McDonnell Investment Management

Fixed Income Market Commentary ✧ December 2017

Market Overview

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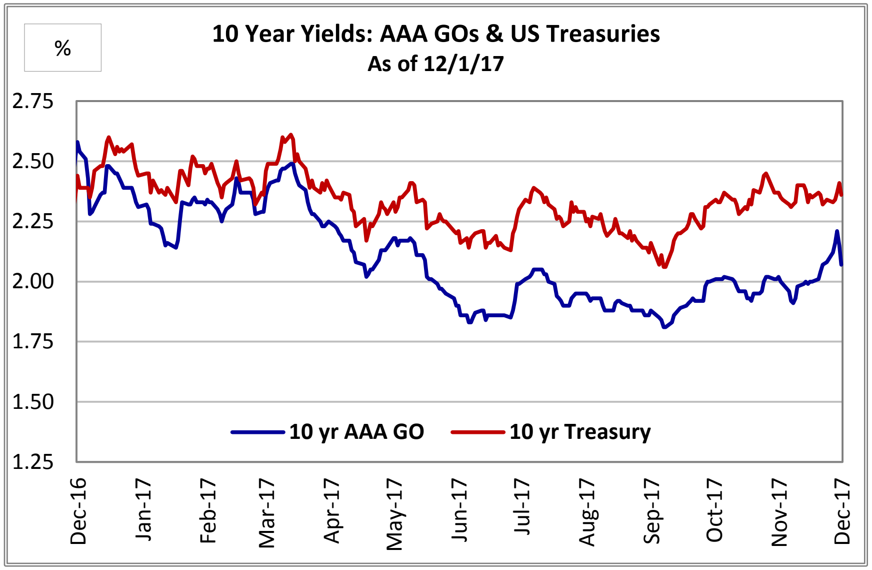
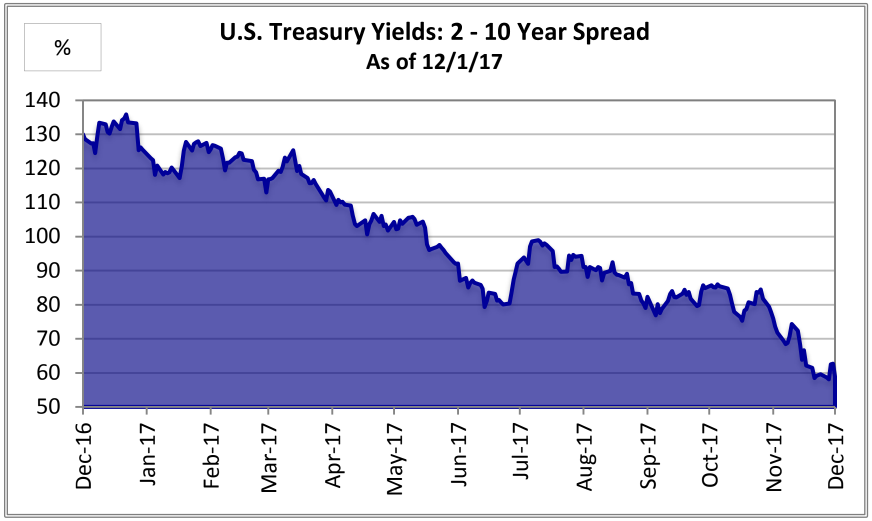
Rate markets continued to retreat as the House and Senate passed companion legislation designed to slash corporate tax rates and usher in a host of other changes to the tax code. While the tax plans still seek to converge into a single bill in the Congressional Conference Committee, the likelihood of a massive corporate tax cut helped trigger a series of new all-time highs in US equity markets. Rate markets took their cue from the risk-on rally and yields promptly moved higher and yield curves flattened. But rate moves were relatively moderate and most of the increase remained confined to the shorter part of the yield curve as investors await resolution of important differences between the current House and Senate plans. The speed at which the legislation passed both houses of Congress was a surprise to most market participants, who typically expect more placid market conditions during the holiday month. But quiet November markets have not been in evidence during the past 2 years, and investors should probably not expect a break over the near-term as groups negatively impacted by the tax plans exert maximum effort to persuade legislators to modify the final bill by eliminating or at least mitigating some of the negative impact that this legislation could unleash. Municipal issuers and investors remain particularly attuned to the final product, and issuers have rushed a torrent of supply to market in an effort to beat the pending year-end deadline for Advanced Refunding and Private Activity Bond Issuance.

- Interest rates rose across much of the curve as expectations of looming fiscal stimulus after years of austerity policies prompted rate concerns.
- Yield curve flattening accelerated as short rates rose amid a reassessment of the likely Fed rate path in light of pending tax legislation.
- Municipals underperformed Treasuries amid surging New Issue Supply as issuers raced to beat an expected year-end deadline for certain types of tax-exempt issuance.
- Equities were propelled to new highs as investors embraced the likelihood of a massive corporate tax cut as Congressional Conferees craft the final product.

Federal Reserve Policy appears on track for another ¼ point rate boost following the Committee's mid-December meeting as the tenure of Fed Chair Yellen draws near its conclusion. A gradual pace of rate normalization alongside the continuation of efforts to reduce the Fed's balance sheet appear on track as Governor Powell prepares to become Chair in February. As anticipated, Janet Yellen announced her resignation from the Committee, expected to be effective after Jerome Powell assumes the Chair in February. The degree of turnover at the Federal Reserve is unprecedented. In addition to replacing the Chair and having appointed one governor and nominating a second; the President will have the opportunity to appoint 3 additional governors should he choose to fully constitute the Board. The unusual degree of turnover is largely the result of retirements as the 7 Governor positions were originally created with staggered tenures to help avoid the potential politicization of the Board. In addition to retirements however, 2 positions have been vacant as Congress has refused to approve nominees from the President of an opposing party. With this obstacle no longer in place it seems likely that the full Committee will eventually be seated. The Federal Reserve has been the most effective driver of economic policy since the Great Recession, as Congress largely abdicated its policy role after its initial response to the economic downturn. Fed initiation of the zero-lower bound interest rate policy in conjunction with its Large-Scale Asset Purchase program were instrumental in paving the road to economic recovery. Investors expect, but should not necessarily assume, that a newly constituted Board will operate as effectively in the event of the next downturn. We remain hopeful that the administration will be cognizant of the vital role assumed by the Federal Reserve as it considers candidates for nomination to the most important central bank in the world economy.





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

Guiding Portfolio Strategies

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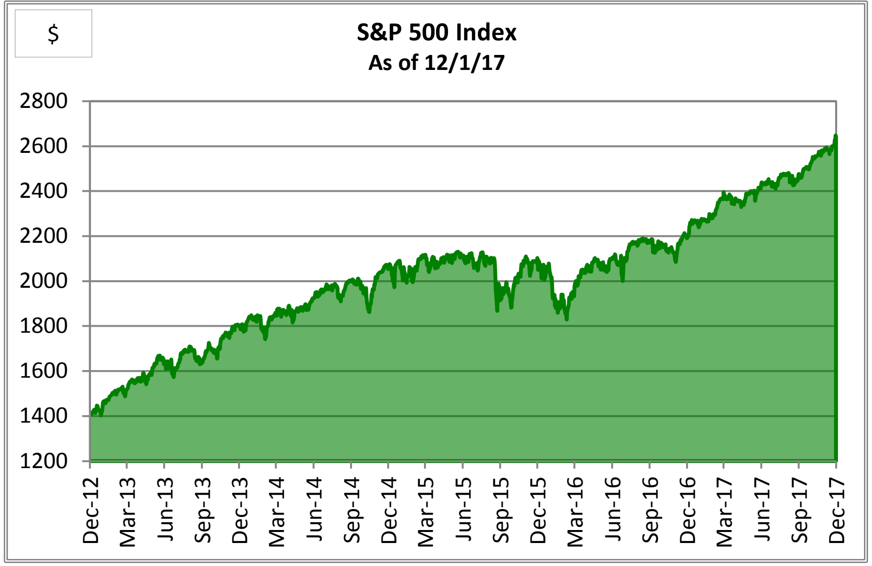
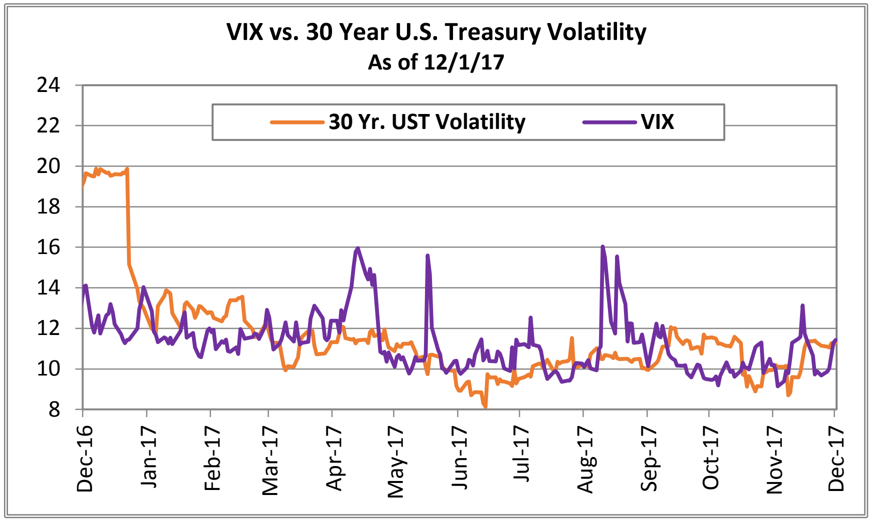
In a late-breaking development, the UK and the EU agreed to the essential outline of a so-called 'divorce settlement' setting the stage for more substantive Brexit trade negotiations to move forward. Overcoming border and regulatory alignment concerns regarding Ireland (EU) and Northern Ireland (UK) were key to the breakthrough. Agreement over payment of Britain's share of EU liabilities after the withdrawal was made, and although no hard numbers were included, estimates range between €40B and €60B as settlement of both existing and contingent liabilities. The border issue was particularly nettlesome given that the Democratic Unionist Party of Northern Ireland represents a small but critical part of the parliamentary majority. Sentiment in Ireland is mostly opposed to a hard border between it and Northern Ireland, while opinion in Northern Ireland is generally opposed to a separate 'regulatory alignment' with Ireland which raises concerns that it would, in effect, result in a barrier with the rest of the UK. Further negotiations over the issue lie ahead, but Britain agreed to keep Northern Ireland in full alignment with EU law absent further agreement, and stated that it was dedicated to an 'all-island economy' while also confirming that the entire UK, including Northern Ireland, was leaving the EU. Agreement was also reached regarding the rights of EU citizens living in the UK (3MM) and UK citizens living in the EU (1MM). The agreement reached in Brussels allows Brexit negotiations to move on to the next phase of the historic process.

Despite uncertainty emanating from pending tax legislation, we anticipate relatively benign conditions for fixed income investors as we approach the end of the quarter. Issuers rushing to beat potential tax law changes by year-end have been met with strong investor demand. As the year winds to a close, it is noteworthy to consider how limited overall rate movement has been despite a more uncertain domestic and geopolitical backdrop. Ten-year Treasury yields continue to be bound by a 60-basis point range from high to low, and the feature of fixed income markets has been quality and sector spread compression. We began the year with expectations of steady economic growth and limited inflation alongside heightened political and geopolitical risk. That narrative provided a workable framework as the year progressed, but the remarkable lack of market volatility, in both fixed income and equity markets, has been surprising. We expect this narrative may continue to be operative going forward unless and until either a correction of significance occurs in risk markets, or the Fed steps on the brake pedal more vigorously than investors anticipate.





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