McDonnell Investment Management

Fixed Income Market Commentary ✧ July 2017

Market Overview

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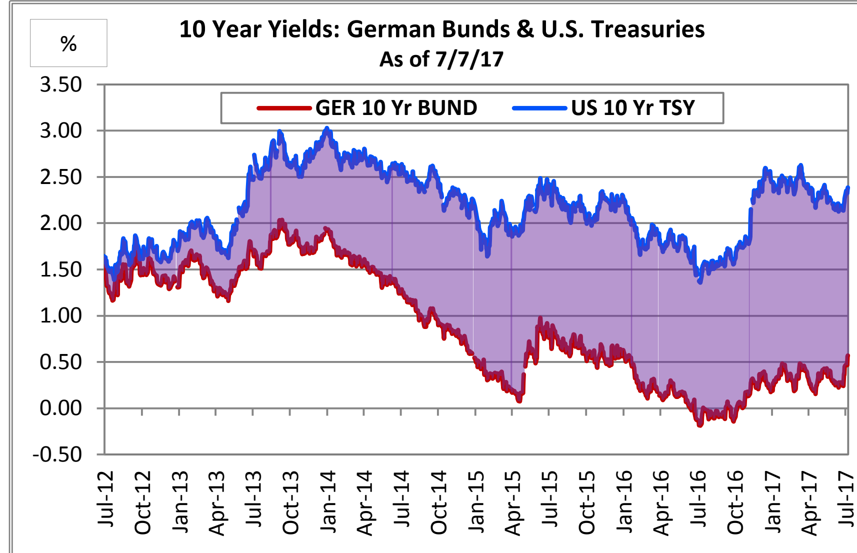
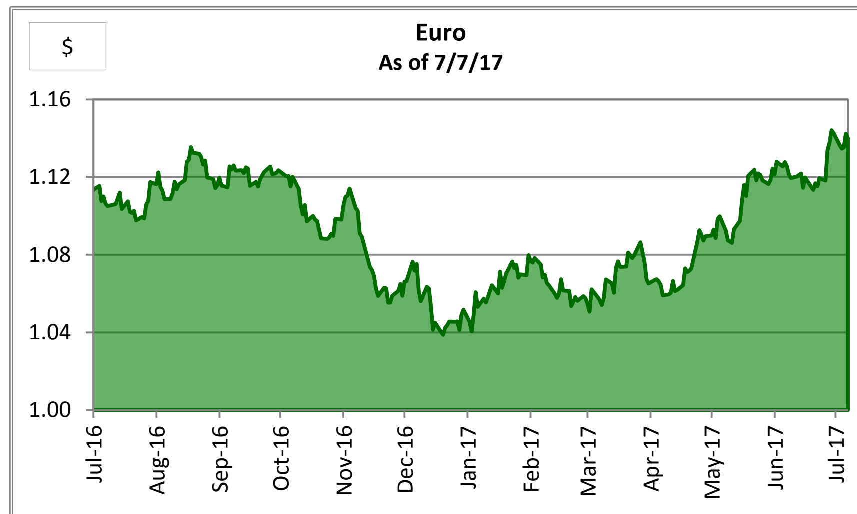
US rates continued to grind lower and yield curves flattened as the Federal Reserve boosted rates by another ¼ point in June and left intact its expectations for another boost before year-end alongside with steps to begin shrinking the size of its balance sheet. Despite somewhat higher short-term rates, however, investor appetite for income continues to weigh on yields further out on the yield curve. Curve flattening, spread compression and ultra-low levels of volatility have remained a feature of fixed income markets throughout the first half of the year. After 4 rate hikes and 100 basis points of policy adjustment in total, yields remain reluctant to work appreciably higher. Since the Fed's initial boost in December of 2015, 10-Year Treasury yields are roughly 10 basis points higher and Municipal yields up by only 5 basis points. Shorter-term yields have adjusted more to be sure, but the predominant impact of policy tightening to date has been to pressure the yield curve to flatten. There continues to be a yawning divide between where the Fed expects its terminal rate to settle and where investors anticipate the rate path will ultimately reach. The Fed's Summary of Economic Projections has the Fund's rate reaching nearly 3% in 2019 while market expectations settle closer to 2% to 2 ¼% over that timeframe. The Committee also released additional guidance regarding its intention to begin unwinding a portion of its $4.5T balance sheet. They expect to begin reducing the reinvestment of principal initially by $10B per month with gradual planned increases that would reduce its holdings by $450B over the first 12 months and at a pace of $600B per year thereafter until the balance sheet shrinks to the desired level. The initiation of the drawdown appears likely to begin later this year.

As we round out of the second quarter and head into the second half, little on the horizon seems promising of a trend change anytime soon. But quiet markets have a tendency to rouse participants out of their torpor, and the second half may be hard pressed to change that tendency. Potential trigger points on the horizon could run through Congress which needs to advance legislation to fund the government (September) and increase the debt-ceiling (October), all while attempting to repeal and replace the Affordable Care Act (July). Investor expectations soared immediately after the election on hopes that the onset of single-party government would result in significant fiscal stimulus over the near-term combined with a long-term program boosting productivity enhancing infrastructure investment. But political momentum has rapidly decelerated, and investors at this point would probably be content with maintenance of the current status quo of positive economic growth, consistent gains in employment and stable inflation. Aside from the legislative front, multiple congressional committees and Special Counsel Mueller continue their probes into Russian interference in the election and whether there was any collusion with campaign officials. While market impact to date from the investigations has been negligible, it remains a potential wild-card buried deep in the deck.

- Treasury rates fell modestly across much of the yield curve as decelerating inflation helped dampen the 'reflation' fears that arose at the outset of the year.
- Yield curves flattened amid further Fed action to boost short rates, while longer-term yields continued to correct lower following the Q4 spike.





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

Guiding Portfolio Strategies
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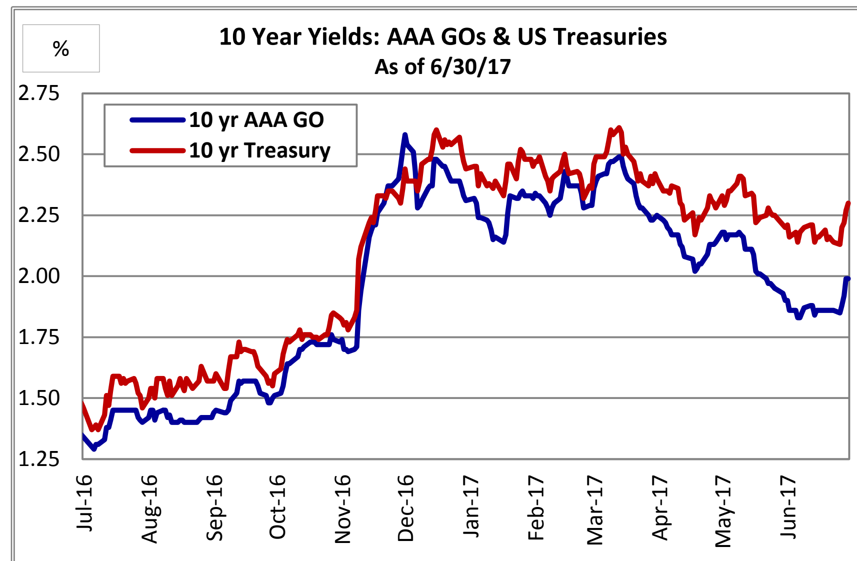
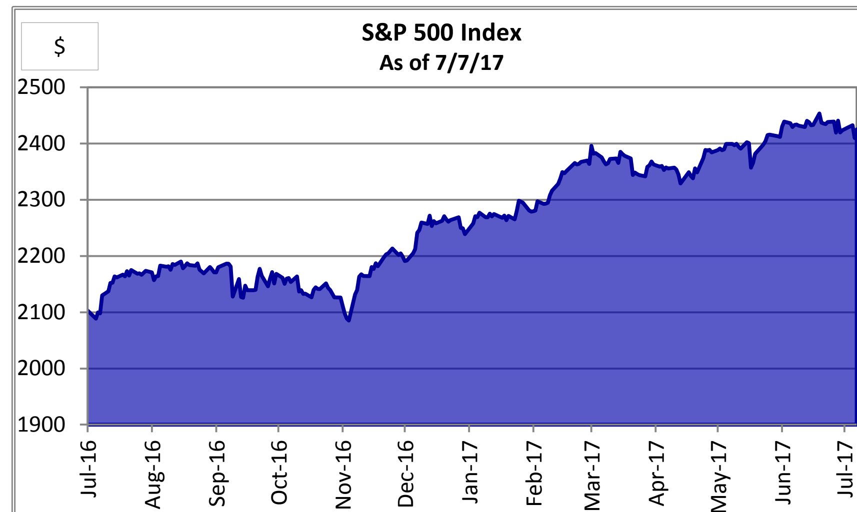
Market Overview

- Municipals sharply outperformed Treasuries for a second consecutive quarter amid slower issuance and strong demand.
- Spread markets strongly outperformed Treasuries as investor appetite for income was further whetted by broadly improving corporate earnings momentum.
- The dollar weakened further against most currencies on diminishing expectations for Fed tightening and a strengthening global growth outlook.
- Energy markets traded sharply lower as expanding supply continued to overwhelm efforts to curb production.

The economic recovery reached the 8-year mark at mid-year amid strong prospects for extending what is now the 3rd longest expansion in the post-war period. Growth is estimated to have registered a 1.4% pace in the first quarter and most analysts expect that gains accelerated in the second quarter. The economy has averaged a 2% annual rate of growth throughout the expansion and we continue to believe moderate growth remains the most likely outcome over the medium-term. The labor market appears healthy with nonfarm payrolls averaging gains of 180,000 per month this year, an unemployment rate of 4.4% (June) and wage growth in the mid 2% area. There is room for improvement on several fronts. Wage gains and hours worked remain relatively tepid for this point in the recovery. Inflation, after a move higher earlier in the year, has settled back solidly below the Fed's 2% target. Fed consensus, including Chair Yellen, believe these shortfalls are temporary and that core economic fundamentals are solid and warrant the continuation on the path toward monetary policy normalization over the period ahead.

On the global front, the strong recovery of the Euro was a feature of the quarter, and it may be no coincidence that confidence in the currency surged in the wake of Emmanuel Macron's victory in France and strengthening prospects for Angela Merkel in the fall. Anti-globalists entered the year with high hopes of making further electoral gains in Europe, but the Macron victory capped a series of nationalist party defeats and left open the possibility that the vital core of the European project, France and Germany, could engineer steps to strengthen the Union over the period ahead. As the Euro flexes its muscles, speculation mounted that the European Central Bank may begin to restrain monetary accommodation sooner or perhaps more aggressively than had heretofore been expected. Speculation was stoked by a parsing of statements in early July from ECB President Draghi to the effect that the risk of deflation has receded, which led to a prompt selloff in German Bunds that dragged global yields higher in its wake. The ECB indicated that the market reaction misinterpreted the President's statement, nevertheless a tremor of fear that a Eurozone 'Taper Tantrum' could be in the offing, prompted some increase in fixed income angst as we entered the second half. We remain of the opinion that the need to generate portfolio income remains the driving factor for most fixed income investors and, as such, would view an increase in market interest rates as an opportunity for portfolio rebalancing and extension, and one that would more than likely prove short-lived.





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Taxable Market

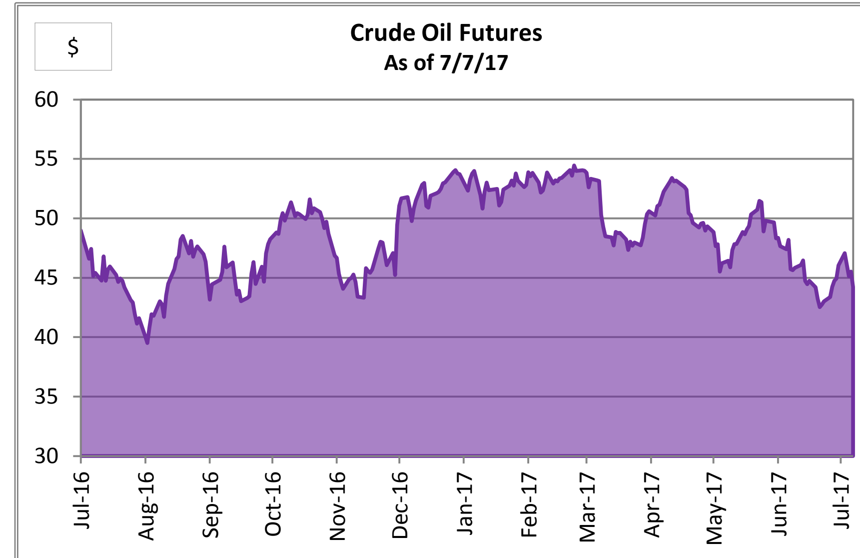
Treasury yields worked lower across most the curve and the yield curve flattened. Gains were modest in comparison to credit gains, however, as spread markets continued to generate strong excess returns relative to Treasuries. As has been the case throughout the first half, credit market gains were strongest for the longest and lowest quality portions of the corporate market. Mortgage product continued to move mostly sideways as full valuations limit the opportunity to generate additional returns versus Treasuries. The prospects for the initiation of Fed balance sheet reduction could well augur changing dynamics in the mortgage market, but the potential market impact remains hypothetical at this juncture as participants await further development.

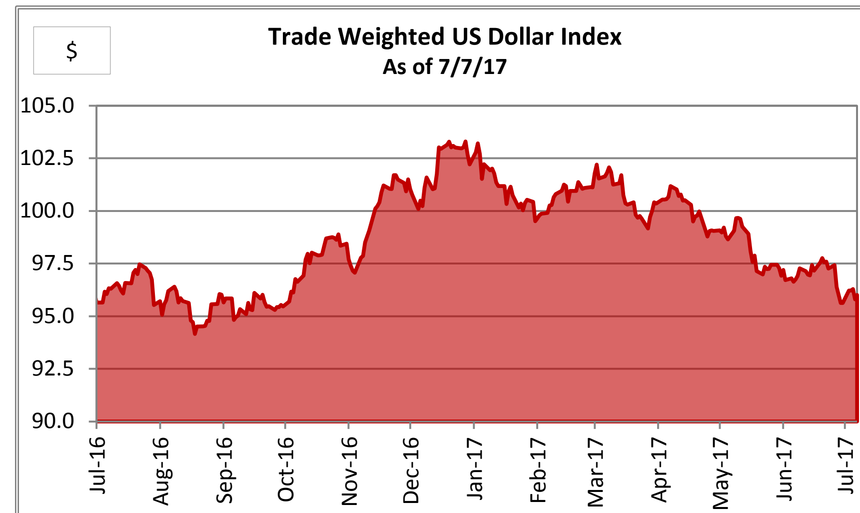
- Shorter-term yields rose slightly in response to Fed action but the yield impact of a combined 100 basis point increase over the past 18 months remains confined to the intermediate portion of the yield curve.
- Credit spread compression remained the order of the day as the demand for income continued to dictate investor behavior.
- Structured product produced positive nominal returns for both the quarter and first half, but was mixed on a relative basis with Asset-Backed and CMBS producing positive excess returns while MBS was mostly flat.
- US stocks continued to trend higher as improving earnings helped bolster investor confidence.
- The dollar weakened against most currencies and was particularly soft versus the Euro.

Fed developments will remain a focus as investors await further potential action both on the rate front and with regard to the initiation of balance sheet reduction. We expect that, despite softness in recent inflation readings, the Fed is more likely to continue its path toward normalization on rates as well as begin the process of gradually reducing the reinvestment of its expanded balance sheet, particularly as uncertainty over the future composition of the Committee remains high. Market participants will be watchful for reassurance that monetary policy will remain largely devoid of political influence and able to continue its central role in crafting and implementing both economic and monetary policy in the wake of legislative economic disengagement.

Municipal Market

The municipal market sharply outperformed Treasuries for a second consecutive quarter. Relative gains were strongest on the shorter-end of the yield curve, and the yield curve flattened during the quarter. A downdraft in the pace of issuance and consistently strong demand were features of the market throughout the first half of the year. Credit developments have also assumed a higher profile role as the Commonwealth of Puerto Rico triggered Title III, which allowed it to enter a bankruptcy like process to help resolve its inability to stay current on debt service and fund its mountain of unfunded pension liabilities.





Sources: Bloomberg.
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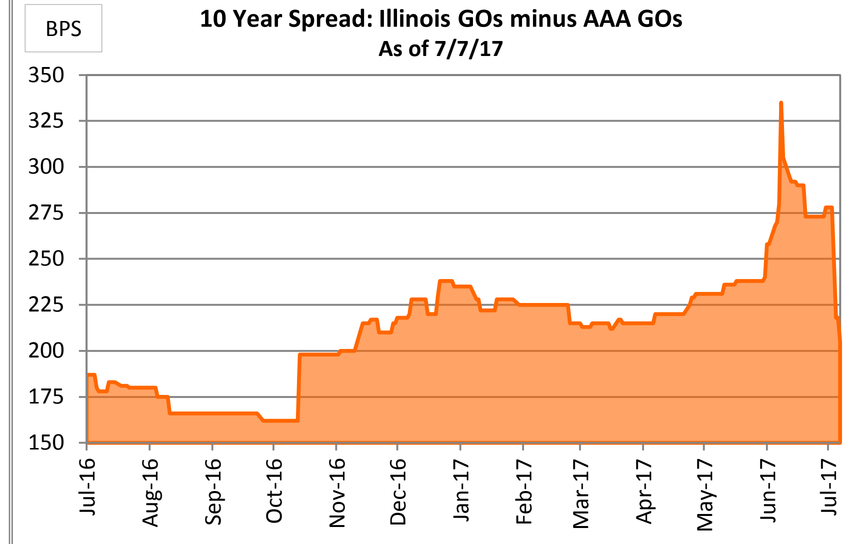
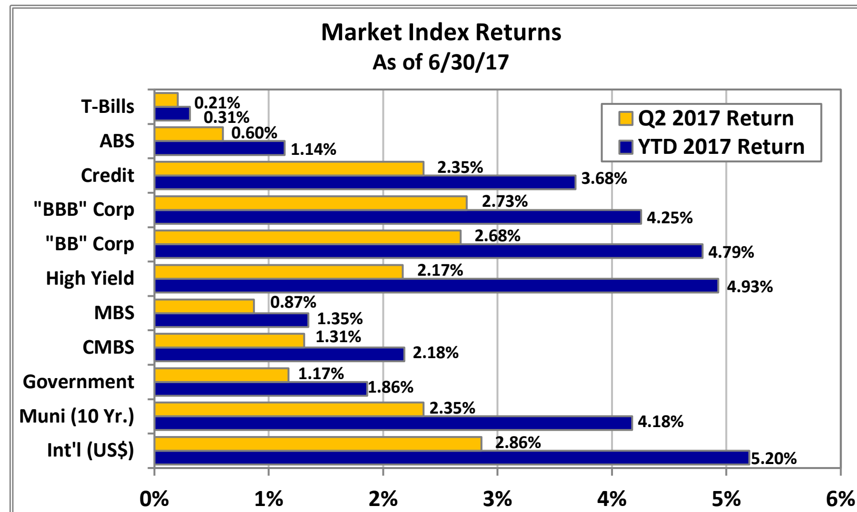
Municipal Market

Although it confronts a far different set of economic circumstances, the State of Illinois just narrowly avoided being the first US state to get downgraded to junk status, when the legislature overrode the governor's veto to pass individual and corporate tax hikes as part of passing a budget for the first time in 2 years. Resolution of the state's underfunded liabilities remains work for another day. The state remains on watch and its rating may still drop, but the legislative resolution will go a long way toward convincing investors of the state's 'willingness to pay.'

- Municipal yields fell across most of the curve as income-oriented investors continued to clamor for paper amid tight market conditions.
- The pace of New Issue Supply slowed nearly 13% year-to-date led by a steep drop in the rate of Refunding Issuance.
- Spread sectors continued a strong run of outperformance as reach-for-yield behavior narrowed both sector and credit spreads across the market.
- Illinois spreads tightened sharply in the wake of passage of a deficit narrowing budget in early July.

Notwithstanding the positive legislative action and strong market affirmation for the State of Illinois, credit challenges, mainly in the form of underfunding of both pension and healthcare liabilities, remain a long-term critical challenge for state and local issuers. Paradoxically, higher interest rates, although they would raise the cost of capital for issuers, would also reduce the underfunded liabilities for pension plans and raise the return prospects for plan assets over the long run. Needless the say, the challenges are large, long-term and not amenable to simple solutions. Policymakers will need to become more engaged, and it is likely that pension plans will need to be modified, spending will have to be rationalized and taxes will have to be raised in order to find a sustainable path forward.





Sources: Bloomberg; Municipal Market Data; Merrill Lynch.
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NOTES AND DISCLOSURES:

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