McDonnell Investment Management

Fixed Income Market Commentary ✧ June 2017

Market Overview

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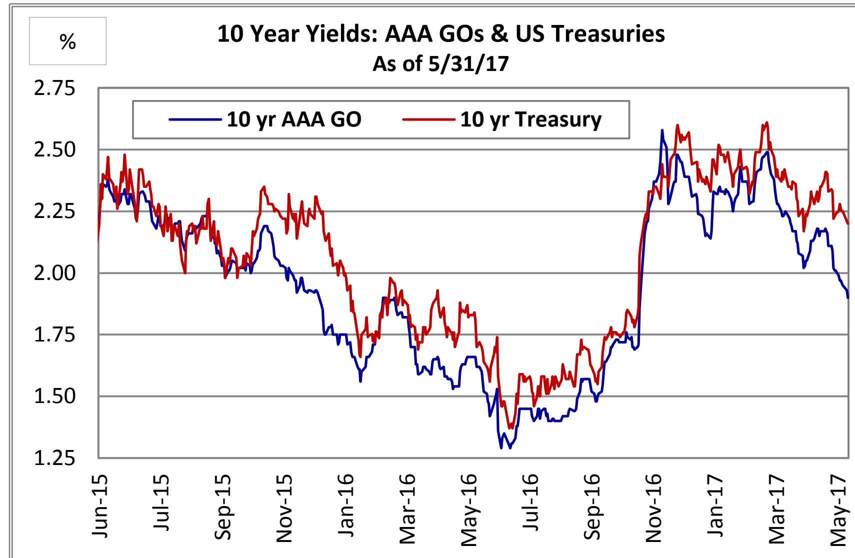
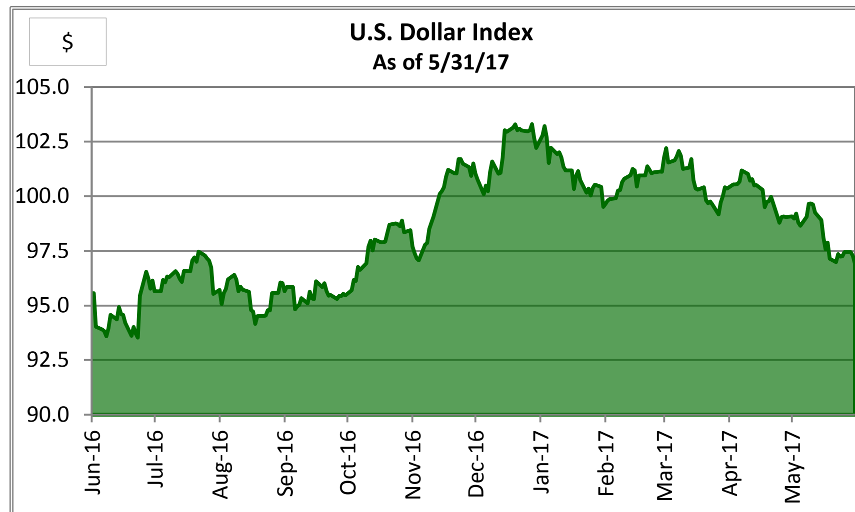
Rates continued to grind lower as cooling inflation and legislative drift provided a bullish fundamental backdrop for fixed income, while the seemingly insatiable investor appetite for yield propelled spread market outperformance across the fixed income landscape. Treasury rates declined and the yield curve flattened in May, while the municipal market registered robust performance with yields falling by more than 20 basis points beyond the 10-year portion of the curve. Credit markets continued to outperform with spread sectors generating positive excess returns versus Treasuries while quality spreads narrowed further. Equity markets edged higher and the dollar weakened. Market performance year-to-date reflects healthy investor demand for income in general, and incremental income in particular. Risk assets more broadly performed well, as equity markets in the US and most bourses abroad rallied smartly, while the dollar generally languished. We view rate and currency valuations as reflective of corrective action following post-election market extremes, while equity markets retain both optimism about near-term conditions as well as hopes for a lower corporate tax rate at some point over the medium-term. We share optimism over near-term economic conditions and remain skeptical regarding the likelihood of significantly lower tax rates given the difficulty of achieving the budget neutrality (or a 10-year sunset) as required by the current legislative roadmap of 'reconciliation'.

- Yields declined as investors continued to focus on maintaining portfolio income amid a persistently low rate environment.
- Municipals strongly outperformed Treasuries during both the month and throughout the year-to-date period.
- Spread markets outperformed reflecting a continuation of 'reach-for-yield' behavior that has been a dominant feature throughout the year.
- New Issue Supply continued at a record pace in the corporate market while volume fell short in the municipal market as plunging Refunding Issuance restrained primary market supply.
- Political developments roiled the Beltway amid the appointment of an independent counsel, but capital markets remained largely unperturbed.
- Political hurdles of a different sort await, as a requisite increase in the Debt Ceiling looms, perhaps as early as August, as well as the passage of a Budget by the end of September.

Market expectations firmed regarding the likelihood of another ¼ point boost from the Federal Reserve following its 2-day discussion of monetary policy which concludes on June 14th. If the Fed moves as expected, it will mark the second boost in 2017 and the fourth since the embarkation of attempts to normalize short-term interest rate policy which began in December of 2015. The Committee is also scheduled to release an update of its Summary of Economic Projections, which will be closely watched for indications as to whether the Fed still anticipates engineering a total of 75 basis points of tightening this year, as well as 75 basis points over each of the next two years . The chasm between Fed expectations and market pricing remains, and debate within the Committee over whether conditions will be sufficiently buoyant to warrant any additional action during the second half of 2017 has likely intensified. A weak Q1 economic trajectory has now been joined by decelerating inflation over the past 2 months. The closely watched Personal Consumption Expenditures Index (PCE) has dipped to 1.7%, and the Core PCE (which strips out Food and Energy) has fallen to 1.5%. Committee member statements have been mixed regarding whether these declines are considered temporary, but enough doubt has been expressed that a Committee consensus regarding a steady march higher in rates cannot be presumed.





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

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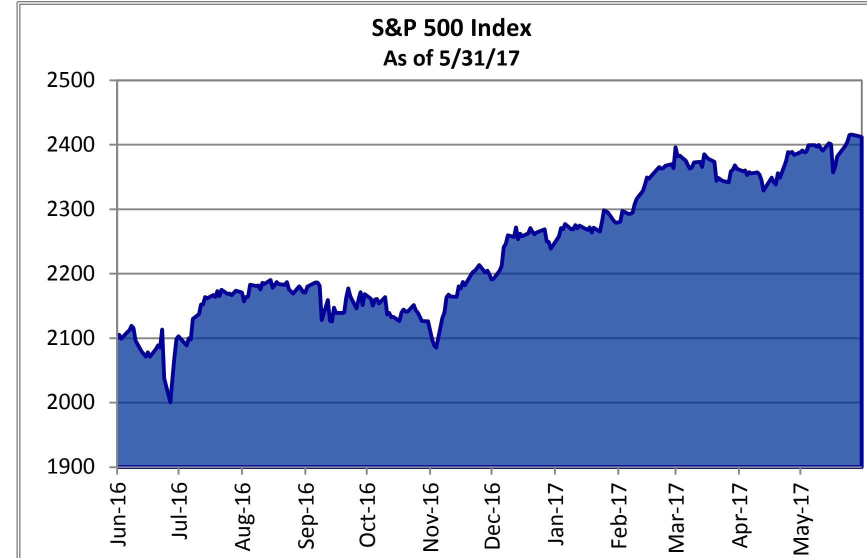
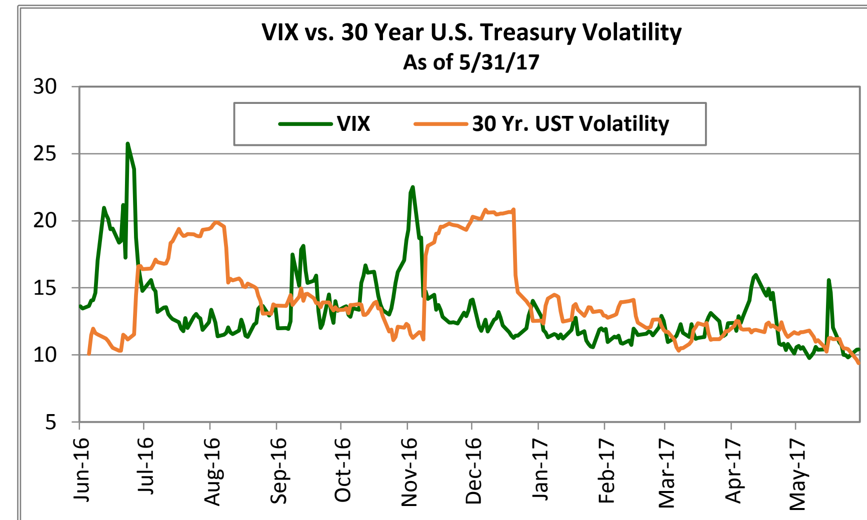
While the Federal Reserve appears likely to move, its ability to impact the longer end of the yield curve remains dubious. Treasury yields beyond the 7-year portion of the curve are lower than they were when the Fed first moved off the zero-lower-bound in 2015, and 2-year rates are only 30 basis points higher. The yield curve spread between 2's and 10's (a widely followed measure of yield curve steepness) has narrowed from 130 basis points to approximately 90 basis points over the intervening time period. The Fed can almost certainly influence longer-term rates by changing the size and mix of its balance sheet. In the wake of several rounds of quantitative easing following the Great Recession, the Fed increased the size of its balance sheet from roughly $870B to $4.5T currently; and the Fed has indicated that it is preparing to trim the size of its holdings, but there are no expectations that they would do so aggressively and risk disrupting the balance in the capital markets and possibly the recovery itself. It is worth noting that both the bond market and the stock market rallied sharply after the Fed's latest move higher in March of this year. Investors hoping for reinvestment yield relief from the Fed may well have a long wait in store.

Helping contribute to the overall environment of low nominal yields and spread compression has been steadily declining volatility, in both the stock and bond markets. Since spiking higher in the wake of the November election, fixed income volatility has been steadily grinding lower; and equity volatility, while it has been somewhat choppier, has also exhibited the same underlying trend of moving lower amid less two-way market flow. The lack of corrective trade results in limited shakeout of holders of positions and less opportunity to enter the market at more advantageous levels. As a consequence, spread markets in general and credit spreads in particular remain very steady and have tended to grind incrementally tighter. But limited market corrections amid declining volatility can breed investor complacency. We expect the economic environment to remain stable over the medium-term, but remain vigilant for market opportunities to present, if and when the complacency breaks.





Source: Bloomberg.
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NOTES AND DISCLOSURES:

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