McDONNELL INVESTMENT MANAGEMENT

Fixed Income Commentary ✧ May 2018

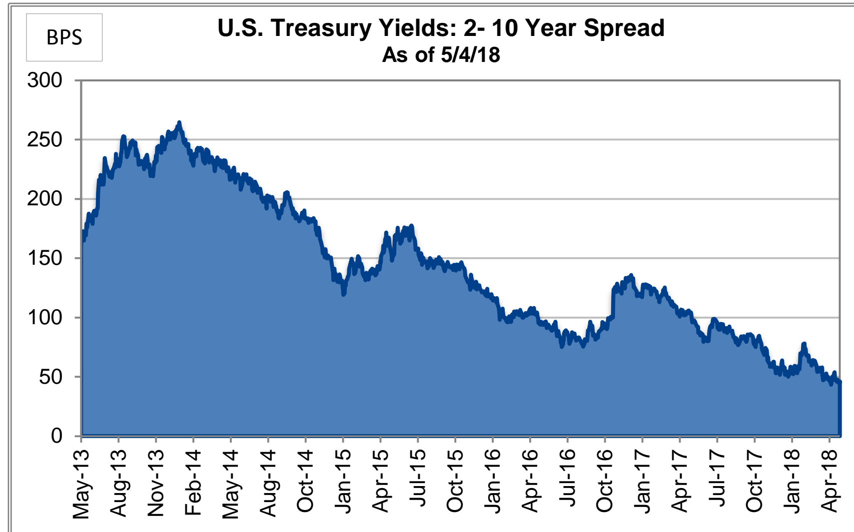
Market Overview

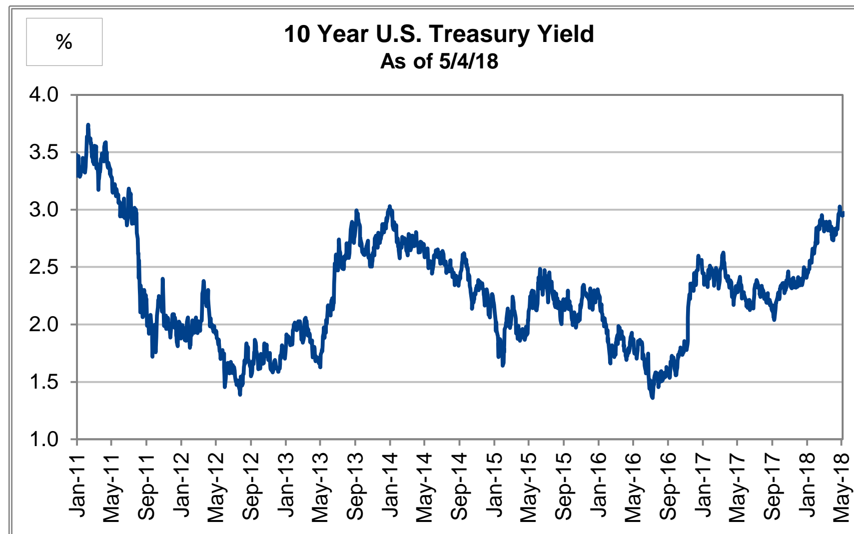
Jim Grabovac, CFA

Rates rose modestly in April as 10-year Treasuries tested the 3% level which was last breached in January 2014 at the end of the so-called 'taper-tantrum.' In this instance, the move in rates seemed largely driven by technical conditions as the combination of expanding Treasury issuance and bearish investor sentiment pressured the market lower. But higher yields continued to prove enticing to yield starved investors who have endured punishingly low interest rates for most of the past decade; and buyers pushed rates back to 2-handle levels as the month concluded. Spread markets mostly stabilized with the exception of long credit which continued to lag. Municipals tracked Treasuries and New Issue Supply remained subdued. Yield curves flattened as much of the upward pressure on rates continued to manifest itself most strongly on the shorter-end of the curve. The yield curve from 2's to 10's has narrowed nearly 220 basis points since the last time yields topped 3%. Whether the Fed's gradual rate policy normalization ultimately pushes long rates higher remains a critical variable underlying the structure of the capital markets as we traverse the 36th quarter of economic expansion.

Equity markets worked sideways amid a massive consolidation move in the wake of the February volatility melt-up that triggered a 10-day, 10% correction that continues to weigh on investor confidence despite strong earnings. A distinguishing characteristic of bull market moves is investor behavior being driven by either the *pain* of being short or the *fear* of not being long. In the case of fixed income markets, behavior has been more characteristic of the former in that long rates were driven lower in large part by the need to generate income in a sharply lower interest rate environment. In the case of the recent bull run in equities, the fear of missing the rally was demonstrably on display and seemed to a reach a crescendo in the wake of the corporate tax cut as investors chased the market higher with seemingly reckless abandon. But the correction and more than 3 months of sideways chop is probably indicative of growing investor angst as trade rhetoric intensifies and a looming policy confrontation with China draws nearer. Perhaps this consolidation will serve as a springboard for further risk market advances; but with tax cuts in the rearview mirror and tariffs, expanding deficits and additional policy tightening on the horizon, it could well presage a rockier road ahead for risk as we near the second half.

- US rate markets retreated as bearish sentiment continued to pervade the domestic bond market.
- Yield curves flattened as expectations of further Fed policy adjustments pressured the short-end, while investor yield appetite helped keep the longer-end in check.
- Credit markets mostly stabilized alongside moderating equity market volatility and strong corporate fundamentals.
- Municipal yields tracked Treasuries amid a continuation of constrained supply conditions since the start of the year.
- The dollar strengthened sharply after enduring a 14-month long slide against most major currencies.





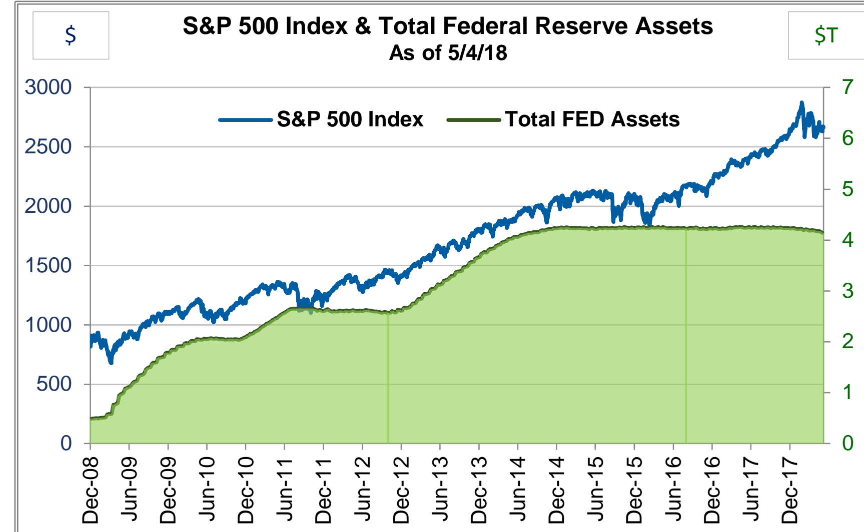
Sources: Bloomberg.
Please refer to the Notes and Disclosures for additional information.

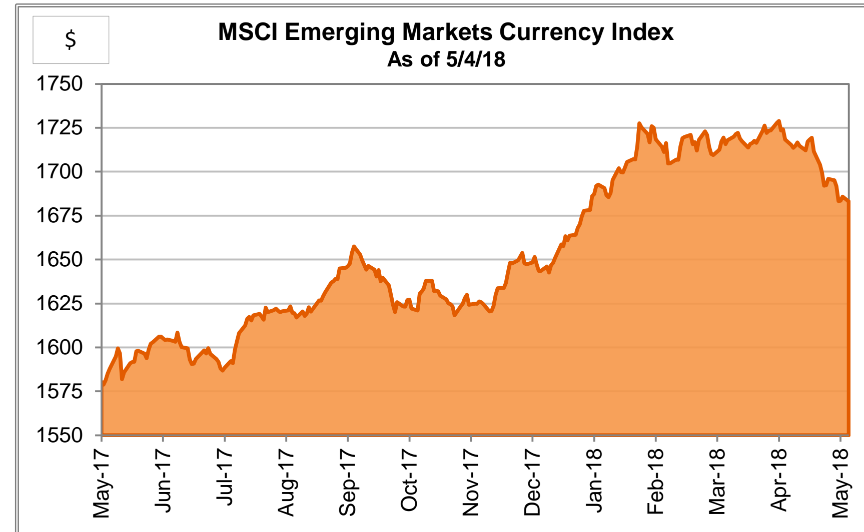
McDONNELL INVESTMENT MANAGEMENT

Fixed Income Commentary ✧ May 2018

Capital markets are exhibiting several behaviors that are indicative of the same underlying fundamental condition; higher short-term interest rates and resultant tighter dollar funding costs. US equity market weakness, emerging market deterioration and yield curve flattening are all reflecting the impact of Federal Reserve policy tightening, both from the standpoint of rising short-term rates and importantly, balance sheet reduction efforts that are ongoing. The flattening of the yield curve, caused by rising short rates, reduces the 'carry' on the longer-end of the curve. Investors funding longer-term bond purchases with short-term financing are realizing an increasingly narrow interest rate differential. Similarly, equity market investors are now discounting prospective future cash flows at a higher risk-free rate, as well as experiencing the impact of higher rates indirectly, as they factor into option pricing which has recently come shockingly to the fore with the quintupling of the VIX Index in February. Emerging markets are the latest sector to experience the disruptive force of tighter funding conditions, with both currency and equity market weakness as short-term US rates work higher and the dollar in turn, begins to appreciate. All of these developments are a reflection of monetary policy working as intended by reducing the return of riskier assets by increasing the return of risk-free assets. As the longest serving Fed Chairman, William McChesney Martin, famously said, the Fed's role is to "take away the punch bowl just when the party gets going."

Against the backdrop of healthy economic fundamentals, we believe the risks of recession over the near-term horizon are quite low. We remain attuned, rather, to potential risks emanating from the valuation structure of the capital markets as having a higher likelihood of causing disruption to the current balance over the medium-term. As discussed at the beginning of the year, we believed that rising equity market valuations were inconsistent with ultra-low equity market volatility. That relationship quickly and resoundingly changed in the first quarter. To date, that market breakdown has not translated into any meaningful change in rate markets. With Fed policy normalization continuing apace and balance sheet roll off increasing, we believe the impact of monetary policy could well be felt more directly across risk markets, which benefited most strongly from quantitative easing. As alluded, the recent strengthening of the dollar, were it to be sustained and continue to advance, could well be the next market driver as we evaluate how capital markets may evolve moving forward. **If the dollar rally begins to gain momentum, it could well be another market move driven by the *pain* of being short the dollar and long risk assets.**





Sources: 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.

18W140 Butterfield Road, Suite 1200 • Oakbrook Terrace, IL 60181 • www.mcdonnellinvestments.com