Bond Market Update

As of December 31, 2017 / Volume 6, Issue 4 / FFTAM.COM

The 4th Quarter of 2017 for the fixed income market saw a historic tax reform package signed, a Federal Reserve that raised the short term rate, and a new Fed Chair announced. The U.S. economy started to show some life, bucking the trend of its historically slow and bumpy growth trajectory. GDP forecast for the 4th quarter is projected to come in at 2.75%. For the quarter, both the AAA taxable yield curve and the AAA tax-exempt yield curve flattened.

Total returns for the quarter came under pressure as short-term rates hit multiyear highs. For the 4th quarter, the Barclays Aggregate Bond Index recorded a total return of 0.39% and the Barclays Muni Index recorded a total return of -0.22%. YTD returns are 3.55% and 3.49%, respectively. As mentioned above, the economy started to show some life from its slow and bumpy growth trajectory as 3rd quarter GDP came in with a final growth reading of 3.20%. It has been 3 years since the US economy has seen back to back quarterly prints above 3%. ISM Manufacturing continued to see strong monthly prints, with all prints in the high 50's. ISM Nonmanufacturing continued to see strong monthly prints, with all prints above 55 (a print above 50 indicates expansion for both ISM's). The unemployment rate ticked down slightly to 4.1% from 4.2% and the labor participation rate edged down slightly to 62.7% from 63.0%. The quarterly average growth in jobs produced on average 215k a month. Average hourly earnings dropped to a 2.5% year over year pace.

The 4th quarter was highlighted by the signing of tax reform. This historic event will cut the corporate tax rate from 35% to 21%, in addition, individual brackets were widened and cut. Over time, this will amount to higher growth projections for domestic GDP. Overshadowed by the historic event of tax reform, the Fed raised the overnight rate by 25bps to a range of 1.25% to 1.50%. This was their third 25bps raise for 2017. Additionally, President Trump announced the appointment of Jerome Powell as the new Fed Chair. Expectations are that Chairman Powell will follow a very similar path already established by exiting Fed Chairwoman Yellen.

Below to the left is the U.S. Treasury Yield curve as of 12/31/16 and 12/31/17. As you will see, the yield curve has flattened since the beginning of the year. Below to the right is the AAA Municipal Yield curve as of 12/31/16 and 12/31/17. As you will see, the yield curve has flattened since the beginning of the year.

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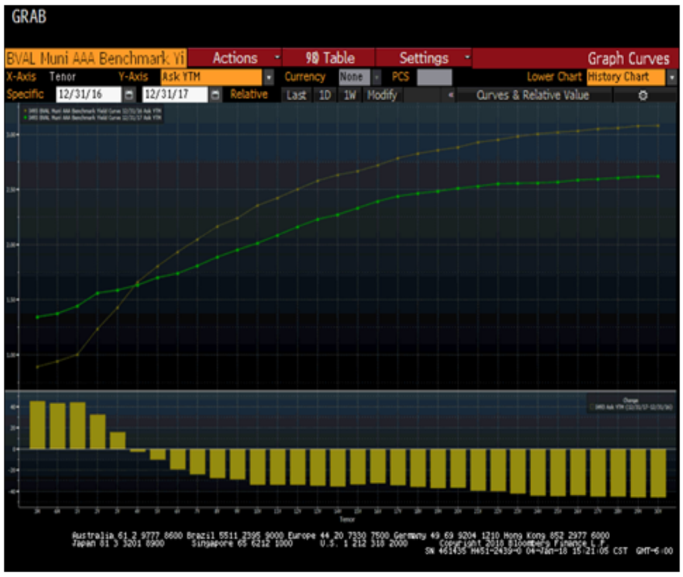

For the quarter and year, investment grade credit spreads were marginally tighter (9bps for the Quarter and 28bps YTD) and high yield credit spreads were marginally tighter (6bps for the Quarter and 65bps YTD) versus the risk free rate.

Looking forward, the historic tax reform signed by the President at the end of 2017 will give the Fed more room to raise short term rates before they enter the policy misstep arena. After two quarters of GDP prints above 3%, the Fed will continue to raise short term rates in 2018. Projections are for three 25bps moves, of course, anything less would be welcomed by the markets and anything more will have the potential to be viewed as a policy mistake. We do anticipate short term rates to continue to edge higher (2 raises are already priced into the market), with the hopes of longer rates bleeding up as well. 10 year rates have about 50bps of cushion before stresses start to emerge. In short, we remain committed to a very high credit quality portfolio with a slight tilt towards credit risk in the short term. As opportunities present themselves, we may selectively change our portfolio composition to take advantage of higher interest rates.

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