Fixed Income Insights

July 1, 2019

Dear Fellow Investor,

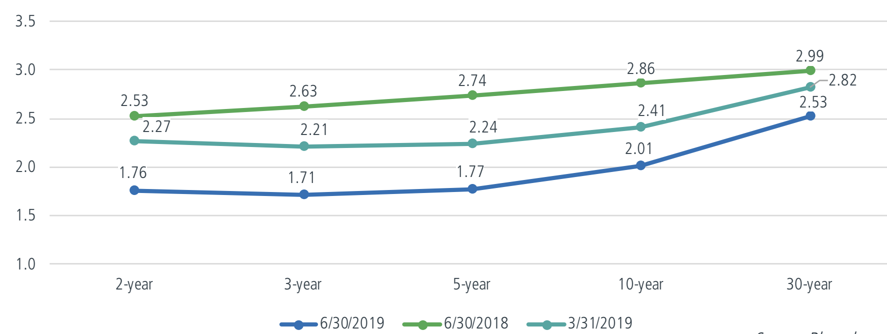
"Markets can do anything," said Richard Russell, the founder of the Dow Theory Letters. This phrase when coupled with central bank largesse seems fitting given what transpired in the first half of 2019. The S&P 500 is off to its best start since 1997 despite escalating trade tensions (some would say "mayhem") and its potential to stunt economic growth, raise inflationary pressures and potentially redraw global supply chains. The Federal Reserve went from hawk (higher short-term interest rates) to dove (lower rates) in less than six months, largely in response to the various trade brawls the U.S. is waging. This dovish pivot may lead to a July rate cut by the Fed, its first since 2008. The prospects of lower short-term interest rates prompted a stampede into U.S. Treasury bonds during the quarter and led to meaningful price gains for investors as yields collapsed across the yield curve (see chart below for magnitude/scope). And like youth sports where everyone receives a ribbon, credit investors were also big winners. Spreads declined as they shook off the negative economic implications of a potential trade war, leading to further gains for fixed income investors.

Weitz equity and balanced funds delivered particularly strong results in the first half of 2019. Please see Wally and Brad's **Value Matters Letter** and the equity and balanced funds' Quarterly Commentaries for detailed analysis.

Despite defensive credit and interest rate positioning, Weitz fixed income funds also delivered good results in the year's second quarter as well as solid investment performance year to date. Further detail about contributors to performance can be found in the fixed income funds' Quarterly Commentaries.

The graph below shows the changes of select Treasury rates over the past quarter and year.

U.S. Treasury Yields (%)

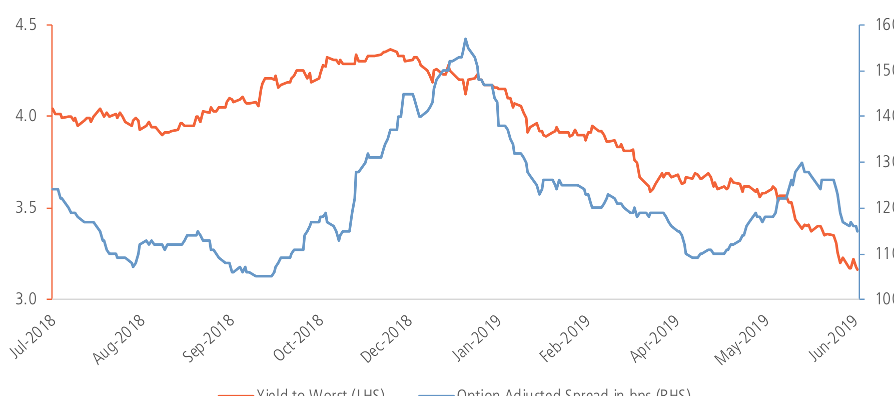


Source: Bloomberg

As mentioned, corporate bonds and other credit-sensitive securities had strong quarterly performance and outperformed Treasury bonds as credit spreads narrowed, particularly for non-investment-grade or high-yield bonds. A broad measure of investment-grade[1] corporate bond spreads, compiled by ICE BofAML, decreased to 122 basis points as of June 30, down 5 basis points in the quarter. Spreads are marginally lower (8 basis points) than they were a year ago.

The chart below highlights the twelve-month progression of yields (to worst[1]) and spreads (option adjusted[1]) for the corporate bond component of the Bloomberg Barclays U.S. Aggregate Index. While spreads have vacillated in the past year, the all-in funding costs for borrowers (i.e., corporations) has trended down by nearly one percent. Funding costs to borrowers as of June 30 are only about 30-35 basis points higher than the turn of the century low of 2.85% set in July 2016. What's good for borrowers isn't necessarily always good for bond investors.

Bloomberg Barclays US Corporate Bond Index



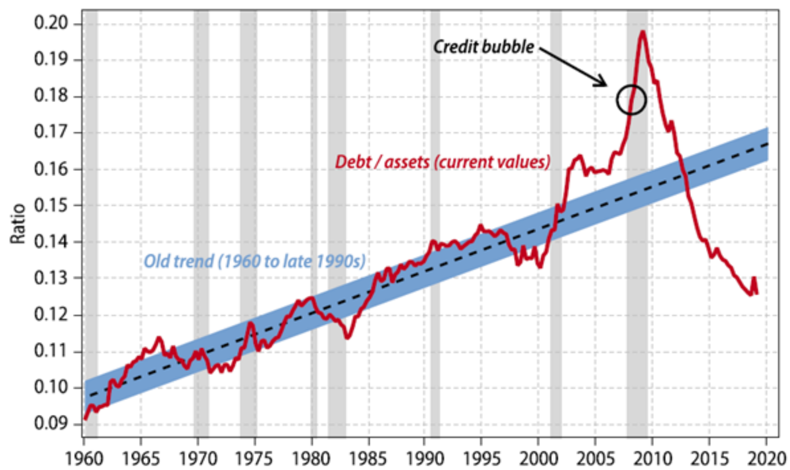
Source: Bloomberg

The Fed–Why cut (short-term interest rates) now?

The Federal Reserve's Federal Open Market Committee (FOMC) has, by statute, a dual mandate–to foster maximum employment and price stability (targeting 2% inflation). With the unemployment rate at nearly five-decade lows (3.7% as of the June employment report) and an economic expansion that is now the longest in U.S. history–and which has helped U.S. households significantly reduce leverage since the Great Recession (see chart below)–this leg of the Fed's dual mandate does not appear to warrant a rate cut.

US household leverage is back to 1980s levels

Leverage=debt / assets (non-debt short term liabilities subtracted from assets)



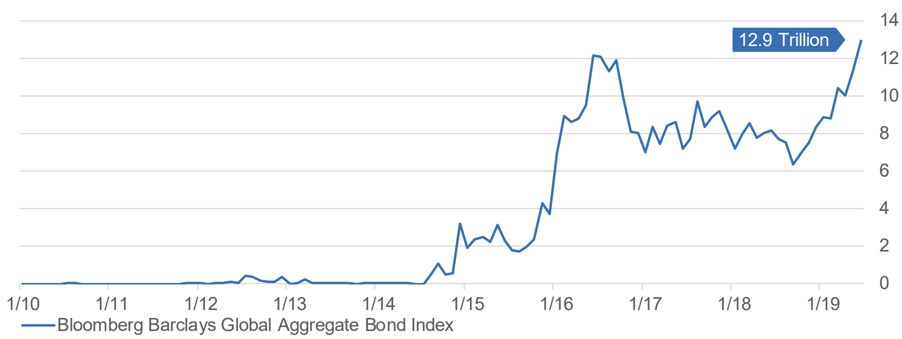
Gavekal Data/Macrobond

The Fed appears to be addressing its other mandate (price stability) along with additional variables (like trade concerns). For the past ten years, inflation as measured by the Fed's preferred statistic of the Personal Consumption Expenditure Index (PCE) has failed to consistently hit, if at all, the Fed's 2% goal. Those familiar with President Ford's "Whip Inflation Now" buttons from 1974 (pictured below) might wonder if the Fed wants to reintroduce the buttons with a new tagline–"*Want* Inflation *Now*." With today's low absolute levels of interest rates, bond investors should take note (we are) since inflation is the boogeyman for fixed income investors, as it erodes the purchasing power of future income returns and principal returned at maturity.

"Flabbergasted"–Charlie Munger

One of the quotes of the decade came from Berkshire Hathaway's Vice Chairman Charlie Munger when asked in 2015 about interest rates, specifically negative ones. Since then, the size of negative yielding debt in the world has increased nearly fivefold, hitting all-time highs in the second quarter (chart below). Now nearly a quarter of the Bloomberg Barclays $54 Trillion Global Aggregate Bond Index, a measure of global investment grade debt from twenty-four local currency markets, trades at yields less than zero. Charlie Munger arguably said it best–"Anybody who is intelligent who is not confused doesn't understand the situation very well. If you find it puzzling, your brain is working correctly."

Bloomberg Barclays Global Aggregate Bond Index–Negative Yielding Debt



As of 6/30/2019 Source: Bloomberg

"To ignore the macro is naïve, but to predict it is arrogant."–Author unknown

Our fixed income investment philosophy is straightforward. We believe the key to winning is not losing. Permanent losses of capital are a bane to long-term compounding—and *especially* so in fixed income investing. We avoid making bold or specific predictions about the direction and pace at which interest rates or credit spreads might move in the future. We certainly do not ignore the macro but understand the pitfalls of trying to guess market moves. Caution has arguably always been our calling card in managing fixed income assets on behalf of clients—we want to be properly compensated for any risks we assume. We are index agnostic and prefer to select assets one at a time. We concentrate in the ideas that we believe best offer attractive risk-adjusted returns, taking into consideration the general level of interest rates and the credit quality of each investment.

This year has certainly started off strong for equity and fixed income investors. Please see all the fund commentaries on our website for additional information regarding second quarter 2019 portfolio activity and current positioning. It seems plausible (if not, likely) that the first half's robust returns have been partly borrowed from the future. Stock returns are a function of long-term earnings growth and multiple expansion or contraction, and a significant portion of this year's returns have come from multiple expansion. And long-term interest rates are a function of long-term economic growth and future inflation expectations. The Fed appears intent on manufacturing higher inflation, and (unless economic growth is destined to decline meaningfully) current levels of interest rates and credit spreads appear to offer little value.

We intend to stick to our knitting and welcome any volatility that may ensue, particularly when it results in a disconnect between price and value. We look forward to taking advantage of any valuation disparities that will invariably develop (as the one constant in markets is change) and hope to continue to earn your trust.

Sincerely,

Tom Carney
tom@weitzinvestments.com

Nolan Anderson
nolan@weitzinvestments.com

[1]**Definitions: Investment Grade:** We consider investment grade to be those securities rated at least BBB- by one or more credit ratings agencies. **Yield-to-worst (YTW):** The lowest potential yield (most conservative yield) that can be received on a bond without the issuer actually defaulting. YTW is calculated by using worst-case scenario provisions, including prepayments, calls and sinking funds. Furthermore, YTW is a forward-looking estimate that ignores capital gains. **Option Adjusted Spread:** A "spread" compares the interest rate on a particular bond against a "base line" bond (typically a U.S. Treasury bond). When a bond issuer (or bondholder) has the option to exercise a right (for example, if the issuer can call a bond before its stated maturity date), then the "Option Adjusted Spread" takes into account the possibility that this option might be exercised—so a bond's Option Adjusted Spread may be more (or less) than its regular spread.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. The Funds' Prospectus contains this and other information about the Funds and should be read carefully before investing. The Prospectus is available from Weitz Investment Management, Inc. Weitz Securities, Inc. is the distributor of the Weitz Funds.