McDonnell Investment Management

Fixed Income Market Commentary ✧ April 2016

Market Overview

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The recovery in crude oil was the signal event of the first quarter. Risk markets took their cue from the reversal that began in February and translated into a broad recovery across risk markets generally. Rates remained tame and much of the flight-to-quality buying that took place early in the period maintained itself throughout the quarter as ultra-low bond yields across the major markets in Europe and Japan acted as an anchor on US rates despite diverging central bank policies. Along those lines, expectations of additional Federal Reserve rate hikes were reduced substantially as investors questioned whether more aggressive Fed expectations were realistic and realizable against a fairly fragile global economic and market backdrop.

- Treasury yields fell sharply amid widespread flight-to-quality buying prompted by a 25% slide in Chinese share prices during the first 4 weeks of the new year.
- US equity markets followed suit and corrected to the downside by more than 10% before finding a foothold and scaling back to unchanged during the final weeks of the quarter.
- Crude oil found a temporary floor in early February as rumors of a potential production freeze at January levels prompted a 60% rally in spot crude prices following a massive 19-month selloff.
- Market expectations of the future path of short-term interest rates moved lower despite some signs of inflation beginning to edge moderately higher.

On the central bank front, policy divergence remains the order of the day. The Bank of Japan was the first out of the gate this year announcing a negative interest rate policy designed to deter a return of deflation and encourage lending to help stimulate the economy. The move was also widely interpreted as an effort to weaken the Yen which has remained stubbornly strong throughout most of the past 3 quarters. In a related development, 10-year Japanese bond yields went negative representing the first time negative rates have stretched this far on the yield curve for a major Developed Market Economy. In Europe, the European Central Bank, which implemented a negative rate policy nearly 2 years ago, announced even lower rates and an expansion and broadening of its asset purchase efforts (quantitative easing.) Despite these measures the Euro strengthened versus the dollar, while bond yields dropped. Ten-year German Bunds shed 50 basis points during the period ending the quarter scarcely above 10 basis points.

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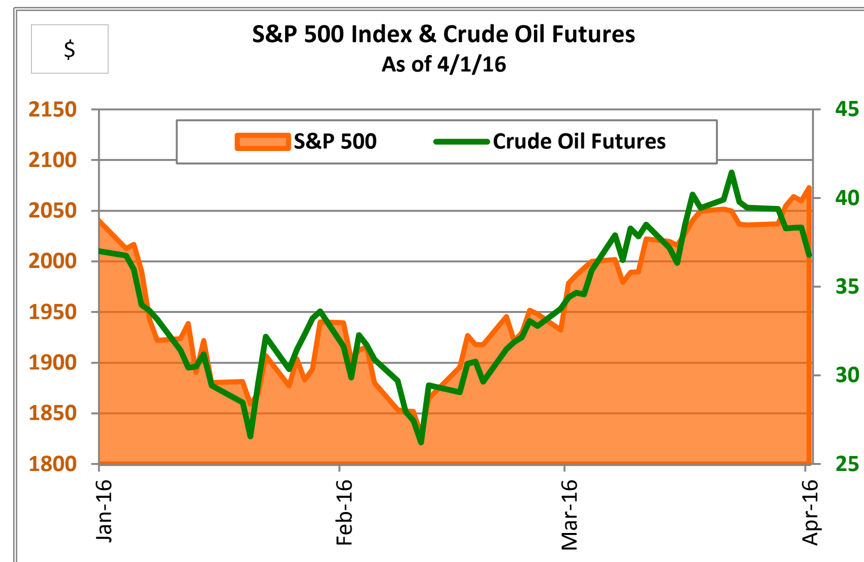

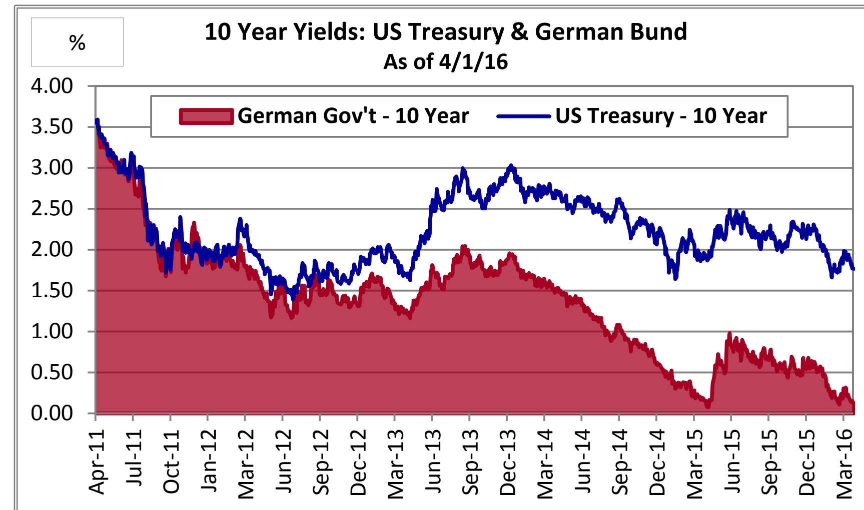

Source: Bloomberg

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Guiding Portfolio Strategies

McDonnell Investment Management, LLC

Back in the US, the Federal Reserve kept policy rates steady and reduced guidance both for its expectations for future rate hikes as well as for its outlook for economic growth. The Fed ratcheted back its projection of 100 basis points of increase in 2016 to only 50 basis points, more in line with market expectations. Policymakers face a difficult balancing act as US growth remains solid, labor markets are strengthening and inflation appears to be moving higher, albeit modestly and from the flatline; while global growth and capital market volatility remain too fraught to ignore. Over the near-term, it seems likely that the slower and lower glide path for rates remains the most probable scenario. Looking beyond the short-term however, there exists a wider gap of expectations as the revised Federal Reserve Summary of Economic Projections foresees short-term rates rising to 3% by the end of 2018 while forward market pricing implies a level closer to 1%. How this gap is resolved will be of intense focus for investors now and going forward.

There is a well-worn equity market maxim that a bull market 'climbs a wall of worry' and the same case can be applied to the US economic recovery. The list of potential disruptions remains long and growing, but the world's largest economic engine continues to power forward. As we approach the 8-year mark of the recovery, it is worth noting that most of the downside risks facing the economy come from abroad. Whether it is slowing growth in China, the refugee crisis facing Europe and now the potential self-inflicted wound of a British exit from the European Union, all of the major risks emanate from abroad. As we view the domestic landscape, we remain optimistic on growth. Employment gains have been steadily reducing the ranks of idled workers and consumption remains relatively strong. Capital investment has been disappointing, but there do not appear to be major dark clouds on the horizon at this juncture. As such, we anticipate moderate growth and low levels of inflation over the medium-term. We expect greater stability in the capital markets will allow the Fed room to resume its intended path of gradually increasing short-term interest rates, and we continue to expect a relatively benign impact on the longer-end of the yield curve. US rate markets over the past 5 quarters have been largely range-bound amid muted levels of inflation domestically, counterbalanced by deflationary impulses from a global economy beset by excess productive capacity and weak aggregate demand.

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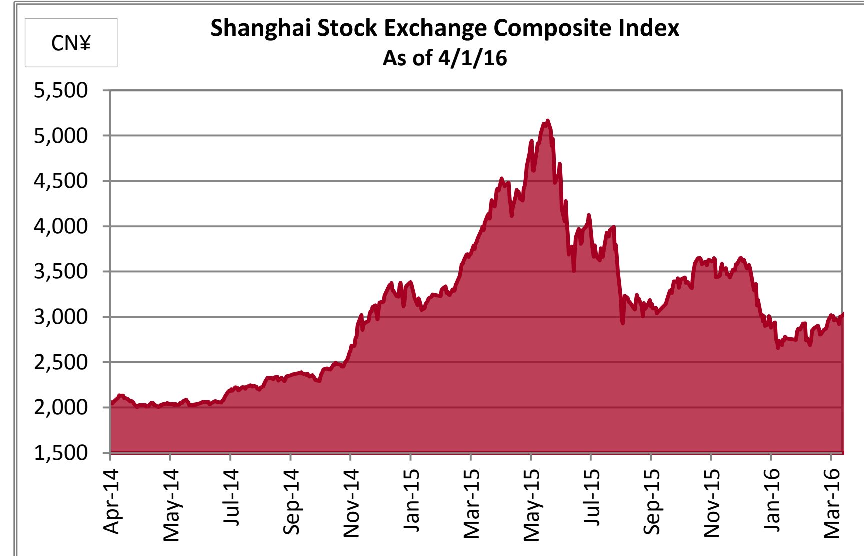

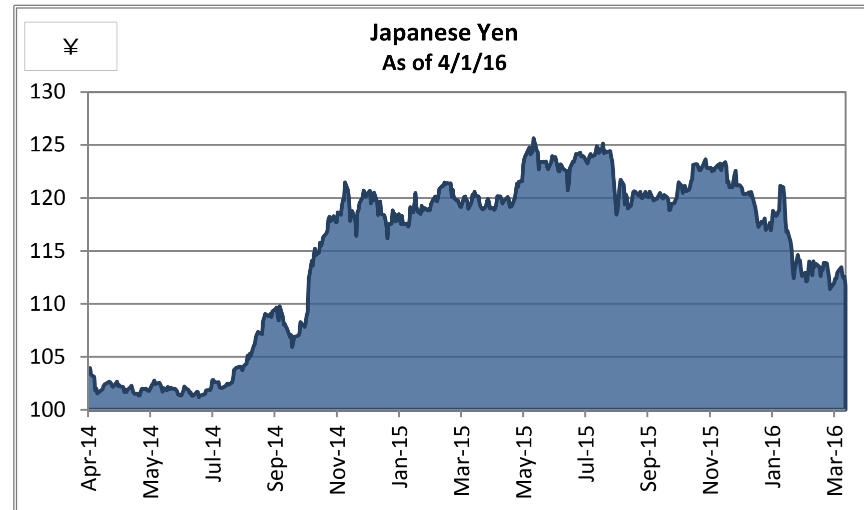

Source: Bloomberg
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- Talks over an agreement to 'freeze' crude oil production remain far from conclusion. Skepticism has grown recently and crude prices have begun to correct lower as we entered the second quarter.
- The Dollar weakened against most currencies during the first quarter on the heels of a more patient Federal Reserve. Currency markets will likely be tested if a June rate hike comes back on the table.
- Market rate expectations versus Fed expectations converged with the Fed climbing down in March; but the divergence chasm over the longer-term remains to be resolved.
- The Chinese Renminbi was stable versus the Dollar but weakened versus a target basket of trading partner currencies. Stability versus the greenback is also likely to be tested going forward.

Taxable Market

Treasury yields fell sharply across the curve and the yield curve flattened as investors sought safe-haven assets amidst a disruptive start to the new year. However, risk markets broadly recovered as crude oil registered a temporary double-bottom in early February, sparking a broad based recovery across equity and credit markets as the quarter evolved. The relief rally resulted in spread sector assets generating positive nominal and, for the most part, modest positive relative returns versus Treasuries. The strongest gains occurred in the intermediate portion of the yield curve as market participants aggressively priced out more substantive tightening by the Federal Reserve against the backdrop of heightened volatility that greeted the start of the year. Furthermore, the gains held, despite the broad recovery in risk markets as Fed Chair Yellen presented a more patient view concerning the pace of rate increases as well as heightened concern over global developments than had generally been expected.

- Treasury yields plunged amid flight-to-quality buying sparked by a chaotic start to equity trading in China.
- Treasury gains for the most part held despite a broad recovery in equity markets which was fueled by a reversal in crude oil markets.
- Credit markets took their cue from oil and tightened modestly. Gains were strongest in sectors directly impacted by energy and commodity prices.
- Reflecting the recovery of investor risk appetite, High Yield debt generated the strongest nominal and relative returns for the period.
- Mortgage-Backed Securities underperformed on a relative basis, as the combination of heightened volatility and negative convexity detracted from returns during the period.

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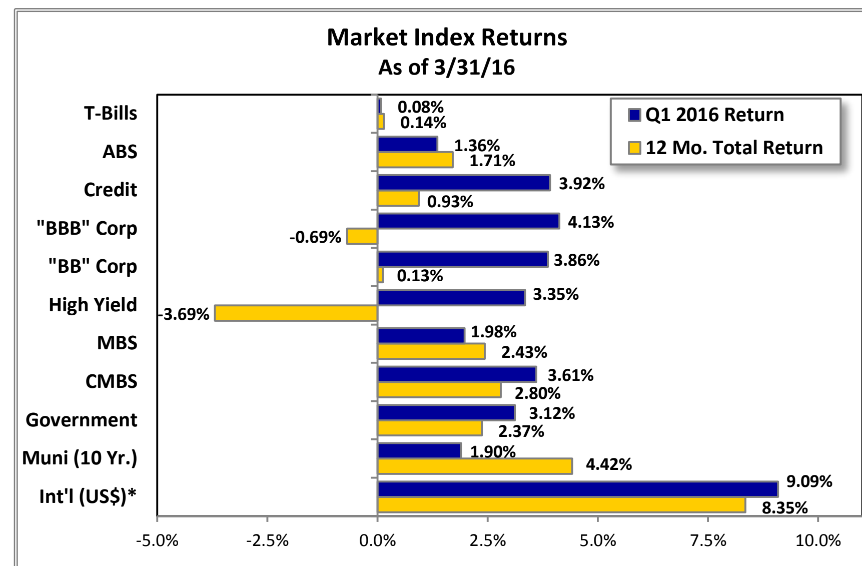
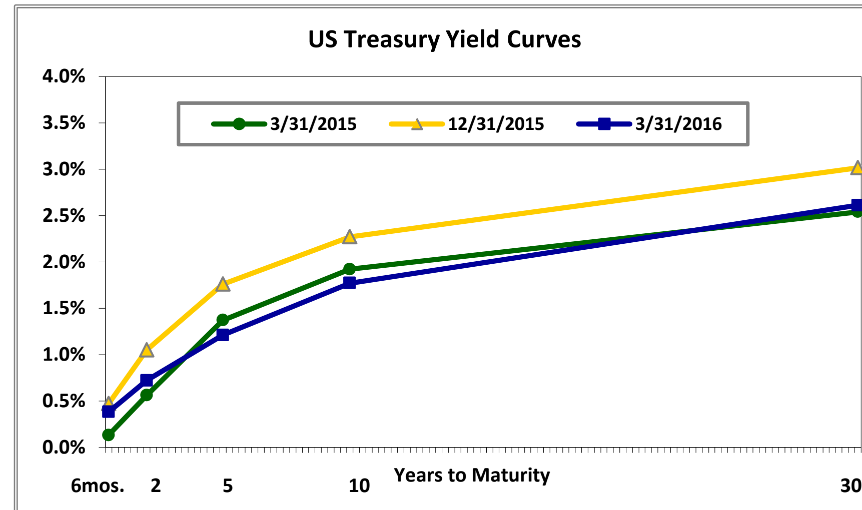


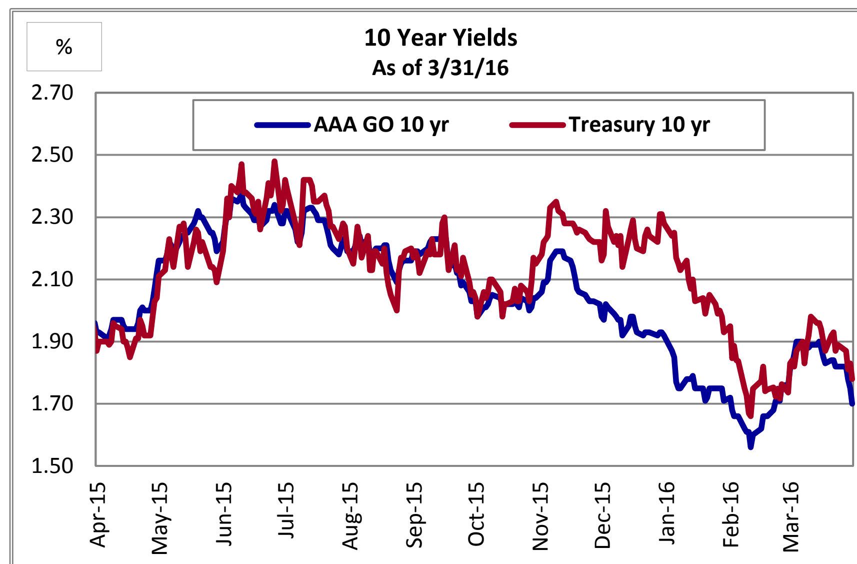


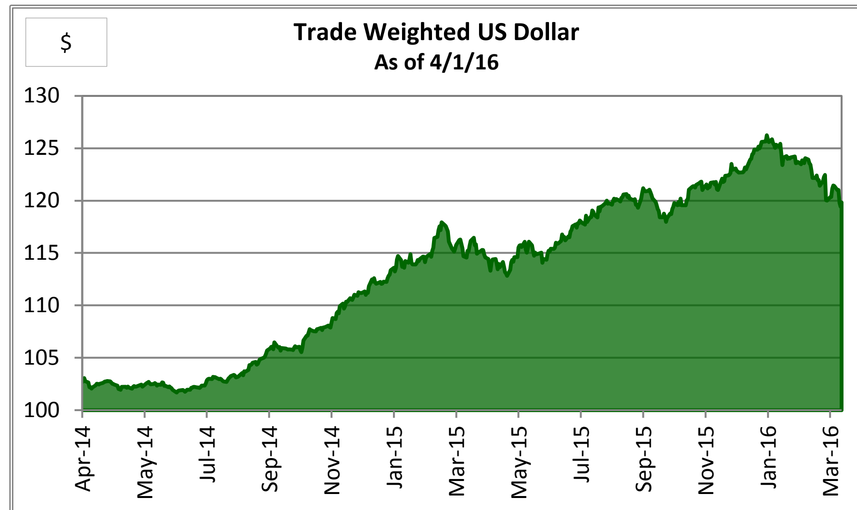
*Source: Bloomberg; Barclays; *Merrill Lynch.*
All indices, other than those noted, are Barclays indices. Please refer to the Notes and Disclosures on the last page for additional information.

Municipal Market

Municipal yields fell as flight-to-quality buying boosted bond prices across the yield curve with gains most pronounced in the intermediate portion of the curve. Volatile capital market conditions combined with a seasonal 'January effect' helped keep a strong bid in the municipal market throughout the first quarter. Price gains were modest however, in comparison to Treasuries. While municipal gains were modest, the strong rally in Treasuries left Municipal/ Treasury valuation ratios in more attractive ranges, particularly on the longer-end of the yield curve. Demand remained strong and municipal mutual funds have experienced 6 consecutive months of positive inflows. The supply front experienced a new dynamic of late with New Money Issuance rising by 34%, while Refunding Issuance dropped 25% versus last year's pace. New issue supply in aggregate fell nearly 9% short of last year's total. We expect the pace of Refunding deals to accelerate as low nominal rates and a large pool of debt eligible for economic refunding should bring issuers back into the market as the year unfolds.

- Municipal yields declined across the yield curve as safe-haven buyers sought refuge in high-quality asset markets generally.
- New Issue Supply continued to fall short of last year's pace marking 7 consecutive months of lighter issuance despite a lower than anticipated rate environment.
- In a reversal of last year's trends, the pace of New Money Issuance rose while Refunding Issuance declined.
- Mutual Fund Flows remained positive and supportive of the market.
- Valuations versus Treasuries improved as Treasury yields fell sharply.





Source: Bloomberg; Municipal Market Data.
Please refer to the Notes and Disclosures on the last page for additional information.

NOTES AND DISCLOSURES:

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