McDonnell Investment Management

Fixed Income Market Commentary ✧ March 2016

Market Overview

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Risk markets regained their footing during the month after experiencing a vicious slide as the year began. In price action reminiscent of 2015, rates plunged in January following the lead from Europe only to begin a correction in February after an emotional overshoot. Rate markets plumbed new move lows mid-month on speculation that deflationary impulses across the Eurozone would prompt the European Central Bank to undertake additional efforts toward monetary accommodation including both rate cuts as well as potentially extending and expanding planned asset purchases. Renewed concerns about the political stability of the European Union (EU) were amplified after Britain announced a referendum on continued membership in the EU set for June 23rd. A vote to leave the EU ('Brexit') would mark a first step down an uncertain pathway and could lead to further fissures as strains from the massive refugee crisis continue to weigh on member states. This toxic mix contributed to negative sovereign rates in Germany out to 7 years and a 10-year yield of scarcely 20 basis points (0.2%). In Japan negative sovereign rates reached out to the 10-year part of the curve for the first time and paradoxically, the Yen strengthened significantly versus most major currencies. The global growth outlook is challenged on several fronts including China's efforts at economic transition which are being hindered by slowing growth and a sharply elevated debt-load which is increasingly difficult to sustain amid decelerating nominal GDP growth. To date, policymakers have opted to err on the side of further accommodation rather than forcing bloated State Owned Enterprises to reform and restructure.

Amid the backwash of negative global developments US rate markets continued to defy efforts by the Fed to 'normalize' short-term interest rates. In its December Summary of Economic Projections, the Federal Reserve laid out its median expectation of 4 additional ¼ point rate increases by the end of 2016. Investor expectations at year-end priced in only 2 potential moves. Following in the wake of negative news from abroad and declining inflation expectations, rate markets have effectively priced out any further action by the Federal Reserve for the balance of the year. The intensifying speculation that the Fed would be unable to act prompted a sharp, if temporary, reversal of sentiment favoring a stronger dollar. Coming into the year, we believed that the Fed was overly optimistic in its projections and anticipated that market expectations would prove a more accurate indicator of the future path of short-term rates. In recent weeks, several Fed members have indicated that they also favor a step back from further action, and it now seems unlikely that we will see rate action over the near term. Nevertheless, the Committee would prefer to move rates further off the zero-lower bound if and when the capital markets and inflation expectations both stabilize. We expect that absent the importation of additional weakness from overseas; moderate US economic growth and continued improvement on the labor front will allow the Fed to move forward, perhaps during the second half of the year.

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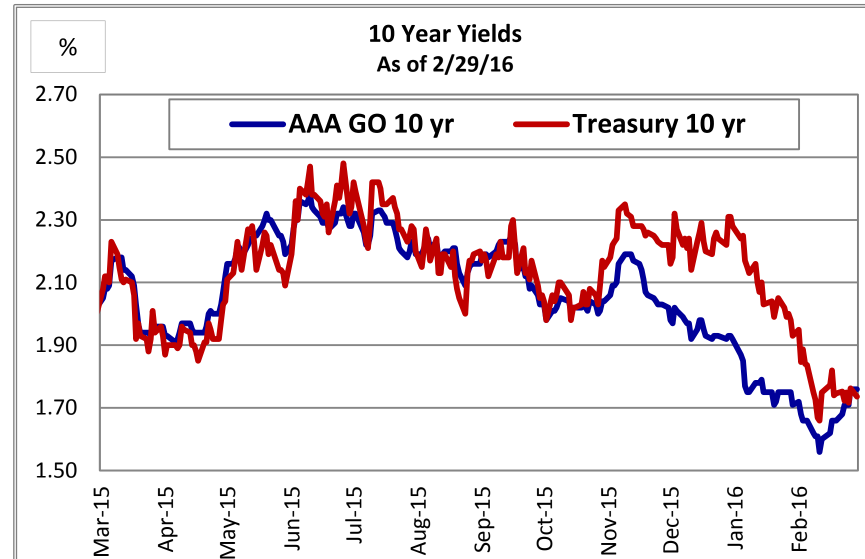
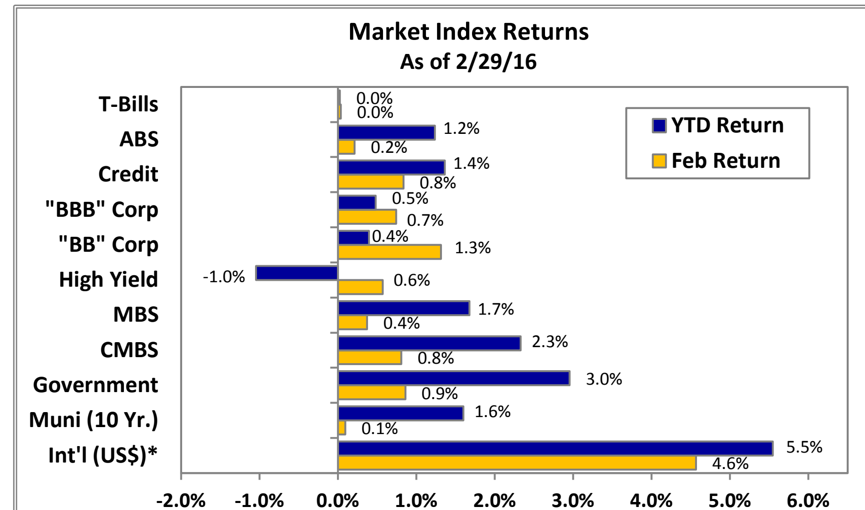




*Source: Municipal Market Data; Bloomberg; Barclays; *Merrill Lynch.*
All indices, other than those noted, are Barclays indices. Please refer to the Notes and Disclosures on the last page for additional information.

Guiding Portfolio Strategies

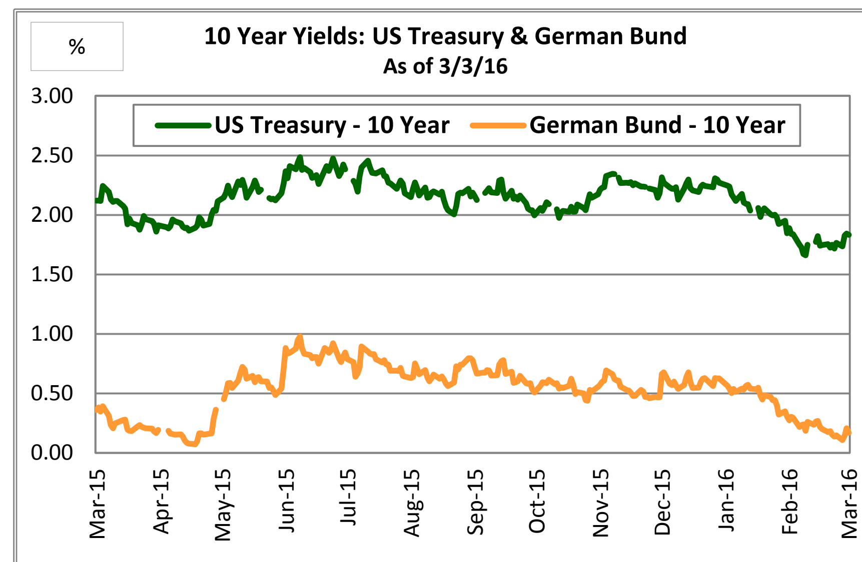
McDonnell Investment Management, LLC

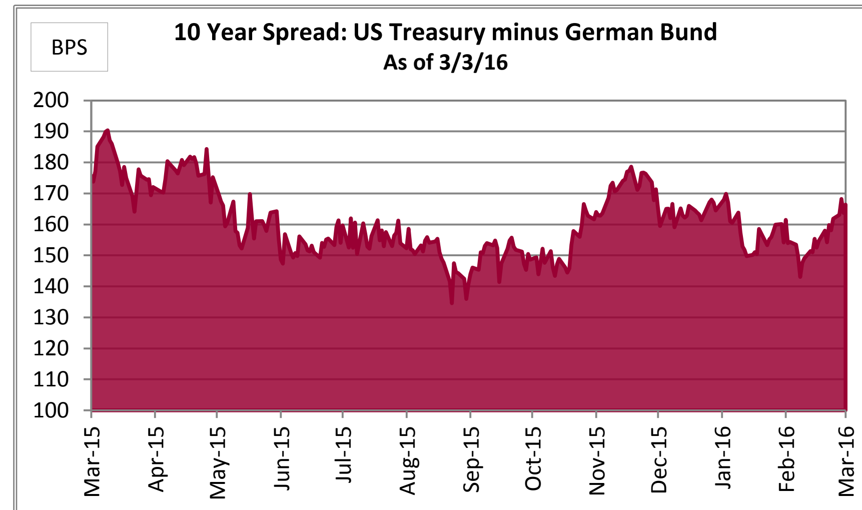
Market Overview

While Treasury rates bounced from their mid-month lows, they nonetheless ended the month down modestly across most of the curve and the yield curve flattened. The strongest gains were registered in the 10-year part of the curve as rate differentials with Germany and Japan exerted a strong gravitational pull. For the first two months of the year, 10-year Treasury yields have declined by more than 50 basis points. Most major spread sectors had difficulty keeping pace and widened modestly during the month. The notable exception was the High-Yield market which generated both positive nominal and relative performance during February following sharp underperformance in January. The municipal market also trailed Treasuries as a modest pickup in supply from January levels prompted a slight backup in rates from 7 years on out. Demand remains strong, however, and quality spreads narrowed slightly during the month. New issue supply is down modestly for the year versus the year ago pace, and the mix of issuance has been evenly balanced between Refunding and New Money Issuance. A pickup in volume would likely require the Refunding Issuance pace to accelerate as it did at the start of 2015.

- US rate markets diverged as the Treasury market rallied and the yield curve flattened.
- Corporate spreads widened and the effect was pronounced on longer maturities as a result of the Treasury curve flattening.
- In contrast, municipal yields rose modestly from 7 years out and the yield curve steepened.
- Rating agencies issued multi-notch downgrades of several energy and mining companies.
- Crude oil prices bounced amid efforts among major producers to forge an agreement to 'freeze' production at January levels.
- Equity markets began to recover after a retest of recent lows.

Despite the spike in capital market volatility, there remains scant evidence that US economic growth is being derailed. While growth slowed in Q4, the latest estimate from the Bureau of Economic Analysis was revised slightly higher to 1.0% versus 0.7% in its initial flash estimate. The revision higher stemmed principally from a smaller inventory drawdown than had originally been estimated. Most analysts anticipate that growth has moved higher in the first quarter, closer to the 2% to 2 ½% range that has been the pace over the past 2 years. Labor markets have also continued to improve. Total nonfarm payrolls now exceed the pre-recession high by 5MM workers, and the unemployment rate has dipped below 5% for the first time in nearly 8 years. The labor market is not completely healed, however, as a weak labor force participation rate, limited wage gains, and swollen ranks of part-time workers continue to characterize current conditions. Nevertheless, we expect that the labor market will continue to improve, and as capital markets stabilize, the Fed may regain the confidence to move rates up modestly over the medium term. We continue to expect the path of increase to be slower and shallower than the Federal Reserve anticipates.





Source: Bloomberg
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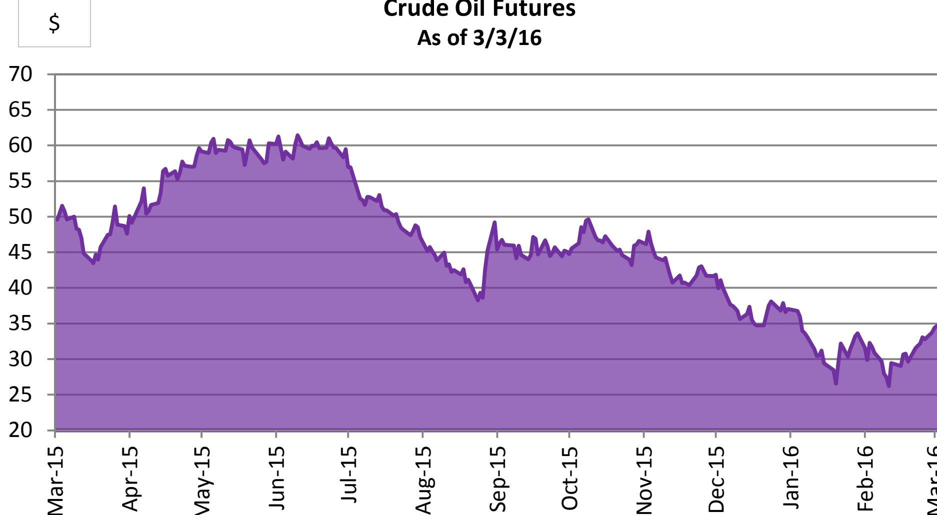

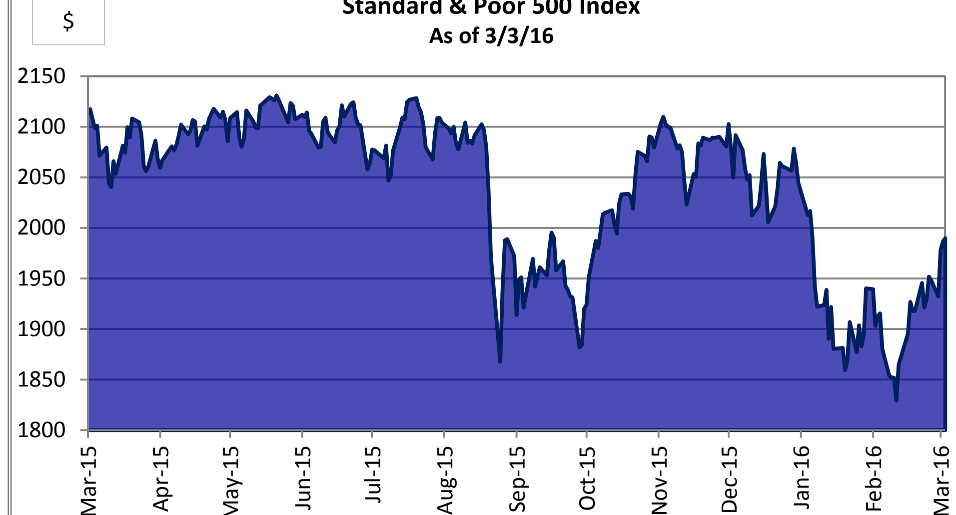

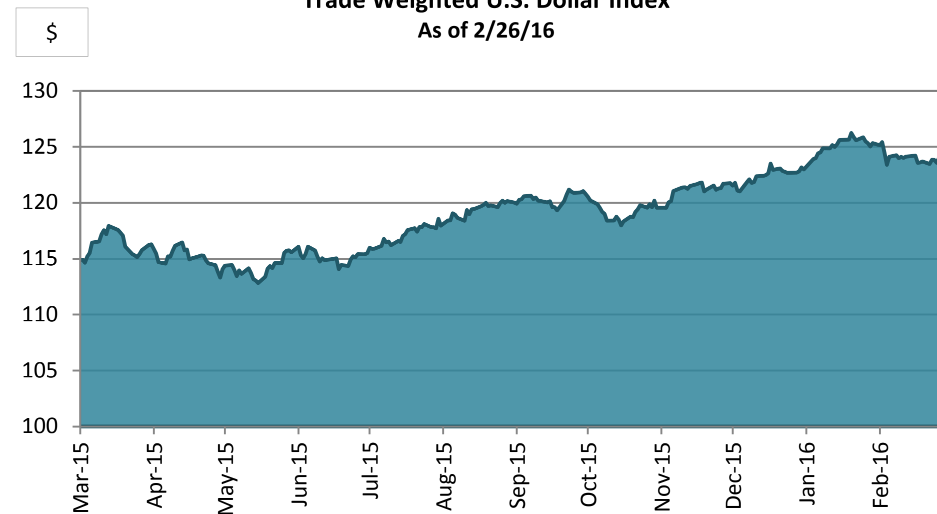

NOTES AND DISCLOSURES:

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Source: Bloomberg
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