McDonnell Investment Management

Fixed Income Market Commentary ✧ July 2016

Market Overview

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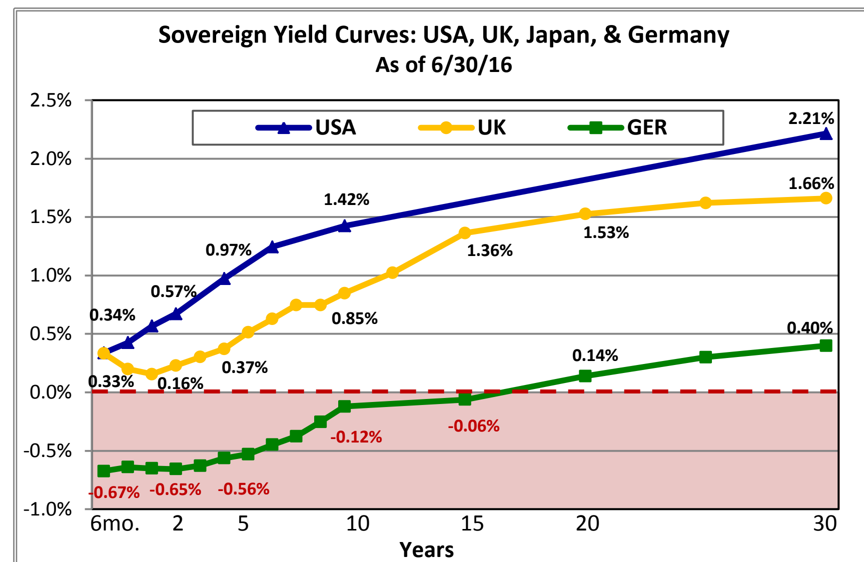
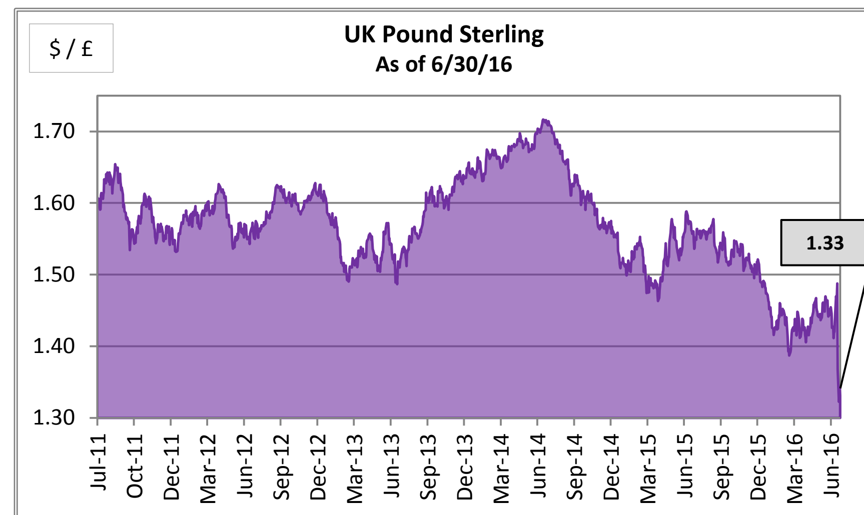
Rate markets rallied and yield curves flattened dramatically as investors reacted to a series of surprising developments which altered the investment landscape and elevated uncertainty as we move into the second half of the year. Markets began the quarter enjoying relatively placid conditions as investors slowly began to price in a greater likelihood of a second Fed rate rise in response to stronger employment gains and more aggressive commentary from Fed Chair Yellen and several other committee members. But the view shifted sharply in reaction to a much weaker than anticipated May employment release which clocked job growth at a meagre 38,000 while revising the previous 2 months lower by 59,000. Adding to concerns arising from weak job growth was a drop in the labor force and a concomitant decline in the labor force participation rate. The combined factors were weak enough to take the June 15th Fed Meeting off the table in terms of rate moves, and Janet Yellen confirmed market expectations in her Q&A following the meeting where she elaborated that the Committee would like to see several months of good momentum in the economy before it embarked upon another rate hike. This seemed to push the possibility of a rate move into September or December. But developments were only getting started.

After the Fed meeting, St. Louis Fed President, James Bullard, released a paper outlining a dramatically different view of interest rates, inflation and monetary policy.* In summary, he conveyed the St. Louis Fed's belief that the existing framework for managing monetary policy was no longer effective and that a new policy which guided central bank actions within the context of 'regimes' was more appropriate in the current environment. He stated that they viewed the current 'regime' as a low-inflation, low-growth, low-rate environment and, as such, would likely require only a single 25 basis point move higher in rates over the next 2 ½ years. We believe this development is indeed significant as President Bullard has been among the more aggressive advocates for higher rates within the Committee. In addition, both the St. Louis Fed and President Bullard are considered to be relatively influential in central bank circles. We presume the dramatic change in thinking may, in part, have been precipitated by the inability of Federal Reserve Economists to correctly forecast relative strength in the economy which has been consistently below Fed expectations.

Brexit Shock - In a surprising and stunning development, UK voters chose to Leave rather than Remain in the European Union in a referendum held on June 23rd. While most polls had the race near even going in, investors had widely discounted the possibility of the Leave camp emerging victorious. Even the leaders of the Leave camp seemed shocked at the outcome as their confused reaction revealed when it became evident that they had won. In what has been widely seen as a significant self-inflicted wound, UK voters elected to scrap 43 years of membership in what has evolved into today's European Union. The backers of the Leave camp argued during the campaign that Britain would be able to negotiate continued access to the European Market while at the same time limiting immigration and exerting greater control over UK borders.





*Source: *The St. Louis Fed's New Characterization of the Outlook for the U.S. Economy, stlouisfed.org; Bloomberg.*

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

Guiding Portfolio Strategies

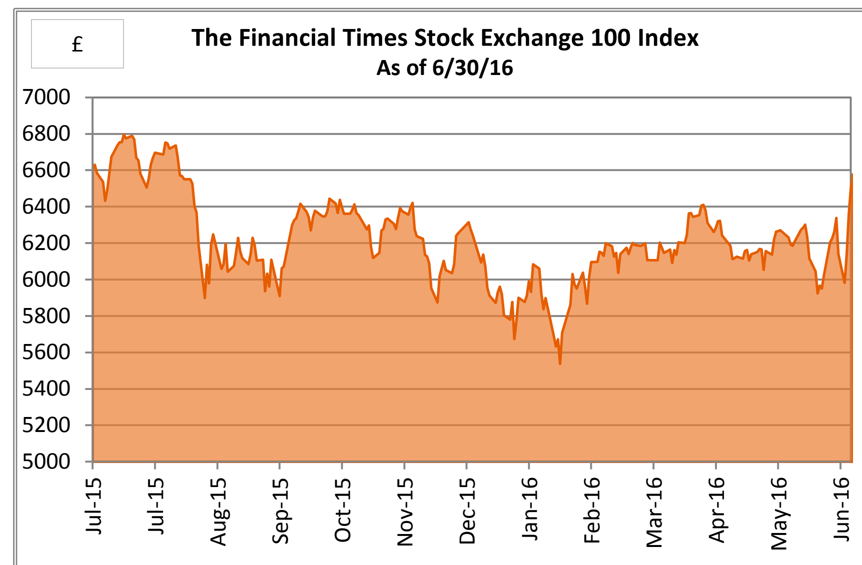
McDonnell Investment Management, LLC

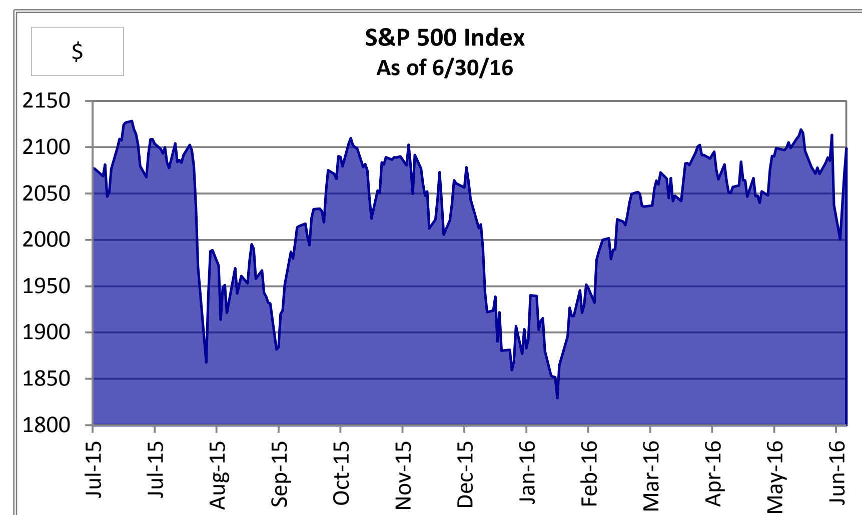
Market Overview

Most analysts view this possible outcome as highly unlikely and take the more sober view that the remaining 27 members of the EU will have little incentive to make the negotiated exit smooth and every incentive to reinforce the cohesion of the EU to avoid the emergence of a contagion effect upon weaker members. The EU is unlikely to grant single market access to a non-member country unwilling to agree to its fundamental principle of free movement of goods, services, capital and labor. The immediate market impact was a risk-off reaction and flight-to-quality buying which drove yields lower and the dollar higher. But as the dust settled, risk markets began to recover. The prospect of slower growth in Europe left a firm bid in the bond market, however. Bank of England Governor Mark Carney has already indicated that the Central Bank may need to cut rates if, as it now anticipates, the uncertainty resulting from the pending withdrawal negotiations acts as a drag on growth.

- UK voters elected to exit the European Union in a June 23rd Referendum that shocked observers and roiled currency and capital markets globally.
- Equity markets generally recovered while gains across fixed-income markets held. Bond markets are reflecting expectations of ultra-low rates for the foreseeable future.
- Prime Minister Cameron, a Remain proponent, announced that he will step down, and fierce intra-party jockeying has left the path forward uncertain.
- Referendum results are non-binding and it will leave the new Prime Minister to lead Parliament to enact legislation authorizing the invocation of Article 50, which will trigger formal 2-year negotiations with the EU regarding Britain's exit.
- Leading candidates vying to head the government all propose to move forward with the invocation of Article 50 despite widespread revulsion with the prospect across large sectors of society along regional and demographic lines.
- In the wake of the outcome, Scotland and Northern Ireland could potentially undertake efforts to remain part of the EU and leave the United Kingdom.

Where do we go from here? While near-term reaction is likely to calm somewhat, the medium and longer-term outlooks are potentially cause for concern. It has been apparent for the much of the 7-year recovery that the Federal Reserve projections have consistently overstated the expected strength in economic potential and the recovery of inflation to the Fed's longer-term 2% target objective. Market expectations have been persistently below the Fed's projections and have, thus far, proven a far more accurate barometer of actual conditions and forward developments. It is against this backdrop that President Bullard's policy conversion can provide perspective.





Source: Bloomberg

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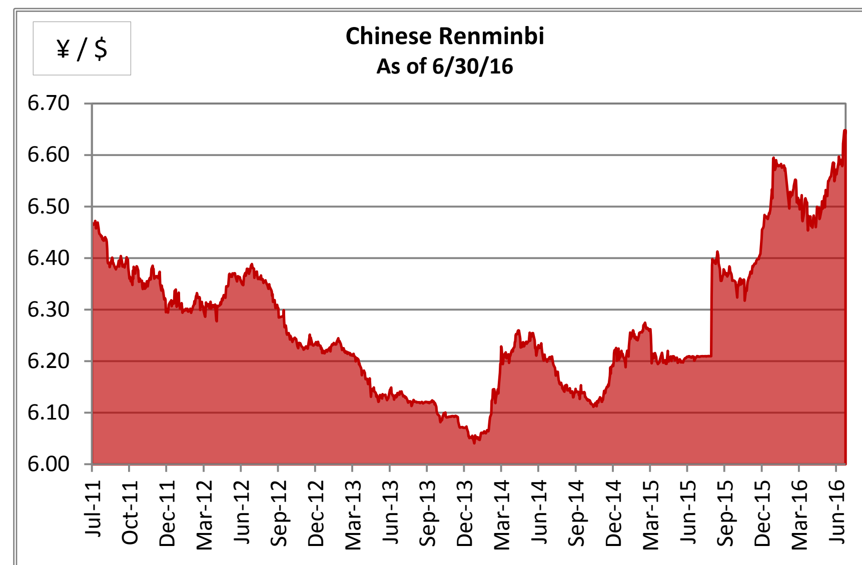
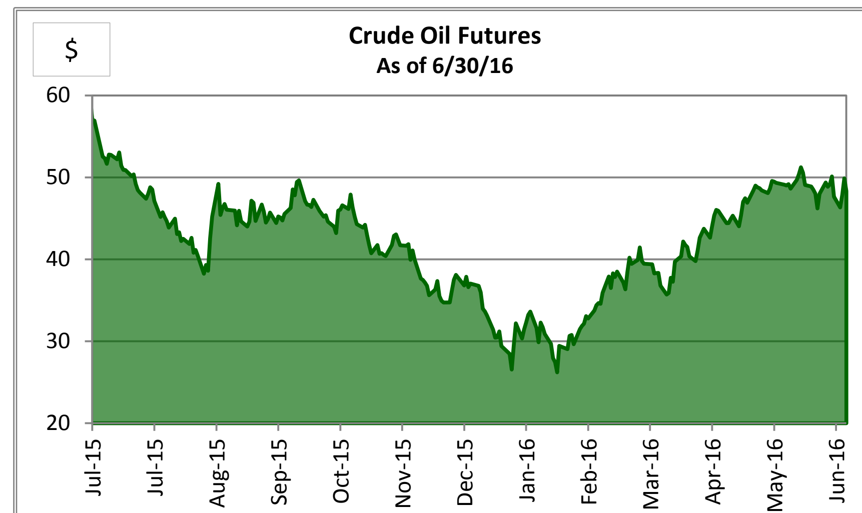
Effective policymaking, by definition, should evaluate the real impact of decision-making and either reinforce or recalibrate the policy levers based upon the actual outcome of events. In this case, President Bullard may well be at the vanguard of thinking at the FOMC in coming to the realization that we are in a different environment than recent cycles and as such must adapt in ways that were heretofore considered unorthodox. Monetary policymakers face a critical juncture and the Brexit impact may well be the catalyst that helps move consensus to a more realistic center of gravity. Should the Brexit outcome ignite a broader realignment of the European Union, or if a more rapid deceleration of growth in China drags global growth lower, monetary policy alone will possess little in its conventional toolkit to help ameliorate conditions. As the world has been painfully reminded, it cannot afford to assume that electorates and their representatives will choose to effectuate rational economic decision-making in the face of economic and political challenges. Fiscal policy has been essentially sidelined for much of the recovery not only domestically but across many Developed Market Economies. As such, it is incumbent upon the Fed and their counterparts, who are less subject to electoral politics, to help stoke the embers of recovery to ensure that economic growth maintains course. The global rate structure indicates expectations of a dramatically different economic future than central bankers either expect, or are willing to project. Attempting to boost rates in the current environment may well present a greater risk than policymakers are willing to undertake.

Taxable Market

Treasury yields plunged to near record lows as safe-haven buying in the wake of the Brexit vote drove rates lower. Investors reassessed the prospect of the Federal Reserve having any scope to tighten policy over the medium-term and snapped up longer-term notes in panic buying as the global yield collapse continued. US 10-year Treasury yields finished the quarter at 1.47% versus 0.83% for UK Gilts, negative 0.13% for German Bunds and negative 0.23% in Japan. The yield curve continued to flatten as investors priced out the possibility of near-term Fed tightening and began reducing the probability of future tightening maneuvers as the shock of events took hold.

- Rate markets rallied sharply and yield curves continued to flatten.
- Credit markets recovered strongly in the wake of the continued recovery in the energy and commodity sectors.
- Spread sector assets broadly outperformed Treasuries as the quest for yield resumed unabated.
- Mortgage paper was mixed, pressured by lower rates and higher volatility during the period.
- Banking and Finance Sectors face potential headwinds in light of the rapid decline in yields and potential outlook for rates longer-term in the wake of Brexit fallout.
- Earnings and revenues generally remain under pressure.





Source: Bloomberg
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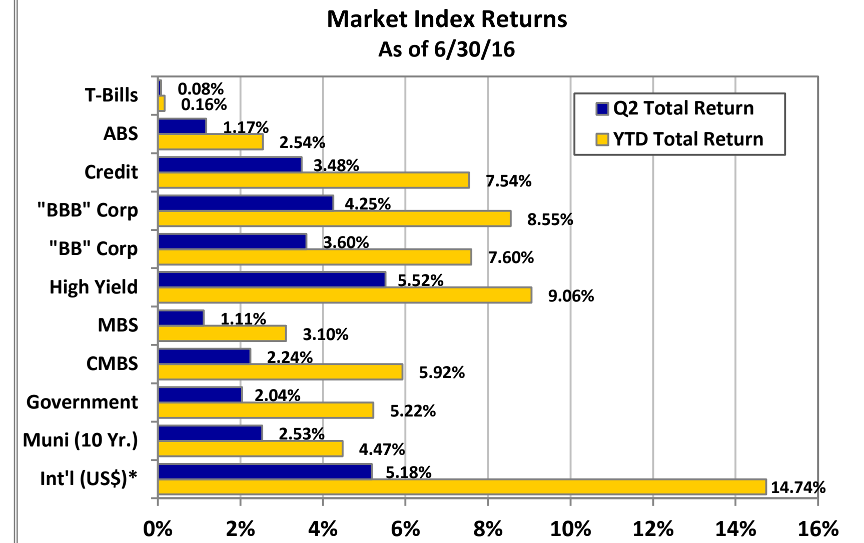
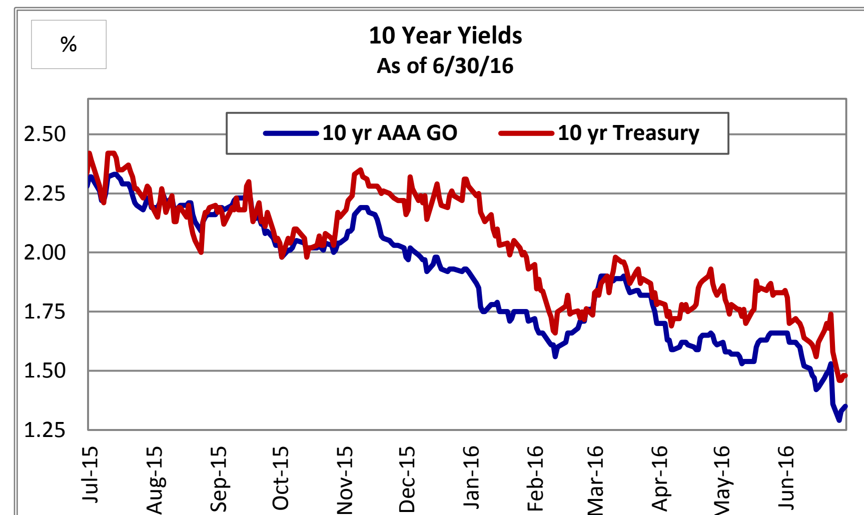
Municipal Market

The municipal market rallied sharply as yields plunged in response to flight-to-quality buying that propelled prices higher in reaction to the outcome of the Brexit Referendum in the UK. Investors began to widely discount the probability that the Federal Reserve would have the ability or the desire to act anytime soon and heavy demand drove buying despite near record low nominal yield levels. Demand has been consistently strong as evidenced by 38 consecutive weeks of shareholder inflows into municipal mutual funds. New Issue Supply began to pick up late in the quarter but remained slightly behind last year's pace. Most of the shortfall can be attributed to a drop off in Refunding Issuance, which has been slow as the low level of short-term Treasury yields rendered potential refunding deals economically infeasible.

- Municipal yields plunged and the longer-end of the curve sharply outperformed Treasuries during the quarter.
- The yield curve flattened sharply as crossover buyers snapped up long-term municipals in the wave of buying that surged into high-quality fixed-income markets at the end of the period.
- Spread sector assets continued to outperform as investors' reach for incremental income amid a collapse in nominal yields.
- Municipal market continued to feature strong and consistent demand against modest new issue supply.





*Source: 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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