McDonnell Investment Management

Fixed Income Market Commentary ✧ August 2017

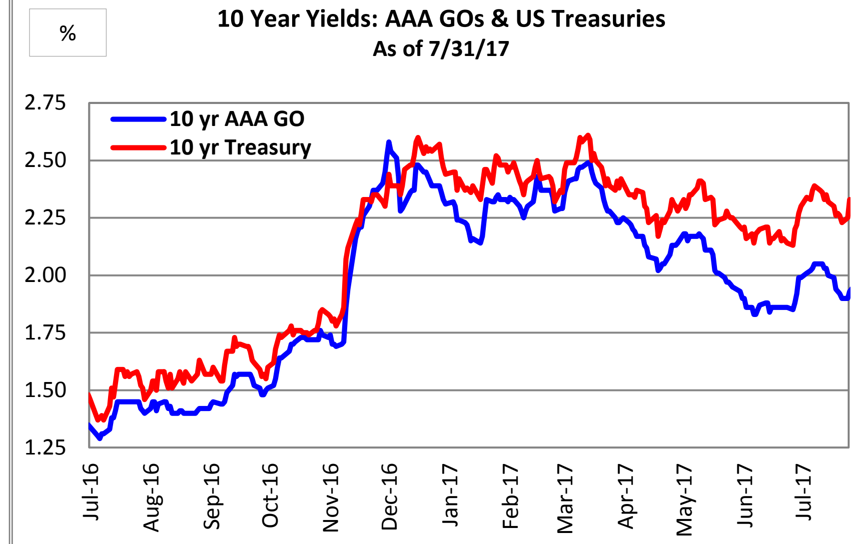
Market Overview

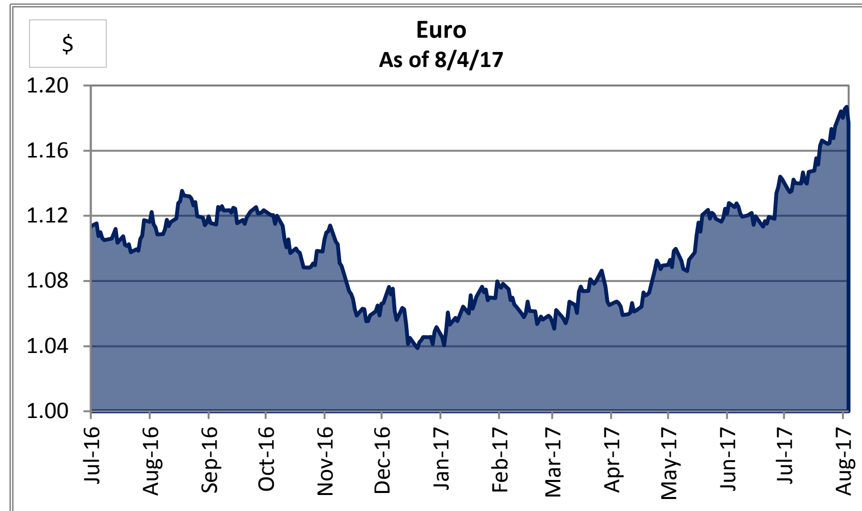
Jim Grabovac, CFA

Rate and risk markets were relatively quiet during the month of July and established trends remained intact. Rates ground mostly lower, credit spreads narrowed further, market volatility declined and domestic equity markets continued to notch new all-time highs. Economic fundamentals remain supportive of the sanguinary conditions being reflected in the capital markets. The advance estimate of Q2 GDP was measured at 2.6%, in line with consensus expectations, up from a 1.2% rate registered in the first quarter, and on pace to continue along a slow but respectable 2% annual growth rate that has been in place over the 8 plus years of economic recovery to date. And readings on the inflation front, while continuing to fall short of the Fed's 2% target, remain quite supportive of fixed-income markets as inflation remains elusive despite labor market conditions widely considered to be at or near full-employment. We expect the Federal Reserve will continue along the path toward monetary policy normalization with moves to begin reducing reinvestment of its expanded balance sheet as well as making additional policy adjustments in the target range for the Federal Funds Rate as the second half unfolds. We expect that persistent dollar weakness year-to-date, will be a factor that helps offset weak inflation concerns at the margin.

- Yields declined modestly across most the curve and yield curves steepened as investors reassessed the likely pace of future Fed action.
- Credit markets outperformed amid investor reach-for-yield as lower-quality categories generated the strongest relative returns.
- Municipals continued to generate strong outperformance versus Treasuries as steady demand chased diminished new issue supply.
- Municipal issuance has declined for 6 consecutive months versus last year's pace, as Refunding Issuance remains muted.
- The Dollar continued to weaken against most major currencies with losses most pronounced versus the Euro.

In contrast to the benign economic environment, the political backdrop that has evolved seems considerably less placid. Efforts to execute healthcare reform fell short of passage and prospects for congress to revisit the repeal and replacement of the Affordable Care Act seem more rhetorical rather than realistic. This development has potentially important implications for investors as it makes the road to substantive tax reform both more difficult and a much steeper climb. Congressional leaders had positioned healthcare reform to reduce the deficit over the 10-year window under the process known as reconciliation, but more importantly, to enable the elimination of $1T of taxes under the Affordable Care Act. Reducing taxes via healthcare reform, paradoxically, would have made it easier to reduce taxes under tax reform in a twist of legislative legerdemain that would have required the CBO to score the impact of tax reform against a revenue baseline that was $1T lower. This would have meant that tax reform could lower taxes by $1T and still meet the requirements of being 'revenue' neutral. In addition to the healthcare breakdown, congressional leaders have also abandoned efforts to include the 'border adjustment tax' as part of upcoming tax negotiations. These two items were estimated to add more than $2T to the tax reform calculus and without them prospects for large rate cuts seem fairly remote. The legislative roadmap had positioned healthcare reform as a critical first step necessary to facilitate tax reform as a second step. The failure of the health overhaul will necessitate an alternate path forward on taxes. Investors, particularly equity investors, will be focused on developments on the tax front, and specifically whether Congress can make good on its promise to reduce the corporate tax rate.





Sources: Bloomberg; Municipal Market Data.
Please refer to the Notes and Disclosures for additional information.

Guiding Portfolio Strategies
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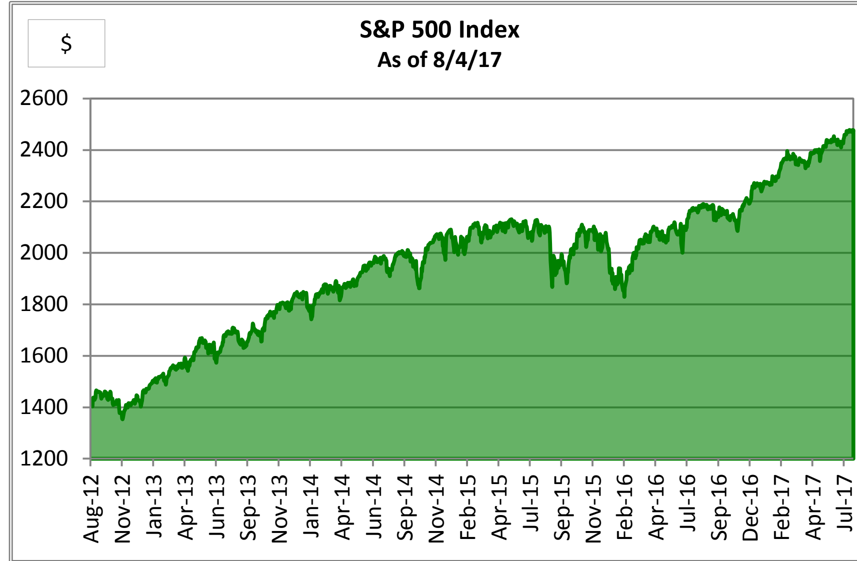
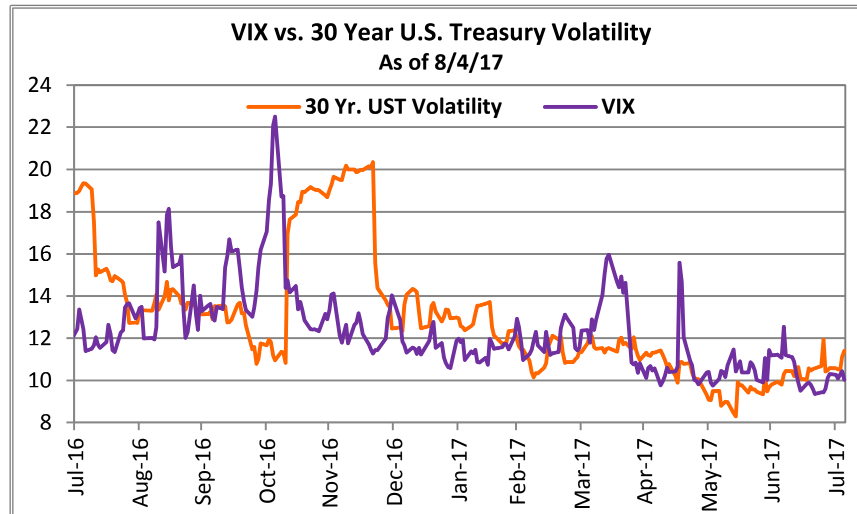
Meanwhile, congressional leaders face two more immediate, and decidedly more pressing legislative challenges when they return from their August recess. Namely, passing a budget, or at a minimum a continuing resolution to fund the government prior to September 29th. And boosting the debt ceiling, probably by late September or mid-October at the latest. Prospects for passing either with simple majority party votes seems unlikely at this stage. The same dynamic that ultimately scuttled the healthcare effort is expected to come into play as congress takes up both requirements. Of the two, raising the debt limit is the more market critical action. When congressional brinksmanship flirted with default in 2011, the US credit rating was downgraded for the first time in history. Tranquil markets could face a rude awakening if the effort to pass a clean debt limit increase, as favored by Treasury and congressional leadership, is met with intransigence. Market consensus 'assumes' that both measures will require a bipartisan majority to reach passage. Whether and when we get there, and how much histrionics investors will have to endure remains a critical issue over the near-term horizon.

Although August can often meet the textbook description of quiet markets marking time amid the summer doldrums, it can sometimes serve up a surprise. One of the traditional events that always garners market attention is the annual Economic Policy Symposium held in Jackson Hole Wyoming and sponsored by the Kansas City Federal Reserve Bank. The focus theme of this year's gathering will be 'Fostering a Dynamic Global Economy.' A program and list of speakers has not yet been published but market participants will be keen to see whether Fed Chair Yellen and ECB President Draghi deliver remarks and whether any potential clues to the continuing evolution of monetary policy are forthcoming. President Draghi set investors on edge in early July when he said the risk of deflation had receded. If he was indeed telegraphing an impending scale back of ECB bond buying efforts, he could well use the forum to clarify or further amplify the Bank's intentions. Finally, Dr. Yellen's term as Fed Chair expires in February. Whether this will be her final summit as Chair or whether she is asked to serve another term will be on the minds of central bank observers. The President has reportedly selected potential nominees for 2 of 3 openings on the Federal Reserve Board but has not made his intentions known regarding Chair Yellen. Investors would welcome her reappointment as the Fed remains an effective caretaker of the economic policymaking apparatus amid an otherwise discordant political environment.





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