McDonnell Investment Management

Fixed Income Market Commentary ✧ September 2016

Market Overview

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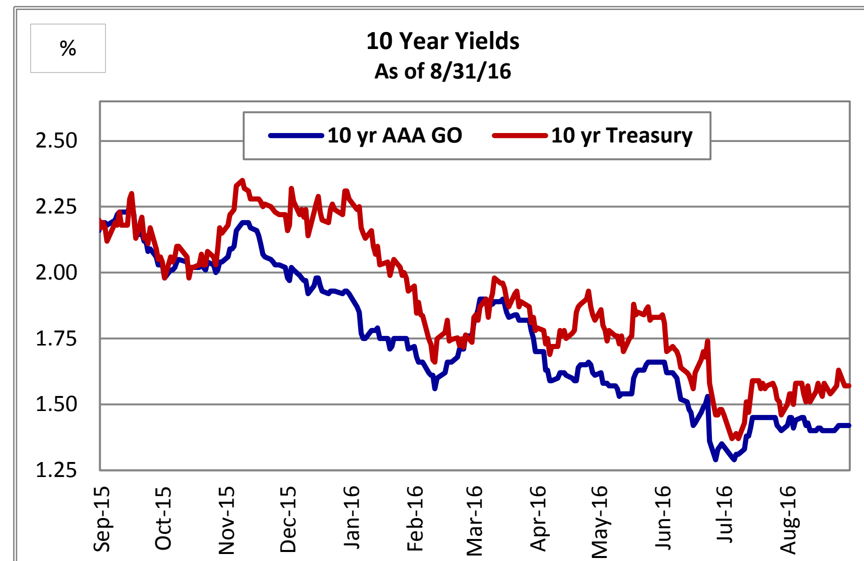
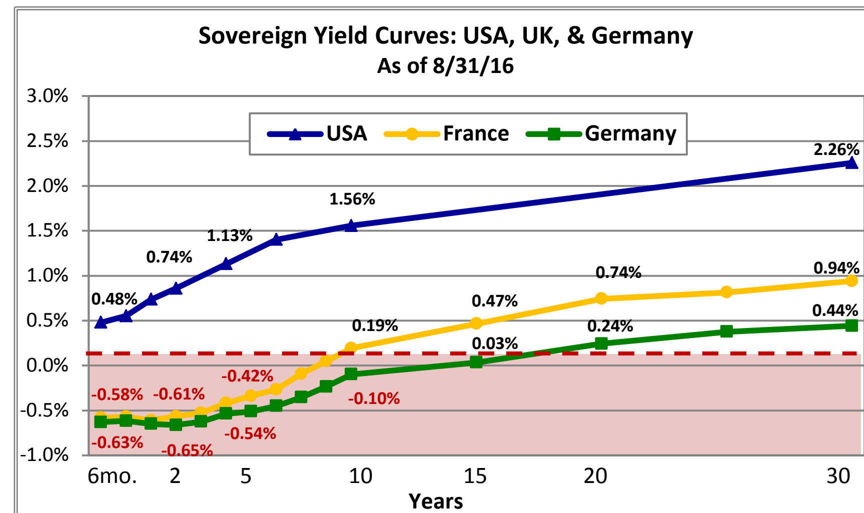
Capital markets mostly marked time as shifting sentiments from various Fed speakers gave market participants more than ample reason to settle into limited movement, range-bound trading, as the summer wound to a close. With changing views seeming to indicate that another quarter-point rate hike could be approaching more rapidly, the market narrative settled on the release of the August Employment Report (released on September 2nd) as the be-all and end-all data point that would finally provide clarity as to whether the Fed could be expected to act following its September meeting. But alas, the employment gains proved mildly disappointing, leaving most Fed-watchers marking down the likelihood of a September move and penciling in a 1-year anniversary move in December should the economic data indicate enough momentum on the jobs and inflation fronts to warrant a bump higher. We continue to reside in the camp maintaining that the balance of risks argues against premature policy tightening given the limited options available should the recovery falter. Furthermore, the case for a sustainable and sudden surge of inflation appears weak given slower global growth and the absence of a visible pickup in global aggregate demand. Nevertheless, should the Fed choose to act, we expect that rate markets will be able to weather the move largely in stride, as the case for a series of hikes remains both weak, and unlikely to come to fruition against the backdrop of ultra-low yields across the Developed Market landscape.

Economic growth remained positive as August marked the 86th month of the expansion, however the pace of growth slackened over the last 3 quarters, downshifting from 2% to roughly 1%. Most analysts anticipate higher growth in the current quarter, but absent a second half surge, we will likely register sub-2% year-over-year growth for 2016. While much focus has been placed on the health of the labor market, other economic inputs offer a less robust picture. Inflation has run below the Fed's 2% target for more than 4 years (US Personal Consumption Expenditure Core Price Index), Investment has been sub-par and Nonfarm Productivity has been declining. In addition, recent readings from forward looking momentum surveys, both the ISM Manufacturing Index and the companion ISM Non-Manufacturing Composite Index, registered sharp declines in August. These factors are not, in and of themselves, enough to heighten concern about the overall health of the economy, but nor are they of little significance; taken together they reinforce the case for prudence on the policy front as the Fed weighs its options.

- **Yields drifted slightly higher in August in mostly directionless trade as market participants slogged through the doldrums of summer.**
- **Spread sector assets continued to outperform Treasuries with lower quality credit generating the strongest relative returns.**
- **The Municipal Market also outperformed Treasuries with yields rising only slightly.**
- **Domestic yield curve movements reflected a bias toward flattening amid slowly evolving Fed expectations.**
- **Equity markets were trendless ending the month practically unchanged for the period.**
- **Energy markets rebounded but faded somewhat as the month drew to a close.**





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

Guiding Portfolio Strategies
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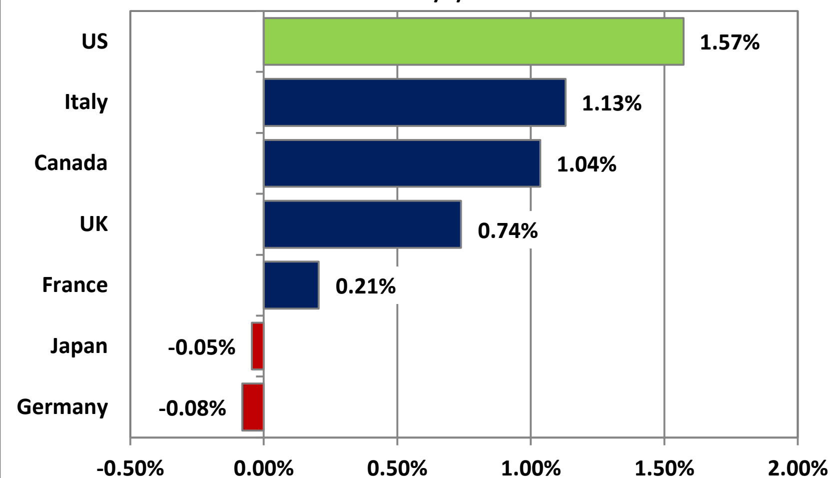
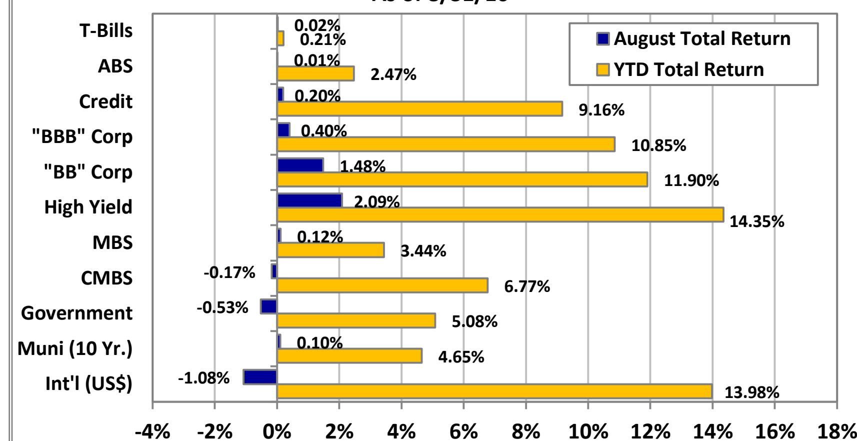
Moving beyond the argument surrounding the likelihood of a September or a December Fed move, we believe the longer-term policy challenges, and in all likelihood the greater potential economic and market impact, will come from the debate over and resolution of fiscal policy. Aside from initial stimulus passed when the economy was in the teeth of the Great Recession, fiscal policy has been either sidelined or contractionary for most of the recovery period. This stands in marked contrast to nearly every other post-WWII recession/recovery period and explains to a substantial degree the issue of why the recovery has been relatively tepid in contrast to the V-shaped recoveries to which we had grown accustomed following normal cyclical recessions.

At last month's Jackson Hole Monetary Policy Symposium, Fed Chair Yellen indicated her belief that the Federal Reserve possessed all of the tools necessary to combat the next downturn should the economy decelerate further. But central to her confidence is an implicit forecast that the Fed will be able to lift rates prior to that eventuality by a significant factor. While it has been an evolving target, the Fed currently estimates a long-term neutral policy rate of 3.3%. Raising rates anywhere near this level seems implausible in the current global interest rate environment. The Fed will posture that it is not the central banker to the world, but the reality is that the US is the largest sovereign issuer of debt and the dollar is the principal reserve currency for most of the global economy. US Treasury rates are already significantly higher than any of its G7 counterparts. For the Fed to engineer that degree of monetary tightening over the next several years would imply that global rates would need to rise roughly in tandem or that the dollar would have to resume appreciating, perhaps substantially. It is difficult to envision either scenario occurring without resulting in perhaps a significant risk market correction and ultimately a potential economic disruption. As such, we believe the overreliance on monetary policy will eventually shift the debate back toward the appropriate use of counter-cyclical fiscal policy strategies in an effort to spur economic growth in an environment of consistently weak aggregate demand.





Source: Bloomberg; Barclays; Merrill Lynch.
Please refer to the Notes and Disclosures for additional information.

NOTES AND DISCLOSURES:

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