Fixed Income Market Commentary ✧ August 2016

Market Overview

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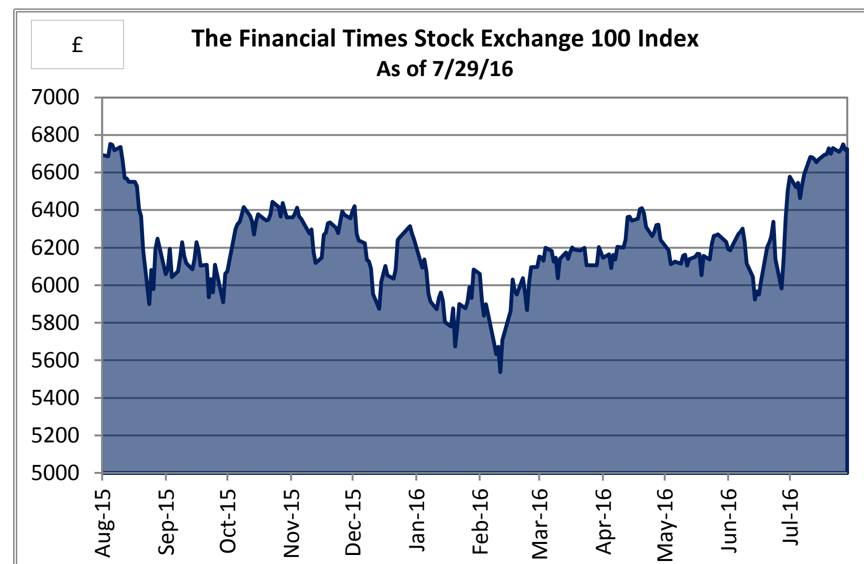
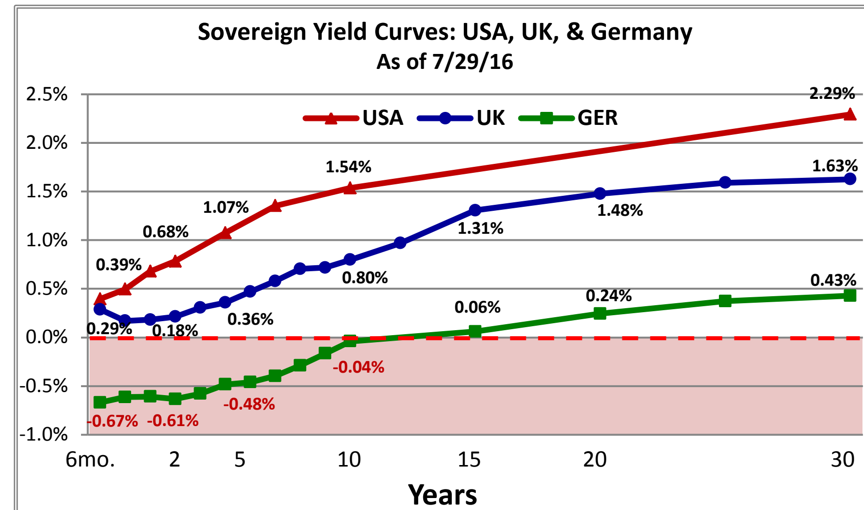
Market reaction began to calm somewhat following the disruptive fallout that followed in the wake of the June 23rd Brexit Referendum. The installation of new Prime Minister, Theresa May, had a mild stabilizing effect following the resignation of David Cameron and the political meltdown of contenders who were once considered his likely successors. May has indicated that she intends to move forward in a disciplined fashion to officially invoke Article 50, after which time, formal 2-year negotiations will commence. But while capital markets calmed, UK economic fundamentals began exhibiting clear signs of the negative impact stemming from falling confidence amid rising uncertainty regarding the shape and timing of the implementation of withdrawal from the European Union. A snap survey of UK consumer confidence suffered its largest drop in more than 20 years as uncertainty clouded the outlook for investment and trade. U.S. rate markets surrendered a portion of their Post-Brexit gains with the Treasury curve flattening as intermediate yields edged higher while the Municipal curve steepened led by a correction on the longer-end of the curve. Equities rallied sharply with U.S. indices scoring fresh all-time highs, while bourses in most Developed Markets also rose. The risk market recovery did not extend to the energy market however, where crude prices sank nearly 20% below last month's highs. Analysts attribute weakness to expanding production from Iran and the U.S. among others, as well as souring market sentiment being fueled by a burgeoning stockpile of gasoline being held in reserve due to persistent price weakness.

The US economic recovery has now entered its 8th year, albeit at a somewhat slower pace of growth than many, including economists at the Federal Reserve, had anticipated. The advance estimate of second quarter GDP was measured at 1.2% which was less than half the pace expected by consensus estimates. The shortfall was largely a consequence of weak investment and declining inventories, neither of which is a new development, although the degree of weakness was more significant. Personal Consumption Expenditures were robust however, and are estimated to have accelerated sharply in the second quarter. While it seems unlikely that businesses will continue to deplete inventories while consumption expenditures are strengthening, this marked the 5th consecutive quarter of inventory drawdowns and may be a reflection of declining business confidence in the growth outlook over the medium term. Global growth prospects were also shaded slightly lower by many observers in the wake of Brexit and also reflecting concerns that steady growth in China, while meeting targets, is being fueled by an unhealthy and ultimately unsustainable buildup of debt. China continues to expand credit at a pace far in excess of nominal GDP growth. By definition, this dynamic cannot be maintained indefinitely. Whether the precarious imbalance is corrected at some point over the medium-term or whether the world's second largest economy can delay reform for longer into the future remains a critical factor in the overall global economic outlook. Given the size of its economy, it is probable that policymakers can continue to push the envelope for awhile; but ultimately forestalling economic reforms will only increase the cost in terms of the ultimate growth slowdown and its duration when the process begins in earnest.





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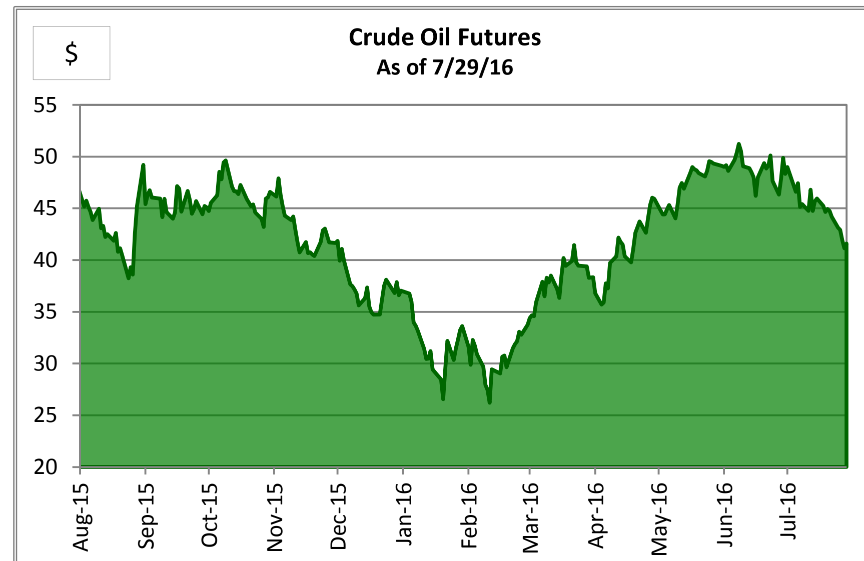
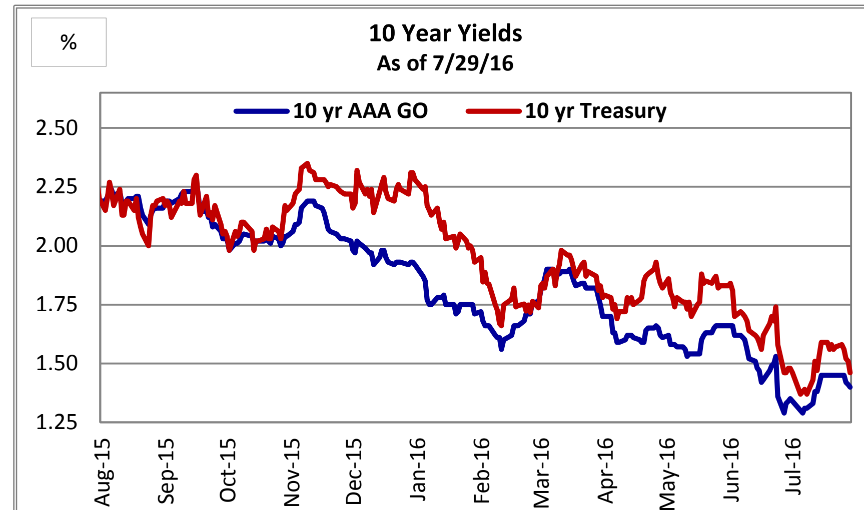
Market Overview

- **Corporate credit broadly outperformed Treasuries as the risk-on mode predominated being led by the lower-quality end of the spectrum.**
- **Domestic yield curve movements diverged with the Treasury curve flattening while the Municipal curve steepened sharply.**
- **Equity markets recovered including a substantial rally in UK stocks largely in anticipation of additional monetary accommodation.**
- **Energy markets corrected markedly lower led by falling crude oil prices which sank nearly 20% below recent year-to-date highs.**

We expect moderate growth to continue and view the hawkish arguments for embarking on a higher rate policy anytime soon with skepticism. We view the risk of holding rates steady to be minimal and harbor concerns about potential unintended fallout that could be triggered by a premature resumption of policy 'normalization.' Roughly half of the outstanding sovereign debt of Developed Market (DM) issuers trade at negative yields through some portion of the yield curve. The sentiment that the Fed can focus exclusively on domestic economic fundamentals would seem to imply that the US can single-handedly lift the global rate structure at a time when growth challenges have intensified rather than abated. The International Monetary Fund and the G-20 Finance Ministers recently recommended that policymakers focus on monetary as well as fiscal policy options to attempt to boost growth to levels that can generate self-sustaining economic momentum to propel and extend the recovery forward. Furthermore, the geopolitical environment remains fraught. The attempted coup in Turkey, the refugee crisis pressuring Europe and the plague of terrorism all add uncertainty to the outlook over the medium-term. While the Fed may indeed choose to act alone, it would risk strengthening the U.S. dollar, pressuring commodity markets (energy) further and weakening the momentum of the U.S. economy.





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