McDonnell Investment Management

Fixed Income Market Commentary ✧ July 2015

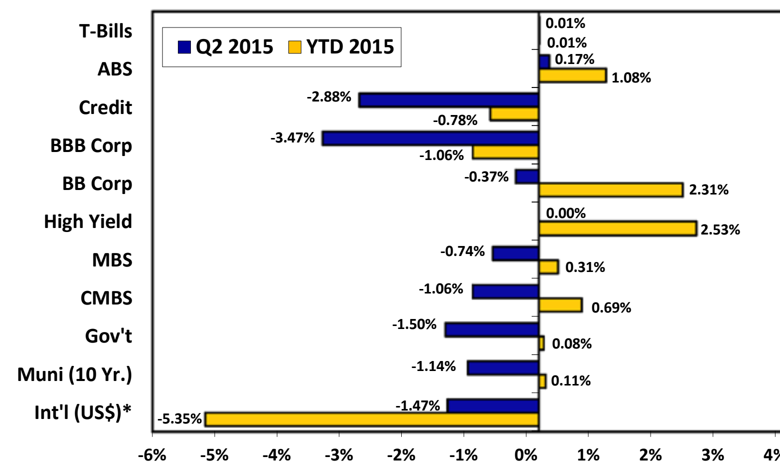
Market Overview

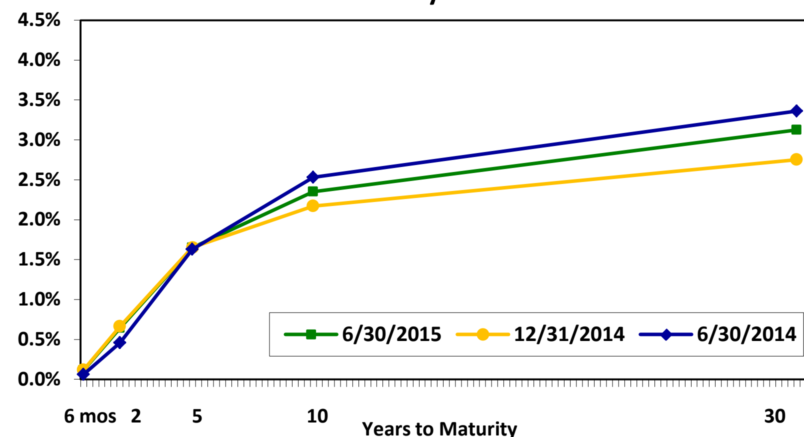
Interest rates moved higher, yield curves steepened and risk markets moved sideways as investors weighed the prospects of timing a potential change in Federal Reserve interest rate policy against a moderately positive economic backdrop producing precious little inflation pressure. The fundamental cause of the backup in rates can be attributed to a step back from the precipice of deflation across Europe, but a strong case can also be made for the backup being attributable to the embarkation of large scale quantitative easing by the European Central Bank (ECB). European sovereign rates declined precipitously when the ECB announced a larger than expected asset purchase program in January; but rate markets reversed course dramatically when the program commenced near the end of March. We expect that the push and pull of major central bank monetary policies may be at the core of market development as it has often been throughout the recovery cycle. Domestic bond markets traded mostly higher in volatile trade as sentiment swings reflected expectations of a Fed rate rise amid declining inflation expectations.

- Domestic bond markets retreated during the second quarter and yield curves steepened.
- Initial round of the €1.1T ECB asset purchase program coincided with a significant selloff in Eurozone sovereign debt.
- The dollar edged lower and consolidated for most of the period following its first quarter surge.
- Negotiations surrounding an extension of the bailout package for Greece intensified dramatically as the quarter drew to a close.

The quarter ended on a discordant note with the near simultaneous eruptions of crises in Greece, a warning of impending debt default in the Commonwealth of Puerto Rico and a sharp downdraft in Chinese equity markets. Developments in Greece occupied center stage however, as negotiators failed to reach agreement prior to a June 30 deadline. Following in short order was the "No" vote on the Greek referendum and two weeks of intense negotiations, culminating in an accord which staved off economic chaos but left prospects for ultimate recovery far from clear. In return for the extension of €86B in new loans, Greece agreed to a package of economic reform measures, a €50B Privatization Fund and further budget austerity, which to date has not been able to slow the growth of its external debt relative to GDP. The Eurozone remains intact for now, but the possibility of member exit has now been placed firmly on the table. While the crisis demonstrated resolve on the part of member countries to remain unified, it also placed into sharp focus the shortcomings of monetary union without banking and political union. Resolution of these critical challenges will likely remain a market focus going forward.

……Continued on next page





All indices shown reflect Barclays Indices, except where noted.
*Sources: Barclays; *Merrill Lynch; Bloomberg; Federal Reserve.*
Please refer to the Notes and Disclosures on the last page for additional information.

Guiding Portfolio Strategies

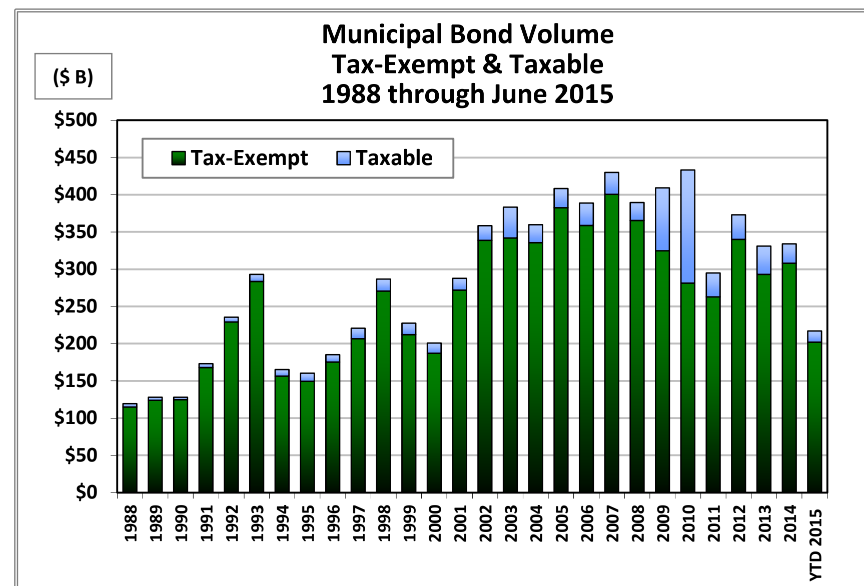
McDonnell Investment Management, LLC

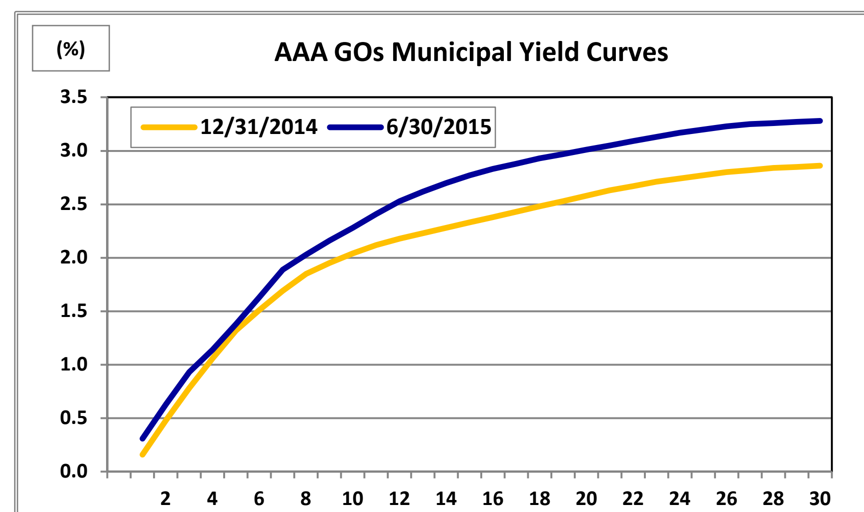
Market Overview *(Cont.)*

Closer to home, Governor Padilla of Puerto Rico stated in a New York Times interview that the debt incurred by the Commonwealth was 'not payable.' While Puerto Rico's problems are widely known in the municipal market, the unexpected and direct acknowledgement of the severity of the challenge was greeted as a shock and reflected quite negatively in secondary market prices for obligations of the Commonwealth and its various related agency issuers. To date however, there have been no payment defaults on obligations of Puerto Rico. The island economy has suffered recessionary economic conditions near continuously since 2006 and has been negatively impacted by a declining population being driven by outmigration of residents seeking greater economic opportunity in the United States. Efforts to advance legislation in Congress authorizing the restructuring of debt through Chapter 9 in Puerto Rico have yet to garner enough momentum for passage, but attempts to build bipartisan support are ongoing. Should such legislation become law, it would add a framework of precedent and a demarcation of authority to aid in the effort to seek relief for this beleaguered US Territory.

Finally, in addition to these problematic developments, China is attempting to stem a major selloff in its equity market. Prices had more than doubled since the 4th quarter and promptly collapsed more than 30% over the space of three weeks. Market action appears to be reflective of heavily margined buyers being forced to liquidate as prices deteriorate. Massive efforts to halt the collapse included trading suspensions, large holder sale bans and interest rate cuts which finally managed to put a floor, at least temporarily, under prices.

On the economic front, domestic growth appears to have resumed in the second quarter following a first quarter dip brought about by harsh weather and a strengthening dollar. Employment growth remained positive, albeit at a somewhat slower pace than registered last year, and inflation remains flat. Prospects for continuation of the economic recovery appear favorable over the medium term. As the recovery advances, the consensus among analysts appears to expect a change in Fed policy in September with a modest move higher in rates. While we share the view that policymakers would like to move off the zero lower bound and begin the process of 'normalizing' rates, we are cautious in light of the other significant developments that are occurring simultaneously that could serve to stay the Fed's hand until these storms weaken. Fed Chair Yellen has indicated that while she expects policy action in 2015, it will be 'data dependent,' gradual and likely to be more moderate than recent historical rate cycles. Against the backdrop of moderate growth and extremely low inflation both domestically and across most Developed Market Economies, we would concur. As such, we do not foresee an economic environment either warranting or sustaining a significant rise in interest rates over the medium term horizon.





Sources: The Bond Buyer; Municipal Market Data; Thomson Reuters.
Please refer to the Notes and Disclosures on the reverse side for additional information.

Guiding Portfolio Strategies

McDONNELL INVESTMENT MANAGEMENT, LLC

Taxable Market Overview

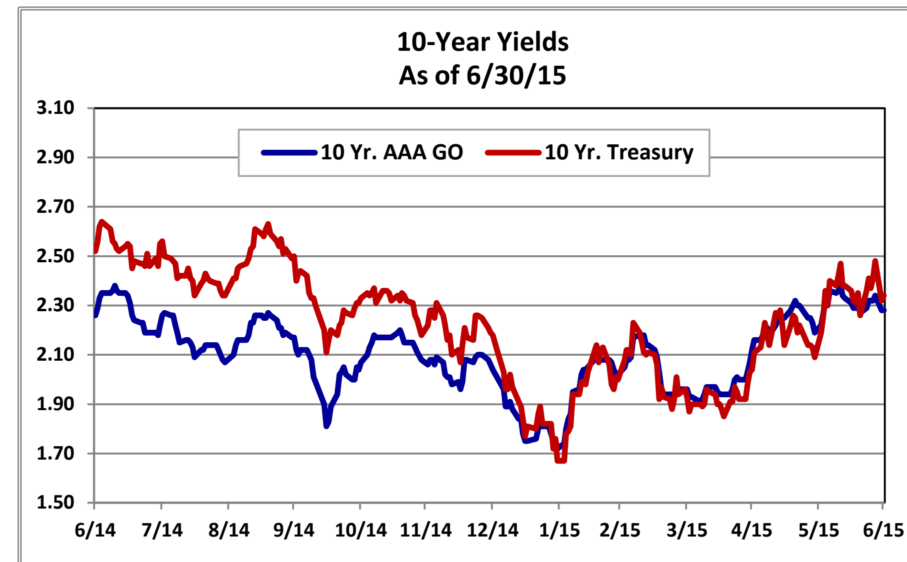
The US bond market surrendered most of its gains from the first quarter as spreads edged wider and yield curves steepened. For the first half, the shorter-end of the Treasury curve was unchanged while yields rose from 20 to 35 basis points across the 10 to 30-year part of the yield curve. Most spread sectors underperformed Treasuries both for the quarter and for the first half, with High Yield and Asset-Backed Securities being the most notable exceptions. Credit performance reflected a pickup in M&A and shareholder friendly activity in general and contributed to a cautious tone in the corporate market. Corporate issuance remained robust and registered a gain versus last year's record first half pace. Mortgage issuance also picked up, reflecting a modest boost in new home sales as well as a slight pickup in the sales of existing homes as the recovery progressed. The mortgage market has struggled this year with negative convexity as rates have risen and mortgage product has extended out and up the steepening yield curve.

- The Treasury market weakened and the yield curve steepened during the second quarter.
- Most spread sectors underperformed Treasuries as credit spreads widened on the back of worries surrounding the tumult in Greece and the steep selloff in Chinese equity markets.
- Corporate issuance remained robust and kept on pace to top last year's record tally.

Municipal Market Overview

Municipal yields rose and the yield curve steepened as investors took a step back amid an even sharper selloff in Treasuries. Municipal funds experienced moderate net outflows during the quarter for the first time since the Taper Tantrum in 2013. Higher supply continues to be a feature of the market as first half new issue volume ran more than 40% ahead of last year's pace. The expansion in volume is being driven by issuers refinancing older higher rate debt. New money financing was flat and continues to feel the fiscal pressure of unfunded liabilities in the form of underfunded pensions and retiree health care liabilities. Efforts to remedy these long-term challenges are ongoing and evolving. Along these lines, challenges facing the Commonwealth of Puerto Rico and the downgrade of the City of Chicago roiled prices for these issuers as well as other large issuers with significant underfunding of long-term liabilities.

- Municipal curve continued to steepen as yields rose amid a sharp selloff in European sovereign debt markets.
- Governor of Puerto Rico stated that the Commonwealth's debts 'are not payable.'
- Recent narrowing of municipal credit spreads paused in the wake of Moody's downgrade of the City of Chicago to sub-investment grade.
- New issue volume remained well ahead of last year's pace but moderated somewhat from the torrid pace set during the first quarter.



Source: Thomson Reuters.

Notes and Disclosures:

This market outlook is prepared by McDonnell Investment Management, LLC ("MIM") for informational purposes only. The information set forth is neither investment advice nor legal advice. It is presented only to provide information on investment strategies and our view of potential market opportunities. The views expressed by MIM on financial market trends are as of the date of this publication, based on current market conditions and are subject to change without notice. Statements of future expectations, estimates, projections and other forward-looking statements are based upon available information and MIM's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions that may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. The data used for this presentation was obtained from publicly available reports. Unmanaged Index/yield returns include the reinvestment of dividends/interest and other earnings and exclude the deduction of advisory fees and other transaction costs a client may incur. It is not possible to invest directly in an unmanaged index. MIM cannot assure that the type of investments discussed herein will outperform any other investment strategy in the future, nor can it guarantee that such investments will present the best or an attractive risk-adjusted investment in the future. There are no assurances that any predicted results discussed herein will actually occur. Past performance is no guarantee of future results.

Guiding Portfolio Strategies

McDONNELL INVESTMENT
MANAGEMENT, LLC