Bond Market Update

As of December 31, 2016 / Volume 5, Issue 4 / FFTAM.COM

The 4th Quarter of 2016 for the fixed income market saw a Republican President win the election and a Federal Reserve that raised short term interest rates. Total returns were negative as the market embraced the pro-growth, less regulation, and lower taxation agenda of President elect Trump. The Federal Reserve (the Fed) followed the market and reinforced its communication of gradualism with the caveat of a possibly greater need to raise rates if politicians can successfully embrace fiscal policy. The U.S. economy continued its slow and bumpy growth trajectory, however, the GDP forecast for the 4th quarter is projected to come in at 2.90%. For the quarter, both AAA taxable and tax-exempt yield curves steepened.

Total returns for taxable and tax-exempt investments were negative. For the 4th quarter, the Barclays Aggregate Bond Index recorded a total return of -2.98% and the Barclays Muni Index recorded a total return of -2.62%. Year to date returns are 2.65% and -0.10%, respectively. As mentioned above, the economy continued its slow and bumpy growth trajectory as 3rd quarter GDP came in with a final reading of 3.5%. ISM Manufacturing saw increased readings each month, with all readings above 50. ISM Nonmanufacturing continued their readings above 50 (a reading above 50 indicates expansion). The unemployment rate ticked down slightly to 4.7% from 4.9% and the participation rate dropped slightly to 62.7% from 62.9%. The quarterly average growth in jobs dropped as the 4th quarter produced on average 165k a month. Average hourly earnings continued its upward trajectory at a 2.9% year over year pace.

The 4th Quarter of 2016 was very eventful. The big news was the election of Mr. Trump as POTUS. The perception of a light at the end of the tunnel versus the darkness of an extension of the Obama agenda has brought alive the animal spirits and caused a huge shift in positive sentiment. While this shift in sentiment is definitely warranted, it may be a little head of itself. Market expectations are high and President elect Trump will need to deliver in a timely manner. Also in the 4th Quarter was the FED raising interest rates. At the meeting, the Fed raised rates by 25bps (as expected). Expectations for 2017 increased to 3 hikes from the prior communication of 2, but the median dot plot for 2017 is still substantially lower than at the start of 2016. Expectations for Fed policy will hinge on President elect Trump's agenda and timeline. We will gain much more clarity on this once Mr. Trump takes office in late January.

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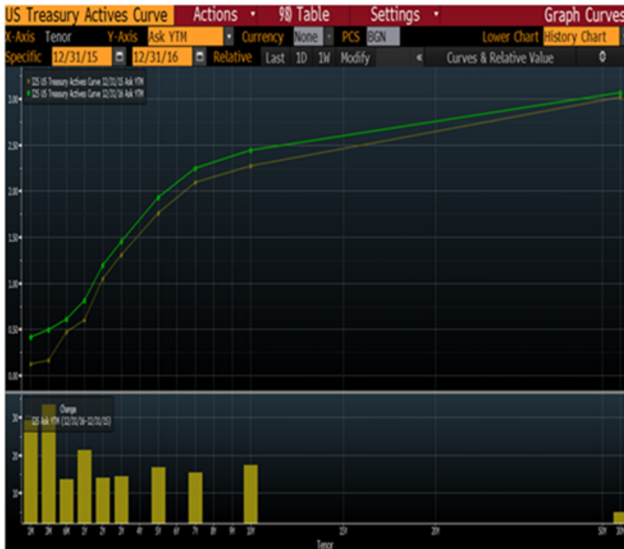
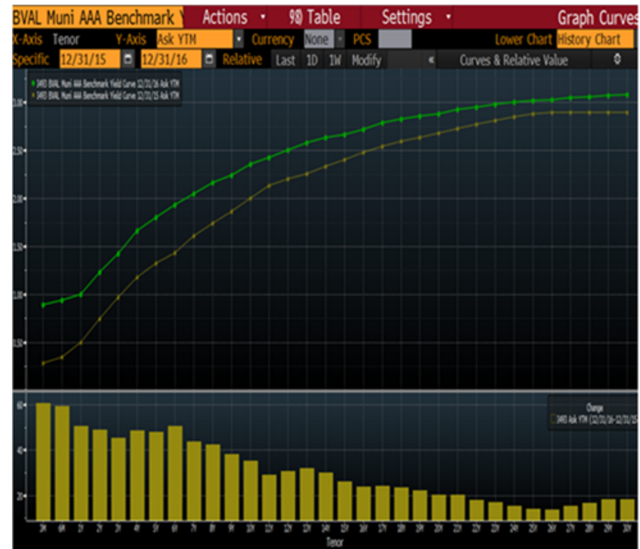
Below to the left is the U.S. Treasury Yield curve as of 12/31/15 and 12/31/16. As you will see, the yield curve has had a slight parallel shift up in rates. Below to the right is the AAA Municipal Yield curve as of 12/31/15 and 12/31/16. It experienced a slight flattening bias as rates shifted up.





For the quarter, investment grade credit spreads were marginally tighter (14bps) and high yield credit spreads were significantly tighter (75bps) versus the risk free rate.

Looking forward, rate projections will hinge on Mr. Trump's policy agenda and timeline in addition to the standard economic performance of the economy. The economy is starting to show some signs of life as a combination of positive economic metrics have improved over the past several quarters. The probability for rates to rise in the future have increased significantly. In short, we remain committed to a very high credit quality portfolio with a bias towards taking on greater credit risk in the short term. As opportunities present themselves, we may selectively change our portfolio composition to take advantage of the prospects of higher interest rates.

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