McDONNELL INVESTMENT MANAGEMENT

Fixed Income Market Commentary ✧ February 2016

Market Overview

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Risk markets suffered a steep slide in January as last year's trends gained renewed momentum and heightened volatility as the trading year commenced. China's market woes intensified as further currency weakness and sizeable capital outflows contributed to a downdraft in share markets of more than 20% in January alone. Share trading was twice suspended during the first week of trading with prices plummeting by the maximum daily limit of 7% during these sessions. While equity market and currency volatility is most visible to capital market participants, these manifestations may dwarf potential problems in the credit markets due to China's rapid buildup of debt and slowing growth combined with deflationary conditions across much of its economy. Prices at the wholesale level in China have declined for 46 consecutive months. Further, the Bank for International Settlements (BIS) estimates total non-financial debt to have more than doubled since 2009 increasing the Debt/GDP ratio by 60% to nearly 244%. The combination of rapid credit growth and slowing nominal economic growth is an inherently unstable condition which can result in economic disruption if policy adjustments are not effectively implemented. Policymakers to date have focused on initiatives to address the imbalances in the economy but are increasingly tempted to backslide in the face of heightened market volatility.

Most other Emerging Market (EM) countries fared better on a relative basis, but commodity and currency market weakness remain common themes across most regions. Equity markets across Developed Market countries also fared poorly as growth concerns intensified. After initially taking December's rate rise by the Federal Reserve in stride, market participants are joining an increasingly loud chorus blaming the Fed for committing an unforced policy error in embarking upon a tightening path in the face of flatline inflation, a strong dollar and weakness abroad. To be sure, such criticism is not universal, but market performance in the wake of December's rate rise will likely temper the Board's enthusiasm for a second round of tightening over the near term. Forward market pricing as the year began reflected expectations that the Fed would only engineer another 50 basis points of tightening by year-end versus the 100 basis point 'expectation' indicated by the Fed. Following the rocky start in January, investors now believe the Fed may only accomplish one additional ¼ point rate boost by year-end. Fed officials have also recently indicated greater uncertainty about the future path for rates in light of current developments.

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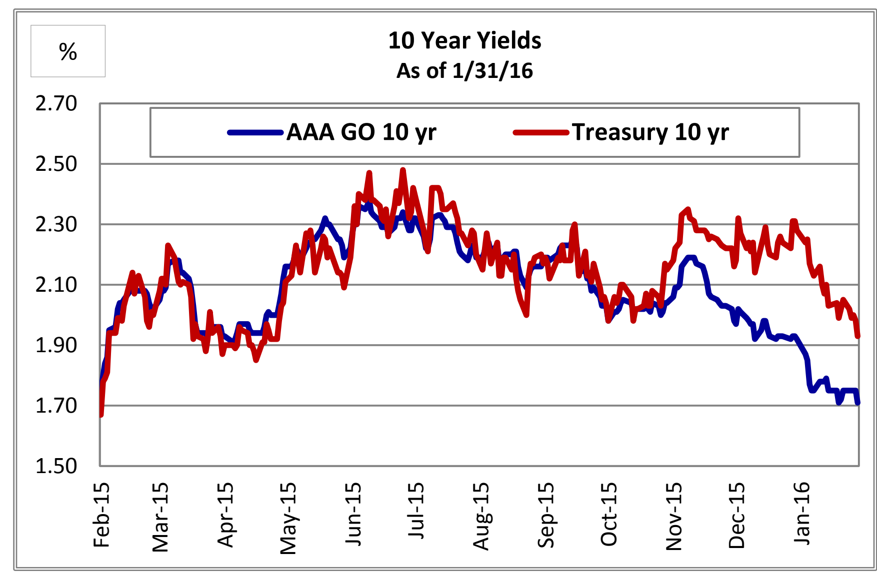

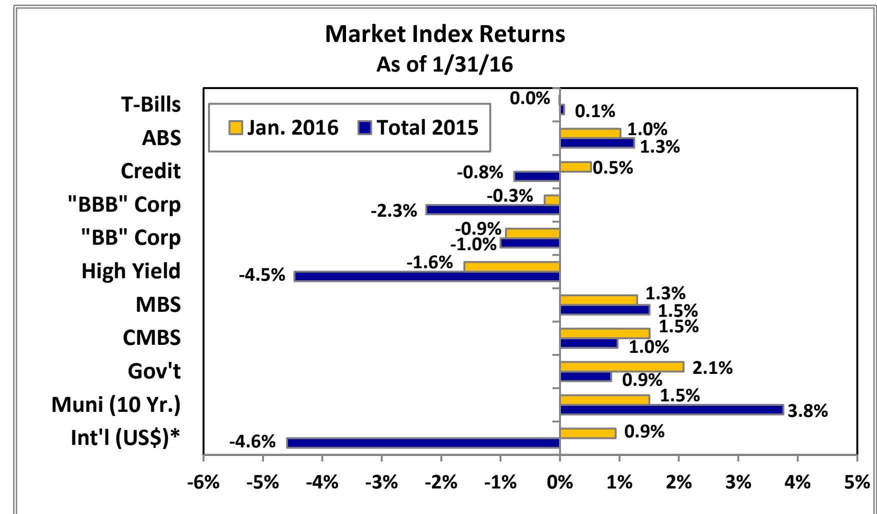

*Source: Municipal Market Data; Bloomberg; Barclays; *Merrill Lynch.*
All indices, other than those noted, are Barclays indices. Please refer to the Notes and Disclosures on the last page for additional information.

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Market Overview

In the wake of the global selloff, US fixed-income markets rallied sharply registering gains across the yield curve with particular strength occurring in the middle of the intermediate curve as expectations of future rate hikes were reduced and deemed a more distant eventuality. Gains were strong in the municipal market as well, but failed to keep pace with the momentum in Treasuries. Meanwhile, other spread sectors also trailed as the corporate market dealt with fresh weakness in energy and commodity related credits as well as a continuation of broadly weaker earnings and revenue results. Plunging crude oil and commodity prices have had both a direct and an indirect impact on risk markets generally and equity markets specifically. Certainly, the impact of plunging revenues and declining earnings is readily apparent in the performance of affected companies. In addition, risk markets are experiencing a second round impact as sharply lower oil prices are rumored to have resulted in large-scale selling by Sovereign Wealth Funds desperate to liquefy asset holdings to help shore up widening budget gaps. Russia recently announced that it is considering privatizing significant state owned enterprises to help stabilize its finances. Market observers are skeptical of whether investors would participate in share offerings should they occur, but it is nevertheless indicative of the pressure being brought to bear on countries which are heavily dependent upon oil revenues.

- **Share markets sold off sharply led by weakness emanating from China.**
- **US rate markets rallied strongly with yield declines most pronounced in the intermediate portion of the curve.**
- **Spread sector assets broadly failed to keep pace with gains in Treasuries.**
- **Energy market rout continued with crude oil plunging more than 20% intra-month and scoring a fresh 12-year low.**
- **US dollar strengthened, particularly versus many EM currencies.**

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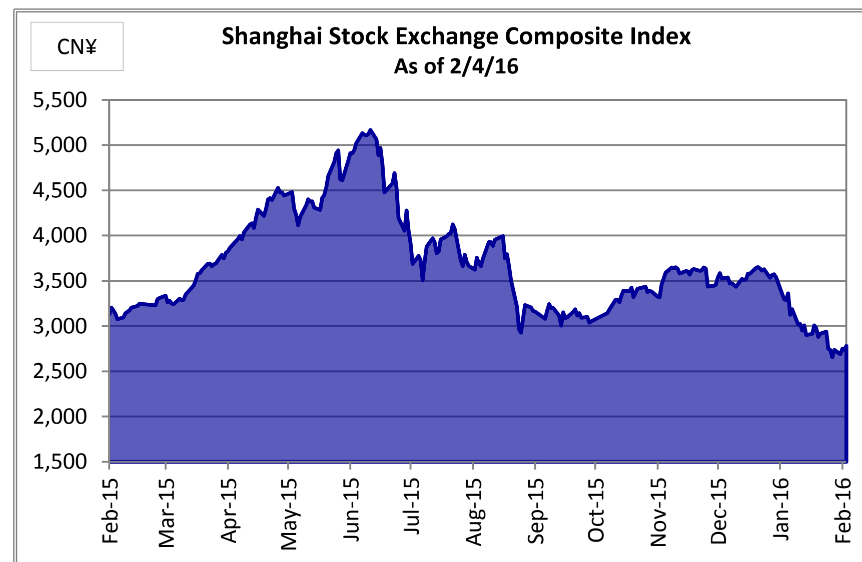

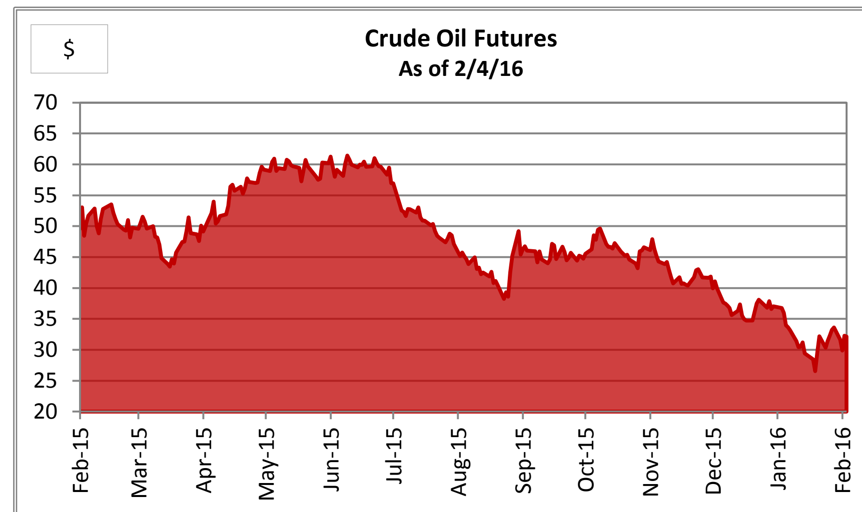

Source: Bloomberg
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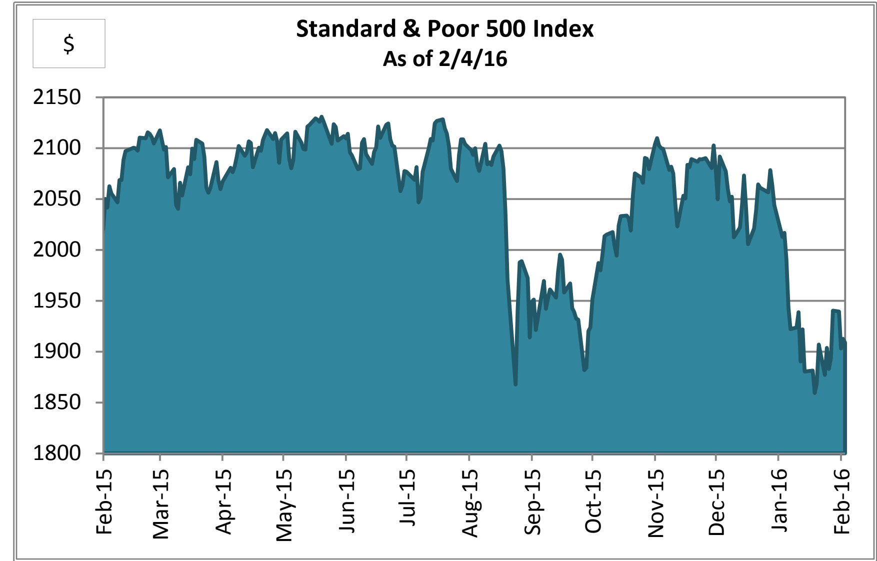
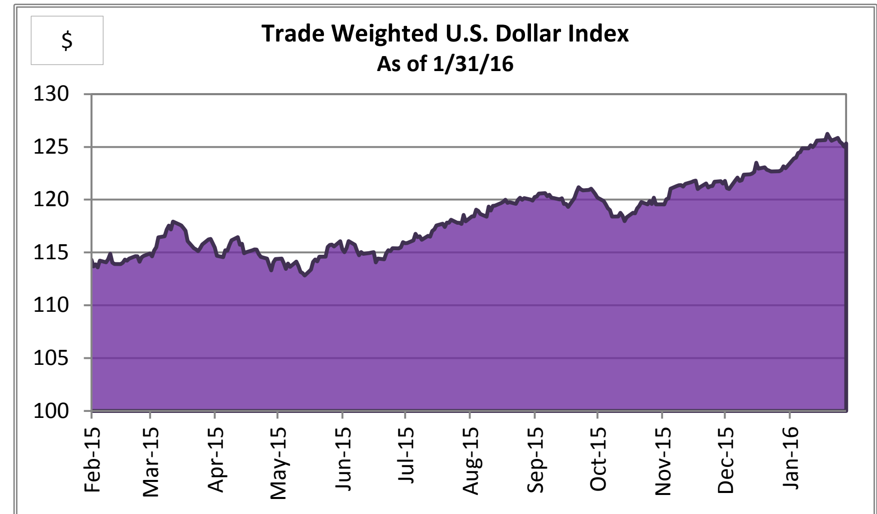
Market Overview

Economic growth is estimated to have decelerated sharply in the fourth quarter reflecting weaker business investment and declining trade in the wake of slower growth abroad. Personal consumption remains relatively strong, however, as job gains continue to power spending and weakness in energy prices adds discretionary dollars to consumer wallets. Growth in employment and strong consumption remain critical elements in the monetary policy discussion to date. Fed policy statements reflect a consensus view that expects diminishing labor slack to ultimately translate into stronger wage gains which in turn could result in upward pressure on inflation. The Fed has also indicated that it believes that weakness in inflation currently is being driven by energy and will soon prove temporary. But policy is not crafted and implemented in a vacuum and persistent currency strength and unremitting deflationary impulses from abroad may yet push policy off course, at least temporarily, or perhaps even directionally should events gain further momentum. We expect US growth to move higher in the current quarter following sub-par performance going into the end of the year. Economic fundamentals are at sharp odds with the current bout of capital market volatility but we expect that despite mixed performance across different sectors of the economy the overall momentum in growth will remain positive over the near term.





Source: Bloomberg

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NOTES AND DISCLOSURES:

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