McDonnell Investment Management

Fixed Income Market Commentary ✧ April 2017

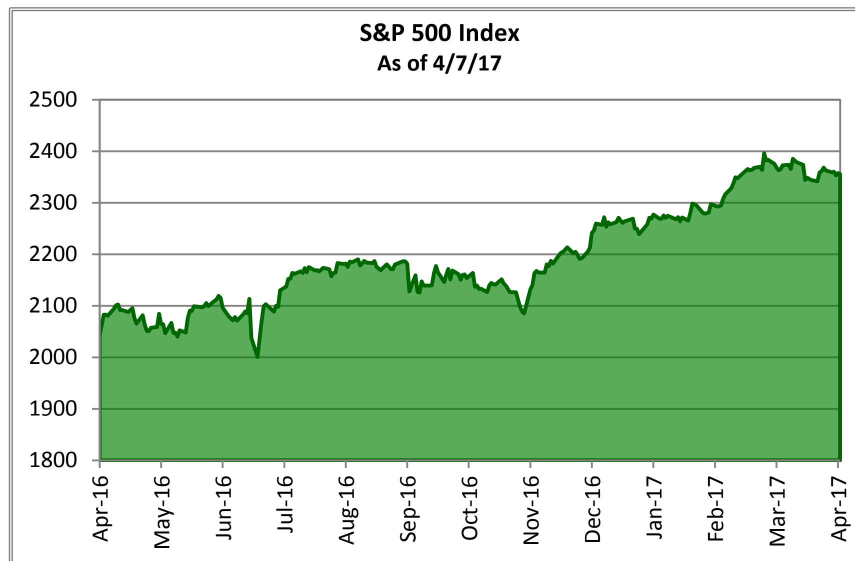
Market Overview

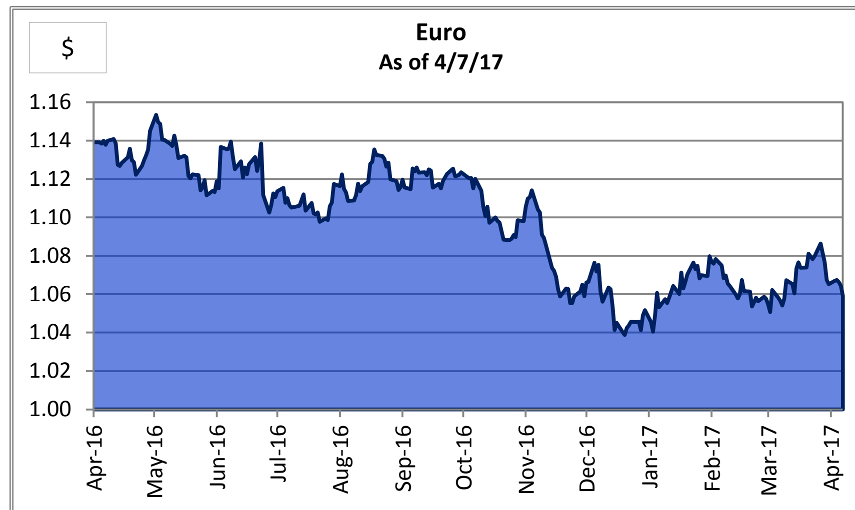
Jim Grabovac, CFA

Rate markets consolidated during the quarter, with yields ending slightly lower across most of the Treasury curve, while municipals outperformed across intermediate maturities, as yields declined more substantively. Spread markets resumed tightening as investor appetite for income predominated in an otherwise relatively quiet environment. Equity investors displayed the most capital market enthusiasm scoring a series of new all-time highs in the middle of the quarter, before settling into a consolidation mode heading into quarter-end. Notably, rate and currency markets have been working sideways since mid-December, while equity markets have powered higher this year, perhaps underscoring the hopes of investors for substantive changes in corporate tax rates. This, in turn, could boost the after-tax income of corporations and, ultimately, cash flow returned to investors. It is worth noting that this prospect is far from legislative reality at present. Economic activity remained on a steady path as the final estimate of Q4 GDP registered 2.1%. This put the year-over-year gain in output for 2016 at 1.6%. The dip in annual growth was largely attributable to weak business fixed-investment and inventory decumulation. Both of those factors saw an uptick in the final quarter, and we expect improving levels of capital investment may continue to boost growth for the balance of 2017. There has been much discussion in recent weeks over the outlook for an uptick in domestic and global growth prospects. Analysts have highlighted a wide divergence between 'soft' data and 'hard' data, the former being sentiment indicators and the latter empirical output data. We expect the expansion to continue to advance but remain skeptical about the prospects for significant and sustainable acceleration from current levels over the medium term.

The Federal Reserve boosted short-term interest rates by 0.25% and indicated that the Committee's expectations for two additional moves during the year remain on track. Investors took the move in stride which had been telegraphed in a series of comments from key Fed officials in the weeks prior to the March 14-15 meeting. But skepticism lingers about the aggressiveness of the path going forward. The Fed's expectations for both the economy and rates have consistently been more optimistic than market expectations, and the Committee may be attempting to reassert control and begin leading rather than following market interest rates higher. NY Fed President William Dudley also indicated that adjusting the Fed's balance sheet may be under consideration, perhaps as soon as later in the year. The Fed has been reinvesting coupon income and principal payments from its $4.5T portfolio since concluding its quantitative easing program in 2014. The Fed has indicated that it expects to begin allowing the portfolio to shrink gradually once significant progress toward the 'normalization' of interest rate policy was underway. President Dudley added that the Committee thought this could take place later in the year and, if undertaken, might coincide with a pause in the rate cycle policy.

- US Treasury yields moved mostly sideways as investors searched for clues regarding legislative prospects for the policy agenda of the new administration.
- Credit markets continued to improve with lower quality issues generating the strongest relative returns in both the corporate and municipal market.
- Municipals outperformed Treasuries inside of 10 years, and the yield and valuation curves both steepened.





Source: Bloomberg.
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McDonnell Investment Management, LLC

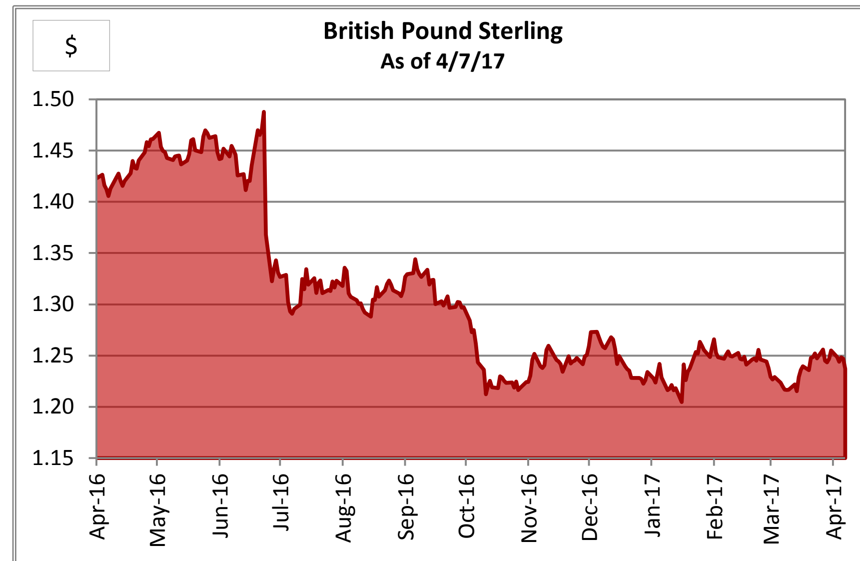
Market Overview

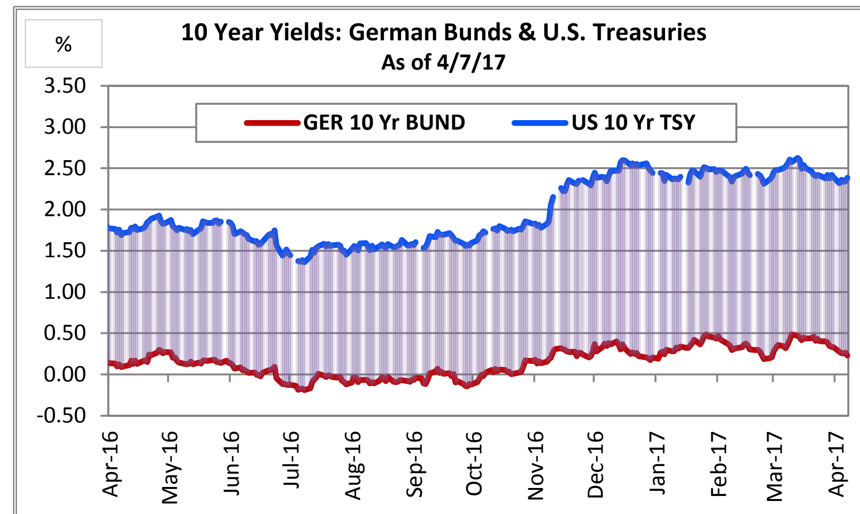
- Corporate Issuance was robust, running nearly 18% ahead of last year's pace; while Municipal New Issue Volume slowed on the heels of a sharp deceleration in Refunding Issuance.
- US equity markets rallied sharply as investors enthused over the prospects for tax cuts and the possibility of fiscal stimulus in the form of an infrastructure investment program.

Political news dominated the headlines with the stunning collapse of congressional efforts to repeal and replace the Affordable Care Act (ACA). The failure to even bring the measure up for a vote in the House indicated a deep fissure within the majority party which called into question its ultimate ability to deliver on the policy agenda that has been communicated to date. Prospects for legislation passing the Senate seemed even more remote as the probability of swelling the ranks of uninsured constituents did little to strengthen resolve in the upper house. The failure of the health care effort makes the road forward on tax policy more difficult. Both the health care effort and tax policy changes were anticipated to be accomplished via the process known as reconciliation. Reconciliation requires only a simple majority vote versus a 60-vote requirement in the Senate. But moving legislation through the process of reconciliation further requires that the legislation be 'revenue neutral' or sunset after 10 years. The repeal of the ACA was expected to help finance tax cuts, and its failure now increases pressure on the House to include the Border-Adjustment Tax in its version of tax policy. The Border Tax is estimated to raise $1T over the 10-year window. As with the health care effort, agreement is expected to be substantially more difficult to reach in the Senate.

Prime Minister Theresa May formally triggered Article 50 setting the stage for negotiations to commence regarding the UK's exit from the European Union. Article 50 sets forth a 2-year timeframe for discussions to resolve the myriad complexities that will surround the separation. The UK desires a simultaneous 2-track course pursuing the negotiated exit alongside with discussions over new arrangements covering trade, migration, legal issues, along with a host of other concerns. Objectively, the accomplishment of conclusive accords covering all manner of the future relationship between the UK and EU will almost certainly take longer than the 24-month window, and negotiators may well seek to carve out agreement as to key principles in the relationship to provide continuity while the process moves forward. In her letter to the European Council, the Prime Minister acknowledged the challenges ahead and stated that sharing the existing legal platform provided considerable comfort as a starting point from which to resolve differences as the negotiations proceed.

As we entered the year, investor expectations centered around the potential for significant fiscal stimulus from the incoming administration, in turn leading to a potential 'reflation' of the economy over the near horizon. The reality on the ground appears to present a much more arduous slog as the legislative wheels that ultimately drive policymakers' objectives, take time to engage. The failure of the initial health care effort will only ensure that subsequent progress toward reaching legislative goals will become even tougher. Tax policy might appear easier to craft and measure than health care policy, but we believe considerable differences over tax policy, both within the majority party and between the House and the Senate, are likely to slow down the timetable and water down the changes as the process winds forward.





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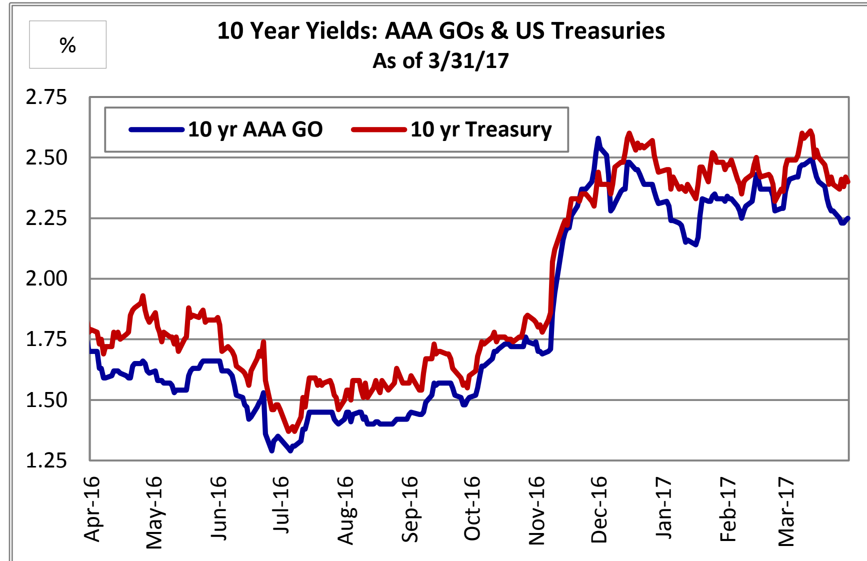
It is estimated by the Committee for a Responsible Federal Budget that each 1% cut in the corporate tax rate would 'cost' $100B in revenues over a ten-year time-period. With the House plan calling for a reduction in corporate rates from 35% to 20%, the price tag would weigh in at $1.5T. Dynamic scoring could mitigate the budgetary cost at the margin, but the possibility of reconciling the House plan through a Senate that is skeptical about the Border Tax would seem dubious at this juncture. There is also strong opposition to another radical policy proposal in the House plan, which is the elimination of the deductibility of interest for corporations. If one or both of these major revenue generators fall short of passage, the prospects for significant cuts in marginal tax rates weakens significantly. We expect the limitations imposed by revenue neutrality, combined with a desire for deficit control, will ultimately move in the direction of a policy favoring modestly lower corporate rates combined with efforts to broaden the tax base.

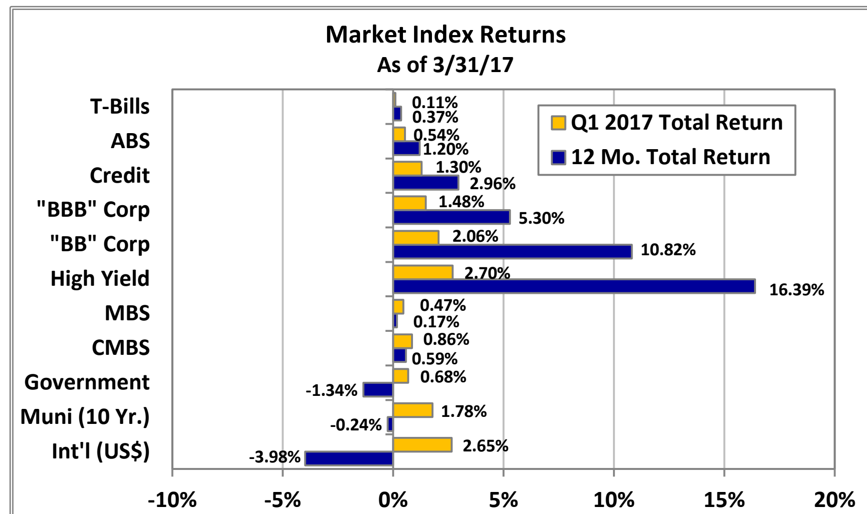
Taxable Market

Treasury yields worked mostly sideways in consolidative trade and the yield curve flattened slightly. Fed tightening was taken in stride as fixed income investors used the Q4 spike in rates as an opportunity to buy rather than a reason to sell. Credit market issuance began the year at an accelerated pace and continued the trend after 5 consecutive years of record corporate issuance. Despite the heavy slate of issuance, spreads continued to tighten with lower quality paper generating the strongest relative returns. Investor appetite for incremental yield remains the order of the day with corrections proving to be short-lived, and the steady grind tighter in spreads providing the path of least resistance

- Rate markets consolidated following the post-election spike higher and, in turn, volatility moved lower.
- The Federal Reserve boosted short-term rates by 0.25% in March and left in place expectations for 2 additional moves over the balance of the year.
- In a continuation of last year's trends, credit spreads tightened further with lower quality paper leading the move.
- Structured product was mixed across the MBS sector while ABS registered strong relative returns.
- The Dollar corrected against most currencies as expectations of substantially tighter monetary policy to balance fiscal stimulus were tempered.

Rate and currency markets have adopted a decidedly different tone from risk markets in the weeks following the initial post-election reaction. The Dollar and the Treasury market have largely been in corrective mode since December, while equity investors continue to chase market momentum higher. Stocks reacted modestly to the downside following the collapse of health care reform efforts, but so far have failed to significantly dent the gains generated following the election of single-party government. It is noteworthy that minutes from the March Fed meeting revealed that several participants considered current equity market valuations as elevated. While risk markets have enjoyed clement conditions of late, the weather ahead may yet provide challenges.





Source: Barclays; Bloomberg; Municipal Market Data.
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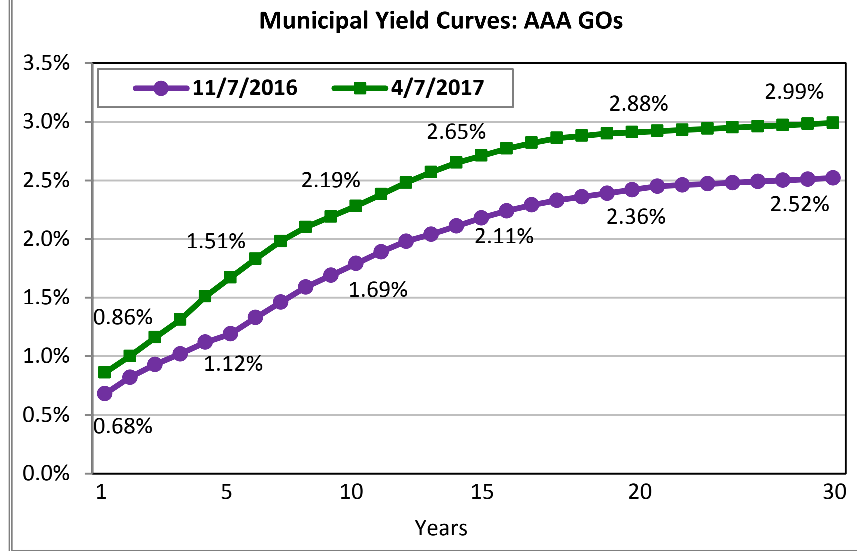
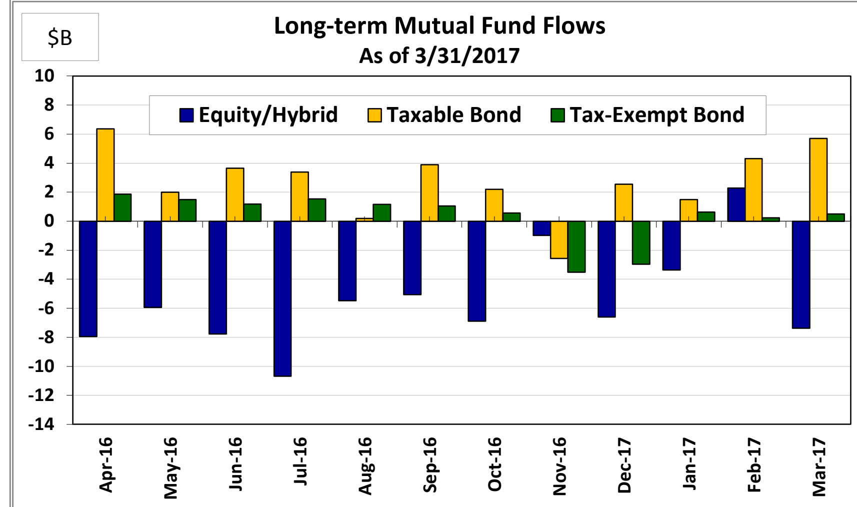
Municipal Market

The municipal market steadied after a volatile 4th quarter pushed yields nearly a hundred basis points above their 2016 lows. Unsurprisingly, the market deterioration prompted a substantial level of mutual fund redemption activity; but the market caught a foothold and fund flows resumed as investors used the backup in yields to rebuild portfolio income. A significant slowdown in the pace of issuance also helped bolster the technical condition of the market, and investors scoured the secondary market to supplement supply in relatively thin market conditions. A drop-off in Refunding Issuance was a contributing factor behind the slowdown in the primary market. The intermediate portion of the market outperformed Treasuries and the valuation curve steepened.

- Municipal yield curve steepened as intermediate yields declined while rates beyond 10-years edged slightly higher.
- The pace of New Issue Supply slowed versus last year's rate as Refunding Issuance decelerated markedly in comparison to year-ago levels.
- Mutual Fund Flows were positive but relatively modest as investors responded to the higher yields in place since last November.
- Legislative policy initiatives with potential municipal market implications, specifically tax policy and infrastructure, have been slow to develop, and in the case of healthcare, have fallen flat.

The collapse of efforts to repeal and replace the Affordable Care Act had both a direct and indirect positive impact on credit quality in the municipal market. The primary impact was to the health care sector directly as expanded Medicaid has served to reduce uncompensated care at many facilities (in the 32 states which opted for expansion under the ACA) and increase utilization. Secondarily, the failure to replace the ACA with the American Health Care Act (AHCA) eliminated the near-term threat of reduced Federal funding to the states, as well as reduced the potential for further budgetary strains likely to have resulted from an increase in the ranks of the uninsured requiring state assistance in order to access to healthcare. We expect substantive healthcare reform efforts will remain sidelined at least until 2018.





Source: Bloomberg; Municipal Market Data; Thomson Reuters.
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NOTES AND DISCLOSURES:

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