McDonnell Investment Management

Fixed Income Market Commentary ✧ December 2016

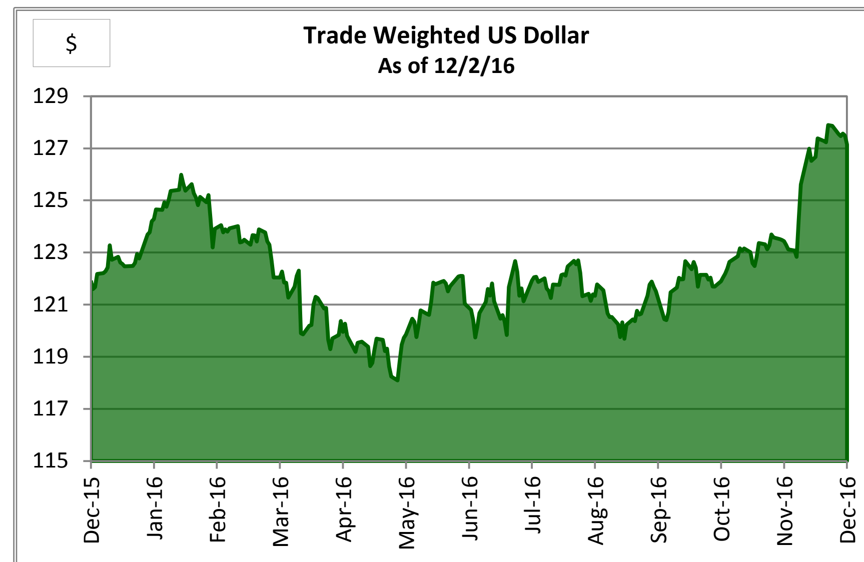
Market Overview

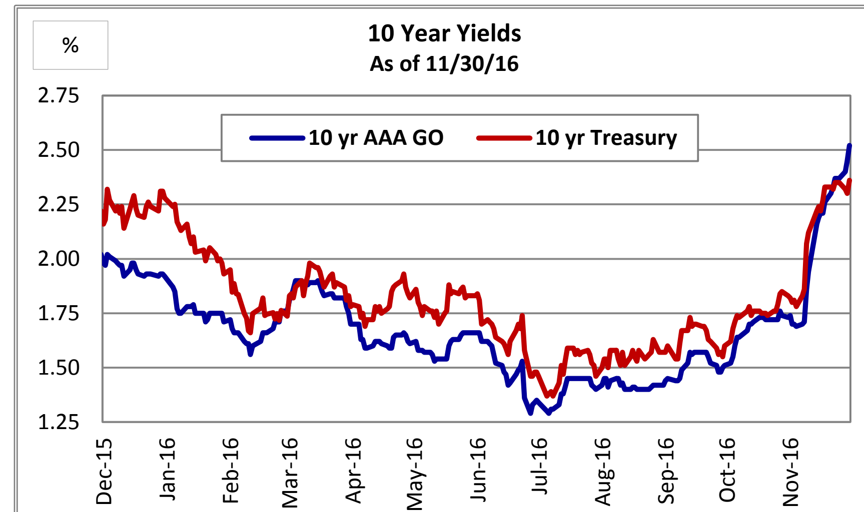
Jim Grabovac, CFA

Rate markets reeled in reaction to the election results and prospects of one-party government potentially pushing through significant fiscal stimulus at a juncture when the economy is running at or near full employment. Inflation expectations rose and yield curves steepened sharply as anticipated Fed action took a back seat to market rate increases which have now positioned the FOMC as following rather than leading rate markets over the period ahead. Most investors now anticipate a second Fed rate boost in December and assess a high likelihood that the Fed will be able to meet its expectations of two additional rate hikes in 2017. Bolstering the case for somewhat higher inflation was an agreement reached by OPEC to cut oil production by 1.2MM barrels per day beginning in January and lasting for a period of 6 months. Russia, a non-OPEC member, also agreed to the new production schedule. Oil has been chopping sideways mostly between $40 and $50/bbl. for most of the past 6 months, but the accord caused prices to firm above $50 at least for the near-term. The prospect of US shale production increasing if price gains hold as well as the historical propensity for OPEC members to exceed production quotas could help limit potential upside however.

Risk markets were buoyed as equities rallied and corporate spreads tightened, but the dominant action was reflected in rising rates and a sharply strengthening dollar. The US dollar consolidated for much of the year but the prospect of higher US rates caused a significant reaction to the upside as global capital market participants weighed not only diverging monetary policies between the US and most major developed market (DM) economies but also the possibility that US fiscal policy may take a decidedly different turn heading into 2017. With the incoming government now controlled by one party, investors will now assess whether fiscal stimulus in the form of an Infrastructure Program and tax cuts will potentially provide a major boost to the economy and possibly increase the glide path for Fed rate hikes over the year ahead. While uncertainty over the outlook for fiscal policy has sharply increased, we anticipate that a strengthening dollar will have an amplifying effect over potential changes in Fed interest rate policy. Global rates were lifted alongside with the US reaction but at a more muted pace. As a consequence, DM rate differentials are at decades wide levels as ultra-low nominal sovereign rates remain the order of the day across much of Europe and Japan. Considering the pressure to replace diminishing high quality income streams facing investors worldwide, we expect the domestic case for higher US rates will be tempered by a continuation of a moderate global growth environment characterized by weak aggregate demand and excess capacity.

- US rates rose sharply in reaction to the election and yield curves steepened.
- Municipals underperformed Treasuries as Fund flows reversed, sparking significant redemptions in the wake of falling bond prices.
- Corporate credit generally outperformed with lower quality and longer-term paper generating the strongest returns relative to Treasuries.
- The US Dollar strengthened amid perceptions of the potential for tighter Fed policy to serve as an offset to greater fiscal accommodation in a period of near-full employment.





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

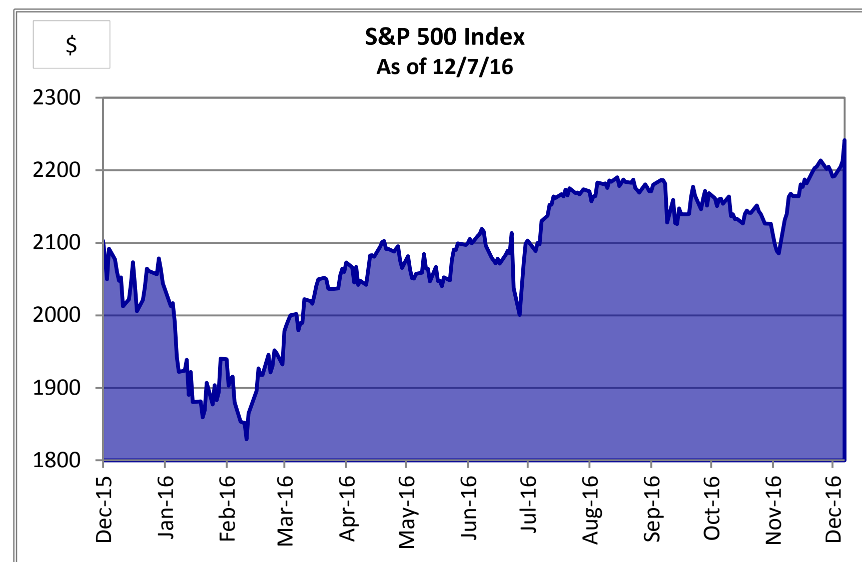
Guiding Portfolio Strategies
McDonnell Investment Management, LLC

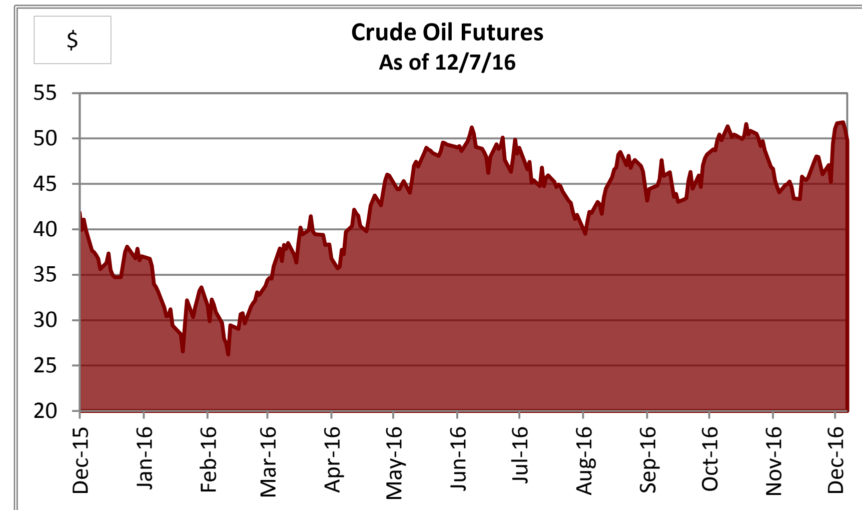
Market Overview

- Equity markets rallied on expectations of accommodative fiscal policy contributing to strengthening growth.
- Crude oil moved up to recent highs on the back of an agreement to reduce production in light of growing oil inventories.

Another political domino fell in the European Union as the Reform Referendum favored by Italian Prime Minister Matteo Renzi was soundly defeated on December 5th. As a consequence, he has resigned, and efforts to form a new government have been undertaken. It is not yet clear if a caretaker government will be formed or if new elections will be held. Significant opposition parties are considered anti-Euro and have expressed the desire to hold a referendum over whether to remain in the Eurozone. Anti-establishment political movements have been on the boil amid slow global growth and policymakers' enforcement of strict fiscal austerity. France will be the next critical European Union member with a scheduled national election in the spring followed by Germany in the fall. The future of the Eurozone may be challenged if the wave of populism gains additional momentum.

We expect the rate markets to catch a foothold given the swift move in yields to date. The Fed will largely be in the position of following the market and, as such, could have more latitude in 2017 amid the move higher in rates across the yield curve. But reinvestment risk has plagued investors for much of the post-Great Recession period with nominal yields down by roughly 200 basis points across most of the curve over the past 8 years. The ability to invest at higher levels and extend along a more positively sloped yield curve should present an attractive opportunity for many investors. We believe the most likely case for the growth mix going forward is some degree of Federal fiscal stimulus adding modest additional momentum to growth over the medium term combined with a gradual drift higher in inflation. The steady march higher in the housing and medical components of the indices should allow the Federal Reserve to meet their policy objective of 2% inflation, and employment gains continue to heal the labor market. We do not expect a regime of significantly higher interest rates will be consistent with the broader economic environment or with the goal of extending the economic expansion over the medium-term.





Source: Bloomberg.
Please refer to the Notes and Disclosures for additional information.

NOTES AND DISCLOSURES:

This market outlook is prepared by McDonnell Investment Management, LLC ("MIM") for informational purposes only. The information set forth is neither investment advice nor legal advice. It is presented only to provide information on investment strategies and our view of potential market opportunities. The views expressed by MIM on financial market trends are as of the date of this publication, based on current market conditions and are subject to change without notice. Statements of future expectations, estimates, projections, and other forward-looking statements are based upon available information and MIM's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions that may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. The data used for this presentation was obtained from publicly available reports. Unmanaged Index/yield returns include the reinvestment of dividends/interest and other earnings and exclude the deduction of advisory fees and other transaction costs a client may incur. It is not possible to invest directly in an unmanaged index. MIM cannot assure that the type of investments discussed herein will outperform any other investment strategy in the future, nor can it guarantee that such investments will present the best or an attractive risk-adjusted investment in the future. There are no assurances that any predicted results discussed herein will actually occur. Past performance is no guarantee of future results.

Guiding Portfolio Strategies

McDonnell Investment Management, LLC