McDONNELL INVESTMENT MANAGEMENT

Fixed Income Market Commentary ✧ March 2017

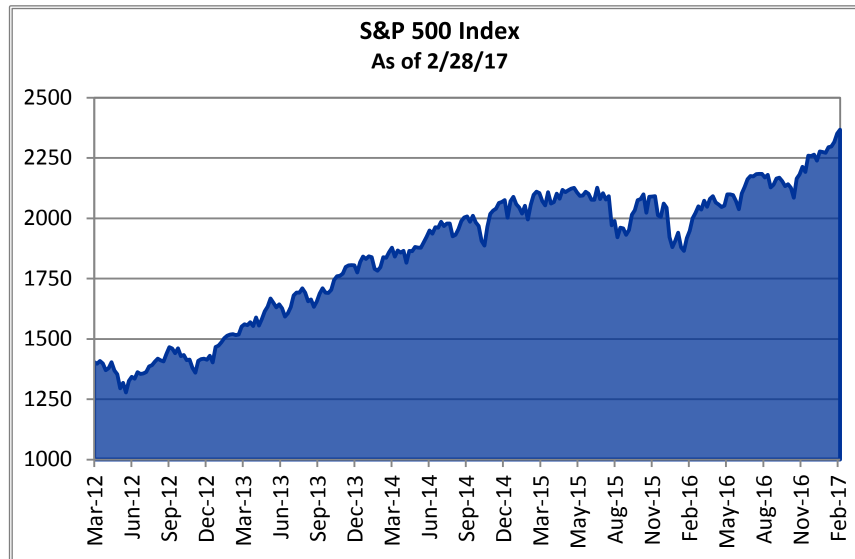
Market Overview

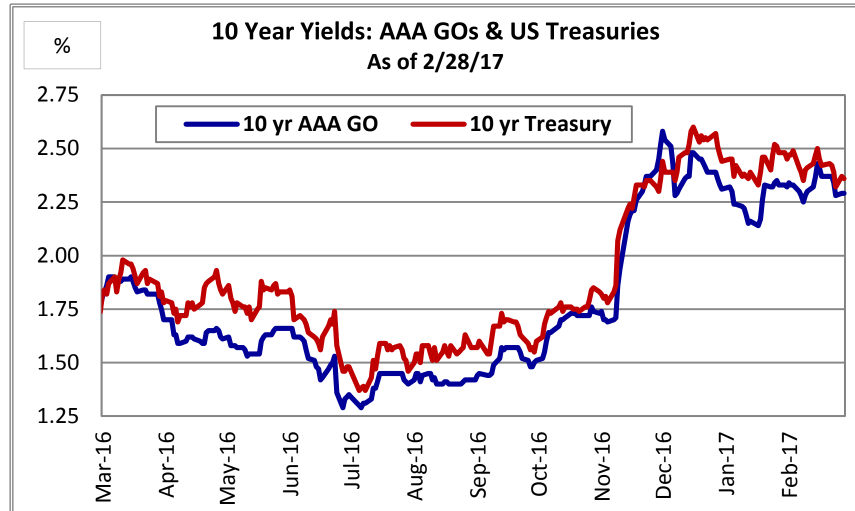
Jim Grabovac, CFA

Equity markets took center stage as US stocks scored a succession of new all-time highs powered by investor anticipation of tax cuts and regulatory rollbacks offering the promise, or at least the hope, of wider profits in the future. Rate markets recovered somewhat and yield curves diverged as Treasuries resumed flattening while the municipal curve steepened. But activity in the credit markets was muted in comparison to the ebullience being evidenced in the US equity market. On the economic front, solid growth remained the order of the day, being fueled by Consumption and aided by continued solid employment gains. Fourth quarter GDP was left at 1.9% in the second estimate and the composition was also little changed. Inflation edged higher with the Consumer Price Index rising to a 2.5% pace while the Personal Consumption Expenditures Index rose to 1.9%. It is evident that the underlying economic data are now within range for the Federal Reserve to boost rates either at the March 14-15 meeting or soon thereafter. Several Fed participants noted that economic conditions appeared to warrant action sooner rather than later and significantly New York Fed President William Dudley joined the chorus before month-end and helped push market expectations for a March move appreciably higher.

As investors prepare for a boost to short-term interest rates they appear to face the prospect with equanimity. Rate movements to date have been limited and credit spreads continue to contract. For the month of February, lower quality corporates generated strong nominal and relative returns, resuming the pattern of behavior they exhibited last year. Despite the bond market gyrations that followed in the wake of the November election, the underlying behavior of fixed income investors continues to focus back to reach-for-yield behavior. Investors, at least in the current environment, seem more pressured to replace lost income than concerned about potential interest rate or credit volatility going forward. This dynamic can and will ultimately change and perhaps do so quickly; but for the time being the operative character of fixed income markets is a focus on income and a tolerance for increased credit risk. The municipal market continued to grind toward recovery as Fund Flows stabilized and New Issue Supply moderated. Likewise, lower quality credit has generated the strongest relative returns and spread sectors, in general, have exhibited a tendency toward improving valuations.

- US rate markets were mixed with longer-end Treasuries rallying and flattening the curve while the municipal market rallied and the yield curve steepened.
- Municipal market outperformance on the shorter-end of the curve has resulted in a steepening of the valuation curve amid limited supply and steady demand.
- Credit was strong with lower quality corporates and municipals generating the strongest relative returns during the month.
- Equity markets rose, marking a series of record highs on the heels of investor enthusiasm over the potential for tax cuts and regulatory rollbacks.
- US Dollar was mixed but strengthened versus the Euro in response to heightened political fears in France.
- Crude oil prices remained range-bound following their recovery from last year's plunge and voluntary production cuts appeared to be holding.





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

Guiding Portfolio Strategies

McDONNELL INVESTMENT MANAGEMENT, LLC

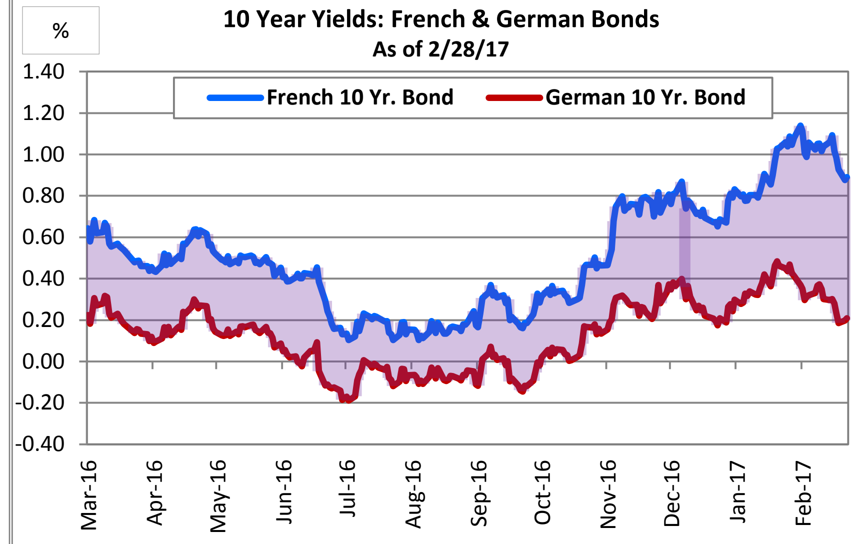
McDonnell Investment Management

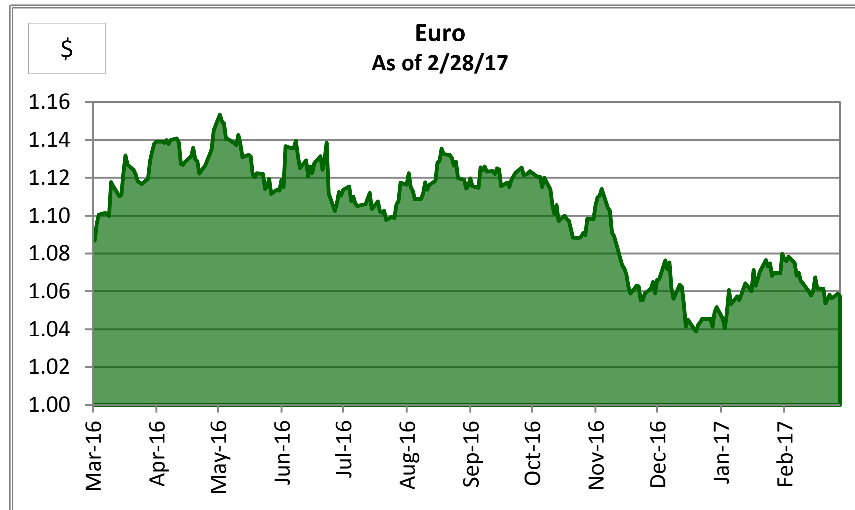
Fixed Income Market Commentary ✧ March 2017

Market Overview

Evolving political dramas continue to loom large for investors. While domestic political momentum has yet to engage, European Union political developments are fast approaching. The elections in the Netherlands take place on March 15th, and investors will be eager to take stock of the relative strength or weakness of the anti-EU Party of Freedom. Even if it were to place first, it is considered highly unlikely to be part of a governing coalition. But a strong showing could raise fears that the siren song of anti-globalist populism continues to attract a significant following which could, in turn, signal new pressures ahead for the Euro and the EU itself. But the main event will take place in the second quarter when France goes to the polls. A nervous consensus as of this writing holds that the anti-Euro National Front Party will finish first or second in the initial round of presidential polling, but likely fail to win in the head-to-head second round balloting which takes place in May. But the consensus was badly shaken during the month when a formal inquiry into allegations of a no-work salary being paid to the spouse of the one of the leading candidates was formally announced. In reflection of investor nervousness over the potential fallout from this investigation, yield spreads between French and German bonds widened sharply on the news, before ultimately recovering much of the move as the month ended.

As the Fed prepares to move it now appears that the positions of the Fed and investors have been juxtaposed relative to the outlook a year ago. Coming into 2016 the Fed had anticipated a series of 4 rate hikes while market pricing was reflective of 2 moves. Market pricing proved the better prognosticator as the Fed moved only once in December. As we entered 2017, the Fed had signaled 3 hikes while many investors expected 2. But recent 'hawkishness' on behalf of several Fed Governors and Presidents, combined with the recovery of inflation and surging equity markets, are prompting more market participants to question their judgment concerning the docility of the Committee and the potential pace of rate moves going forward. Developments on the rate front now seem likelier to follow the Fed path than the more cautious market expectations heretofore. We concur with the wisdom of re-evaluating policy expectations going forward, as the progress toward the realization of the Fed's dual objective of full-employment and price stability appears nearing fruition. Domestic conditions in isolation offer a relatively compelling case for a quicker pace of policy normalization than has been in operation since the end of 2015. But we remain skeptical that domestic economic conditions alone, will set the policy agenda as the year develops. Domestic and geopolitical risks remain elevated and developments may yet alter the policy path going forward.





Source: Bloomberg.
Please refer to the Notes and Disclosures for additional information.

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