# Fixed Income Commentary ✧ April 2018

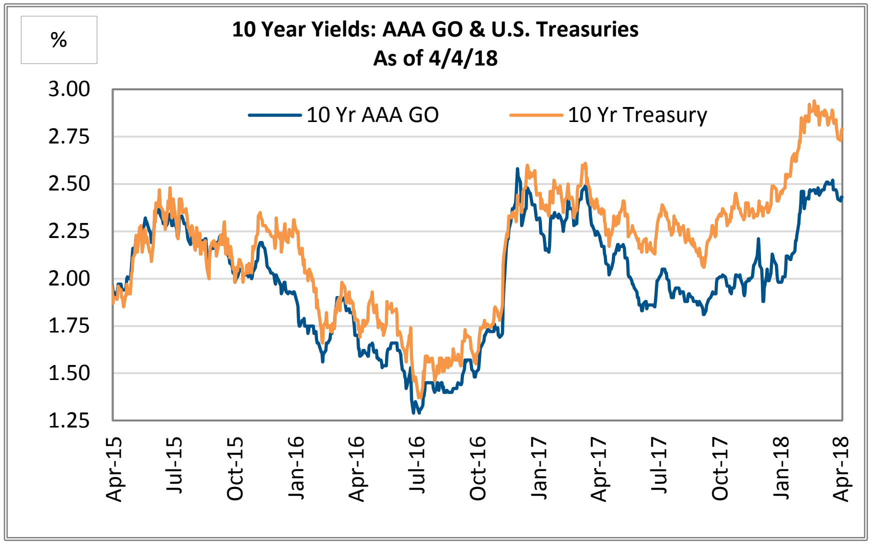
## Market Overview

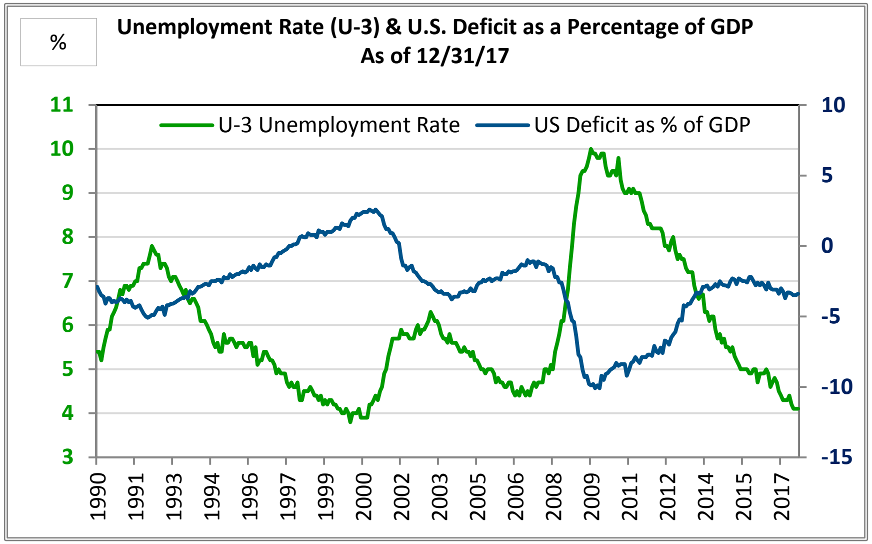
*Jim Grabovac, CFA*

**Capital market investors received a resounding reminder that quiescent volatility conditions and ever rising risk market valuations can be a toxic combination when the inevitable reaction seizes control. As if by definition, the reaction occurs when it is least expected and can exert the maximum pain on the greatest number of participants possible.** The first quarter began with near euphoria in the equity markets as investors responded to the massive corporate tax cut with panic buying that drove major equity indices to 13 new all-time highs over the first 18 trading days of the year. In turn, this prompted fixed income participants to question whether the operative narrative of solid economic growth, recovering inflation and gradual Fed normalization accompanied by a gently rising rate environment and flattening yield curve conditions, was overly sanguine. Fear that the equity euphoria might be reflecting resurgent growth, bond markets sold off swiftly, adding roughly 50 basis points (bps) to yields across much of the curve. But the rate rise helped create a feedback loop in the equity market, and fear of higher rates helped spark an implosion of 'short-volatility' strategies that rocked the capital markets. When the dust settled, both equities and fixed income markets found corrective levels, attractive enough to rekindle two-way trade. Equities ended the quarter with relatively modest losses after a 10% mid-quarter correction while rate markets tacked on 30 to 40 bps of additional yield.

- Rates rose as fears of economic acceleration in the wake of significant fiscal stimulus pressured bond markets both domestically and abroad.
- Jerome Powell took the reins at the Federal Reserve and, as expected, engineered another ¼ point rate hike following the March meeting. He expressed confidence in the economic outlook and a readiness to adapt policy as necessary.
- Municipals modestly underperformed Treasuries as yields rose despite a steep drop in New Issue Supply. Issuance declined by nearly 32% from last year's pace following passage of the tax plan.
- Equity markets experienced a surge in volatility as rate fears triggered a downdraft that derailed the rally and crushed investors in short-volatility strategies.
- Credit spreads widened as healthy fundamentals proved no match for an upsurge in volatility and a risk-off environment.

**Tariffs and trade wars are back in the headlines as China responded forcefully to the unilateral action being threatened by the US. The ultimate impact on US producers and consumers has yet to be felt, but market reaction has registered a strong vote of no-confidence in the policy to date.** The announcement of the policy initiative claimed the administration's economic policy chief, Gary Cohn, who resigned in protest after losing his battle to forestall what most mainstream economists view as a retreat from long-held free trade principles that will ultimately detract from economic growth.




Sources: Bloomberg; Municipal Market Data.
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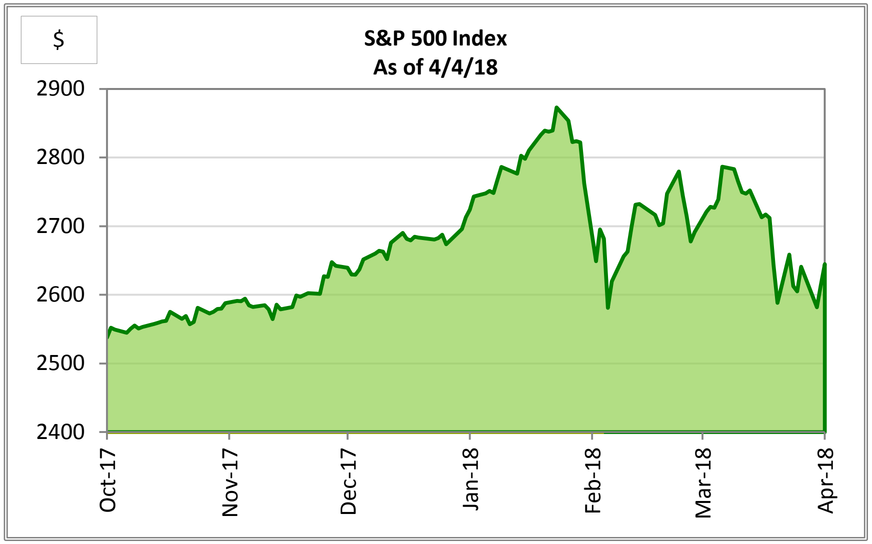
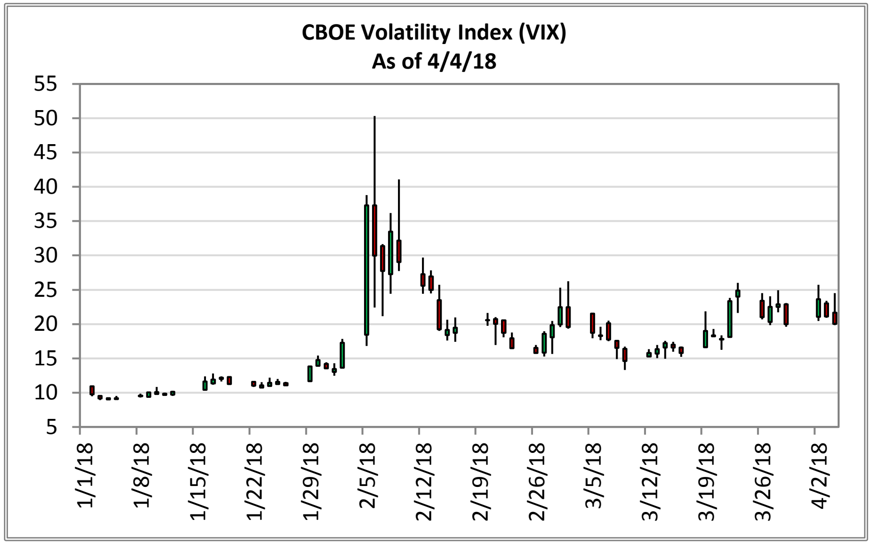
***Cont.***
In addition to the potential growth impact, it will also raise the prices paid by consumers for both targeted goods and products that use raw materials as inputs that are subject to the levies. The once benign backdrop of broad trends toward globalization, free trade and economic and political liberalization that served to foster global growth and development are all currently in retreat. But permanent reversals of these trends seem unlikely as the costs for those economies pursuing centralized political control and government-managed trade are likely to build.

**Despite the sharp increase in market volatility during the first quarter, prospects for growth remain strong and upward pressure on wages well contained. Economic fundamentals point toward a continued expansion with Consumption fueled by a healthy labor market and Investment buoyed by changes in the tax law.** The ability for corporations to expense investment (for the next 5 years) offers an attractive inducement to invest in property, plant and equipment. Capital Investment had already firmed in 2017 and the additional incentive should only bolster the uptrend. In addition to the fiscal stimulus contained in the tax plan, Congress increased outlays by nearly $290B in an omnibus spending package that boosted defense spending and increased domestic program funding over a two-year period. While the ingredients supporting the growth outlook appear notable, the timing of stepping on the fiscal accelerator as the economy approaches its 9th year of growth with unemployment below pre-recession lows could prove problematic. But inflation remains largely in check, with the Personal Consumption Expenditures Index, the Fed's preferred measure of inflation, still running below the FOMC's 2% target. Nevertheless, market participants are leery of a return of the 'bond vigilantes' should any signs of acceleration on the price front materialize.

**As we began the year, we looked at 5 key elements of capital market behavior and posited that they could individually continue to occur, but that collectively they would likely prove unable to coexist beyond the medium-term horizon.** These elements were ***1) Strong Economic Growth; 2) Rising Equity Market Valuations; 3) Monetary Policy Normalization; 4) Yield Curve Flattening; and 5) Low Equity Market Volatility.*** The explosion of equity market volatility was the most spectacular occurrence during the 1st quarter. What began as a gentle market pullback from the new highs reached in January turned more ominous in early February. But the ignition occurred when short-volatility strategies started to implode. After flat-lining near record lows for weeks, implied volatility quintupled as panic selling by desperate investors and traders drove stocks into 10% correction territory in the span of only 10 trading days. Price action in the intervening weeks has demonstrated that now elevated volatility can be expected to be a feature of the market for some time to come. What has been most surprising during this episode, however, has been the relative absence of 'flight-to-quality' behavior in the bond market. In previous bouts of equity market panic, Treasury bonds would reflexively catch a strong bid, as investors assumed the Federal Reserve would be quick to ameliorate conditions with supportive monetary action. This time market behavior was decidedly different.

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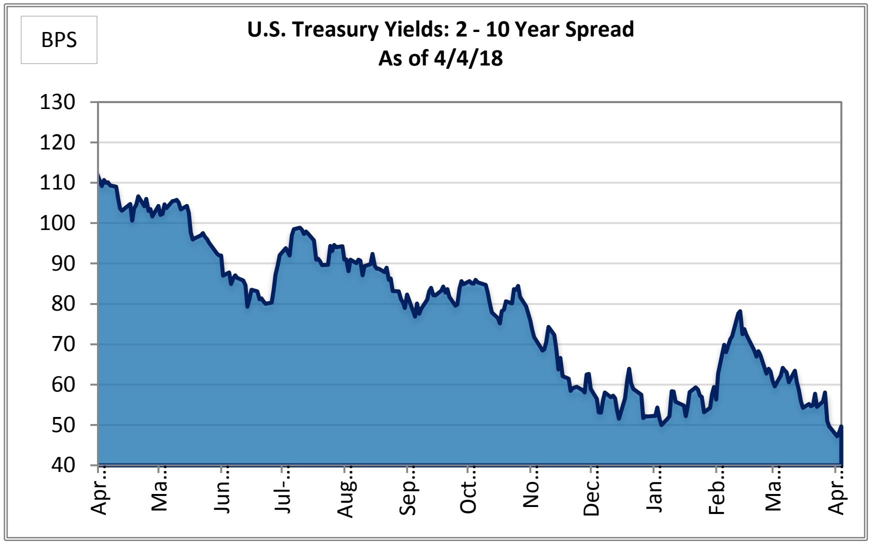
**In terms of economic and market expectations, we are most confident in the outlook for the economy. Growth fundamentals remain sound, business confidence is strong, corporate profits are solid and the labor markets are healthy.** As discussed, added to the mix is a significant injection of fiscal stimulus, particularly over the next 2 years. While this backdrop can and will change, it is difficult to envision it changing rapidly. The Federal Reserve seems likely to add another 50 or possibly 75 bps to the Funds Rate over the next 3 quarters and, to date, the longer end of the yield curve has been relatively well-contained. We believe the base case narrative continues to be operative with modestly rising rates and a flatter yield curve. With sound fundamentals in place, it seems unlikely that credit spreads are in danger of imminently widening substantially. The potential wild cards for the capital markets are an unexpected flare-up in inflation or untoward developments on the political or geopolitical landscape. We are concerned about the pro-cyclical nature of the fiscal policy mix but do not expect to see negative consequences over the medium-term.

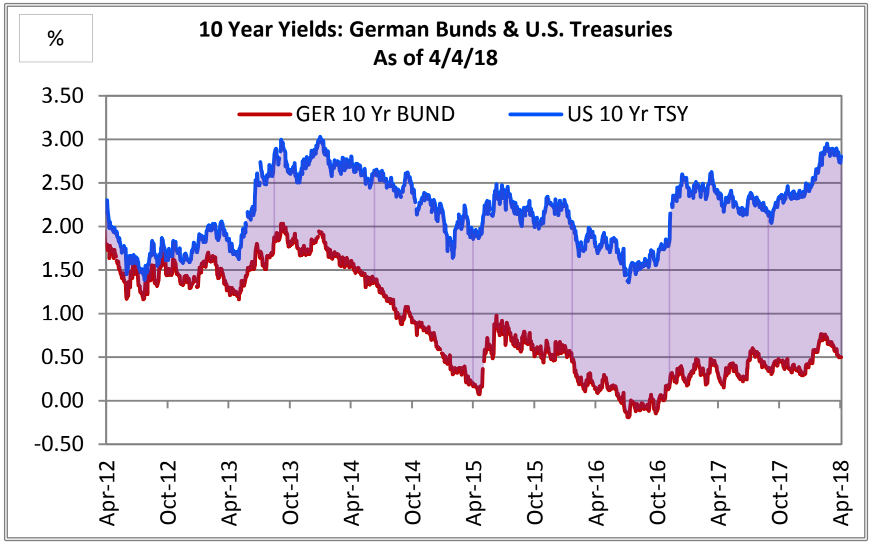
## Taxable Market

**Treasury yields rose as investors reacted to the large measure of fiscal stimulus that was contained in the tax plan as well as a second round of spending added by Congress in the omnibus spending bill that passed near the end of the first quarter.** In total, legislation passed in the past 100 days is expected to add nearly $1.8T to the deficit over the next 10 years, with a large portion of that front-loaded over the next 2 years. Rate concerns were amplified in part due to the addition of stimulus in what is presumably the latter part of the economic cycle and coming at a time when growth momentum is already accelerating. Spread sectors retreated as credit markets reacted to the sharp increase in volatility that accompanied the equity market correction.

- Rates rose and the yield curve ultimately flattened as rates approaching 3% on 10-year Treasuries helped stabilize the bond market.
- Spread sectors underperformed Treasuries as a doubling of average equity market volatility tilted markets into a risk-off mode.
- Long credit produced both the weakest nominal as well as relative returns versus Treasuries during the period.
- Structured product mostly widened amid the rise in rates and volatility during the outset of the period.
- The Fed boosted short-rates by a ¼ point and provided no clear indication as to whether the pace of policy normalization was likely to change.

**Rate markets weathered sustained pressure in the immediate wake of the changes in tax policy and added fiscal stimulus. The downdraft in prices, however, was met by strong support as yields approached the highest trading levels in over 4 years.** We expect investors will continue to find longer term yields attractive given the wide rate differentials carried by the US versus its G7 counterparts. We expect the yield curve to continue to exhibit a tendency toward flattening as the Federal Reserve pursues a deliberate normalization of monetary policy consistent with above trend growth and a gradual recovery of inflation back to target.

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McDONNELL INVESTMENT MANAGEMENT

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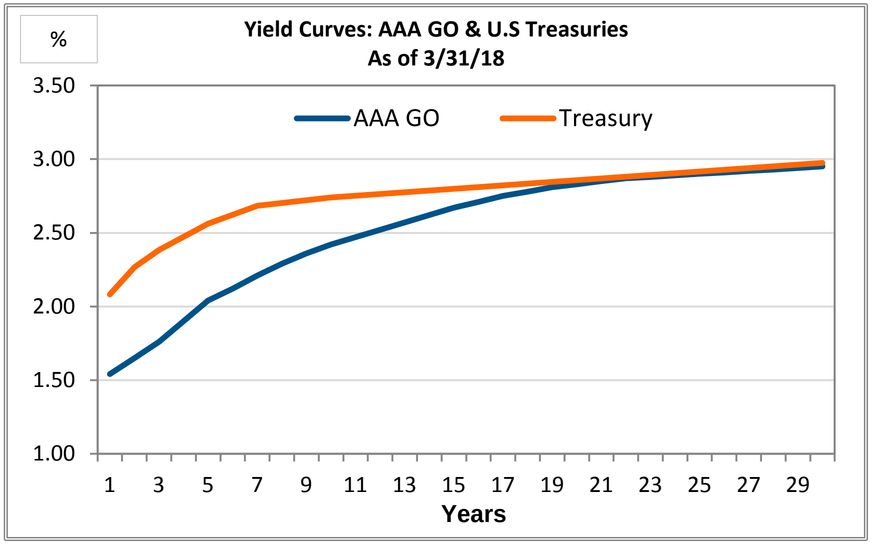
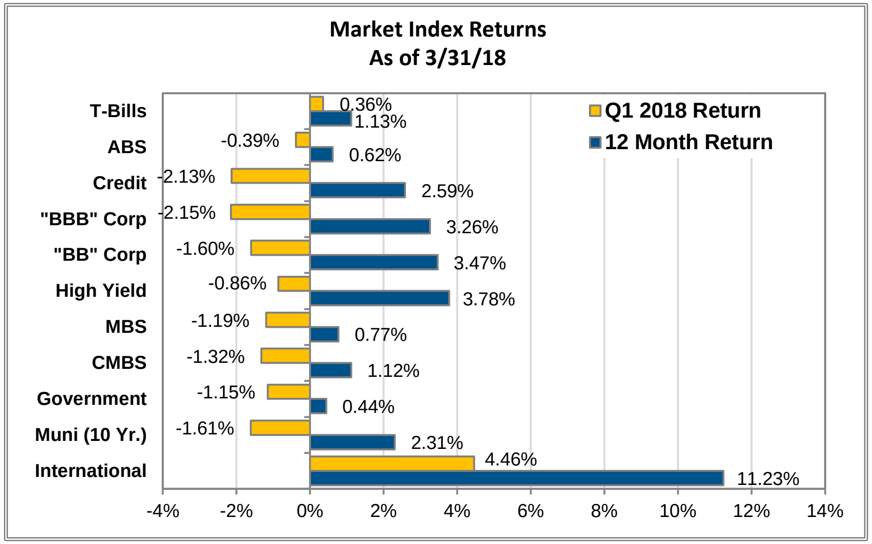
## Municipal Market

**Despite a steep drop in issuance in the wake of the year-end surge, municipal yields rose along with the general retreat in rate markets globally. Municipals underperformed Treasuries across most the curve, and the yield and valuation curves both steepened.** While New Issue Supply is gradually showing signs of building as we move forward, the market environment is still adapting to the significant expected impact on both supply and demand as issuers and investors respond to the shifting landscape brought about by changes in tax plan. The near-term supply impact was not unexpected, and while we anticipate some acceleration as we move into the 2nd quarter, we still anticipate supply-constrained conditions over the medium-term. Demand remains strong and the market has not experienced noteworthy selling on behalf of commercial bank or insurance company portfolios.

- Yields rose by more than 40 bps beyond the 10-year part of the curve and the municipal yield curve steepened.
- Municipal valuations widened versus Treasuries across most of the curve and 30-year ratios neared 100% of Treasuries.
- The pace of New Issue Supply decelerated by nearly 32% versus year-ago levels.
- Quality spreads were mostly stable.
- Some issuers began responding to the elimination of tax-exempt advance refunding by shortening the call features on new issue financings.

**We expect the municipal market to continue to experience supply constraints as the year unfolds. The rise in yields, to date, has not encountered significant selling but rather, seems to have been met with good demand in what has been a persistently low nominal interest rate environment.** Whether demand will remain buoyant in the face of further Fed tightening will ultimately resolve the question of the validity of the market narrative of modestly rising rates combined with a tendency toward curve flattening.

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18W140 Butterfield Road, Suite 1200 • Oakbrook Terrace, IL 60181 • www.mcdonnellinvestments.com