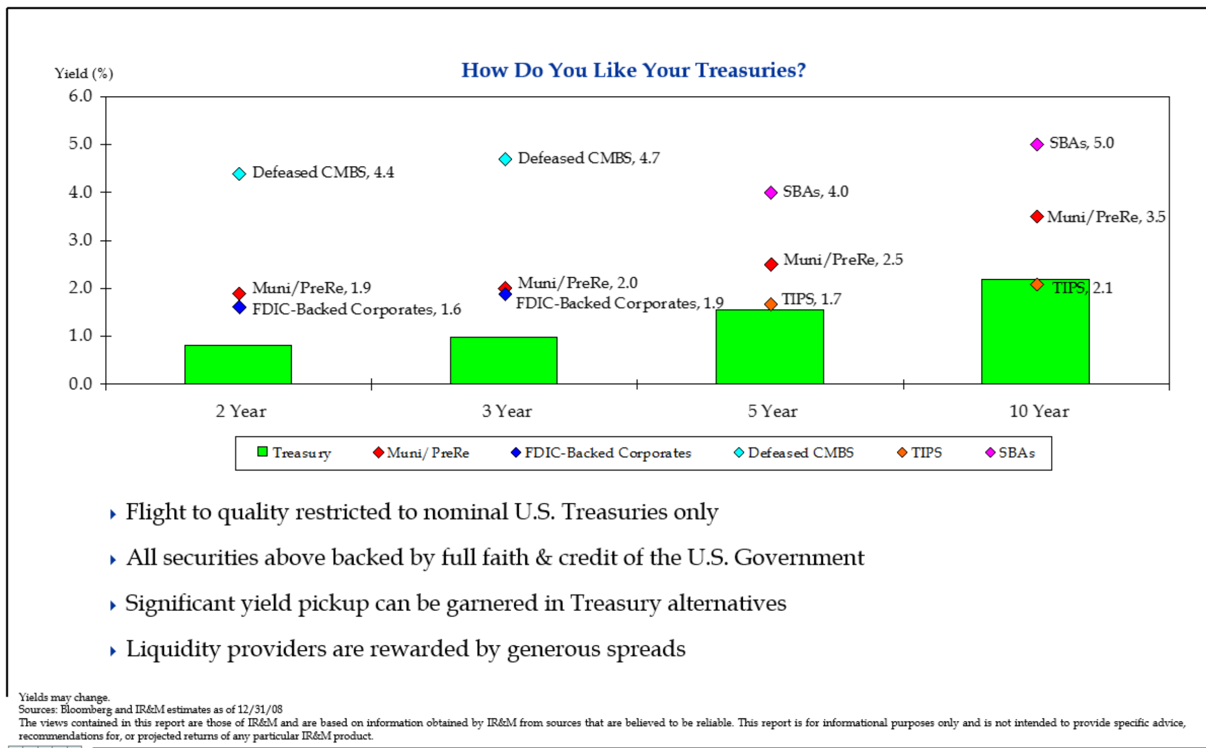
September 13, 2018

Ten years ago, the financial markets were in disarray. After some spread widening in 1998, 2000, and 2002, volatility was quite subdued from 2003 into 2007. There was little compensation for risk, but as we all know now, in actuality, risk was pervasive. Lower mortgage rates allowed consumers to assume larger loans. Liquidity was rampant, and home prices and housing starts were skyrocketing. The good times were poised to last forever – until they didn't.

Remarkably, the market withstood an onslaught of bad news. The hits were seemingly successive – structured investment vehicles (SIVs), Bear Stearns, collateralized debt obligations (CDOs), subprime mortgages, bankruptcies, and fraud. Many investors chose to ignore the warning signs that the party might be ending. In September 2008, the sobering announcement of Lehman's bankruptcy filing shook the market to its core. The market finally paid for the excesses that had fueled its rallies.

The ensuing fallout was immediate and unsettling. However, for those investors who maintained their composure and adhered to their investment processes, there were bargains to be had. Governments' elevated involvement in the financial system allowed some investors to capitalize on attractive opportunities.

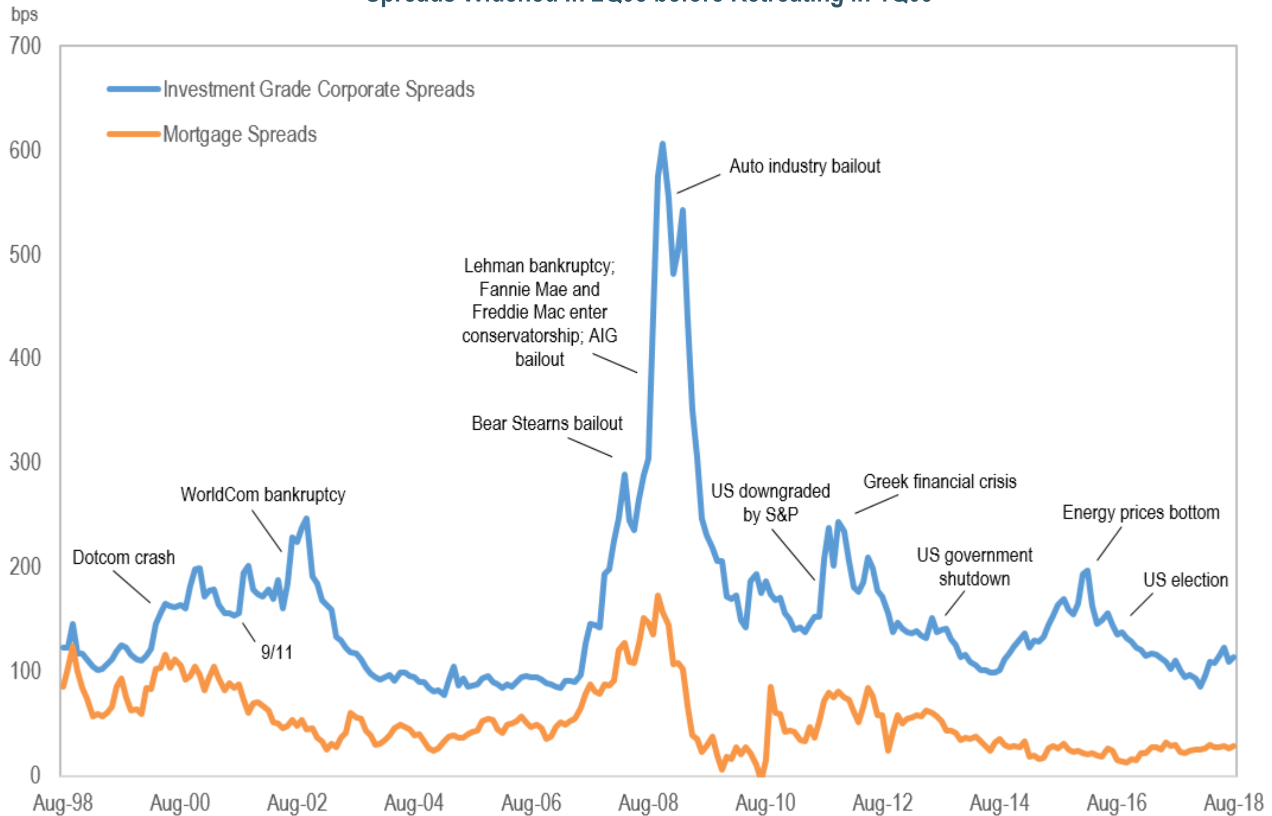
The chart below, which we used in client books in late 2008, was a particular favorite.



Income Research & Management

Through the chaos, we worked closely with our clients and invested in high quality, attractively-priced bonds. As we mark the 10-year anniversary of Lehman's collapse, we take pause and evaluate the current risks in the system. While regulations like Dodd-Frank, the Consumer Protection Act, and the Basel III Accord helped decrease various risks in the system, are there red flags that we should be acknowledging?

Spreads Widened in 2Q08 before Retreating in 1Q09[1]



The current US economic outlook is healthy, but there may be cautionary signs ahead. While we don't foresee a 2008-type spread widening, we believe that, based on current economic and geopolitical risks, we shouldn't be completely risk-on. A 20-year look back at investment-grade and mortgage spreads suggests that a measured approach is advisable. We believe that it's time to lean on our years of experience, security selection skills, and conviction that a well-balanced portfolio, with prudent risk and liquidity, is the recipe for late 2018.

Bill O'Malley
Managing Principal, Director of Investment Team, Senior Portfolio Manager

[1]Bloomberg Barclays as of 8/31/18. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission from Income Research & Management.