# McDONNELL INVESTMENT MANAGEMENT

## Fixed Income Market Commentary ✧ November 2016

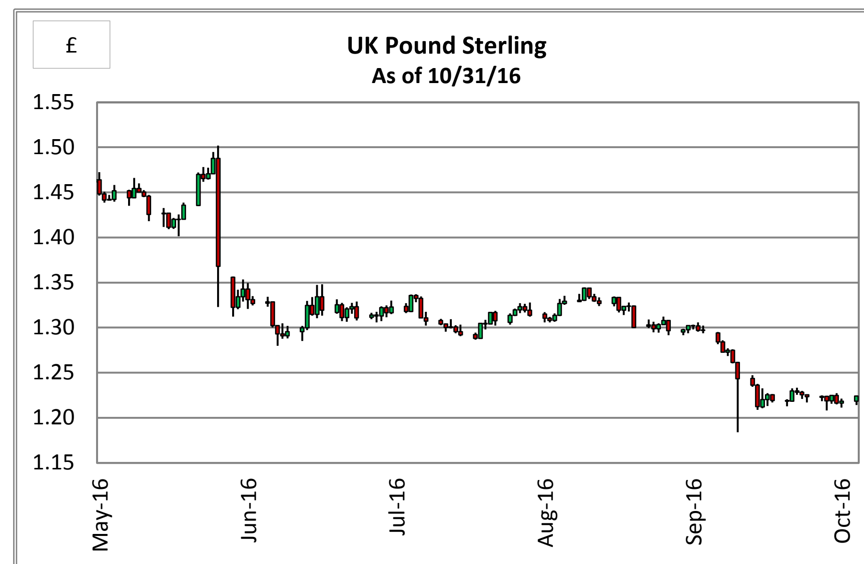
## Market Overview

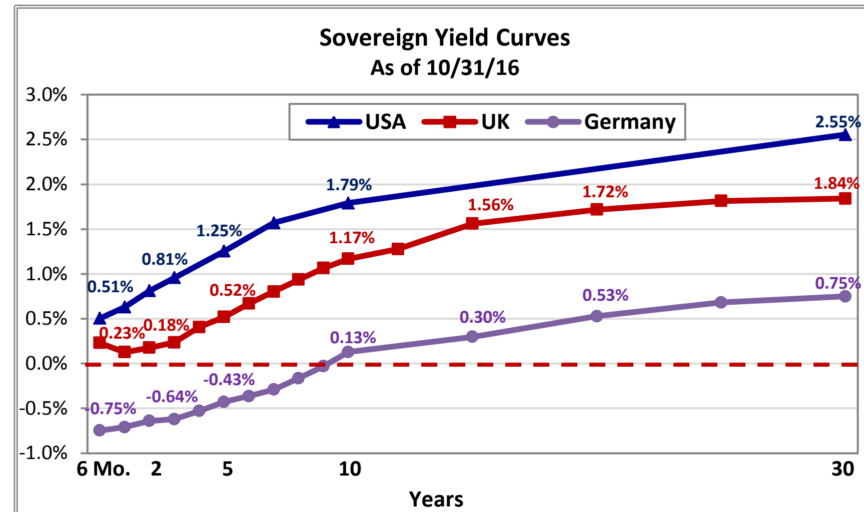
*Jim Grabovac, CFA*

**Domestic rate markets continued to correct in October with 10-year yields rising by roughly 25 basis points while yield curves steepened.** The trading activity and yield curve movement reflected an ongoing correction in Developed Market (DM) Sovereign bond yields which was led by a sell-off in the UK. Gilt yields plunged in the aftermath of the Brexit Referendum in June, but as the looming drama surrounding withdrawal from the European Union dragged slowly on, market participants began to factor in a milder near-term economic reaction than initially anticipated and began to gird for a more lengthy and uncertain process as developments inched forward. **Perhaps the most significant development during the past month was the indication by Prime Minister Theresa May that the invocation of Article 50, formally announcing the UK's intention to withdraw, would take place in the first quarter of next year, and that her government's plan was to negotiate a firm exit which established UK control of borders and legal sovereignty.** The clear implication of which is that membership in the single market is not a first priority and may indeed be rendered non-negotiable by the EU under the terms she has put forward. This formulation has acquired the moniker 'hard Brexit' and potentially sets the stage for more significant economic headwinds and potential market disruption over the next 2 years.

**Brexit developments were significantly clouded however, by a recent High Court ruling holding that Parliament, as representative of the citizens of the UK, and not the Government, as the representative of the Crown, held the authority to invoke Article 50.** The Government has stated that it will appeal the ruling but absent the ruling being overturned, Parliament will now have the opportunity for full debate as to the timing of the invocation and the terms of negotiations over withdrawal. The Government has indicated confidence that the process will move forward but opponents have been bolstered by the delay and the opportunity to revisit critical issues impacting constituents. In any event, considerable uncertainty has now been added to an already uncertain situation. Sterling rallied on news of the ruling but remained substantially weaker versus pre-Brexit levels. Currency trading included a 'flash crash' where the Pound plummeted more than 6% in Asian trading before catching a foothold and recovering as the session wore on. Sterling has declined more than 17% since the surprise outcome of the Brexit Referendum.

- **Rates rose and yield curves steepened as the post-Brexit correction that has characterized most of the second half continued.**
- **Spread sector assets continued to outperform Treasuries with lower quality corporates registering the strongest relative returns.**
- **The municipal market largely tracked Treasury movements during the period with modest outperformance on the shorter-end of the curve.**
- **The dollar strengthened against most major currencies.**
- **Equity markets continued to move sideways in mostly featureless trade.**
- **Recovering energy markets began to roll over after failing to close above the yearly highs reached in early June.**




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

McDONNELL INVESTMENT MANAGEMENT, LLC
*Guiding Portfolio Strategies*

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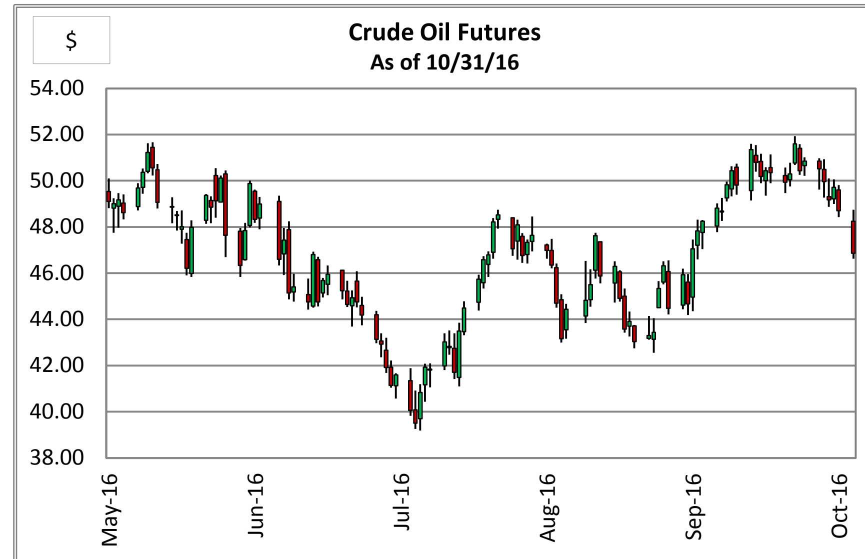
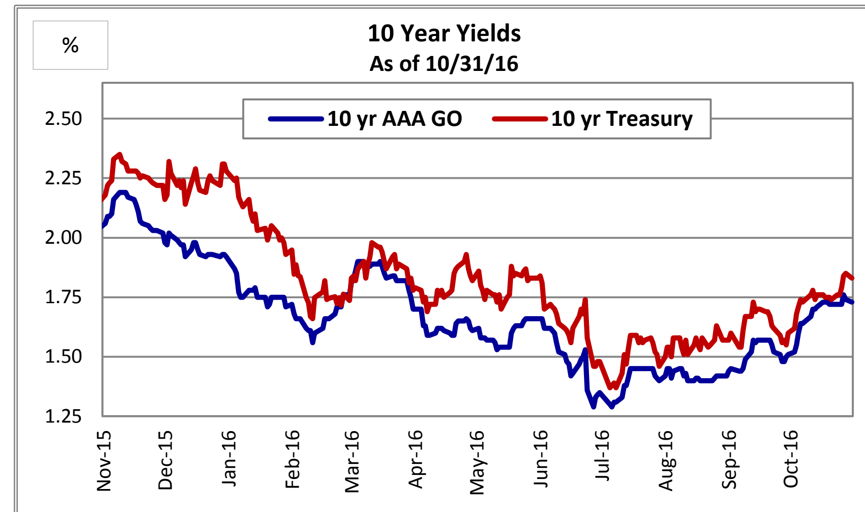
**US economic growth was estimated to have accelerated to 2.9% during the 3rd quarter as Net Exports rose and Inventories snapped a 5-quarter decline.** The increase in net exports was aided by a surge in soybean exports, which analysts interpreted as a temporary phenomenon. The Inventory rebuild was unsurprising following 5 quarters of drawdowns that coincided with a period of relatively strong Consumption. Labor markets continued to improve with nonfarm payrolls rising by 156,000 in September, marking 72 consecutive months of positive job growth, or 6 full years as the expansion continued. Labor market improvement is meeting half of the Fed's dual mandate, and an uptick in inflation from levels which have been below the Fed's target for more than 4 years is now moving closer to meeting the second half of the mandate. The uptick in inflation has principally been driven by medical and shelter costs at the core level, and more broadly by the recovery in energy prices at the headline level.

**November promises to be an eventful month as investors prepare to digest the results of the national election and await the decision of the Federal Reserve in mid-December.** While the potential exists for market volatility in the wake of the electoral outcome, we expect economic fundamentals to remain supportive of a modest move in short-term rates given the prevailing views being expressed by the Federal Reserve. The road forward, however, is less clear. Market participants will await not only the rate decision by the Committee, but also its update of the Summary of Economic Projections. September's release indicated expectations of a ¼ point move this year and 2 additional ¼ point hikes in 2017. These are modest expectations when viewed against a domestic backdrop but more aggressive when placed in a global context. Global rates remain extraordinarily low and even negative across portions of the curves in many Developed Market Countries, and rate differentials between the US and its G7 counterparts remain near historical wides. Absent a reversal of economic and policy fortunes abroad, it is difficult to envision the Fed engineering much in the way of additional tightening without resulting in renewed dollar appreciation. A stronger dollar will amplify any policy tightening that occurs. We believe that global capital market and economic factors may continue to play a more significant role in the crafting of US monetary policy than purely domestic economic considerations. The imbalances abroad are likely to leave the punchbowl on the table for a while longer.




*Source: Bloomberg; Municipal Market Data.*
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***NOTES AND DISCLOSURES:***

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