Fixed Income Commentary ✧ March 2018

McDONNELL INVESTMENT MANAGEMENT

Market Overview

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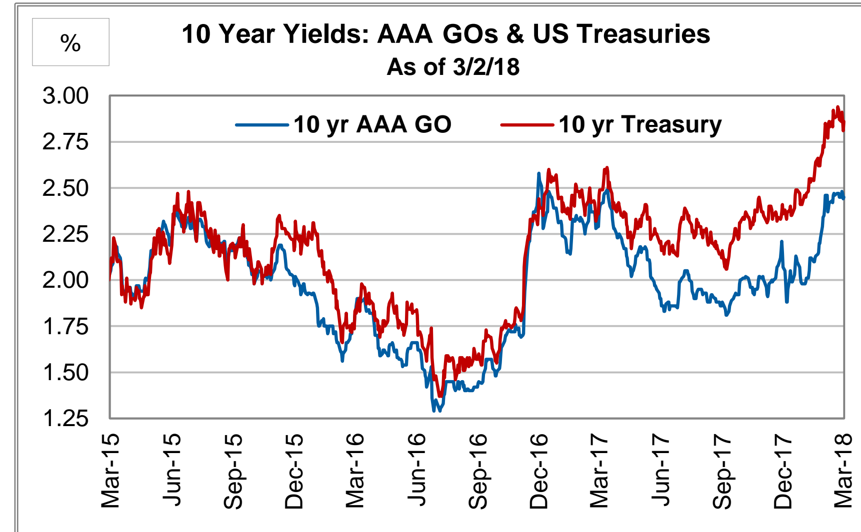
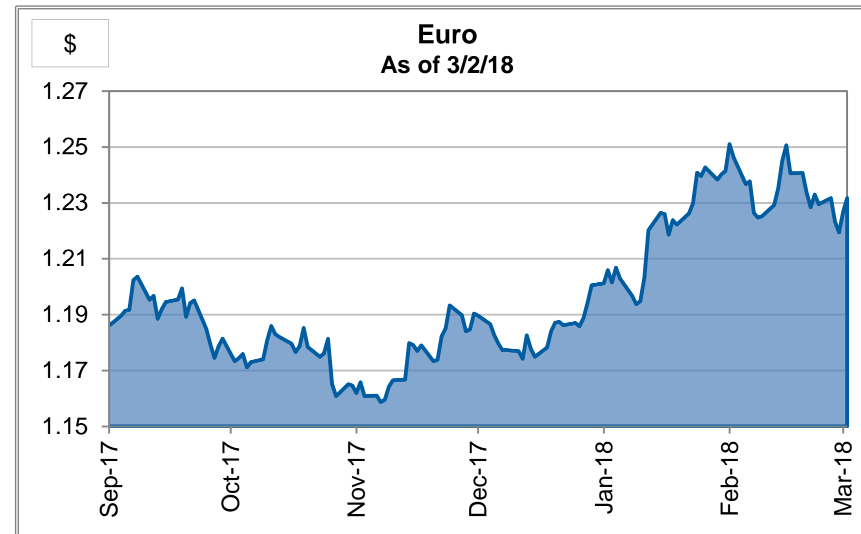
Volatility continued to roil the equity markets as the stunning downside correction that started the month experienced a sharp snapback that recovered more than ¾ of the decline. As the market vacillates, equity investors are now faced with a more difficult environment than the slow and steady march higher that characterized most of last year. Rate markets were also pressured but yields began to find greater stability as the 10-year Treasury neared 3%. Many analysts, ourselves included, did not expect to see bond yields climb so quickly or so easily as the Q1 swoon prompted a rethink as to whether some element of the market narrative of gradually rising short rates and a flattening curve was awry. Ultimately, we expect not, but the swiftness with which yields rose seemed anomalous as expectations of strengthening economic growth also ran parallel with a forecast of only a moderate uptick in inflation and a gradual tightening of monetary policy. Credit markets more broadly underperformed Treasuries as downside equity volatility contributed to modest spread market widening across the complex. The municipal market tracked Treasuries and issuance remained subdued in the wake of last quarter's surge. Municipal market conditions remain largely balanced amid a sharp slowdown in issuance alongside modest mutual fund outflows.

The evolving fiscal and monetary policy mix are principal contributors to the increase in market volatility. Tariffs and the prospects of retaliatory trade action have now been added to the economic policy inputs. The corporate tax cut, to date, has played the biggest role in influencing market psychology. The aggressiveness of the rate cut combined with policymaker willingness to embark on a $1.5T 10-year deficit expansion contributed to the bearish sentiment that pervaded the bond market. Congress added more fuel to the fiscal fire with an additional $300B in authorized spending over the next 2 years in budget legislation passed during the month. The policy of fiscal austerity that Congress enforced for the past 7 years is clearly is in the rearview mirror. The president added to capital market fears when he announced the administration's intention to impose tariffs on steel and aluminum of 25% and 10%, respectively. The inflationary consequences of such a policy are clear, and the possibility of retaliation is apparent. In this early stage it is probably premature to expect a full-blown trade war, but investor anxiety could easily grow if this controversial economic policy directive becomes contagious.

- Treasury yields rose modestly, and the yield curve continued its corrective steepening as markets reacted to a shift toward potentially inflationary fiscal and trade policy.
- Credit spreads edged wider amid the downdraft in equity markets and spike in volatility.
- Municipal yields rose alongside Treasuries, but scant new issue supply cushioned the move and modest fund outflows failed to impact valuations.
- So-called 'short-volatility' equity strategies imploded as a modest equity market correction turned into a full-scale rout which sent the VIX Index higher by nearly 5-fold as traders desperately cut losses.
- The dollar temporarily found support after scoring fresh 14-month lows in the middle of the month.





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

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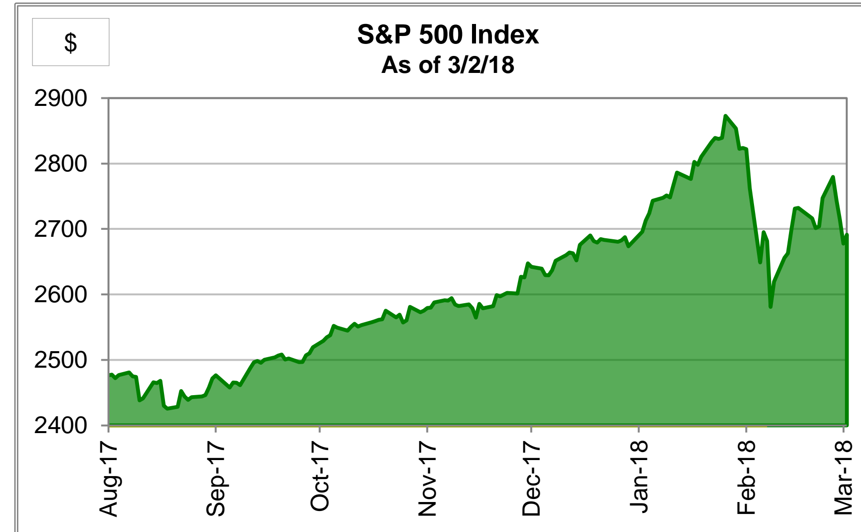
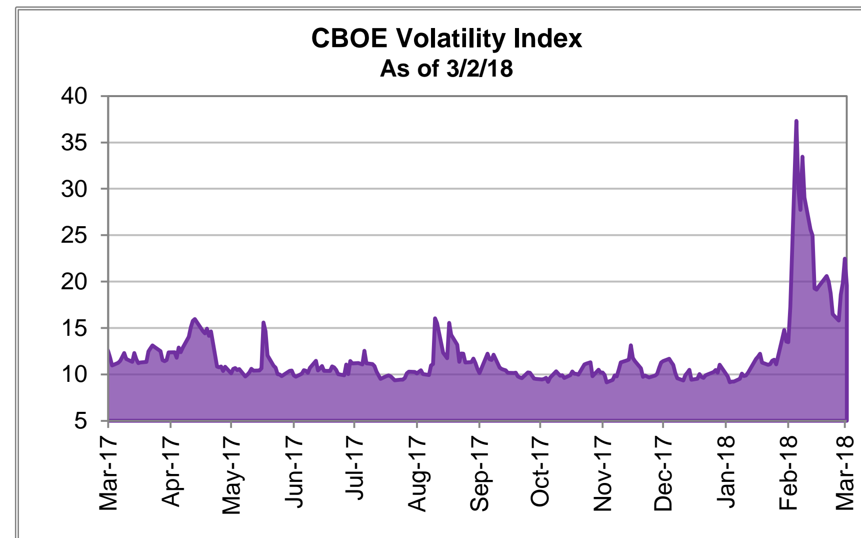
Geopolitical developments continue to evolve negatively for global stability and economic progress over the medium-term. Italy's national election on March 4th unsurprisingly produced a likely hung parliament, but strong gains by Eurosceptic, anti-immigrant parties now loom ominously for the advancement of EU reforms over the near term. Most analysts anticipate the formation of a muddle-through coalition, but with Italy moving up as the third largest economy in the European Union (after the UK departs in 12 months), accommodating more internal pressure within the EU itself will only add to a difficult transition over the period ahead. Meanwhile, Russian efforts to sow discord in the West continue apace with seemingly little effort being expended to combat the assaults. As its own March 18th election approaches, there is little doubt as to the outcome, making it likely that a hostile environment will continue to overshadow relations for the foreseeable future. But perhaps the greatest blow to political liberalization comes from China where President Xi appears poised to have maneuvered a constitutional change, effectively installing himself as president for life. It is difficult to envision this decision having positive long-term consequences for China's development as its growth path decelerates and debt burden expands.

The fundamental backdrop of the US economy remains sound with solid labor fundamentals combined with tame price pressures and healthy corporate profits. In addition, growth prospects appear positive across most of the Developed Market economies with few storm clouds on the horizon. With this benign backdrop it is difficult to ascertain the policy rationale for implementing unilateral steel and aluminum tariffs into the mix. The administration appears to have walked back its initial position of across the board implementation to a more targeted range of trading partners, but it would be preferable if Congress can mute the effort entirely or, at a minimum, curtail its duration. Despite this latest curveball, we anticipate healthy growth for the balance of the year and only a modest uptick in inflation as job gains sustain continued strong consumption. We expect the Federal Reserve to continue along the policy path of gradual short-term rate hikes combined with its established program of balance sheet reduction. The March 20-21 meeting will be Fed Chair Powell's first meeting at the helm, and we anticipate a ¼ point boost in the Funds' rate which is fully priced into the market. We think the likeliest path for bond market development is one of limited upward movement on longer-term yields and a flattening yield curve as the Fed proceeds to adjust the policy rate gradually. If longer rates were to rise further, we believe it may ultimately represent a good opportunity for investors to rebalance portfolios and extend durations as the economic cycle matures.





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