



### Market Overview

*Jim Grabovac, CFA*

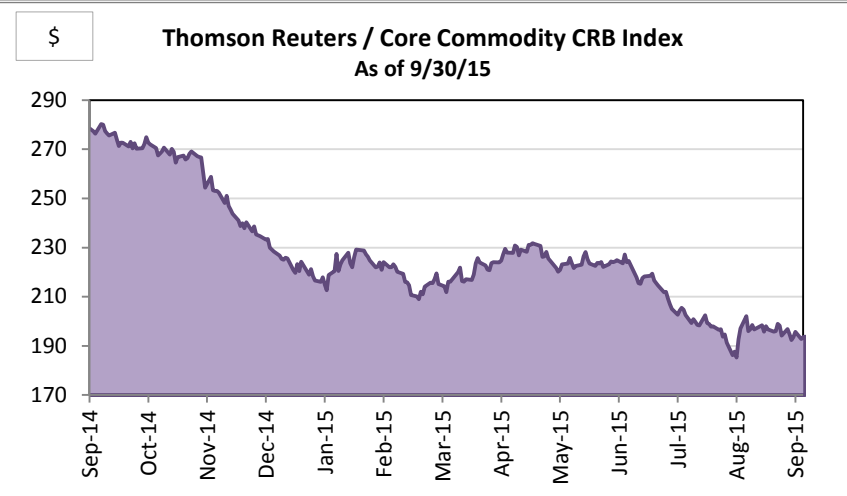
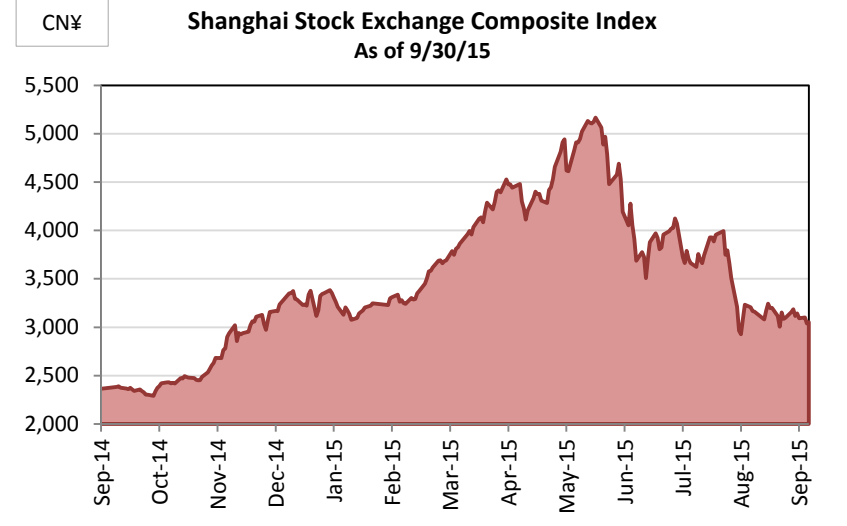
Market volatility rose during the quarter as the vicious slide in Chinese share markets sent jitters across developed market bourses worldwide. The confluence of events resulted in falling inflation expectations and declining yields, particularly on the longer-end of the yield curve. In addition, risk assets corrected sharply with the S&P 500 falling more than 10% during the quarter. Spread sector assets also widened in reaction to increased equity market volatility, weakening energy prices and declining earnings momentum in the credit sector. Commodity markets broadly came under renewed pressure amid heightened concerns that the growth slowdown in China would prove to be more significant than official estimates were forecasting. While the dollar marked time versus most major currencies, it continued to rally against already weak Emerging Market (EM) currencies which have faced significant downward pressure as the recent growth slowdown in China (the world's largest importer of raw goods) has unfolded. Adding to market volatility was the decision by the People's Bank of China to widen its trading band versus the dollar, which sparked fears that this mini-'devaluation' of the renminbi was indicative of further weakening of economic fundamentals in the world's second largest economy.

It is important to consider why EM developments have come to loom large in domestic monetary and economic policy considerations. As we step back into the onset of the Great Recession, it was led by the US and quickly spread to other major Developed Market (DM) economies. Amid the economic downdraft, China embarked on a massive expansion of investment fueled by a rapid buildup of debt. This policy initiative enabled China to escape much of the negative impact of the Great Recession despite a steep fall in exports to its major trading partners. But the expansion of investment inevitably began to reach an exhaustion point, and Chinese policymakers have drafted a change in course in an effort to rebalance its economic growth components by emphasizing greater domestic consumption and de-emphasizing investment. This rebalancing will represent an enormous challenge, and the recent upheaval in equity markets suggests that the transition could be far from smooth sailing.

In summary, four key trends continue to dominate the economic and capital market landscape:

1. **Slowing Growth in China.** As China attempts to transition to a more sustainable balance of Consumption versus Investment, growth has slowed.
2. **Commodity Market Weakness.** Decelerating global growth has pressured commodity markets and countries reliant upon commodity export significantly and unexpectedly.
3. **Strengthening US Dollar.** As growth has slowed abroad, economic recovery in the US has resulted in a strengthening of the dollar as investors anticipate a gradual move higher in US short-term interest rates.
4. **Inflation Consistently Below Target Objective.** Finally, falling commodity prices, most notably energy, and a strengthening dollar combine to depress both inflation and economic growth in the US and in turn long-term interest rates.

.....Continued on next page



Sources: Shanghai Stock Exchange; Thomson Reuters; Bloomberg.  
Please refer to the Notes and Disclosures on the last page for additional information.



Another development that added to investor concerns was the surprise resignation of Speaker Boehner, which likely heightens the risk of political brinkmanship as we head into the final quarter. While a Continuing Resolution was passed funding the Government through early-December, issues surrounding the Federal Debt Ceiling, Highway Funding and the Export-Import Bank loom with rancorous disagreement potentially cleaving congress both across the aisle and among splinter factions within the majority caucus. Threats of another government shutdown could become a fresh market concern as legislative deadlines approach.

The Fed, for its part, deferred action on rates in September and was unusually forthright in its commentary, addressing the weight placed on both the dollar and EM weakness during its policy deliberations. The case for tightening received an additional body blow with the release of the September Employment report which showed clear evidence of decelerating momentum on the employment front and the continued absence of upward pressure on wages. Fed policy remains on hold and may remain so into 2016, despite the protestations of policymakers anxious to move off the zero-lower bound. Unless and until deflationary pressures abate, it will be difficult for monetary policymakers to run the risk of tightening accommodative conditions in the face of downward price pressures emanating from abroad.

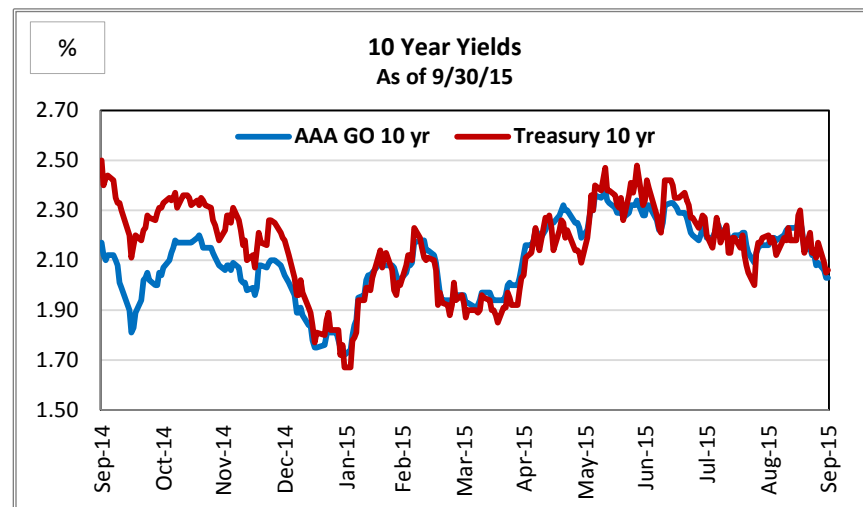
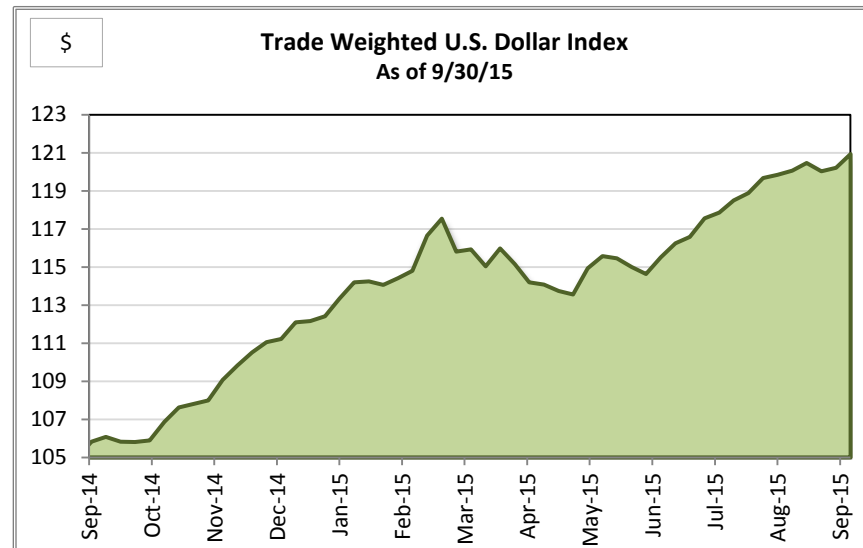
Whether the Fed moves this quarter or next, we expect the cycle of policy implementation to reach a substantially lower target rate than recent historical ranges. We also anticipate that policy changes will proceed at an extremely gradual rate of inclination as the Fed attempts to move from zero lower bound short rates while still fostering conditions that can accommodate continued economic momentum. Against the backdrop of cooler global growth, limited upward pressure on prices and a strong dollar, we would expect that conditions will favor a relatively range-bound US rate market.

### Taxable Market

Nominal returns were positive across most taxable sectors with the exception of Treasury Inflation Protected Securities (TIPS) and High Yield Corporates, as Treasuries rallied and the yield curve flattened. Relative returns were less compelling across the continuum of spread sectors as most widened versus Treasuries amid increased market volatility and pronounced energy and equity market weakness. Relative Credit underperformance was most notable in the Sovereign sector as an S&P downgrade of Brazil to sub-investment grade as well as further EM turmoil drove yield spreads wider. Credit underperformed, particularly on the lower quality end of the spectrum, and was more pronounced on the longer-end of the yield curve. Corporate Issuance slowed during the third quarter as renewed energy and equity market weakness prompted borrowers to step back from unfavorable market conditions. For the year, however, total issuance remains ahead of last year's record pace.

- The Treasury market rallied and the yield curve flattened as declining inflation expectations helped bring longer-end yields lower.
- Most spread sectors underperformed Treasuries amid increased equity market volatility.
- The Mortgage Sector remained challenged by negative convexity and heightened interest rate volatility.
- Sovereign issuers of dollar-denominated debt registered the worst relative performance.

.....Continued on next page



Sources: Municipal Market Data; Federal Reserve Bank; Bloomberg.  
Please refer to the Notes and Disclosures on the last page for additional information.



### Municipal Market

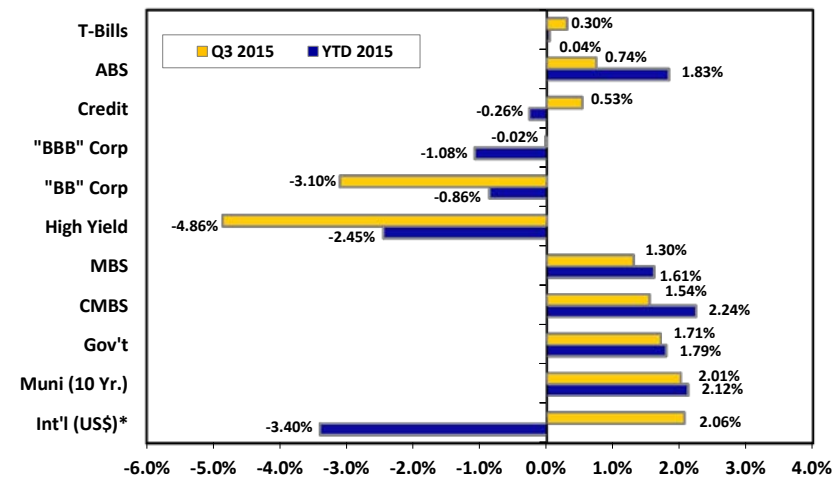
Municipals performed generally in line with Treasuries across most of the curve, and yield movements largely tracked Treasuries in otherwise lackluster trade. Declining inflation expectations contributed to a yield curve flattening as rates from 10 to 30 years fell by 25 basis points. Municipal Mutual Fund flows turned modestly negative in May and have remained so but are still positive year-to-date. While fund flows are negative, demand from bank portfolios remained robust as the low cost of funding encouraged banks to add exposure at a pace that has nearly doubled bank holdings since 2007. The pace of new issue volume declined versus first half levels but remained ahead of last year. Overall, volume is roughly a third ahead of 2014 with most of the increase coming in the form of Refunding Issuance. The municipal market remains relatively well-bid as higher spread new issue offerings continue to receive strong investor interest.

- Municipal market rallied and the yield curve flattened as declining inflation expectations brought longer-end yields lower.
- The municipal market moved broadly in tandem directionally with Treasuries but displayed less volatility at market extremes during the quarter.
- Sector and Quality spreads were little changed during the quarter as limited supply kept valuations in check despite heightened capital market volatility.
- New Issue Volume remained ahead of last year's pace but moderated somewhat from the torrid pace set during the first half.

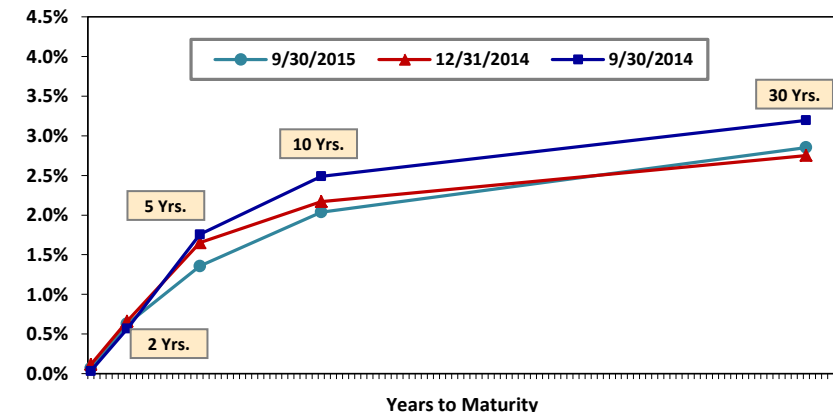
#### NOTES AND DISCLOSURES:

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.

### Market Index Returns As of 9/30/15



### U.S. Treasury Yield Curves



All indices shown reflect Barclays Indices, except where noted.  
Sources: Barclays; \*Merrill Lynch; Bloomberg.  
Please refer to the Notes and Disclosures for additional information.