Fixed Income Commentary ✧ June 2018

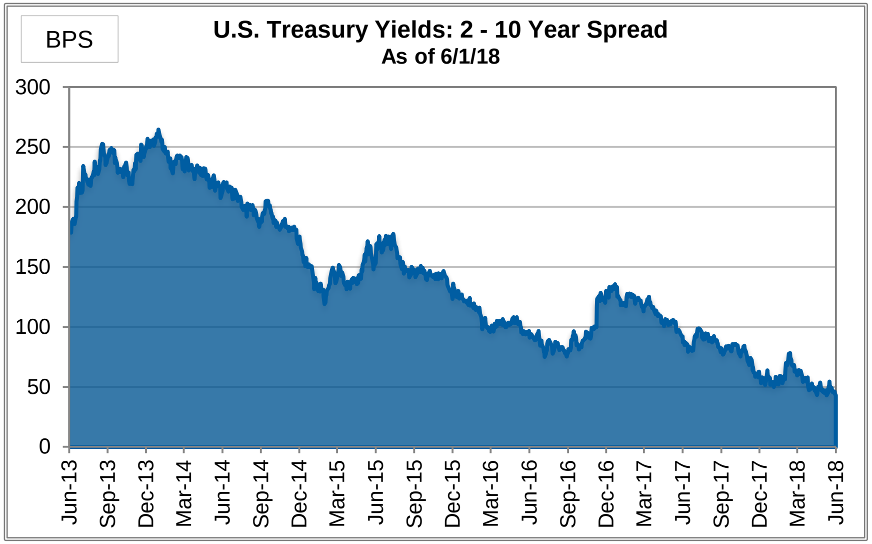
Market Overview

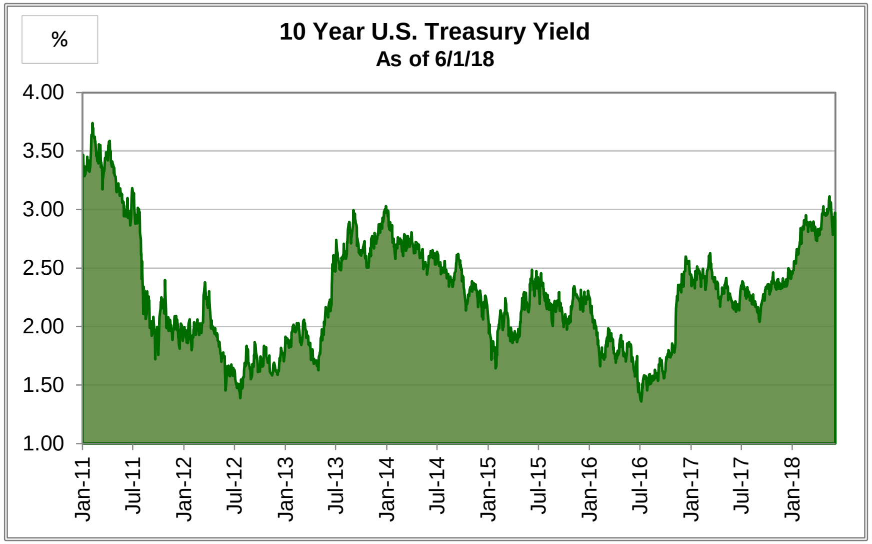
Jim Grabovac, CFA

Rate markets rallied, and credit continued to widen despite a bounce-back in the equity markets as trade/tariff woes weighed on industrial issuers in particular. Italian political developments were also a source of significant concern as a coalition of populists from the left and the right struggled to coalesce into a government. Investor concerns were heightened when word of a proposal to repudiate a portion of Italy's debt circulated and the parties were forced to quickly walk back the proposal as only one of many ideas that had been explored and quickly rejected as part of an economic program to be pursued. But damage to the Italian bond market, while having lessened from its worst levels, remained significant. The yield premium to German sovereigns widened to nearly 290 basis points (bps) in the 10-year part of the curve and 340 bps on the 2-year portion of the yield curve. In the wake of the initial reaction, yield levels have moderated to spreads of roughly 240 and 185 bps, respectively. Nevertheless, this carnage in the 4th largest sovereign market in the world was not the only pocket of debt market distress in evidence over the past month. Turkey, Brazil, Argentina and Indonesian markets are under pressure, and Venezuela is in acute distress. We expect that fissures developing in the global fixed income markets will ultimately factor into the determination of monetary policy in the US and, at the margin, will limit both the latitude as well as the need for policy to shift into a higher gear.

Monetary policy expectations reflect the continued debate as to the slope and ultimate destination of short-term interest rate policy. As we began the year, Fed Funds Futures Markets implied only a 10% chance of four ¼ point increases over the balance of 2018. Despite the tumult percolating in the aforementioned sovereign debt markets, the futures markets now reflect a nearly 50% likelihood of such an occurrence. We are becoming increasingly skeptical that expectations for a more aggressive rate track are well grounded. We believe a US-centric evaluation of the potential policy path fails to fully factor in the likely feedback from a strengthening Dollar, and the impact that higher rates and tightening financial conditions will have on the global economy and the capital markets more broadly. While we appreciate the fact that the US economy remains on a firm growth trajectory and is likely to continue to advance, particularly as aided by an ample amount of fiscal stimulus, we regard the case for a substantial rise in interest rates to be unconvincing. The impact of the Fed's balance sheet wind-down will add measurably to the stringency of monetary conditions as the pace quickens over the coming quarters. As such, we continue to favor the slow and steady policy course that, at least until now, the Fed has advocated and communicated to market participants. The risk/reward for policymakers, in our view, continues to favor gradualism over acceleration.

- US rate markets advanced as several sovereign debt issuers came under intense pressure amid both untoward political developments and a stronger Dollar.
- Spread markets mostly widened with industrials and financials shouldering the heaviest pressure.
- Valuations in the municipal market bucked the trend as credit spreads narrowed and valuations versus Treasuries tightened across most of the yield curve.
- Yield curves flattened in advance of an expected Fed rate boost following the June meeting.
- Crude oil prices corrected lower in part due to a strengthening Dollar and expanding inventories, as well as expectations of a lessening of output discipline following 18 months of restraint.





Sources: Bloomberg.
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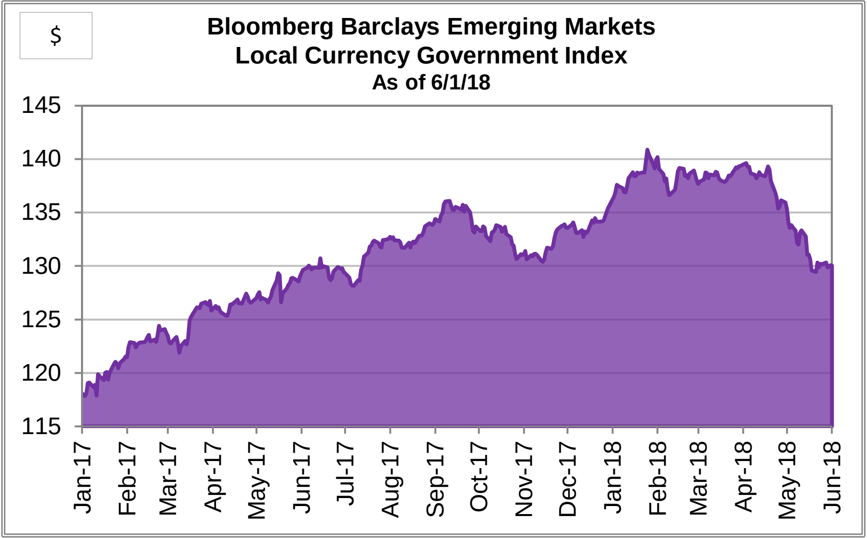
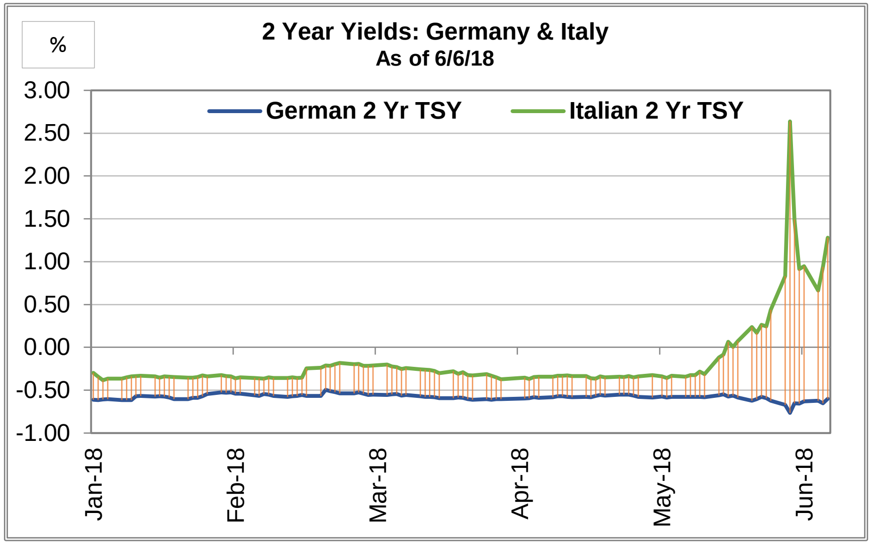
Capital market investors face a multiplicity of potential obstacles to the enjoyment of a relaxing summer. On the near-term docket are an unusually discordant gathering at the G-7 Summit in Quebec, a 7th Fed rate hike accompanied by revised forward guidance, as well as a historic summit in Singapore with the North Korean leader. These developments only account for the next week. Still to come are continued Brexit negotiations, further political developments in Italy, a general election in Mexico, US mid-terms in November and the steady advance of the Russia investigation accompanied by risks of a threatened constitutional crisis as the inquiry proceeds. Other major issues likely await. We remain to a large degree in the same posture that we held at the beginning of last year. Economic fundamentals are strong and we expect the expansion to continue throughout this year and, as yet, see no obstacles to its continuation into next year. But political and geopolitical uncertainty remain highly elevated. As market participants it is easy to get lulled into a false sense of complacency when risks are visible, but market conditions remain favorable and are buoyed by economic growth. Whatever the period ahead holds, it almost certainly will not be characterized by tranquility.

We continue to have a relatively benign outlook for US rate markets. That view has certainly been tested through the first 5 months of the year and will likely be tested again. But the backdrop of a modest rise in short rates accompanied by a low level of inflation and gradually tightening financial market conditions is not one that is particularly nettlesome for investors with a longer-term time horizon. If Fed policy continues along a path of gradual normalization, fixed income markets will likely fare reasonably well, especially considering the move to higher market yields that has already occurred. In the unexpected event that the Fed chooses to adopt a more aggressive policy or if we were to see an inflation spike, we believe the capital market impact would be more directly and perhaps more vigorously felt across the risk market spectrum. We consider the full valuations present across much of the risk market spectrum as a critical element shaping our rate market expectations as we move later into the economic cycle.





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