McDONNELL INVESTMENT MANAGEMENT

Fixed Income Commentary ✧ January 2018

Market Overview

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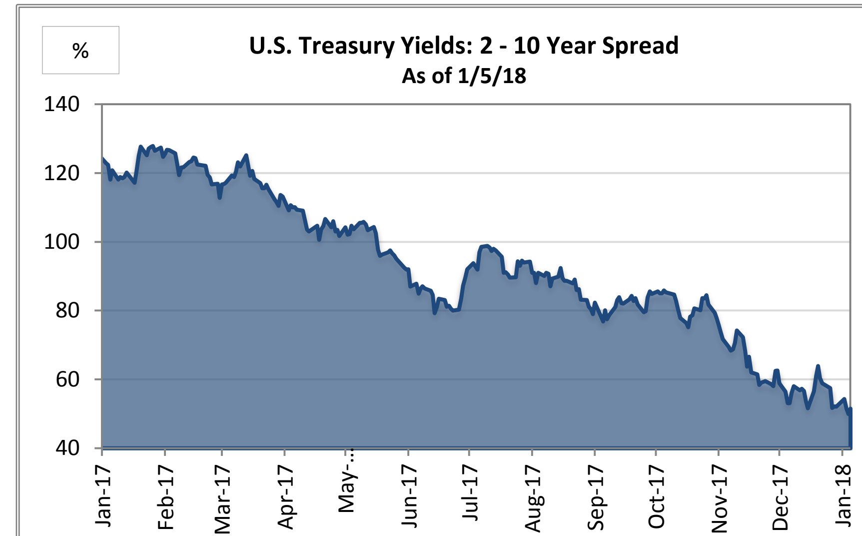
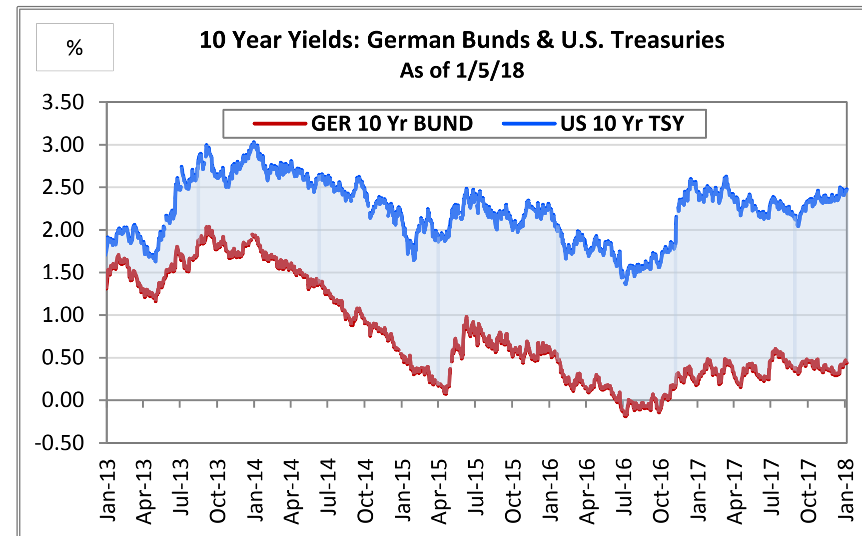
Capital markets reacted to the surprisingly swift passage and enactment of the tax package which was introduced, passed, reconciled, passed again and signed into law; all within a narrow 2-month timeframe. As a consequence, rates rose across much of the yield curve and risk markets continued to score new all-time highs with the S&P 500 tacking on another 6% during the 4th quarter, swelling annual returns to more than 19% for the full year. Rate markets finished the year in retreat, but the range in yields remained remarkably contained with 10-year Treasury yields spending most of the year within a 40 basis point (bps) range (60 bps at its widest). The dominant trend of yield curve flattening continued unabated regardless of market direction. For the full year, the Treasury curve as measured by the spread between 2 and 10-year Treasuries flattened by 72 bps while the municipal curve flattened by 68 bps. The other dominant trend of spread compression also continued to feature during the final quarter as it had throughout the full year. The market narrative of steady growth and contained inflation provided a benign backdrop for fixed income investors and remained securely on track throughout 2017. Investors continued to lean against this support to reach for yield by extending further on the yield curve and reaching for lower credit quality in an effort to bolster portfolio income in a persistently low yield environment. While the narrative may remain in place as we enter 2018, the backdrop will continue to evolve and react as the economy marches toward its 9th year of growth following the Great Recession trough of June 2009.

- US rate markets operated in a low-volatility, tight range environment throughout the year, with spread compression continuing to remain a feature of the market.
- Despite 3 additional rate moves from the Federal Reserve, boosting the policy rate by ¾ of a point, market reaction remained contained to the shorter-end and yield curves flattened.
- The municipal market registered a strong year with gains across most of the curve and tightening valuations versus Treasuries across the entire curve.
- Equity markets racked up surprisingly strong gains amid expectations of corporate tax cuts and regulatory rollbacks, and investors undeterred by richening valuations were well-rewarded.
- The dollar continued to retreat amid stronger than expected growth in Europe, Japan and steady growth in China.

Passage of the tax plan alters the landscape for corporations, investors and State and Local issuers in several potentially significant ways. Corporations received the bulk of the largesse with a massive reduction in rates from 35% to 21%. Tax law changes will now limit the deductibility of interest paid by corporations to 30% of income (EBITDA: Earnings before interest, taxes, depreciation and amortization); this will impact more highly levered corporations and may result in a deceleration issuance for those borrowers as Treasurers recalibrate efforts to more efficiently manage their cost of capital. Municipal issuers were impacted significantly by the legislation which prohibits the use of tax-exempt borrowing to refinance outstanding debt through a technique known as Advance Refunding. This will reduce issuer refinancing flexibility, increase the cost of capital and likely result in a reduction of New Issue Supply available to investors by as much as 25% in certain market environments.





Sources: Bloomberg.
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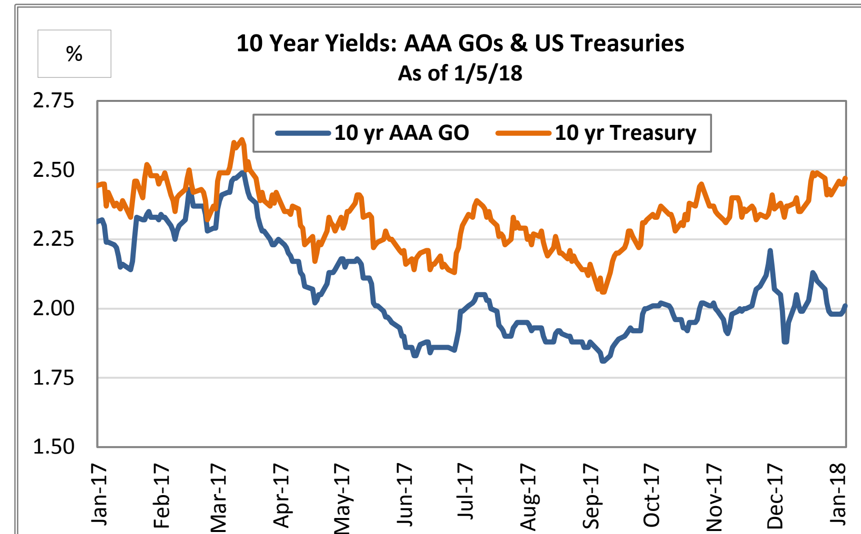
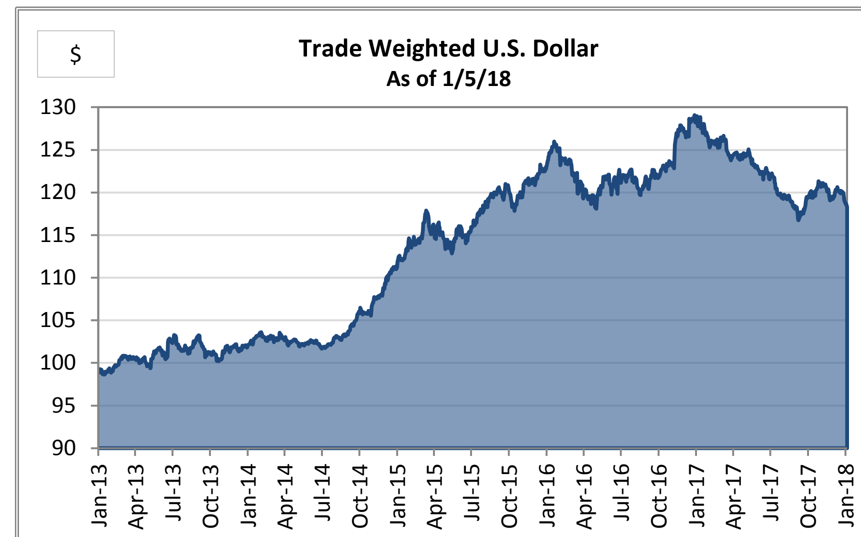
The municipal market, because of its unique characteristics, can be subject to large swings in investor demand. For much of the past several years the market has been characterized by a surfeit of demand and insufficient issuance to accommodate the potential investor base. We expect this legislation will further exacerbate this trend by immediately reducing supply and perhaps only marginally impacting demand from investors subject to the 21% corporate rate; particularly if the supply of corporate issuance is ultimately impacted. In terms of potential economic impact, we expect the legislation will exert a modest short-term positive impact on economic growth. Business confidence has been expanding and there will likely be a 'wealth-effect' impact from recent equity market gains. But these effects are not likely to alter the fundamental growth trends in the economy as the plan, despite its $1.4T price tag, is not designed to directly boost growth through traditional means such as a reduction in withholding taxes or incentives for State and Local Issuers to undertake infrastructure investment that could enhance economic productivity over the long-term.

Global economic growth has experienced a coordinated uplift and looks set to continue as we enter 2018. As mentioned, Europe and Japan quickened the pace of output in the second half of last year, and domestic growth appears likely to have comfortably topped last year's pace on the back of stronger Investment and improved Net Exports, aided by a weaker dollar. But geopolitical challenges remain daunting as 2018 unfolds. Europe faces a number of major hurdles, not the least of which is the glacial pace of Brexit negotiations. It is becoming apparent that the UK has put itself in an extremely weak bargaining position as it attempts to work toward agreement on the terms of its separation from the European Union with a March 2019 deadline looming. In Germany, Chancellor Merkel continues her 3-month long attempt to form a governing majority, Italy heads to the polls in March with Eurosceptic parties battling for representation, Spain remains disquieted by the Catalonian crisis and in North America, Mexico holds a national election in July. So-called populist or anti-globalist forces remain an undercurrent across the globe. The political waters are far from placid in the US as mid-term elections loom in November. Whether the majority party maintains unified control of the legislature or whether the electorate seeks a return to divided government will be a critical marker not only domestically but perhaps globally as well.

The capital market environment has been characterized by 5 key elements; each unlikely to change in isolation, but together unlikely to coexist as viable investment narrative beyond the medium-term horizon: moderate economic growth, rising risk market valuations, tightening monetary policy, a flattening yield curve and ultra-low volatility. As we consider the environment facing investors in 2018 we consider the following scenarios:

- **Growth appears likely to continue apace with no recession clouds on the near-term horizon.** If growth decelerates, can asset valuations continue to rise? If growth accelerates, will the Fed be forced to tighten more aggressively?
- **Rising equity market valuations and tightening credit spreads have shown little inclination to reverse course.** Can equity valuations continue to rise as monetary policy tightens and the yield curve flattens? If equities falter can credit spreads remain compressed or will they join the correction?
- **Fed policy 'normalization' appears on track to continue with the Fed anticipating another 75 bps of tightening over the next year, combined with a $420B reduction in its balance sheet.** Will risk markets be able to weather this degree of stimulus withdrawal? Could a risk market reaction, in turn, cause an economic disruption?





Sources: Bloomberg; Municipal Market Data.
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- **The yield curve has been flattening for 4 consecutive years and shows no signs of abating.** Will Fed normalization cause a yield curve inversion that presages a recession? Will Fed tightening ultimately drive long rates higher and cause equity valuations to correct?
- **Equity market volatility rests at the lowest levels in a generation.** Can stretched equity valuations weather the next upturn in volatility that inevitably occurs? Will increasingly crowded 'short-volatility' strategies cause a rush for the exits?

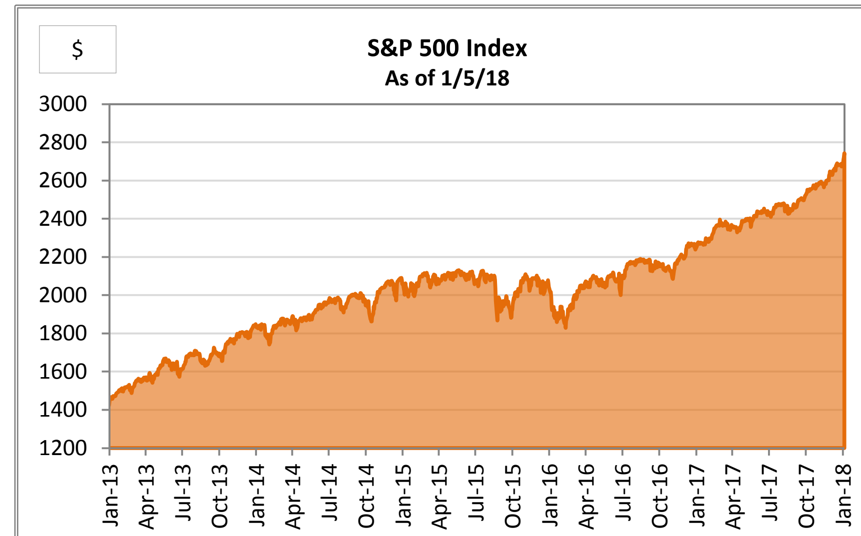
We expect that these market characteristics can peacefully co-exist over the near-term, perhaps well into the year. But co-existence requires a delicate balance, and with a restive domestic and geopolitical environment as a backdrop, we believe the odds favor a disruption to the status quo as we move forward. We remain largely constructive on credit and spread market exposures, but with a critical emphasis on credits bolstered by sound underlying credit fundamentals as we approach the 9th year of the economic cycle.

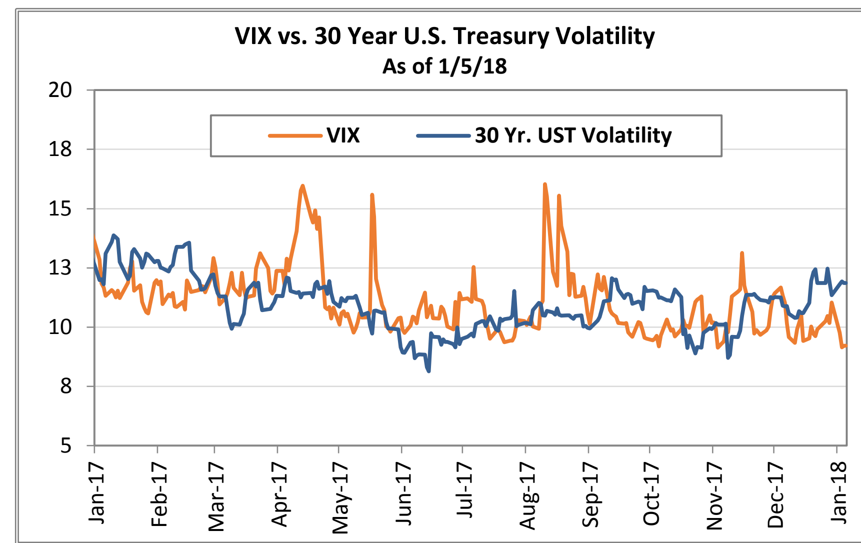
Taxable Market

Treasury yields rose across much of the curve during the 4th quarter in reaction to the surprisingly swift passage of the tax package. The dominant trends of yield curve flattening and spread compression continued to exert the main impact on return differentiation, with the longest and lowest quality components of the market generating the strongest nominal and relative returns both during the quarter as well as the full year. Consistent with these trends, all major spread sectors of the taxable market outperformed Treasuries as investors continued to reach for yield in an environment of steady economic growth combined with low levels of inflation amid a persistently low global rate structure.

- Treasury rose across much of the curve and the yield curve flattened during the quarter as investors priced in a higher likelihood of additional Fed rate hikes following swift passage of the tax plan.
- For the full year, Treasury yields pivoted around the intermediate portion of the curve as shorter-term yields rose while yields 10 years and longer declined.
- Spread sectors continued to generate strong outperformance versus Treasuries as reach-for-yield behavior remained the order of the day.
- The longest and lowest quality sectors of the market generated the strongest nominal returns while Taxable Municipals boasted the strongest relative returns for the year.
- Structured product also outperformed as it benefited from ultra-low volatility in general, while lower coupon mortgages were aided by rising short rates during the period.

The Treasury market has been dominated by yield curve flattening as the Fed picked up the pace of short-rate 'normalization.' Critical to investors over the year ahead will be the market's ability to absorb a substantial increase in supply as the Fed's balance sheet wind-down moves into high gear. To date, the Fed's removal of monetary stimulus has impacted only the shorter and intermediate portions of the yield curve. The low level of global rates has helped keep the long-end in check despite 125 bps of tightening over the past 2 years. Whether this behavior remains operative going forward will be a critical determinant not only of capital market comportment but also of broader macroeconomic performance over the period ahead.





Sources: Bloomberg.
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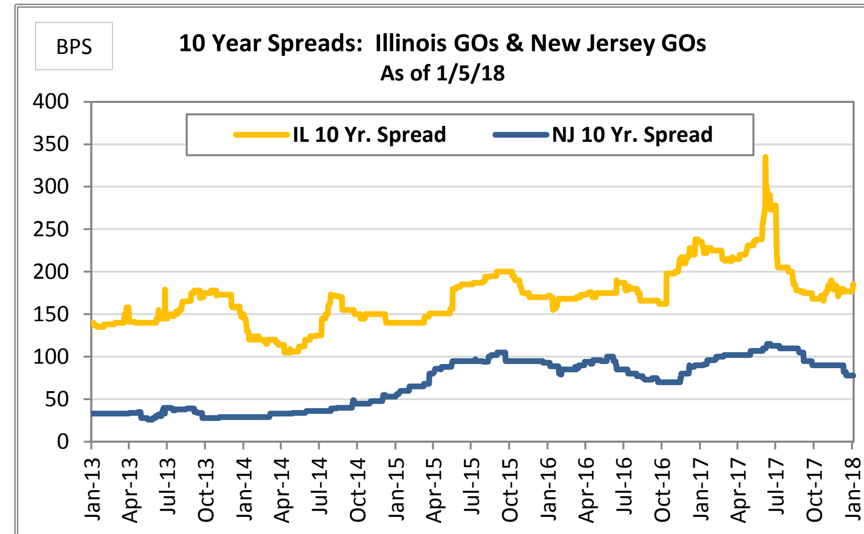
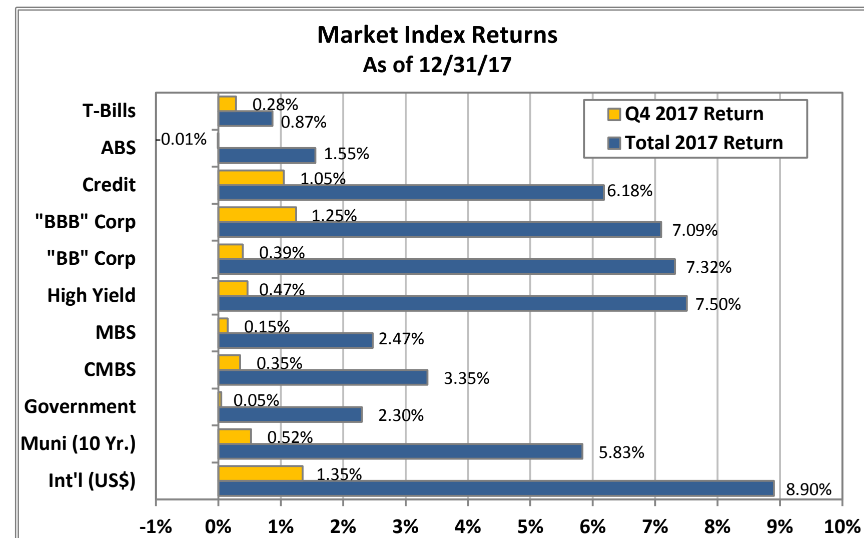
Municipal Market

The municipal market came under unexpected assault with the release of the House and Senate Tax plans in November. Despite administration reassurances that State and Local issuers were not on the table, both branches of Congress sought to legislate broad restrictions on tax-exempt issuance. The enacted legislation eliminates the ability for issuers to use tax-exempt borrowing to refinance outstanding debt through the process known as Advance Refunding. This will reduce the financial flexibility for State and Local issuers, increase their cost of capital and likely result in a substantial reduction of issuance going forward. Tax-exempt issuance for Advance Refunding has been a significant source of new issue supply, generally ranging between 15% to 25% of total new issue volume in recent years. The initial uncertainty over new restrictions and final passage of legislation resulted in a rush of issuance prior to year-end. We expect this will result in a sharp slowdown in the pace of new issue volume, at least during the first half of the year.

- The municipal yield curve flattened during the quarter as yields rose inside of 10 years and declined on the longer part of the curve.
- Municipal valuations tightened versus Treasuries across the curve during the past year, and yields declined from 5 years and longer.
- New Issue Supply surged during the 4th quarter exceeding last year's pace by nearly 40%, which in turn drove annual issuance to near record pace.
- Quality spreads tightened sharply both during the quarter and the full year, and lower quality components of the market generated the strongest relative returns.
- Shareholder inflows into municipal funds were consistently positive throughout most of the past year.

We expect the municipal environment will be buoyed by a scarcity of supply over the near-term as the market recovers from the year-end surge of issuance. The beginning of the year often experiences a downdraft in New Issue Supply, and the trend this year will likely be exacerbated. The municipal market may also experience some shift in demand from bank and insurance company portfolios as buyers target longer-maturity spread sectors of the market offering more attractive ratios versus taxable alternatives.





Sources: Bloomberg; Municipal Market Data; Merrill Lynch.
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