Fixed Income Market Commentary ✧ May 2016

Market Overview

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The broad recovery in risk markets continued to feature in April as investors favored higher volatility asset classes across global markets. The crude oil recovery, which initially helped trigger the upside reversal in February, was amplified with another strong move higher during the period. Spread markets tightened and domestic equities moved sideways following the 4th consecutive quarter of declining corporate earnings. US rate markets notched modest changes with Treasury yields edging higher while municipal yields moved lower. Talks in Doha, Qatar among major oil producing countries, rumors of which initially sparked the oil rally, failed to achieve the sought after 'production freeze' but oil continued to rally despite the meeting stalemate. Dollar weakness also played a role in facilitating the crude oil recovery which tacked on another 20% increase in April alone. From the lows reached in February, crude has rallied more than 70%. Additional production is anticipated to be added to the market soon and will likely test the resolve of the recently emboldened bulls. After soaring to new highs against a broad basket of currencies, the dollar has spent the past 3 months in a steady downward trajectory, moving back toward the trading levels of last October. Much of the weakness can be attributed to changed investor perceptions of the likely pace and ultimate destination of Fed policy.

Recent greenback weakness could provide currency for the more hawkishly-inclined Fed members to press their case for a rate rise in June. The case for standing pat in March was largely built upon below target inflation, excessive dollar strength and extreme capital market volatility. The dollar has corrected, risk markets have recovered and the third leg of below target inflation is becoming less compelling; we would not be surprised to see a quarter-point rate hike back on the agenda soon. Should conditions warrant action by the Fed, we expect currency markets to be the epicenter of market reaction and the area from which the broader capital markets will take their cue. Whether it is taken in stride or whether another policy move disrupts recent calm could be a key for market development moving into the second half of the year. For the near term however, expectations as implied by market prices remain firmly in the 'no action' category, as least for several months forward.

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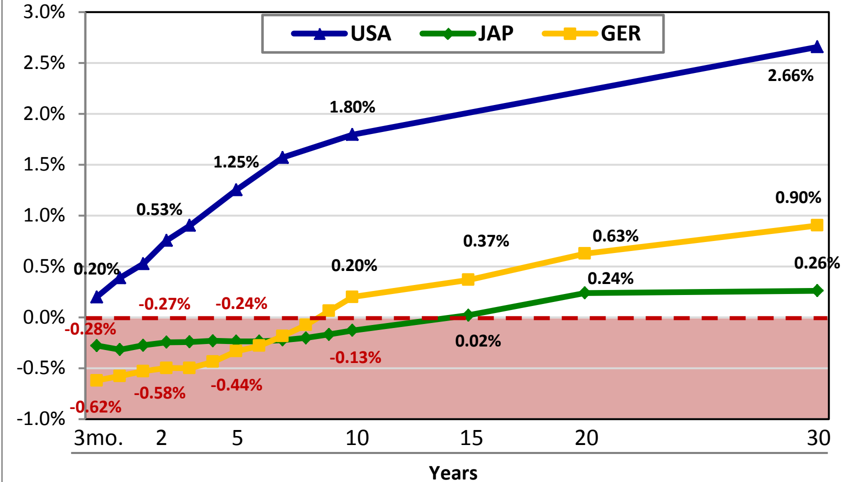

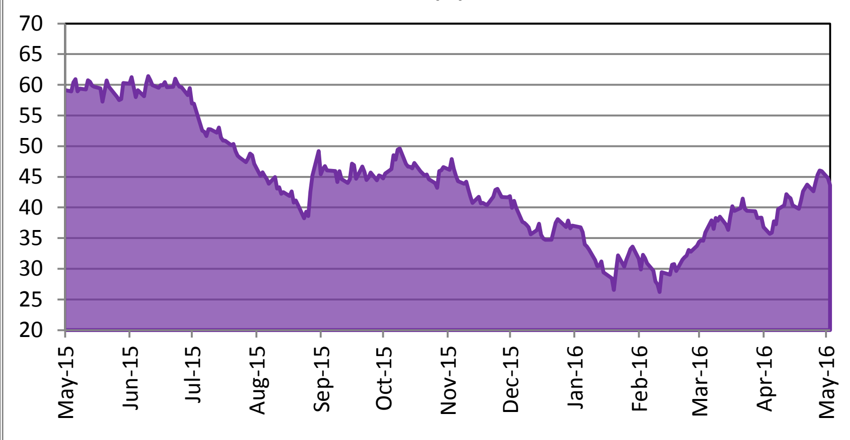

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- Treasury yields drifted higher as safe haven buyers sought to increase risk exposure amid a sharp recovery in crude oil.
- Municipal yields moved lower amid continued strong demand. Mutual Fund flows have been positive, garnering more than $18B of net inflows year-to-date.
- Risk markets continued to recover led by crude oil which tacked on another 20% jump in April alone.
- Credit spreads narrowed across the board with lower quality and longer maturities generating the strongest excess returns during April.
- A slower pace of issuance in April contributed to a strong environment for spread compression. Year-to-date Corporate and Municipal New Issuance are both down more than 10% versus last year's pace.
- The Federal Reserve removed explicit reference to the risks posed by 'global economic and financial developments' following its April meeting, which opened the door for consideration of a ¼ point increase following the June meeting.
- Ultra-low Bond Yields in Germany, Japan and several other major sovereign issuers continue to exert a gravitational pull on US rates.

The advance estimate of Q1 GDP was released registering an anemic 0.5% annualized rate of growth for the first quarter. Consumption, Investment and Government Spending all contributed to the decline. While this was well off the 1.4% pace measured in the final quarter of last year it was also consistent with weak first quarter results in each of the last 2 years. Despite the downdraft however, underlying economic fundamentals remain sound. Employment gains have been strong and recent dollar weakness should help reduce the drag from Net Exports. Weaker global economic conditions remain a concern, but the domestic fundamentals are for the most part positive. We expect growth to accelerate in the current quarter and anticipate moderate growth for the balance of the year. The strong dollar has been a constraint and its recent moderation should provide a boost in the current environment.

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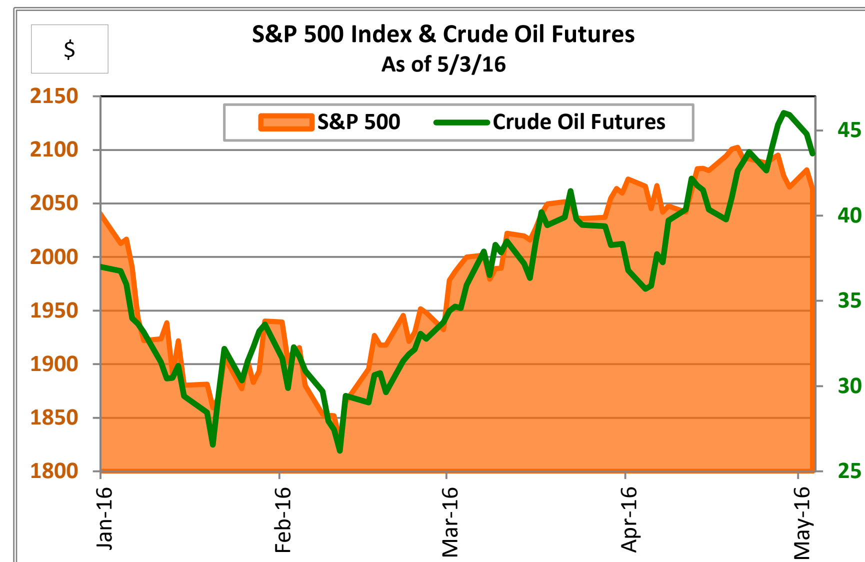

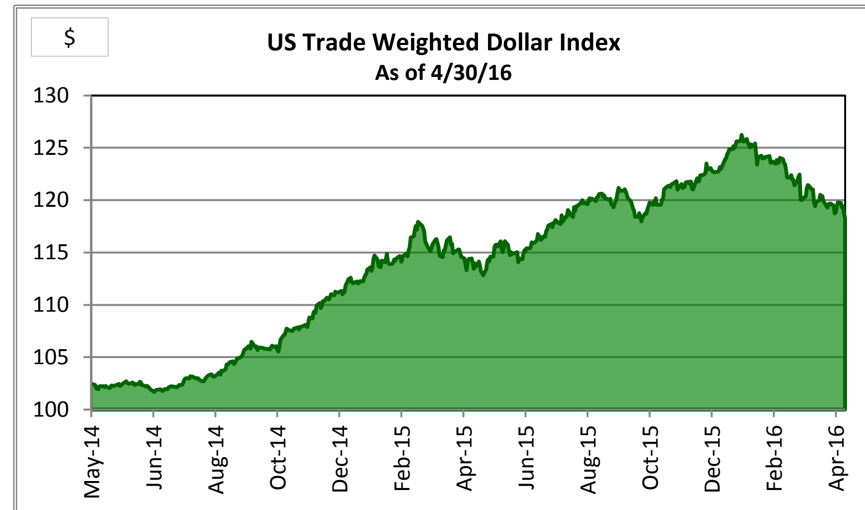

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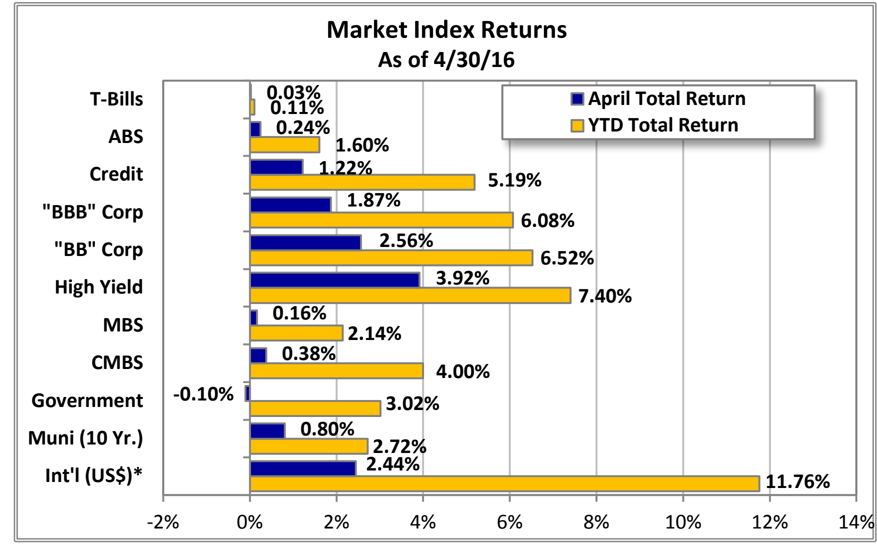
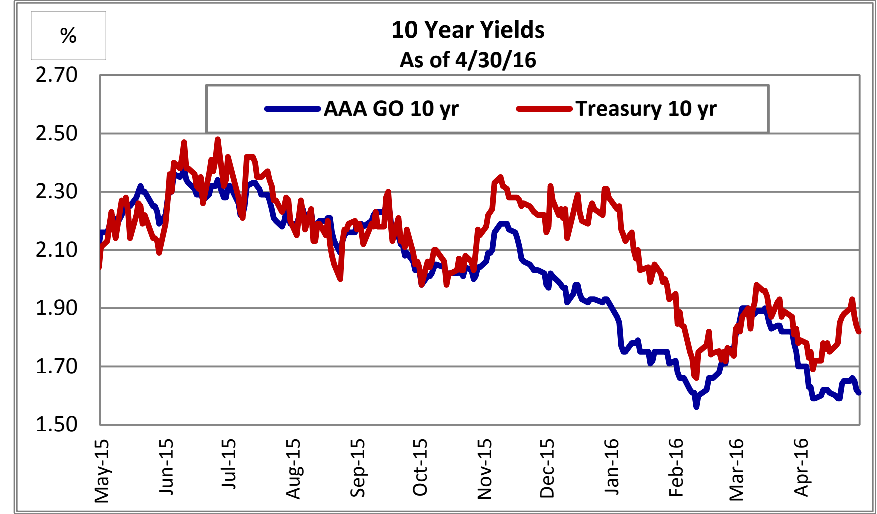
Markets may well begin to consolidate as we approach mid-year as several important decision dates begin to loom larger. First on the agenda will be the June 15th Federal Reserve Open Market Committee Meeting. Whether the Fed maintains its current wait-and-see policy regarding further rate hikes or whether the recent clement conditions in the capital markets make them eager to move further off the zero lower bound will be critical. As noted earlier, market pricing reflects extremely low expectations of the possibility of future rate hikes and the June meeting may well test those convictions. UK voters head to the polls a week later, for a June 23rd referendum on whether to remain in the European Union or begin the process of exiting the Union. Current polling puts the Remain camp with a slight but uncomfortable lead. While populist sentiment, a phenomenon not unique to Britain, fans the flames of the so-called 'Brexit' supporters wishing to leave. If the Leave camp were to succeed, it could create additional fissures in the European Union which is already strained under the weight of the recent Debt and Economic Crisis and now the immense human tragedy of the current refugee crisis. Anticipating these developments and potential outcomes may well induce market participants to mark time while awaiting the results. We would not be surprised if recent market ranges become familiar trading territory over the near term.





*Source: 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.

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