Market Overview

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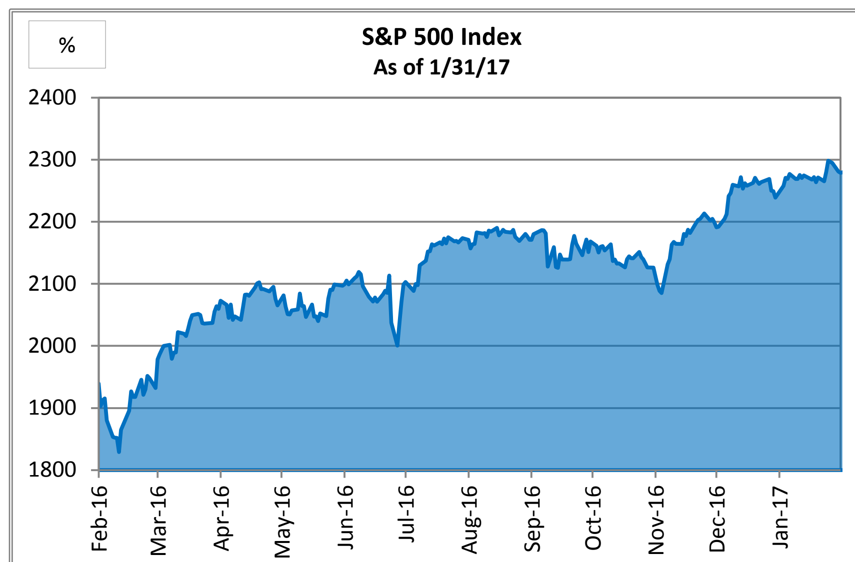
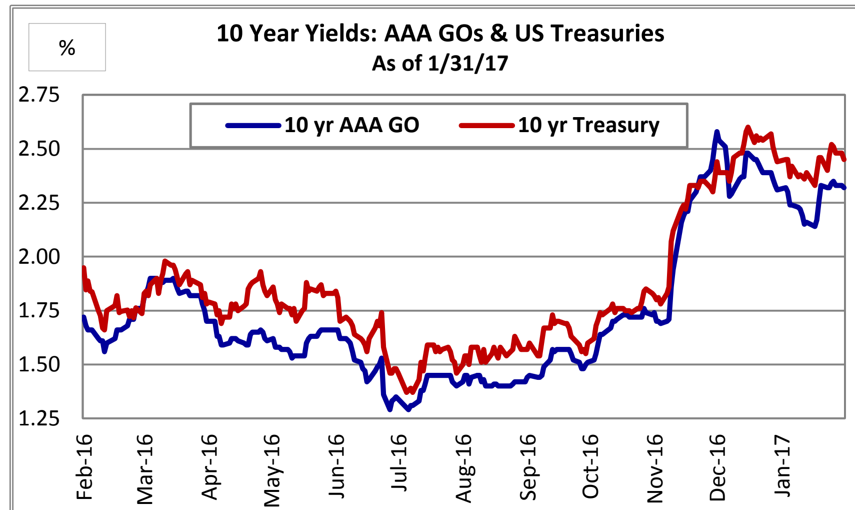
Politics took center stage as the new administration assumed office and began to shape the policy agenda that is likely to dominate the market narrative as the year unfolds. Rate markets moved mostly sideways with yields on Treasuries ending the month largely unchanged, while the municipal curve steepened with shorter-end yields declining while longer-end yields edged higher. Equities scored fresh highs boosted by hopes of corporate tax cuts which, in turn, helped buoy corporates while the dollar weakened. Investor expectations have factored in a more growth-friendly fiscal policy trajectory, but the reality of negotiating and passing legislation will now come front and center as the executive and legislative branches prepare to engage. To date, market reaction has been a reflection of investor hopes and fears; and as the reaction function begins to recede and the potential policy impacts begin to manifest themselves, we anticipate some moderation of growth hopes and tempering of rate fears that occurred in the weeks immediately following the election. On the tax front, Congress is moving to radically alter the corporate tax code by instituting a so-called border tax which would tax goods US companies import while exempting revenues earned from exports from taxation. A separate proposal to eliminate the deductibility of interest expense is also in discussion and would change the taxation landscape dramatically. It is unclear at this early stage whether these policy options can withstand the legislative grinder, but it is important to consider the possibility of rhetoric becoming reality in some fashion as we move forward.

In European developments, the march toward Brexit moved further along in the wake of a UK Supreme Court ruling that maintained that the Government must receive the approval of Parliament to invoke Article 50 triggering formal negotiations for withdrawal from the European Union. The House of Commons voted in favor of authorization, and the House of Lords is expected to consider the issue before the March 'deadline' imposed by Prime Minister May. It is expected to pass, but given the political shocks that have been registered in recent quarters, nothing should be taken for granted unless and until it actually occurs. Elections in the Netherlands which take place in March are next in line, and the anti-immigrant, anti-EU Party for Freedom narrowly leads opinion polling. Investors will be closely monitoring developments for any potential that a second EU member could opt to leave the Union rather than accept open borders. But the major electoral battle with the greatest potential economic and market impact will take place with the French Presidential Election which culminates in May. The initial round of balloting occurs in April. The candidates with the 2 highest vote totals then square off with a second round in May. Pro-European observers are hopeful that France will act as a bulwark against the wave of anti-globalist populism that has been gaining momentum. The events come amid the backdrop of the new administration taking the unusual step of actively encouraging anti-EU sentiment and potentially destabilizing Europe in the process.

- US rate markets consolidated following a volatile Q4, as investors looked to Washington to attempt to divine future policy direction, magnitude and timing.
- Municipal Mutual Fund outflows reversed course and modest inflows resumed during the period.
- Spread sector assets were mixed with corporate credit generally producing positive excess returns, particularly on the lower-end of the quality spectrum.
- Domestic equity markets rallied, adding to gains generated during the swing higher following the November election.
- Currency markets corrected sharply and the dollar weakened against most Developed and Emerging Market currencies.
- Crude oil prices traded sideways as voluntary production cuts came on track to be implemented in January.





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

Guiding Portfolio Strategies

McDONNELL INVESTMENT MANAGEMENT, LLC

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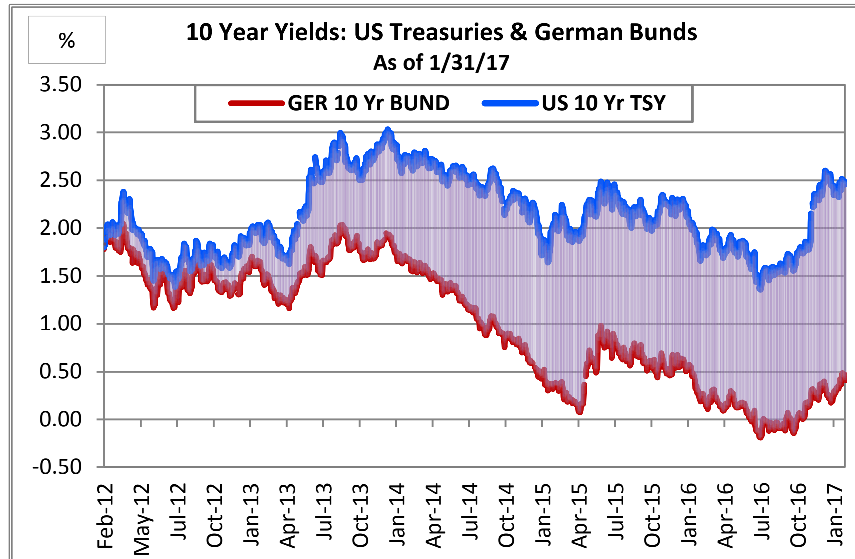
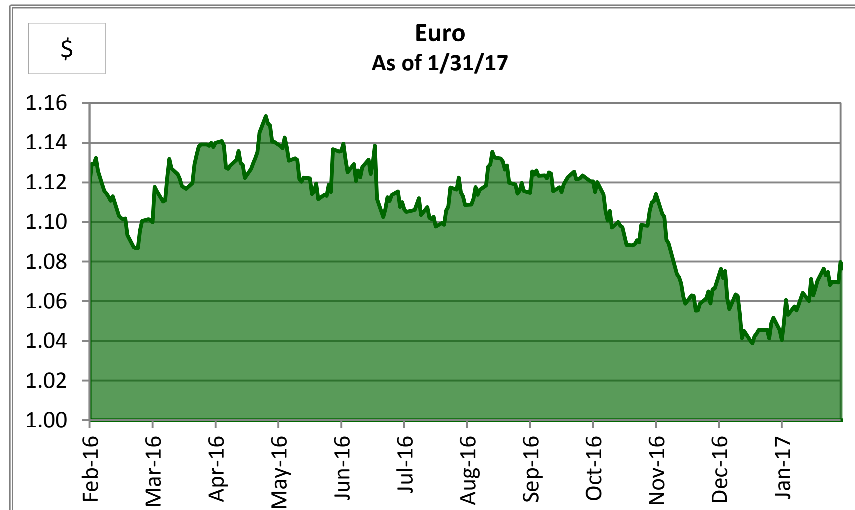
Economic growth was estimated to have declined to 1.9% during the fourth quarter from the 3.5% rate registered in Q3. In the Advance Estimate issued by the Bureau of Economic Analysis, a one-time Q3 surge in soybean exports was noted as a contributing factor in the deceleration. Personal Consumption remained strong and Business Fixed Investment and Inventory rebuilding contributed to output gains. The fundamentals driving the economic expansion appear solid and the recovery is set to become the third longest expansion since the mid-1950's. It has, however, the dubious distinction of producing the slowest average growth rate of any recovery period during that time. The combination of post-crisis deleveraging and a half-decade of self-imposed fiscal austerity created significant headwinds which slowed economic momentum more than would otherwise have likely been manifested. In terms of job creation, the current expansion produced gains which now exceed the pre-recession peak in employment by more than 7MM jobs, and nearly 16MM in gains from the employment trough in 2010. Meanwhile, inflation has been recovering and is approaching the Fed's 2% target. CPI inflation (fixed-weight index) has now moved above target, while inflation as measured by the Personal Consumption Expenditures Index (variable-weight index) remains modestly below target. Nevertheless, gradually recovering inflation has likely eased Fed concerns as the Committee approaches monetary policy deliberations.

Employment growth and recovering inflation provide a more favorable backdrop for the Fed to continue its attempts to 'normalize' monetary policy. In the December release of the Summary of Economic Projections, the Federal Reserve indicated expectations for 3 additional ¼ point rate hikes in 2017. We expect that domestic economic conditions could readily weather the removal of policy accommodation in stride; however, we remain more skeptical that the global rate and currency markets are similarly situated. Yield spreads between US Treasury rates and major Developed Market Sovereign rates are in many instances at or near historically wide levels. The dollar, while it has corrected recently, may well resume its uptrend if a series of rate moves begins to develop a higher likelihood of occurrence. For now, investors are pricing in a much less aggressive monetary policy path than is being considered at the Fed. We concur with that conclusion at this juncture. We continue to expect that moderate economic growth along with inflation returning to target will provide the Federal Reserve room to raise rates further, but we expect the pace and ultimate level of tightening to be tempered by global economic and capital market restraints. Finally, we view potential political developments as likely to play an outsized role in market development over the period ahead.





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