McDonnell Investment Management

Fixed Income Market Commentary ✧ January 2016

Market Overview

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US rate and share markets finished the year near where they started but that simple narrative fails to capture the evolving dynamics that continue to drive market and economic development as the recovery lengthens and policymakers shift direction. The plot as we entered 2015 was fairly clear as the trends dominating valuations and returns were quite strong coming into the year. As we begin 2016, these major trends appear to be in continuation mode as opposed to preparing for imminent reversal. However, how they might evolve and what new key factors will play an important role will be the focus of investors as the new year unfolds. A cooling global economy, particularly in China, weaker commodity prices, a stronger dollar and resultant downward pressure on inflation all played fundamental roles in last year's market development.

- Treasury yields rose modestly and the yield curve continued to flatten.
- S&P 500 treaded water but the cap-weighted index was bolstered by strong performance from a narrow list of market leaders amid broadly declining earnings momentum.
- Commodity markets continued to weaken. Oil traded at an 11-year low and helped the broader CRB Index score a fresh 13-year low.
- US Dollar continued to power higher against most major currencies.

The slowdown in China continues to loom large, due both to the size of its economy and its importance to world trade. Transitioning the emphasis in the economy from an overreliance on investment to a greater emphasis on consumption in an effort to create a more sustainable model of economic growth will present meaningful challenges for the world's second largest economy. In a companion part of the policy agenda, China has reiterated its intention to target the valuation of its currency, the Renminbi (RMB), to a basket of currencies (chiefly comprised of its major trading partners) as opposed to a managed peg versus the dollar. While there may well be an understandable logic to this intention, it is nevertheless encouraging speculation that the People's Bank of China will use the policy as a screen to permit weakening of the RMB to relieve pressure on its debt-levered economy as the growth deceleration continues.

The valuation of the RMB remains an important market input because although its decline versus the dollar has been quite mild in comparison to many EM currencies, it remains a special case due to the size of the Chinese economy and the massive impact its slowdown has had on commodity and currency markets worldwide. Further devaluation will serve to exacerbate the export of deflationary price pressures emanating from China and may well keep inflation in Developed Markets short of policy objectives. It is worth stating that the Fed noted increased uncertainty and declining confidence in the growth outlook for China as one of its concerns in statements following its September meeting.

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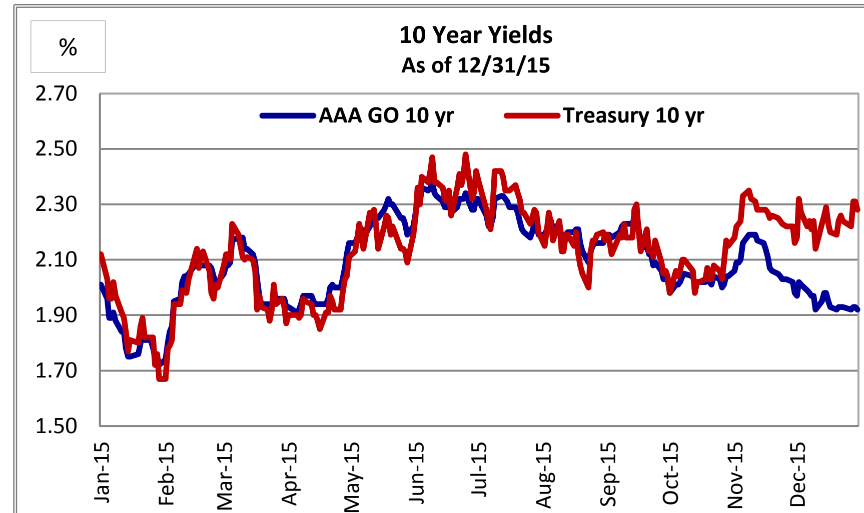

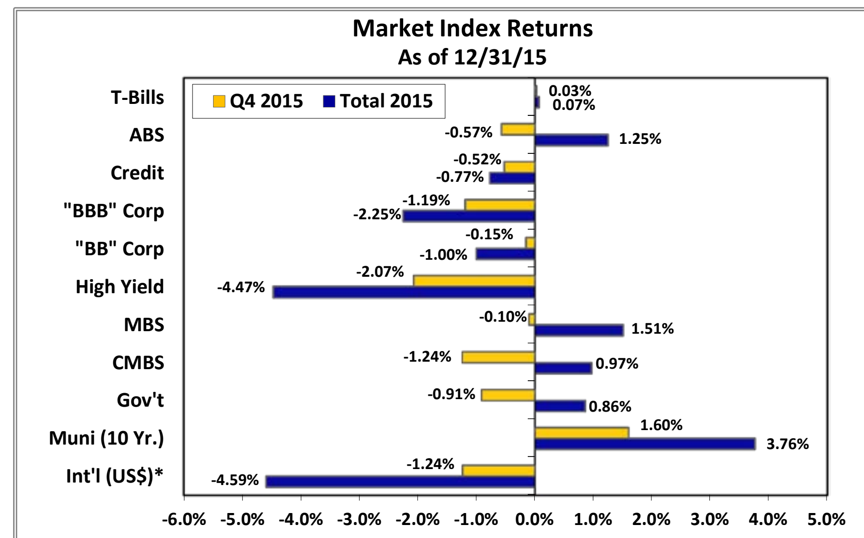

*Source: Municipal Market Data; Bloomberg; Barclays; *Merrill Lynch.*
All indices, other than those noted, are Barclays indices. Please refer to the Notes and Disclosures on the last page for additional information.

Guiding Portfolio Strategies

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Market Overview (cont.)

In a much anticipated move, the Federal Reserve announced its first policy action to adjust short-term interest rates higher in nearly a decade. The Fed boosted its target for the Federal Funds Rate to a range of 0.25% to 0.50%, marking the first move off the zero-lower bound in 7 years. The statement accompanying the policy announcement noted that "in light of the current shortfall of inflation from 2%, the Committee will carefully monitor actual and expected progress toward its inflation goal." This statement highlights an important divergence facing investors as the year ahead unfolds. The median range of Fed member projections would place the Fed Funds Rate at 1.4% at year-end 2016, implying 4 additional quarter-point hikes while market-based estimates project only 2 additional moves. Whether the Fed or the markets have more accurately divined the future path of inflation and short-term interest rates will prove a critical development as the year unfolds. We expect a more gradual and shallower path of increase is likelier in light of the fact that expectations for a lift in inflation are based predominantly upon a continuing drift higher in rent and medical care. While these price inputs are important factors they are not, in and of themselves, necessarily indicative of inflationary conditions. Unless and until wage pressures gather significant steam, it is difficult to envision an uptick in inflation developing from a blip into an embedded problem, particularly when placed within a broader context. The combination of weakening global growth and a strong dollar continue to favor a low level of US inflation over the medium term.

Will 2016 be a continuation year or a watershed? For now, the odds favor modest continuation of existing trends. Steps likely to interrupt or potentially reverse the dominant trends do not appear in evidence on the near-term horizon. Nevertheless, important issues loom large as investors determine asset allocations in the current environment.

- Flatline inflation has been a mainstay for the longer-end of the fixed-income markets. How likely is that to continue to be the case?
- Market prices reflect the belief that Fed expectations for the Funds Rate are too high. What if the markets are mispricing future policy steps?
- Commodity markets have collapsed. Can prices rebound sharply simply due to a correction?
- Bullishness on the dollar is widespread. Can crowded trades result in more than just near-term volatility?
- Will the actual embarkation of monetary policy divergence result in a second leg higher in the dollar and will that, in turn, lead to an EM shakeout that impacts DM economies more broadly?
- Rate markets have displayed a penchant for volatility and an aversion to directional movement. Have they been too stable for too long?

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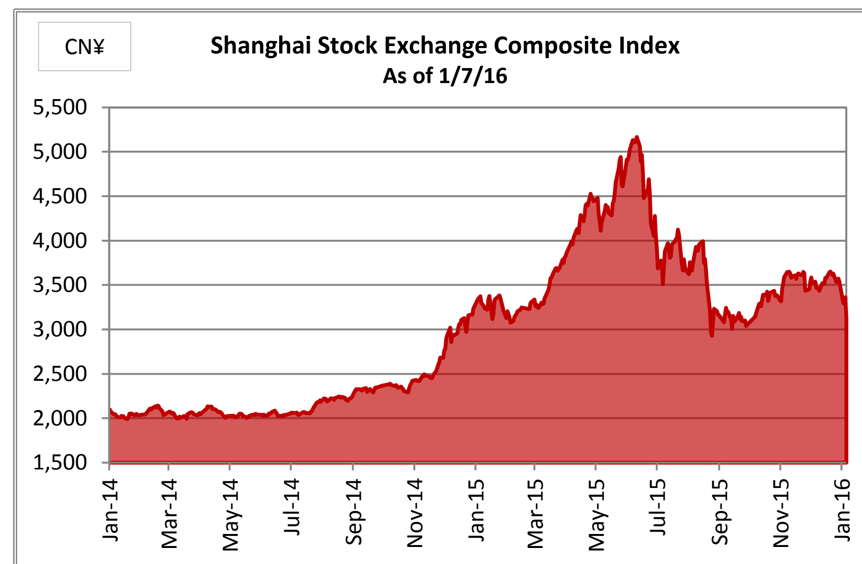

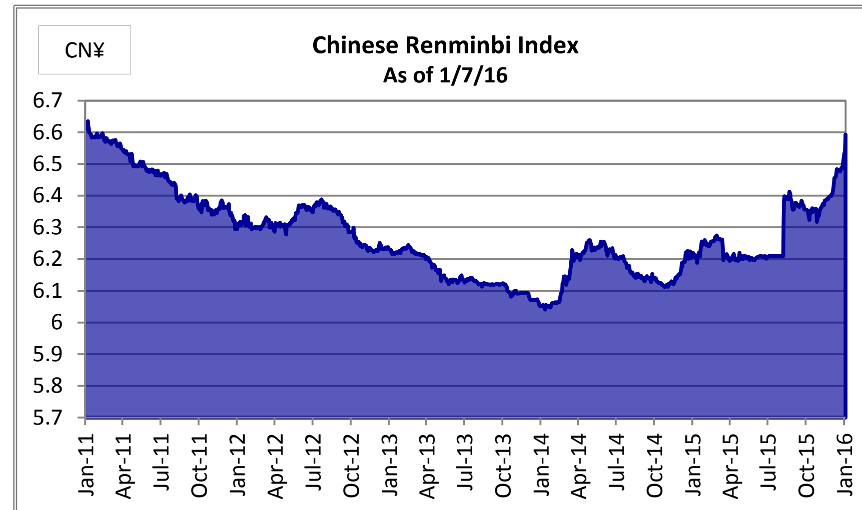

Source: Bloomberg
Please refer to the Notes and Disclosures on the last page for additional information.

Market Overview (cont.)

We expect the economic recovery to continue into its 8th year. Labor markets have improved further and consumer spending is healthy. Business fixed-investment has been somewhat disappointing thus far despite record corporate borrowing as stock buybacks and merger and acquisition activity have predominated. Global economic health is less robust however, particularly in Emerging Market Economies. Investors will keep a keen eye on China as efforts at economic transition have, to date, proven challenging as well as volatility-inducing both for Chinese share markets as well as other risk assets worldwide. Also of critical importance will be the relative valuation of the dollar. The dollar has marched higher against most currencies over the past year and a half. Whether this strength continues now that the Fed has embarked upon its effort to 'normalize' short-term rates or whether markets have already discounted future interest rate differentials remains to be seen. While rate markets may move higher in response to policy actions, we expect the environment will continue to favor limited potential for significant directional movement.

Taxable Market

The yield curve flattened and rates moved higher during the quarter as the Fed announced its first short-term rate boost in nearly 10 years. Despite the modest move higher, Treasury rates ended the year remarkably close to where they began, with 10-year yields moving higher by only 10 basis points. Most spread sectors recovered somewhat during the quarter but ended the year wider producing negative excess returns versus Treasuries. The significant exception for the year were Asset-Backed Securities which benefited from good credit quality and limited supply availability.

- Credit spreads generally widened during the year but return differentials varied widely by sector and curve position with longer credit lagging the most.
- Finance was the standout for the year producing both positive nominal and excess returns.
- Industrials were the worst performing sector for the year being dragged lower by Energy and Commodity related issuers, in particular.
- Lower quality holdings generally fared poorly with BBBs being the laggard for the year while bearing the brunt of price deterioration for index holdings falling out of the Investment Grade Universe.
- Mortgage-Backed Securities had slight negative excess returns over the year despite limited movement in rate markets over the period.

Sector and security selection have played an increasingly important role in the corporate market as companies and industries face widely different influences from benign to malign. With divergences widening sharply, credit investors will be focused not only on which names to sell, but which names have the potential to rebound sharply if valuations begin to tighten.

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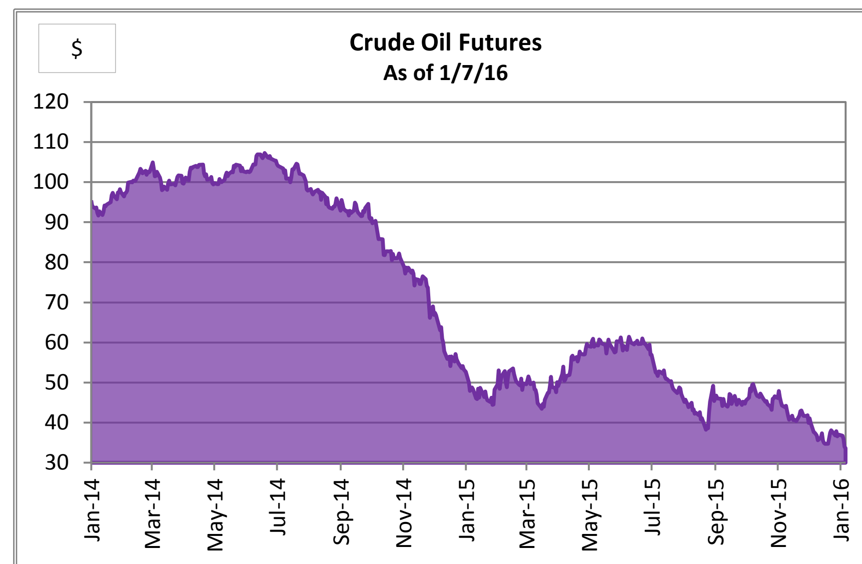

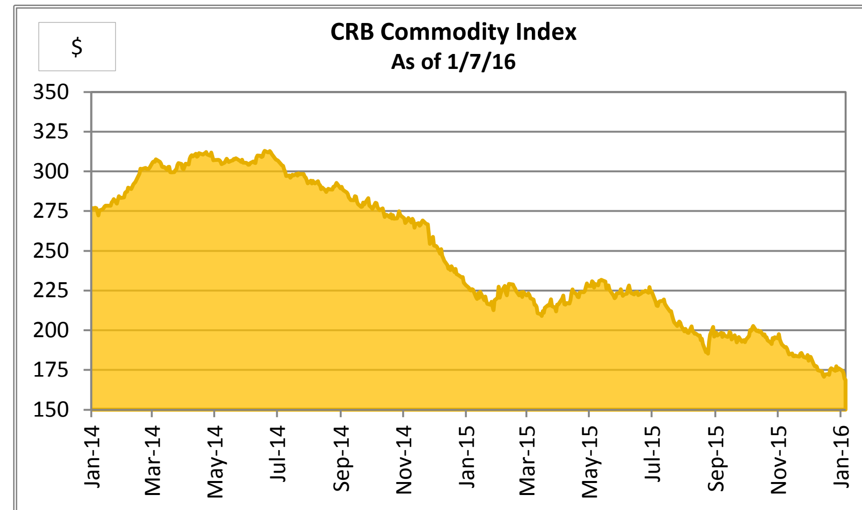

Source: Bloomberg
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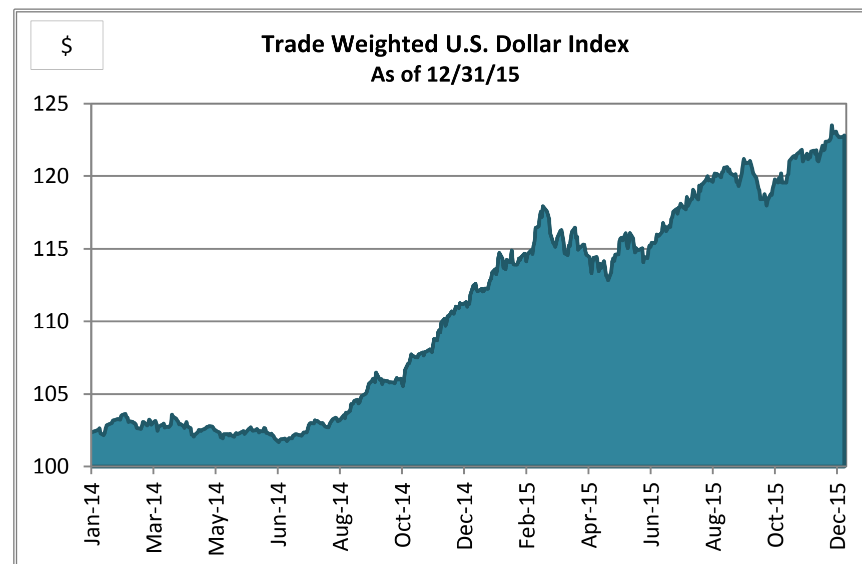
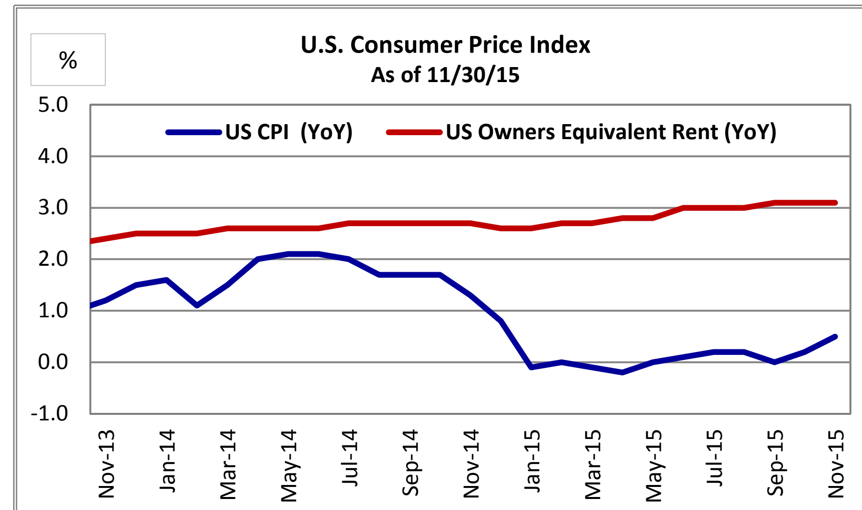
Municipal Market

The municipal market bucked the trend among major spread markets, registering sharp outperformance versus Treasuries both for the quarter and the full year. Steady demand remained the order of the day throughout most of the year, and the boost in new issue supply caused by a surge in Refunding Issuance was easily absorbed. Demand for incremental yield has been a strong undercurrent of the market for the past several years. Despite the widening of spreads in the corporate market, credit spreads in the municipal market showed little inclination to widen. This partly reflected differing fundamentals. The credit quality of state and local issuers has broadly continued to improve as property markets rebound and the recovery continues. Historically, credit trends tend to lag developments in the broader economy and current developments have proven to be no exception.

- New Issue Supply declined for 4 consecutive months versus the prior year's pace and helped contribute to strong outperformance versus Treasuries during the 4th quarter.
- Refunding Issuance comprised two-thirds of total issuance for the year and helped elevate year-over-year volume totals by 17%.
- Credit quality continued to improve broadly despite isolated pockets of valuation deterioration for several high-profile distressed large issuers.
- Quality valuations continued to tighten in contrast to the corporate market where spreads widened during the year.
- Steady demand for municipals helped dampen volatility further during a year of generally muted rate movement overall.

New Issue Volume going forward is expected to approximate last year's range. Factors which could boost those totals include a flatter yield curve, recent strong outperformance of municipals versus Treasuries and perhaps somewhat lower interest rates than most analysts anticipate over the year ahead. Similarly, if rates were to move unexpectedly higher, it would likely dampen Refunding Issuance and curtail the principal source of recent supply.





Sources: Bloomberg; Bureau of Labor Statistics.
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