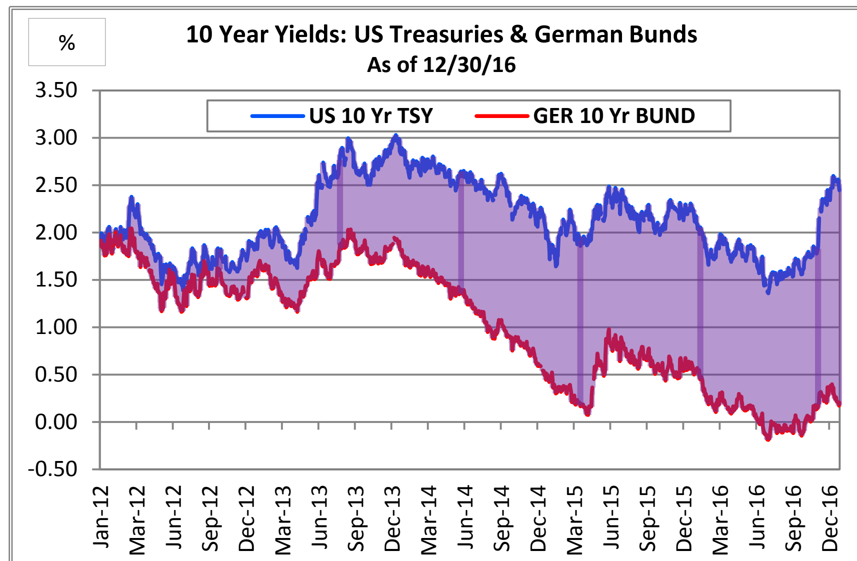
Market Overview

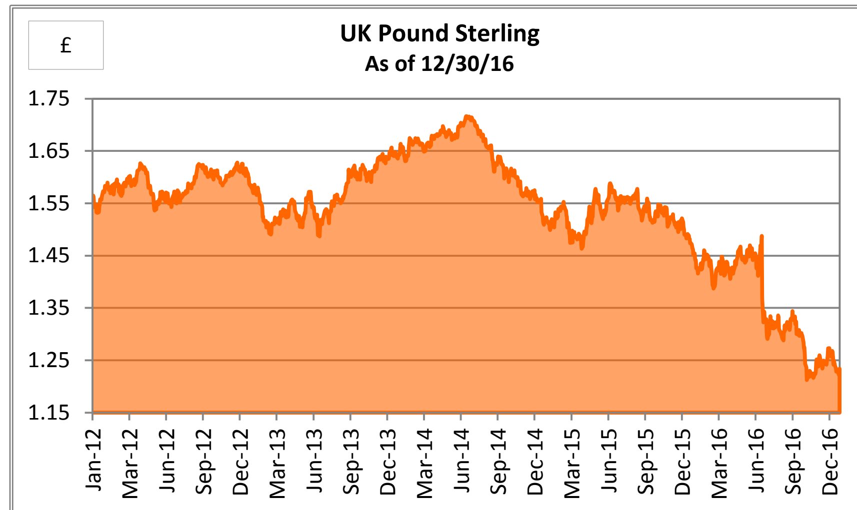
Jim Grabovac, CFA

Yields rose sharply during the quarter, erasing the gains generated during the first half of the year and tacking an additional 17 basis points to 10-Year Treasury yields for the year in total. While much of the period was characterized by calm conditions, the year was punctuated by 3 distinct market-jarring events. The first catalyst was the double-bottom in crude oil prices in February which served as a bellwether for a broad recovery in risk market assets and helped reverse widening corporate spreads. Markets stabilized only to be upended with the shocking results of the Brexit Referendum in June which caused yields to plummet not only in the UK but across the developed market landscape. The episode seemed to indicate, at the time, the fragileness of the prevailing global interest rate structure and heightened awareness of the possibility of a further leg down in US rates should the recovery falter. The effects of the Brexit vote, however, proved to be relatively short-lived in rate markets, and the adjustment was principally factored into a sharp depreciation of Sterling, but unexpectedly steady economic and equity market performance in the UK. Going into November, US rates were 20 to 50 basis points lower and the yield curve was flattening. But yields rose sharply and surprisingly following the election as investors quickly shifted from a scenario of flight-to-quality to flight-from-quality as the prospect of single-party government becoming re-engaged in fiscal policy after a six-year disengagement stoked expectations of potentially significant fiscal stimulus and reflation on the horizon.

- Treasury yields rose sharply during the quarter and ended the year modestly higher across the yield curve.
- Equities rallied in the final quarter generating gains of more than 10% for the S&P 500 overall and with gains more broadly based than the narrow market focus that characterized last year.
- Energy markets staged a strong recovery after plunging at the start of the year. Stabilization was ultimately bolstered by an OPEC production cut agreement scheduled to take effect in January 2017.
- Commodity markets recovered broadly with Energy and Metals leading the way with strong gains while Agricultural Commodities were mixed to mostly higher.
- The US dollar powered to new 14-year highs against the Euro and more than 30-year highs against a Brexit-battered Pound Sterling.

Market reactions to major political developments to date are based primarily upon expectations and will soon be tested with policy proposals and policy outcome realities. Investors will be challenged to divine how asset class valuations will fare while balancing the policy objectives of across the board tax cuts, increased infrastructure investment and maintenance of a strong social safety net in the US that can be crafted within the framework of responsible budgeting. In the UK, the preference to control borders must be weighed against foregoing some or all of the benefits of access to the EU single market. In addition, the policy preference favored by a narrow majority of Referendum voters is faced with strong regional and generational preference for the benefits derived from the existing EU membership. Electorates across major Eurozone countries will similarly weigh in with national elections in the Netherlands, France, Germany and possibly Italy before the year is out. Populist anti-globalization movements are a factor in all of these Core Eurozone Countries, and many of these factions favor exiting the Eurozone at a minimum or the EU entirely. Whether the EU will emerge weakened or with renewed commitment to the European project will be both interesting and potentially disquieting to observe as the year unfolds.





Source: Bloomberg.
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Guiding Portfolio Strategies

McDonnell Investment Management, LLC

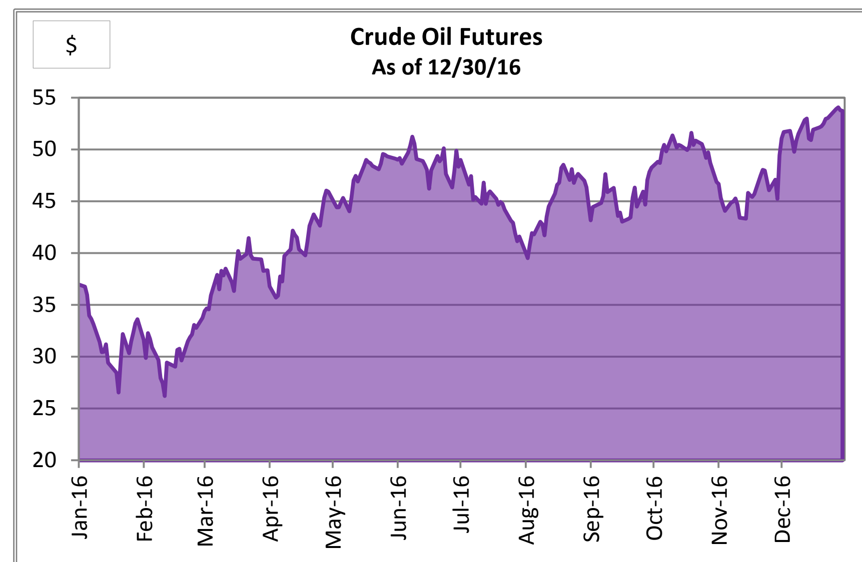
Market Overview

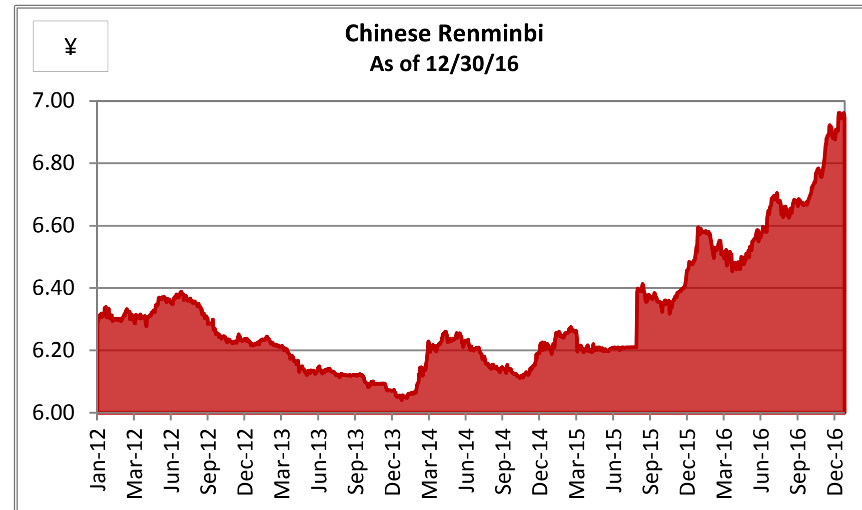
Asia also faces geopolitical challenges as an emboldened China increasingly flexes its economic and military power across the region as it seeks to expand control of the important South China Sea shipping lanes. To date, the US has been measured but firm in its commitment to freedom of the seas along international boundaries and not in accordance with China's more wishful interpretation. Nevertheless, potential market flashpoints abound and, as this past year proved, investors should be prepared to expect the unexpected.

Growth concerns which surfaced last year for China have been forestalled at present and replaced with debt concerns as ultimately unsustainable credit growth continues to power the economy forward. The rapid increase in debt levels remains an unaddressed problem, and analysts now view efforts to curtail debt acceleration and reform of inefficient State Owned Enterprises as taking a back seat to meeting government growth targets in advance of the 19th Peoples' Congress in the fall. Speculation has grown that President Xi Jinping, who recently assumed the honorific title 'core' leader of the Communist Party, may move to consolidate power and potentially pave the way to enable him to serve beyond the traditional 2 consecutive 5 year terms. But high-stakes political maneuvering will not eliminate the imbalances and challenges facing the second largest economy in the world. Alongside rapid debt growth and decelerating growth is a weakening currency which is helping to trigger significant capital outflows and draining currency reserves as the central bank tries to slow currency depreciation amid steady pressure.

As 2016 proved to be a year of surprises, 2017 will usher in a period when the consequences of a significant shift in prevailing political sentiment begin to take hold. The incoming Administration, bolstered by congressional majorities, has promised sweeping tax and regulatory changes combined with substantial infrastructure investment. When and to what degree these legislative changes take place will be critical factors helping to shape the investment landscape as the year unfolds.

- Global economic conditions have been characterized by weak aggregate demand which, in turn, has resulted in slower growth and weaker inflation. Will fiscal pump priming kick growth into a higher gear or will late cycle stimulus create imbalances which ultimately jeopardize the expansion?
- Investors have embraced a narrative of higher growth and reflation which would enable the Federal Reserve to finally begin to 'normalize' interest rate policy. Have investors gotten ahead of the cart and will risk markets face a correction following the 4th quarter rally?
- The Federal Reserve Summary of Economic Projections indicated expectations of 3 additional ¼ point rate hikes in 2017. Will favorable US rate differentials continue to drive the dollar higher resulting in less growth, lower inflation, and a shallower and more gradual path of interest rate increases than currently anticipated?
- The incoming Administration will inherit a strong economy amid a still unstable geopolitical environment. Will economic conditions provide the latitude to focus on foreign affairs or could a global policy misstep ultimately imperil the stable economic environment?





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Market Overview

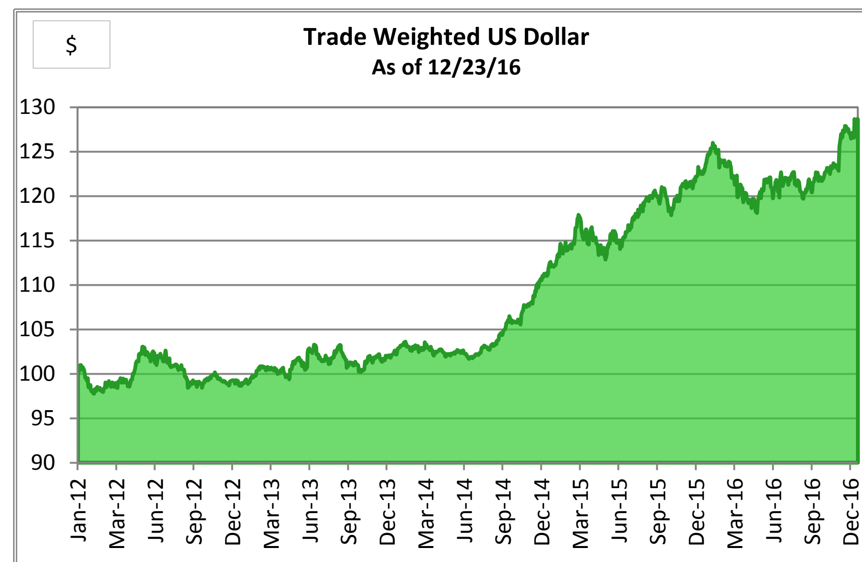
Thematically, we view the economic expansion as likely to continue apace as we enter 2017. Growth appears solid and labor market gains have been steady and should provide the wherewithal to continue to fuel consumption. Capital Investment has been somewhat disappointing but global growth prospects recently appear somewhat brighter and may offer a spark for a modest uptick in Business Fixed Investment alongside the prospect of an inventory rebuild after several quarters of decline. The potential for a positive GDP contribution from the Federal Government has bolstered investor confidence in recent weeks but will take shape over time and will not likely impact growth prospects over the medium term. The State and Local contribution has been a more positive factor of late and has the potential to have an increasingly additive impact going forward, dependent upon the size and scope of any potential infrastructure initiative. Inflation has been drifting higher and we expect it may be less problematic for the Fed after several years of below target readings that have influenced policy. Political risk, however, appears heightened both from a geopolitical standpoint and on the domestic front. Potential global flashpoints include a series of critical national elections in the EU, increasing Russian efforts to destabilize the West, rumblings from North Korea and the unaddressed economic imbalances in China. On the domestic front, while the prospect of unified government offers the potential for newly effective economic policymaking it also presents an opportunity for overreach and unintended consequences. While we remain optimistic on the economy we maintain a healthy wariness of the possibility of either domestic or geopolitical missteps as we enter unchartered waters.

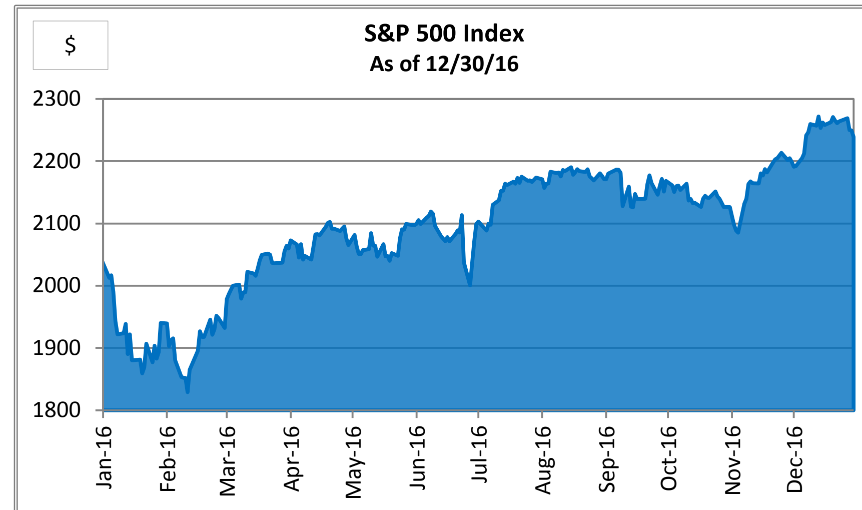
Taxable Market

Rates declined and the yield curve flattened throughout most of the year, but a volatile reaction to the November election results left Treasury yields modestly higher on a year-over-year basis. Credit markets began the year on the back foot as plunging crude oil prices negatively impacted energy bonds, but a subsequent recovery in crude helped broadly stabilize the corporate market and valuations tightened as the year progressed. Most spread sector assets generated positive excess returns versus Treasuries both for the quarter and the full year. The exception were Mortgages which were negatively impacted during the volatile 4th quarter and mixed for the full year.

- A volatile 4th quarter reaction to the November election left Treasury yields modestly higher for the year and the yield curve somewhat flatter.
- Spread markets generally had a positive year with lower quality corporates generating the strongest nominal and relative returns.
- Strong market conditions through much of the year facilitated robust Credit issuance which ended the period with the 5th consecutive year of record volume.
- Mortgage product performance was mixed and marked the 3rd consecutive year of relatively limited performance differentials versus Treasuries.

Corporate investors will closely follow developments regarding the potential for Corporate tax policy changes which are a policy preference of the incoming Administration as well as the congressional majority. In addition, talk of efforts to craft a deal to repatriate what the Joint Economic Committee in Congress estimates at $2.6T of untaxed overseas corporate profits will likely begin to take shape during the upcoming legislative session.





Source: Bloomberg.
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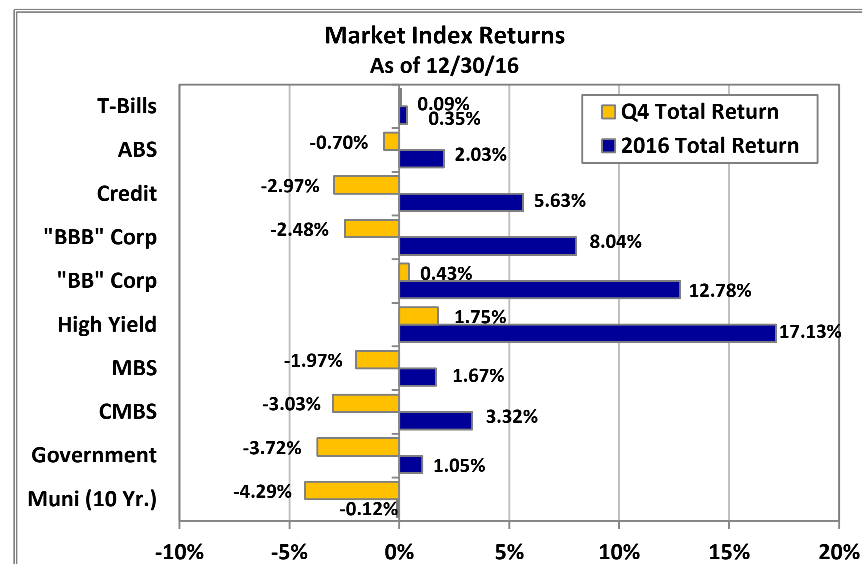
Fixed Income Market Commentary ✧ January 2017

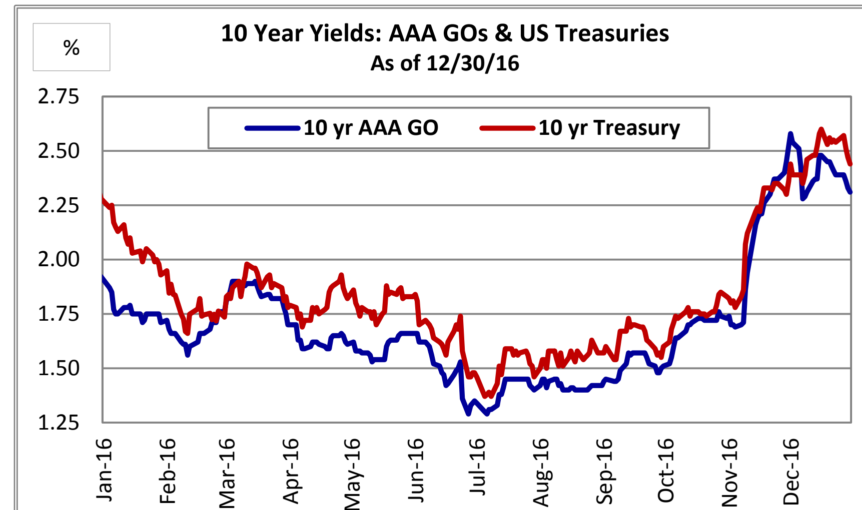
Municipal Market

The municipal market experienced 2 dramatically different periods during the past 12-months. Most of the year, through October, was characterized by strong demand, quality spread compression and moderately declining yields across the curve. But yields spiked in the wake of the November election as investors quickly settled on the narrative that unified government would open the fiscal floodgates in the form of tax cuts and infrastructure investment and force the Federal Reserve to more aggressively raise short-term interest rates. Markets corrected and stabilized, however, after absorbing a significant bout of mutual fund shareholder redemptions that followed on the heels of 54 consecutive weeks of inflows through October.

- Municipal market experienced record New Issue Supply of $445.8B representing a near 19% increase from last year's pace.
- Refunding Issuance represented more than 60% of total volume while the pace of New Money Issuance accelerated by more than 25% versus 2015.
- Commercial Bank and Insurance Company portfolios added municipal exposure during the year, while individual direct exposure and mutual fund holdings declined.
- Municipals underperformed Treasuries for the year resulting in more attractive valuations across the yield curve.

Municipal market investors face potentially important policy changes as the new Administration and Congress take the field. Directionally, it is clear that policymakers would like to lower marginal tax rates, both for corporations and individuals, embark on a large infrastructure investment program and repeal the Affordable Care Act. It is considerably less clear, however, what legislative proposals will actually emerge and ultimately what changes may become law and be effectuated.





Source: Barclays; Bloomberg; Municipal Market Data.
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NOTES AND DISCLOSURES:

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