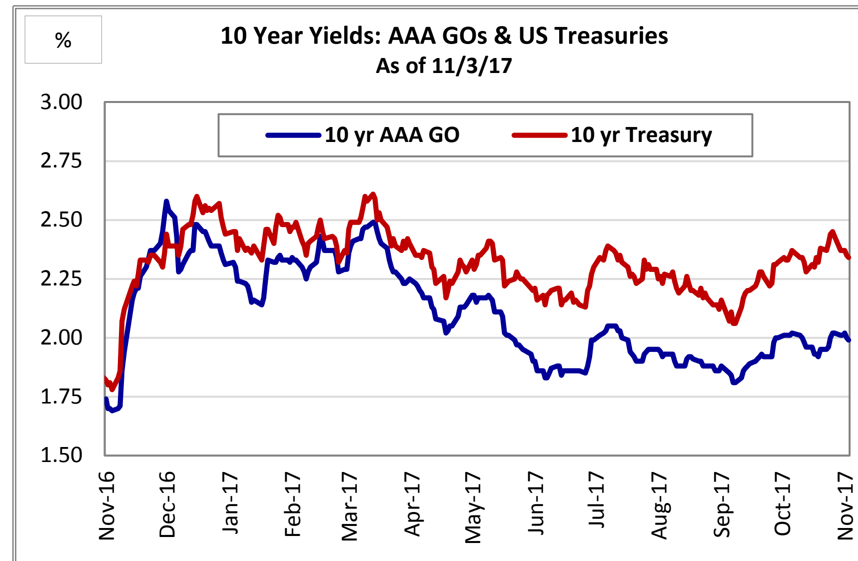
Market Overview

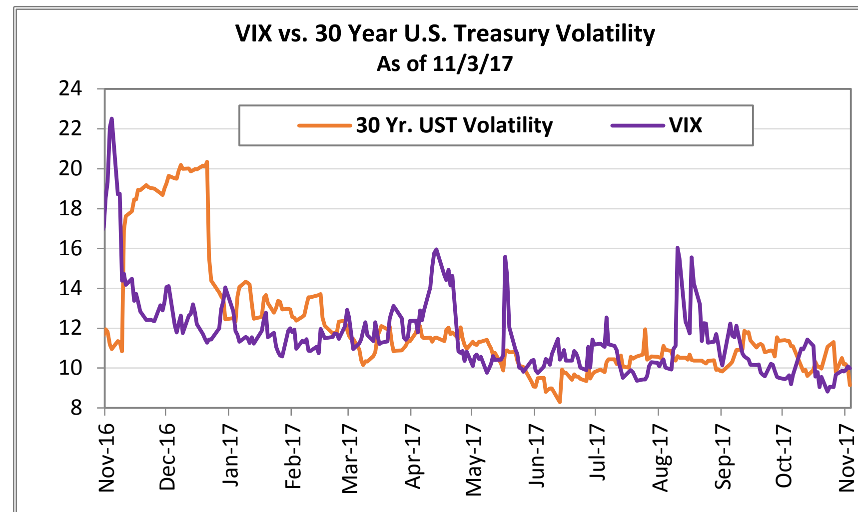
Jim Grabovac, CFA

Yield curves continued to flatten as rates drifted modestly higher alongside a firming of investor expectations for an additional Fed rate boost when the Fed meets again in December. Rate moves were effectively contained however, as yields continued to consolidate within a remarkably narrow range. Ten-year US Treasury yields have been bound by a 60-basis point range year-to-date with most of the period being contained within an even narrower 40-basis point boundary. Unsurprisingly, with such limited price movement, fixed income volatility has been moribund. Equity markets remained a focus of market activity as US bourses scored a series of new all-time highs which boosted benchmark indices to gains of more than 15% for the year. Investor enthusiasm for the equity market has been reflected in the absence of corrective price action as well as an accompanying lack of volatility. The combination of rising risk market valuations and diminishing volatility were noted with concern in a recent IMF Global Financial Stability Report which highlighted increased investor activity in volatility targeting strategies. The report noted a characteristic of many of these strategies was an increased exposure to risk assets during periods of low volatility which could, in turn, result in systematic selling in the event of a sustained upturn in market volatility.

Fed Governor Jerome Powell, who has served on the Federal Reserve Board since 2012, was nominated to replace Fed Chair Yellen when her term expires in February of next year. Market reaction to the changeover was quite muted however, as Governor Powell has been a consistent supporter of the policy agenda since his initial appointment, and most observers expect a continuation of the gradual normalization of monetary policy in the current environment. In a break with tradition, Fed Chair Yellen was not re-appointed to a second term despite having presided over a period of stable prices and declining unemployment, as well as having engineered the initial policy lift off from the zero-lower bound which had been in place for 7 full years. As she concludes her tenure she will also have directed the initiation of balance sheet reduction efforts which will represent an important milestone in the normalization process over the period ahead. It is possible, though not expected, that Dr. Yellen could remain on the Board, as her term as Fed Governor does not conclude until 2024. But most observers expect that she will step down from her duties leaving a fourth open seat, including the Vice Chair position, for the President to appoint. Adding to the unprecedented turnover at the FOMC, NY Fed President William Dudley announced his intention to retire in the first half of next year. President Dudley assumed his position at the trough of the Great Recession and his departure will leave a void of crisis experience as the new policy team is assembled.

- Rates worked modestly higher and yield curves steepened amid anticipation of another ¼ point rate boost following the Fed meeting in December.
- Spread compression continued to be a feature of the fixed income market as credit markets outperformed with longer maturity and lower quality categories generating the strongest relative returns.
- Municipals tracked Treasuries and yields rose modestly while the yield curve flattened. While return differentials were modest, lower quality continued to outperform higher quality paper.
- Municipal issuance rose during the month but remained well behind the pace set last year. For the first 10 months, New Issue Supply is down by more than 17% versus last year's pace.
- The Dollar continued to recover from its 3-quarter slide as traders focused on strong economic fundamentals and firming rate expectations.





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

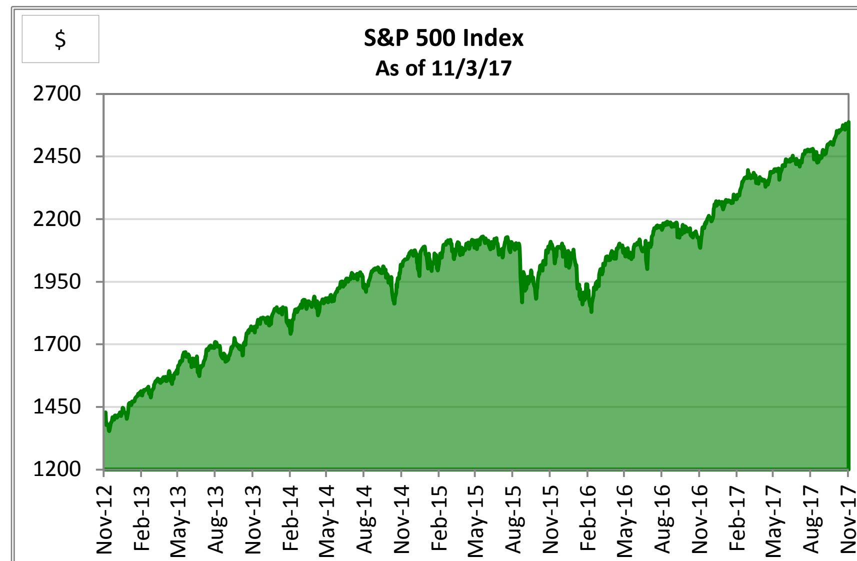
Guiding Portfolio Strategies

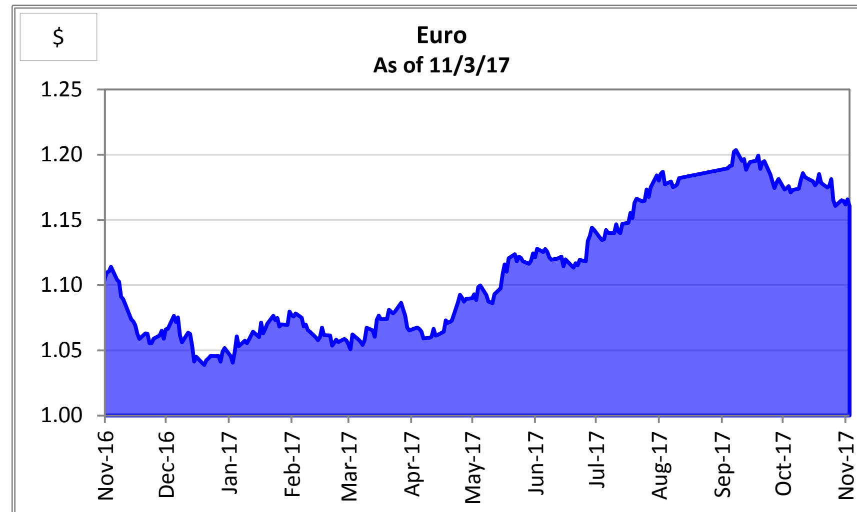
MCDONNELL INVESTMENT MANAGEMENT, LLC

Market Overview

Investor focus will now pivot toward tax policy as Congress kicks off deliberations on efforts to cut the corporate tax rate in conjunction with an attempt to simplify the tax code. The House released its plan which includes a reduction in the corporate tax rate from 35% to 20% as well as a host of other changes affecting individual taxpayers, including elimination of the Alternative Minimum Tax, a narrowing of tax rates to 4 from 7, and changes in the deductibility of state and local taxes and home mortgage interest. In addition to eliminating the AMT, there are several other changes that, if they were to become law, would have a major impact on issuers in the municipal market. The House plan would eliminate the ability of state and local issuers to 'advance refund' outstanding debt. This process enables issuers to reduce their cost of capital by allowing issuers to refinance older, higher rate issuance with new, lower rate financing. In addition to reducing the financial flexibility for issuers, it would also likely result in a substantial reduction in new issue supply. The House also proposed to eliminate 'private activity' bonds, which carves a wide swath through the municipal market and includes issuers involved in healthcare, housing, airports, water and sewer facilities, redevelopment projects, among others. Industry analysts estimate that as much as 20% to 40% of municipal new issue financing would no longer qualify for tax-exempt treatment. The inclusion of these provisions places the House plan at odds with the stated Administration goal of creating a large infrastructure investment program as an important piece of its legislative agenda. We expect substantial pushback on these aspects of the proposal and will be interested to see whether the Senate version travels down the same path.

Tax policy is not the only item on the agenda for Congress as the calendar year races toward the finish line. The hurdle of reaching an agreement to fund the government will be on the docket in early December. Legislators will have to craft an omnibus appropriation package or, at a minimum, a series of continuing resolutions to avoid triggering a government shutdown before the end of the year. The same dynamic resulted in the bipartisan passage of the package that funded the government and suspended the debt ceiling back in September. But the short-term deal expires on December 8th and Congress will likely need to address government funding concurrent with its deliberations on tax policy. Extraordinary measures by Treasury are expected to extend the necessity of addressing the debt ceiling into the first or second quarter of next year, but the requirement of funding the government enjoys no such luxury. The likelihood of a recurrence of bipartisan comity seems less probable amid the rancor of the current tax policy debate. Whether markets continue to enjoy placid conditions into year-end or whether they face a renewed bout of unexpected volatility may well hinge more on the prospects for the passage of a simple appropriations bill than they do on the passage of fundamental tax reform.





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.