Fixed Income Market Commentary ✧ September 2017

Market Overview

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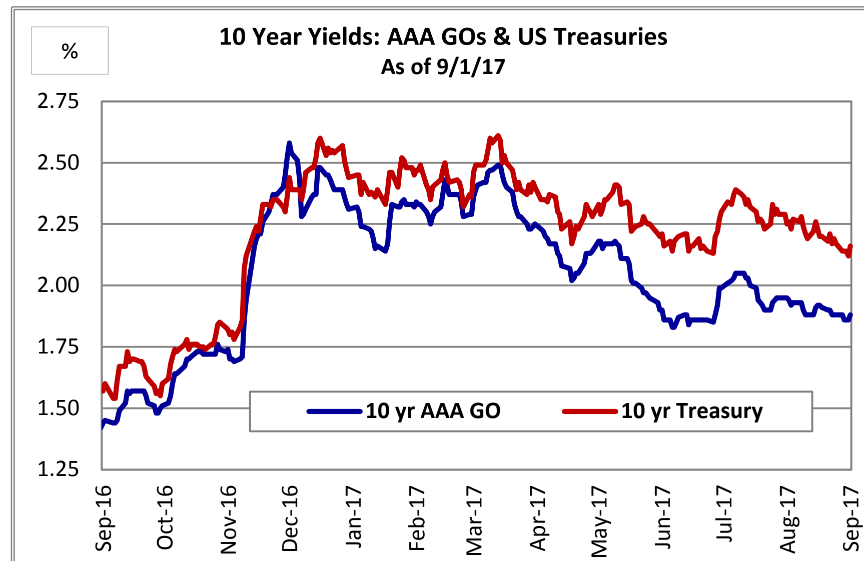
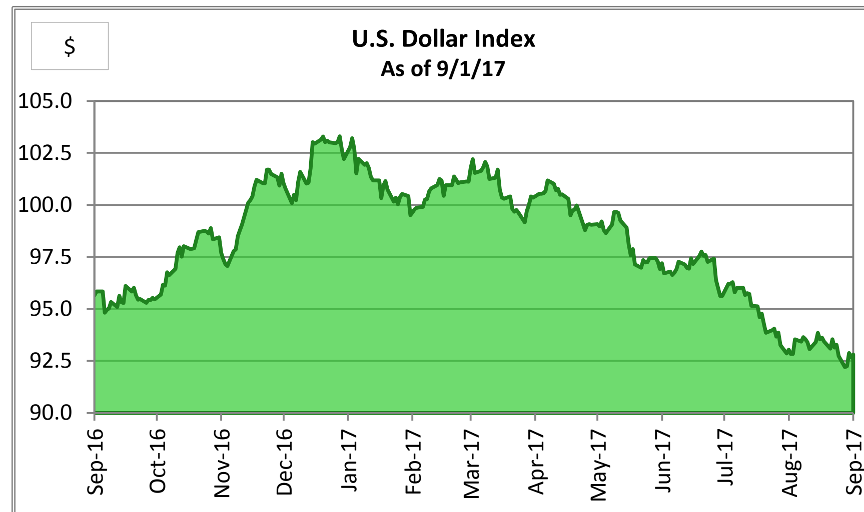
Market developments paled in significance in comparison to the immense humanitarian catastrophe unfolding in the wake of Hurricane Harvey which made landfall almost 12 years to the date of Hurricane Katrina. Harvey was characterized by an unprecedented amount of rainfall, the largest ever recorded in the continental US, impacting a significant swath of the Texas and Louisiana Gulf Coast regions. Flooding will make the recovery efforts particularly challenging as the corroding impact of water damage can take months to manifest itself. Furthermore, since much of the damage will be a consequence of flooding as opposed to wind destruction, conventional insurance coverage will provide only a portion of the funds required for recovery and rebuilding. It is estimated that less than 15% of homes in Harris County were covered by flood insurance. In addition to the physical damage to property, environmental degradation is also expected to exact a heavy toll as more than a third of the nation's productive capacity of petrochemicals is concentrated in the flood soaked region. The economic impact of the storm will unfold over time. In past storm experiences, regional growth is negatively impacted in the immediate wake of the storm and often receives an economic boost as the pace of recovery accelerates. The acceleration, if it is to take place over the near-term, will be heavily contingent upon the passage and effective implementation of large-scale Federal Disaster Relief Assistance.

Rates continued to grind lower and investor appetite for risk began to show signs of being sated, at least over the short-term. Treasury rates declined modestly across the curve and the yield curve flattened. Municipal gains were more muted and, in contrast, the yield and ratio curves steepened. The modest correction in risk markets also impacted taxable sectors where most spread sectors continued to produce positive nominal returns, while failing to keep pace with the gains generated by Treasuries during the month. U.S. equity markets churned mostly sideways as investors began to tap the brakes out of caution in reaction to an escalation of political acrimony between the Administration and congressional leadership. A difficult legislative agenda will not become easier with rhetorical sand being thrown into the gears. September marks a month when it will be essential for congress to function effectively as a short legislative calendar meets up with a long and critical 'to-do' list. As Congress returns from its summer recess it is faced with the following critical needs:

- Hurricane Harvey Relief
- Passage of a budget for Fiscal Year 2018 or a series of Continuing Resolutions to fund the government
- Extension of the National Flood Insurance Program
- Suspension or permanent increase of the Debt Ceiling
- Extension of funding for the Children's Health Insurance Program
- Reauthorization of the Federal Aviation Authority

We anticipate that the enormity of the devastation and the ongoing heroic actions of the first responders and citizen rescuers will spur Congress to set aside brinksmanship over the near-term. Ironically, the crisis in the Gulf may make it easier to advance legislation to avoid a government shutdown and/or default as the catalyst for responsible action is now too politically powerful to ignore. At the time of this writing, indications are that Congress will advance legislation combining emergency Harvey Relief Funding with a short-term extension of the Debt Ceiling and a series of Continuing Resolutions to avert a government shutdown by the end of the month.





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

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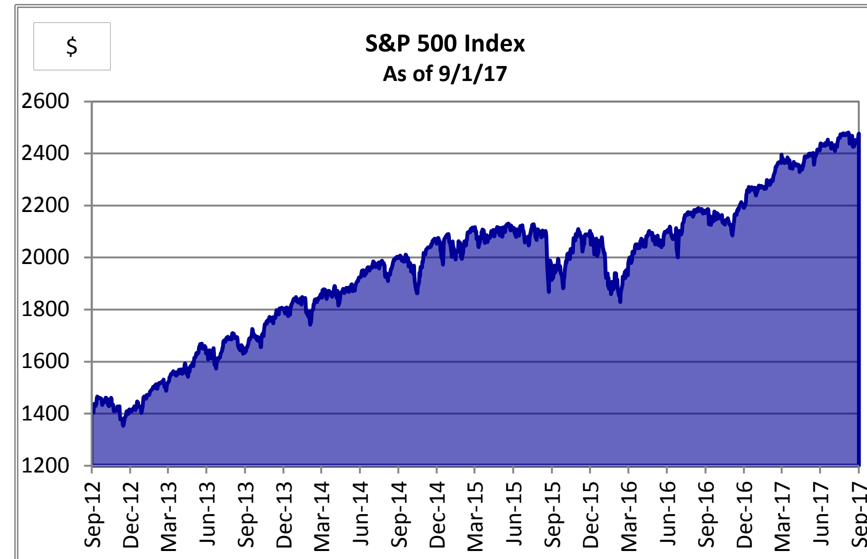
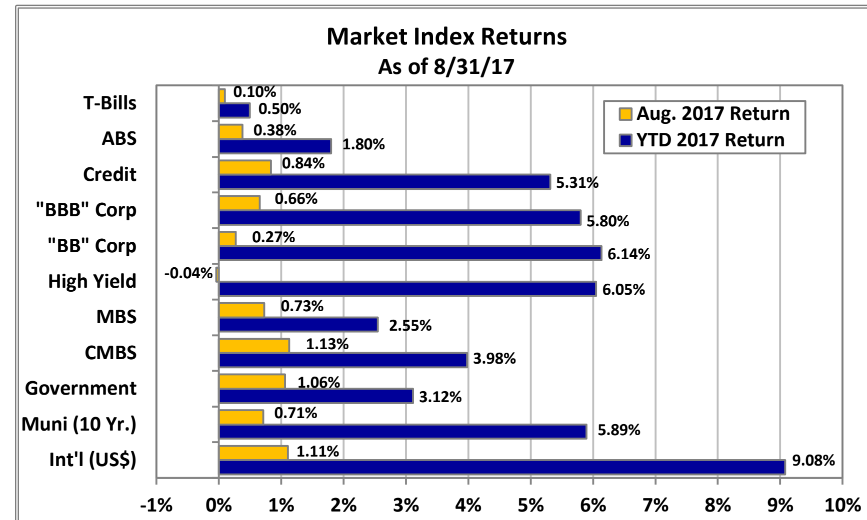
But surmounting these hurdles, not to mention the other critical items expiring on September 30th, still leaves Congress with a long uphill slog as it undertakes its goal of fundamental tax reform. To undertake tax reform through the process known as reconciliation (requiring a simple majority vote in the Senate), Congress will first have to pass a 2018 budget outlining continuing resolution instructions. That it has not done so to date, is indicative of deep division within the majority party. The fissures that proved an insurmountable obstacle to health care reform may prove equally problematic as congress attempts to undertake an overhaul of tax policy.

Federal Reserve policy comes back into focus as expectations remain that the Fed will announce the initiation of balance sheet reduction efforts following the conclusion of its two-day meeting on September 20th. The Fed outlined the composition and expected pace of reduction following its June meeting, but refrained from indicating the timing of when it was likely to occur. Market consensus has centered on the upcoming meeting as a likely starting point. But Committee members and market participants remain divided on the issue of additional policy rate boosts however. The Fed's dual mandate is on track with respect to its goal of full employment (4.4% unemployment) but remains below its price objective of 2% inflation (1.4% Personal Consumption Expenditures Index). Inflation percolated higher briefly at the beginning of year but failed to stabilize despite steady growth and strong labor market conditions. At issue is whether the Fed should pause its interest rate normalization effort or assume the current softness in pricing is temporary, particularly against the backdrop of a weak dollar, and continue apace with another ¼ point boost in December. We continue to lean toward the direction of another move in December. Economic fundamentals remain on solid footing and buoyant financial market conditions add to the generally benign monetary conditions present in the current environment. We expect the most likely path going forward remains one of steady growth accompanied by low inflation. Against that backdrop, it is difficult to envision rates rising significantly on the longer-end of the curve irrespective of potential policy action by the Federal Reserve. Fixed income investors continue to face pressure to generate portfolio income and credit and curve extension remain the path of least resistance.





Sources: Bloomberg; Merrill Lynch.
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