Market Overview

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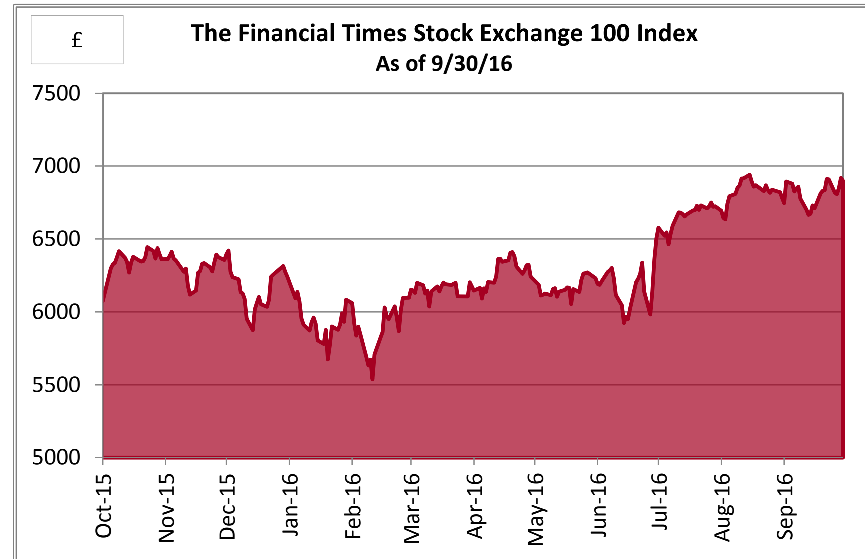
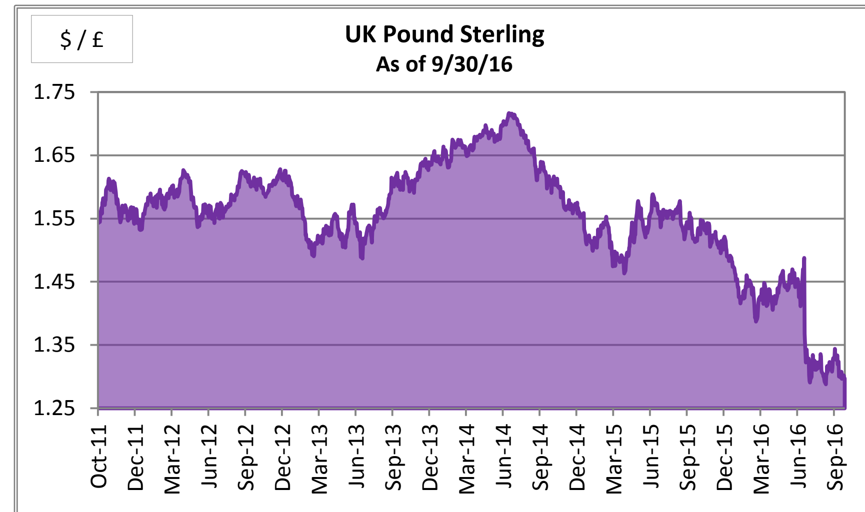
Domestic rate markets were mixed in the 3rd quarter as yields rose modestly across the Treasury and municipal curves while spread sector assets continued to rally. Yield curve movements also diverged as the Treasury curve flattened while the municipal curve steepened. The quarter featured strong performance by spread sector assets which produced positive excess returns relative to Treasuries as investor demand for incremental income served to compress spreads further. Taking a measure of the market, year-to-date frames the 3rd quarter as a modest rate market correction and consolidation within the context of a declining interest rate environment being led by diminishing inflation expectations across major markets and reflected in a pronounced flattening on the longer-end of the yield curve. Quiet market conditions and relatively low volatility have characterized much of the action since February, with the exception of a short burst of explosive activity that followed in the wake of the Brexit Referendum. We had expected the Brexit outcome would serve to depress economic activity in the UK and, in fact, the opposite has occurred. To date, the only significant negative UK economic impact has been the sharp depreciation in the Pound Sterling. As the process begins to unfold however, we expect the impact to be less benign as the combination of slower investment spending and rising inflation begin to weigh on consumer and business confidence. This may be a situation that turns the old adage on its head with the 'bite' proving worse than the 'bark.'

US economic growth appears poised to accelerate modestly from a disappointing first half characterized by weak Investment and a continuation of inventory drawdowns. Some of the factors that weighed negatively earlier in the year should prove transitory, and their recovery could serve to quicken the pace going into the end of the year. Consumption has remained strong and continued gains in employment and a modest uptick in wage growth should help to keep the consumption engine of the economy moving forward. Putting the labor market into context, total non-farm employment now exceeds the pre-recession peak by 6 million persons, and the unemployment rate is below 5%. Inflation remains below the Fed's 2% target (Personal Consumption Expenditures Index.) Global growth remains less than robust. The International Monetary Fund estimates Global GDP at 3.1% this year and expects a modest acceleration in 2017. Concerns over the Brexit impact on the UK and an increase in protectionist trade rhetoric remain disquieting, however.

The Federal Reserve left rates steady following its September meeting but indicated that the underlying conditions in favor of a rate hike were strengthening. The Committee split with 3 District Presidents dissenting in favor of an immediate move higher, while the Committee voted to keep policy unchanged. It was noteworthy that Fed Governor Lael Brainard laid out the case for caution in a speech immediately prior to the Fed's self-imposed 7-day blackout period, during which no public statements are delivered. She made a significant point of the fact that the risk of a policy error was asymmetric with rates close to the zero-lower-bound. She argued, and Fed Chair Yellen reiterated the point in subsequent remarks, that the risk of providing the economy 'room to run' was small in comparison to the risk of removing accommodation prematurely and potentially slowing the economy to stall speed. We concur with this assessment. Inflation, as measured by the Personal Consumption Expenditures Index, has been below the Fed's 2% target for more than 4 years. GDP growth has averaged about 1% for the past 3 quarters versus 2.2% over the previous 3 quarters. Employment gains have been strong but are averaging about 180,000 per month this year versus a pace of nearly 230,000 per month last year. Wage gains have gradually worked higher but remain far below a pace that would be considered problematic in terms of providing a catalyst to reignite inflation.





Source: Bloomberg.
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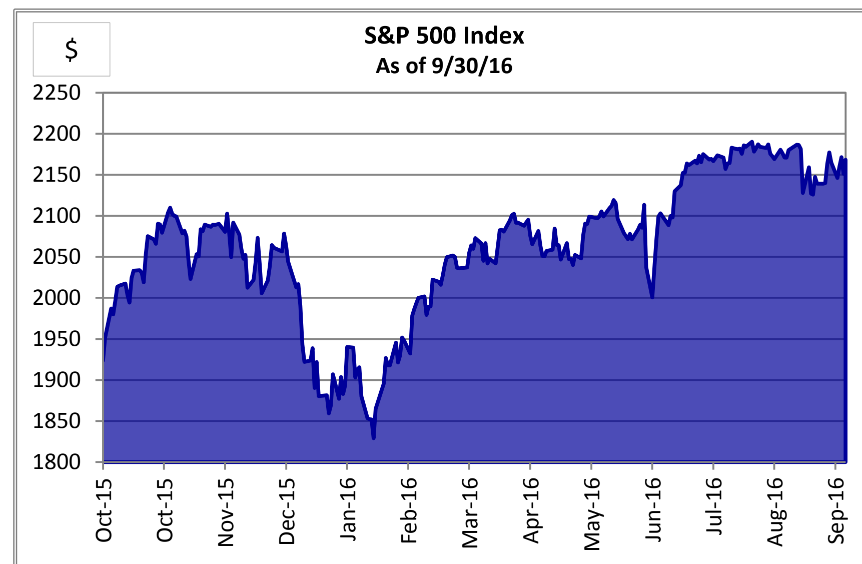
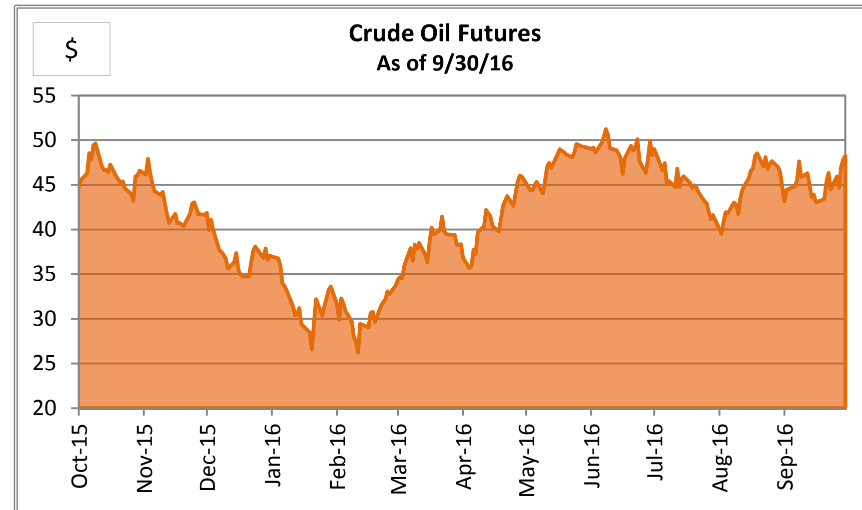
Market Overview

If the Fed chooses to offer a second ¼ point rate boost it would likely follow its meeting in mid-December and would mark the one-year anniversary of its initial move off the zero lower bound that held for 8 years. It will be a stunning reminder of how extraordinary monetary policy has been since the Great Recession and how difficult a challenge it has proven for the Federal Reserve to attempt to 'normalize' policy. When the first hike was announced, guidance accompanied the announcement in the form of the Summary of Economic Projections (SEP) which indicated expectations of 100 basis points of additional tightening over the course of 2016. Market expectations have consistently undershot the SEP and market expectations have consistently proven more accurate. With the most recent SEP that accompanied the September announcement, the Fed now estimates that it will be able to hike 25 basis points this year and 50 basis points in 2017. The gradual climb-down has been necessitated by global economic forces which have compressed and flattened the Developed Market rate structure to an unprecedented degree. It is this reality that restrains policymakers facing calls from critics arguing that the central banks are conspiring to hold rates at extreme levels. The actuality is the probability that the 'neutral rate,' or the short-term policy rate that supports full employment and non-accelerating target inflation, is probably near zero. As such, to argue that central banks are artificially holding down interest rates appears specious even in the most generous of lights.

- **Rate markets consolidated and corrected modestly after 2 quarters of strong gains for US fixed-income markets.**
- **Spread sector assets produced the strongest relative returns as investors continued to reach for yield in an effort to replace lost income.**
- **Municipals underperformed Treasuries despite strong demand. Municipal Mutual Fund inflows registered a stunning 52 consecutive weeks of positive inflows.**
- **Equity markets were mostly higher as Brexit panic at the end of the second quarter gradually subsided.**
- **UK equities recovered but Sterling declined sharply along with rates across the entire Gilt Sovereign yield curve.**
- **Crude oil chopped sideways and was bolstered by an OPEC 'agreement' to cap production that was light on specifics.**

As we advance into the 4th quarter investors face uncertainty surrounding the outcome of the Presidential and Congressional election and the prospect of a Fed rate hike shortly thereafter. Nevertheless, we think the most likely outcome for fixed income markets is more of the same sideways rate movement accompanied by a tendency toward a flatter yield curve. While a knee-jerk reaction is always possible, particularly after extended periods of relative market tranquility, we expect economic fundamentals will ultimately guide and contain the rate market path. The fundamentals of moderate growth, low inflation and well-crafted monetary policy all favor a relatively range-bound interest rate environment over the near-term horizon.





Source: Bloomberg.
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Taxable Market

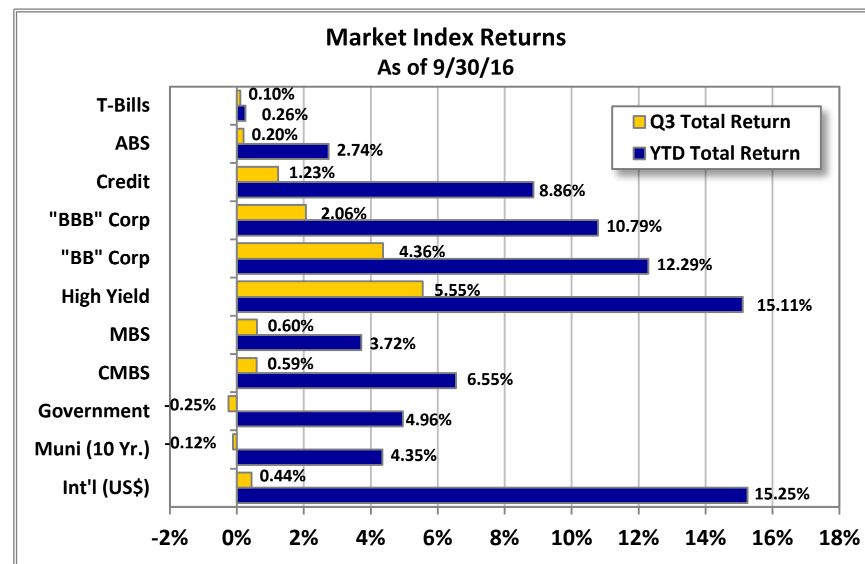
Treasury yields edged modestly higher led by the shorter-end and the yield curve flattened. Spread sectors rallied, however, and produced positive returns despite the backup in Treasuries as investors continued to search for yield. Issuance continued at a brisk pace in the corporate market and appears poised to reach another annual record as we move into the final quarter. The shorter-end of the yield curve gyrated on shifting expectations of possible Fed action, but consensus is currently firming that the Committee is leaning toward favoring a ¼ point boost before year-end. Most analysts expect that the Fed would prefer to act in December to avoid the perception that it is attempting to influence the election. Nevertheless, Fed Chair Yellen continues to state that the November meeting should be considered a 'live' meeting and that the Fed will act if it believes underlying conditions in favor of removing accommodation warrant action.

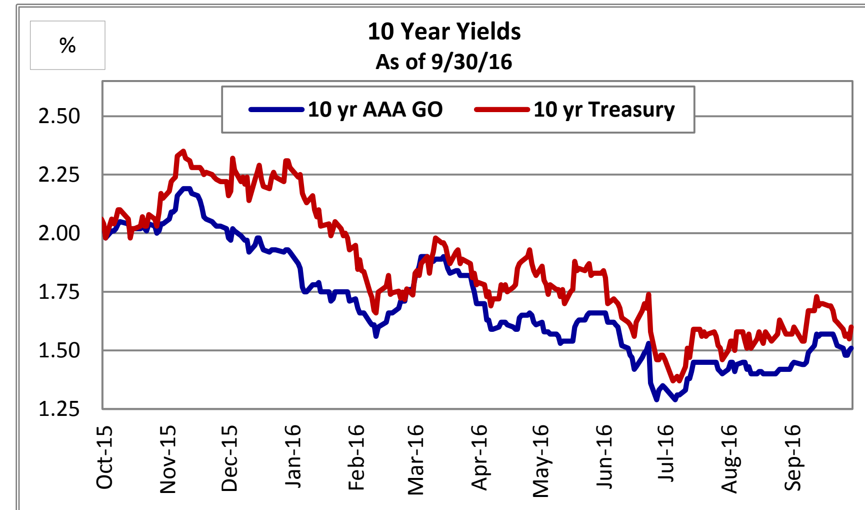
- **Treasury yields rose slightly in relatively quiet trade and the yield curve flattened.**
- **Corporate issuance continued at a record clip amid strong demand for spread product.**
- **Spread sectors produced both positive nominal and relative returns with lower quality issues generating the strongest performance.**
- **Mortgage product generally outperformed Treasuries amid declining volatility and relatively stable rate markets.**

Municipal Market

Municipal yields rose modestly and the yield curve tended to steepen despite continued strong demand for paper. Higher issuance was partly responsible for the backup in yields and the municipal market underperformed Treasuries. New Money issuance accelerated as generally improving fiscal conditions began to bring issuers off the sidelines and into the market to take advantage of a favorable rate environment and strong demand. Mutual fund inflows remained relentless reaching 52 consecutive weeks of positive flows. During the past 12 months, municipal mutual funds have received more than $60B in net shareholder purchases. Analyzing Federal Reserve data on the holders of US Municipals, however, would seem to indicate that individuals are moving from direct holdings of municipal bonds to mutual fund purchases, perhaps as existing holdings mature. Other categories of municipal bond holders continue to expand their exposure with Banks and Insurance Companies also boosting their outstanding holdings.

- **The pace of new issue volume accelerated during the quarter as New Money issuance rose sharply helping to boost the overall pace of volume year-to-date by 6%.**
- **Demand remained extraordinarily strong as evidenced by reaching the 52-week milestone of consecutive positive inflows into municipal mutual funds.**
- **Spread compression remained a feature of the market as investors continue to clamor for yield in the face of a persistently low nominal rate environment.**
- **Stronger issuance contributed to underperformance versus Treasuries across the curve which brought valuations to levels that could attract crossover buyers.**





Source: Municipal Market Data; Barclays; Merrill Lynch.
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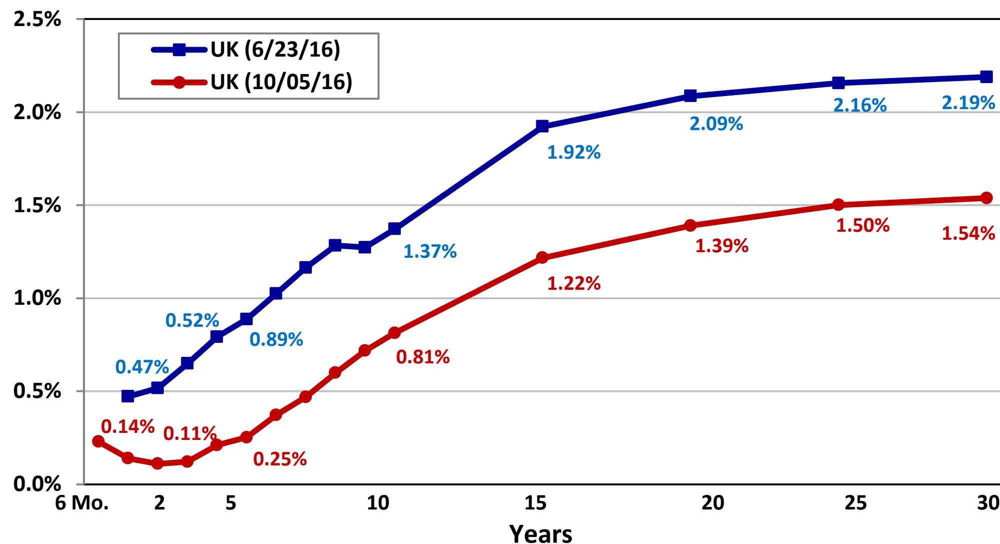

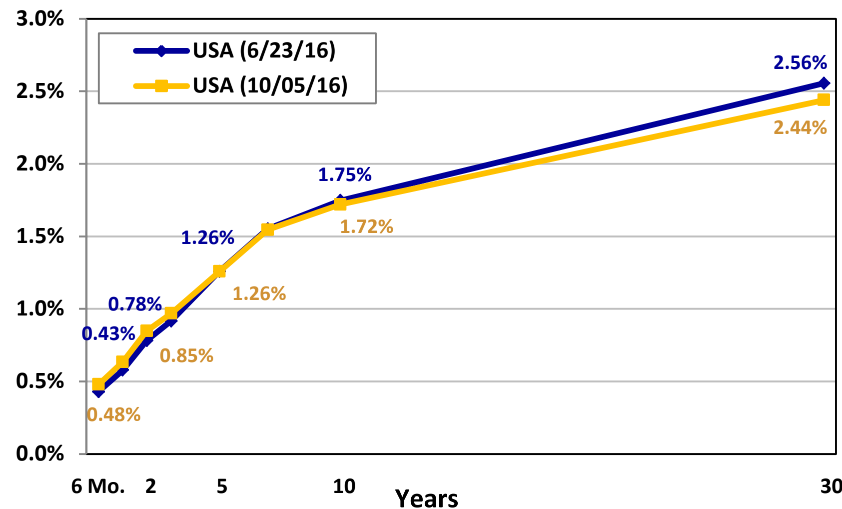

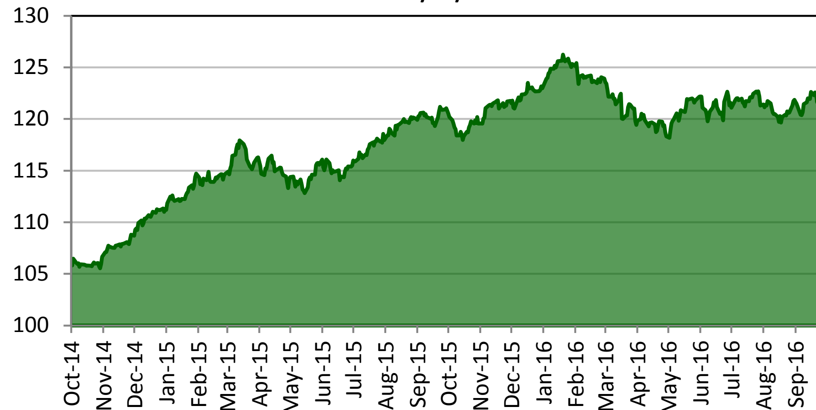

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