McDonnell Investment Management

Fixed Income Market Commentary ✧ October 2017

Market Overview

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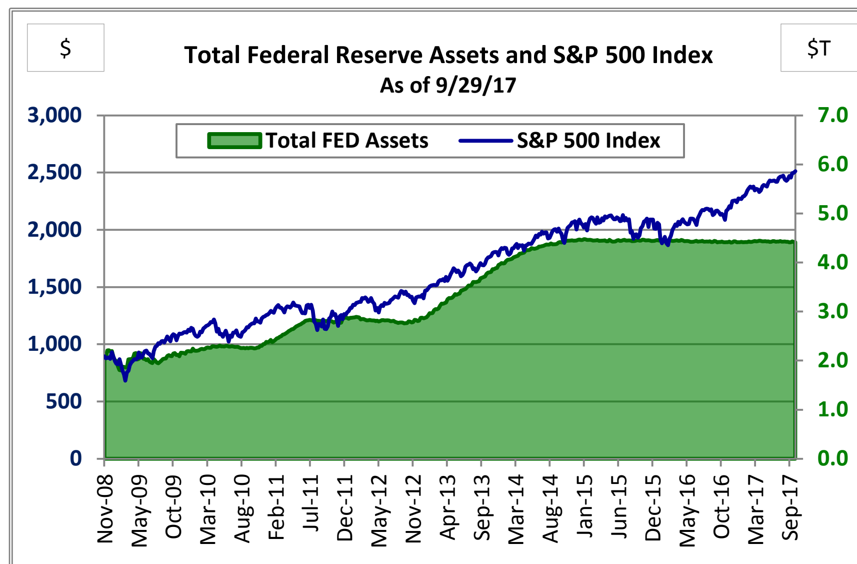
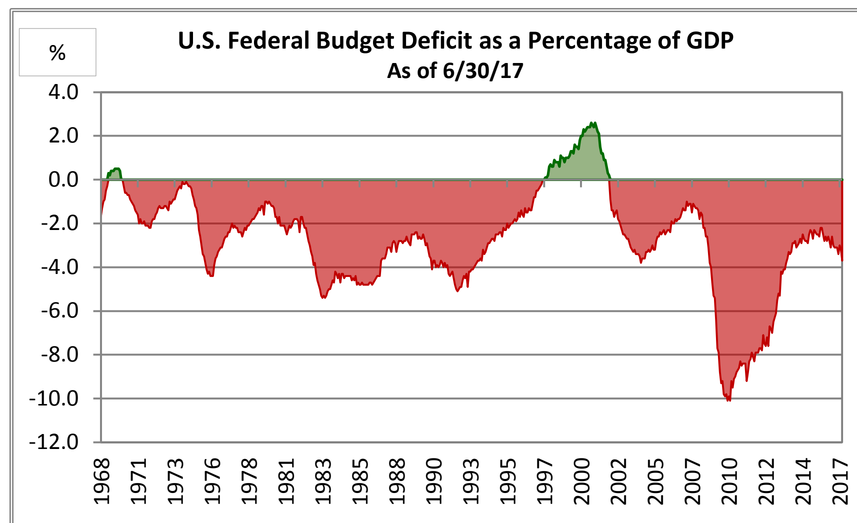
Rate markets remained becalmed during the third quarter amid a battering of hurricane activity which ripped across the Gulf Coast and Caribbean. Political uncertainty mounted in the wake of repeated failed efforts to repeal the Affordable Care Act, and the beginnings of engagement on the upcoming attempt to engineer fundamental tax reform. The Administration, in conjunction with House and Senate Leadership, put forth an outline of goals they hope to attain which include a significant reduction in the corporate tax rate as well as various changes to so called 'pass-through' income and other items affecting nearly all US taxpayers. The outline of the tax agenda is deliberately vague and leaves the heavy lifting to Congress to craft legislation that can be passed to achieve the main objectives of the President's proposal. Reducing the corporate tax rate is an important, if not principal, goal of the tax outline. It is also the most expensive plank of the proposal. It is estimated that reducing the corporate tax rate from 35% to 20% would reduce Federal revenues by more than $1.5T over the next 10 years. Finding an offsetting source of revenue through other changes in the code will be politically fraught. Most analysts do not believe that the 20% target can be achieved without significantly expanding the federal deficit and, therefore, anticipate that a compromise rate in the mid to high-20's is more likely to be crafted into a final package if indeed legislation is advanced.

Economic growth continued to march ahead despite the intense storm impact afflicting various parts of the country, including the impact of Harvey on the energy and petrochemical sector. Expectations for significant Federal Assistance to aid in the recovery and rebuilding efforts for all affected regions should eventually help restore growth that was 'borrowed' from the third quarter, but the wealth destruction caused by the unprecedented series of storms will continue to have an economic impact going forward. Congress may well need to scale back its wish list on spending increases and tax cuts as Federal aid requests mount. Estimates of storm damage from this season's hurricanes range from $200B to $300B, and the Federal portion of recovery package will add directly to the deficit as no offset is expected in the wake of the emergency aid requests. Deficits are expected to begin expanding over the medium-term after 6 years of decline as a percentage of GDP. Deficit 'hawks' will be key to the fate of tax reform negotiations as the fundamental blocking and tackling of formulating a realistic budget move front and center. We anticipate a challenging road ahead for tax reform.

The Federal Reserve stayed front and center for market participants as the initiation of its balance sheet reduction efforts begin this quarter. While the road map is clear and gradual, the eventual market impact could ultimately be more significant. During the multiple implementation phases of the Fed's Large-Scale Asset Purchase program, the strong performance of risk markets, not only domestically but abroad, was quite notable. The Fed first embarked upon the expansion of its balance sheet in November of 2008 in the vortex of the economic storm. It would ultimately quintuple the size of its holdings through 3 rounds of quantitative easing and the addition of $3.6T of assets, mostly in the form of Treasuries and mortgage-backed securities. In doing so, the Fed supplied a massive liquidity injection into the global capital markets which contributed to a lessening of the availability of 'safe assets' and, in turn, a sanguinary environment for risk assets which prompted investors to chase returns in an effort to shore up income. The balance sheet drawdown will begin at $10B per month beginning in October and is expected to gradually work up to $50B per month after a full year of implementation. The ultimate target objective for the balance sheet is undecided at this juncture, but most analysts anticipate the Fed will need to maintain a larger footprint than it had pre-Great Recession. This would imply a roll-down of perhaps $2T over the next several years if the economic expansion continues.





Sources: Bloomberg.
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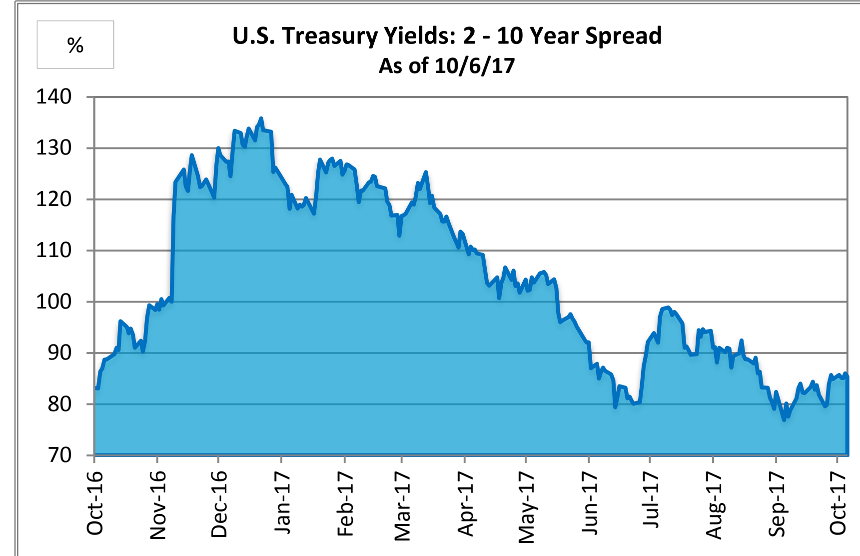
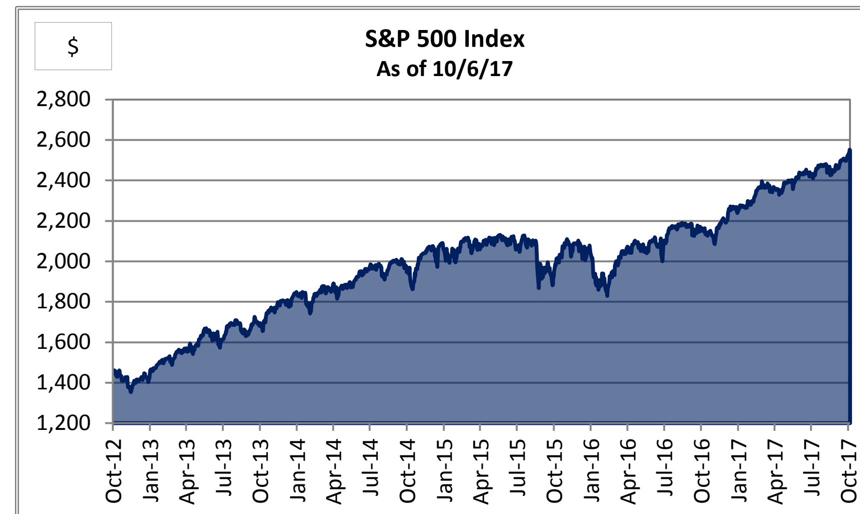
- Treasury rates were little changed and the yield curve continued to flatten at the margin as investors remained focused on income.
- Taxable spread sector assets all outperformed Treasuries as full valuations proved no obstacle to a continued stretch for yield.
- Municipal yields were nearly unchanged and the sector continued to outperform Treasuries, if only modestly, across the yield curve.
- Credit continued its run of strong performance across the corporate and municipal markets with lower quality categories generating the strongest relative returns.
- The dollar weakened further during the quarter but seemed to find a floor, at least temporarily, as participants reassessed the prospects for another Fed rate boost in December.

Developments in Europe were mixed with Angela Merkel winning a 4th term as Chancellor, but a narrowed mandate left her forced to attempt to form a government with a new coalition in the wake of significant electoral gains generated by a rival far-right party. Anti-globalist sentiment continues to be a potent underlying force shaping and, in some cases, significantly altering the political landscape. Adding significantly to Eurozone pressures, Catalonia staged a referendum on independence which precipitated a harsh crackdown by Spanish Prime Minister Rajoy. This resulted in confusion and chaos as a backlash of anti-secessionists took to the streets in protest of any further potential steps by the autonomous Catalan government to declare independence. The potential rupture within the EU itself threatens to bring Eurozone pressures back on the boil after what seemed like a pivotal turn following the French elections in the second quarter. Even Macron's approval has now withered alongside a souring of attitudes about the prospects for political progress as the default position for a core of voters across the globe seems to be a toxic mix of resignation and desperation. Finally, a weakened Theresa May attempted to re-engage Brexit negotiations after she lost her parliamentary majority by agreeing to essentially accede to all EU rules and contribute €20B after the March 2019 formal withdrawal from the European Union as transition negotiations continue. Critically, the UK will then be in the limbo of having left the EU without yet gaining any of the 'sovereignty' that the Brexiteers had both anticipated and promised.

As we enter the final quarter of the year, investors are faced with a decidedly divergent range of potential policy and economic paths to consider. The economy remains in much the same mode as we began the year. Growth is solid, labor markets are strong and inflation is benign. But policy risks loom large. The Fed is operating effectively, communicating clearly and gradually implementing a 'normalization' of monetary policy after a decidedly non-normal economic event. Will the policy lever continue to be ably steered if Fed Chair Yellen is replaced when her term expires in February? And will potential appointments to fill Board vacancies be met with reassurance by the markets or concern? It is worth reiterating that the Federal Reserve has been largely operating as the primary engine of economic policymaking. A reappointment of Dr. Yellen would almost certainly be viewed more favorably by investors than any potential replacement.





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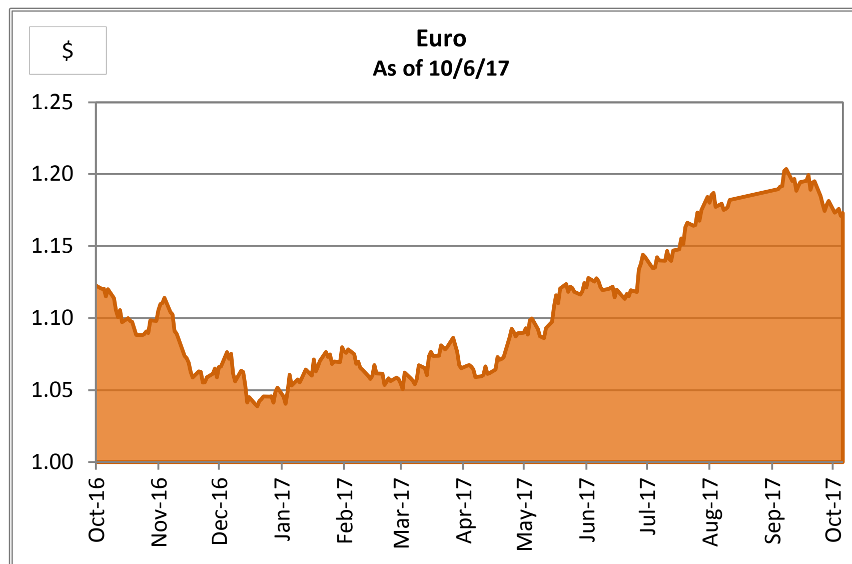
The legislative front remains equally concerning. The House and the Senate have passed 2018 budget resolutions but significant differences will need to be reconciled before legislation can be advanced for approval. Passing a budget is a necessary step before tax reform can be taken up via the legislative route of reconciliation. In addition to taking up the goal of tax reform, Congress will also need to raise the debt ceiling (December 15th), reauthorize the Children's Health Insurance Program (expired September 30th) and reauthorize the National Flood Insurance Program (December 8th). To date, markets have weathered the range of political and geopolitical risks largely in stride. Valuations continue to tighten and volatility remains moribund. We expect the Fed to boost rates in December and maintain a benign outlook with regard to both longer-term rates and the prospects for economic growth. We expect the evolution of risk market valuations amid the Fed's balance sheet runoff will become an increasingly important factor as monetary normalization advances.

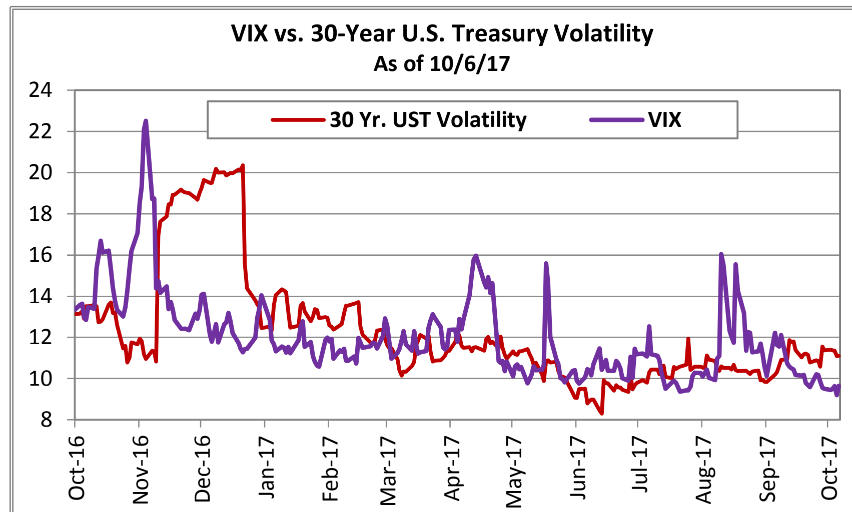
Taxable Market

Treasury yields edged slightly higher and the yield curve flattened further amid the onset of reduced balance sheet reinvestment from the Federal Reserve beginning in October. In addition, investors began to reassess the likelihood of another ¼ point rate boost when the Fed convenes its 2-day meeting in December. Spread sector tightening remained the feature of the market as each major taxable spread sector outperformed its comparable duration Treasury counterpart during the period. Investor reach-for-yield continues to dominate market performance throughout the first 3 quarters of the year. Credit fundamentals provide a healthy backdrop and corporate issuance on pace for a 6th consecutive record year has been met with a voracious market appetite for income. As has often been the case of late, lower quality credit produced the strongest relative returns.

- Treasury rates ended the quarter slightly higher as the narrative shifted between flight-to-quality geopolitical fears versus increasing expectations of a December Fed action.
- The yield curve remains biased toward flattening as the cumulative Fed policy impact remains muted on the longer-end of the curve.
- Spread compression continues to dominate returns year-to-date as the demand for income outweighs all other concerns in the current environment.
- Lower quality credit produced the strongest relative returns across the corporate market.
- Build America Bonds were the top nominal and relative performance sector for the quarter.
- Structured Product also generated solid gains during the period amid muted volatility.

Treasury market reaction to Fed tightening to date has been largely concentrated in the intermediate portion of the yield curve. With the yield curve flattening through the first 3 quarters, the 2's – 10's spread has narrowed by roughly 40 basis points and will continue to garner attention if the Fed moves as anticipated in December. We expect the Fed will move forward in December in part due to the increased policy flexibility afforded by a weak dollar, but the yield curve could loom large on the prospects for future rate moves if the flattening pressure continues.





Sources: Bloomberg.
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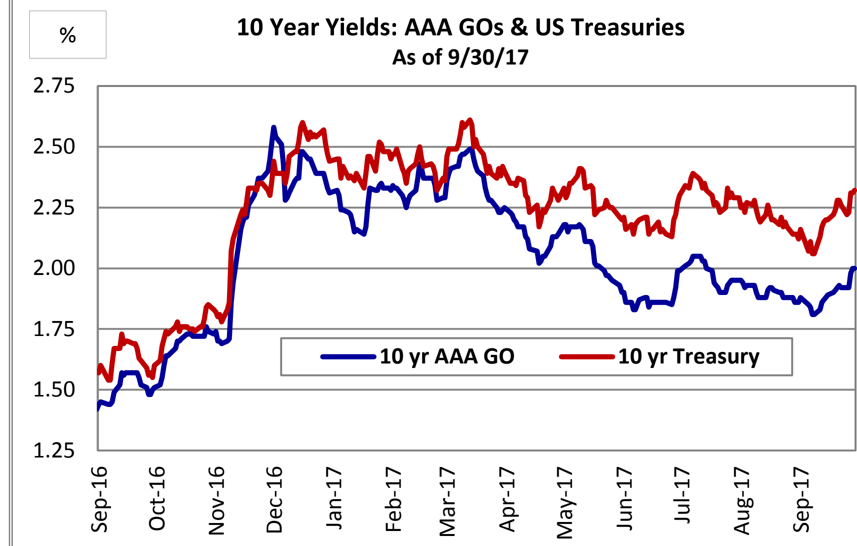
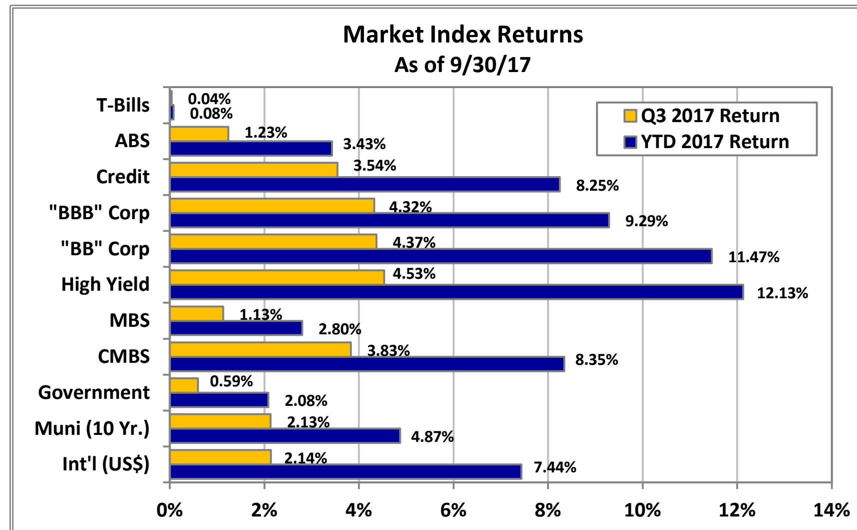
Municipal Market

The municipal market continued to feature consistently strong demand and disappointingly limited supply. Yields were nearly unchanged across most of the curve and valuations remained more attractive versus Treasuries further out on the yield curve. New issue volume is down 16% versus last year's record pace as Refunding Issuance slowed to crawl. Through the first 3 quarters of the year, Refunding Issuance, which last year accounted for 61% of total volume, is running nearly 30% below last year's levels. Against the backdrop of limited supply, spread compression remains rampant and includes both quality and structural elements of the outstanding market. We expect that uncertainty over the fate of the ACA repeal effort, prospects for tax reform and an uncertain agenda for infrastructure have all contributed to policymakers' reluctance to raise capital in the current environment.

- Municipal yields ended the quarter with limited change across most of the curve.
- New Issue Supply continues to trail last year's pace as a steep drop in Refunding Issuance drags volume totals lower.
- Tightening quality spreads in aggregate helped lower quality ratings generate the strongest relative returns, but market action was heavily dominated by valuation recovery in Illinois and New Jersey state-related credits.
- Shareholder inflows into municipal funds have been consistently positive and have contributed to the tendency for spreads to compress.

Prospects for a change in the current supply demand dynamic in the municipal market do not appear imminent. The efforts to repeal the Affordable Care Act have failed to date which is clear positive for the market, but substantive efforts to shore up and reform the ACA have yet to garner critical momentum. The greatest potential opportunity for municipal investors would likely emanate from legislation to fund infrastructure investment. The President recently indicated a shift away from an exclusive preference for the public private partnership model. We have long held that the road to effective infrastructure investment program runs through the traditional municipal market. Direct federal grants or subsidies to state and local issuers have long proven to be the most effective means of financing capital investment in core infrastructure. For the time being however, the path forward remains beyond the near-term horizon.





Sources: Bloomberg; Municipal Market Data; Merrill Lynch.
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