

Bond Market Update

As of June 30, 2017 / Volume 6, Issue 2 / FFTAM.COM



The 2nd Quarter of 2017 for the fixed income market was calm, with the only news worthy events being derived from the Federal Reserve. Total returns were positive as the market continued to digest the increased probability of no meaningful legislation from the Republican controlled congress and White House. The Federal Reserve (the Fed) raised the overnight rate by 25bps, reinforced its communication of gradualism, and laid out a plan of balance sheet reduction later this year. The U.S. economy continued its slow and bumpy growth trajectory. The GDP forecast for the 2nd quarter is projected to come in at 2.50%. For the quarter, both the AAA taxable yield curve and the tax-exempt yield curve flattened.

Total returns for taxable and tax-exempt investments were positive. For the 2nd quarter, the Barclays Aggregate Bond Index recorded a total return of 1.45% and the Barclays Muni Index recorded a total return of 1.39%. YTD returns are 2.27% and 2.96%, respectively. As mentioned above, the economy continued its slow and bumpy growth trajectory as 1st quarter GDP came in with a final growth reading of 1.4%. 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 4.4% from 4.5% and the labor participation rate edged down slightly to 62.8% from 63.0%. The quarterly average growth in jobs produced on average 183k a month. Average hourly earnings dropped to a 2.5% year over year pace.

While politics dominated the news channels, the main fixed income event in the 2nd quarter was the actions by the Federal Reserve. At the June meeting, the Fed raised the short term overnight rate by 25bps (as expected) to a range of 1.00% to 1.25%. Indications for the remainder of 2017 are for one more hike. In addition, the minutes from the June meeting revealed that the Fed is prepared to start the process of reducing their \$4.5T balance sheet and has created a formal plan that outlined the principal cash flows from maturities/pay downs not to be reinvested.

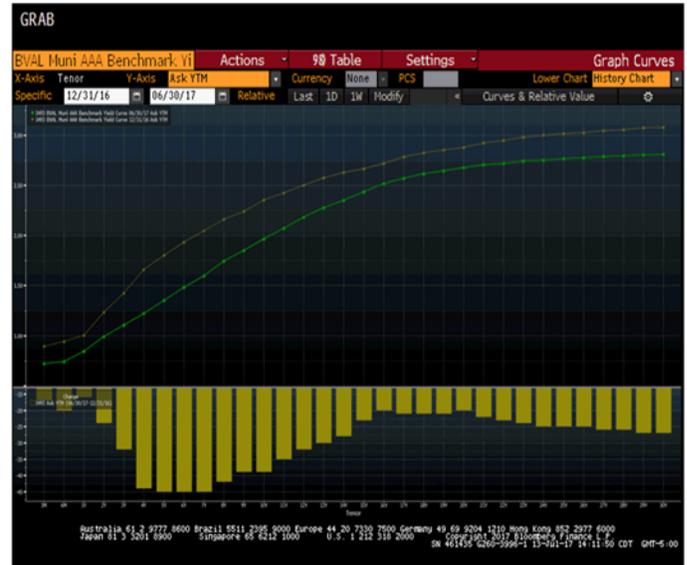
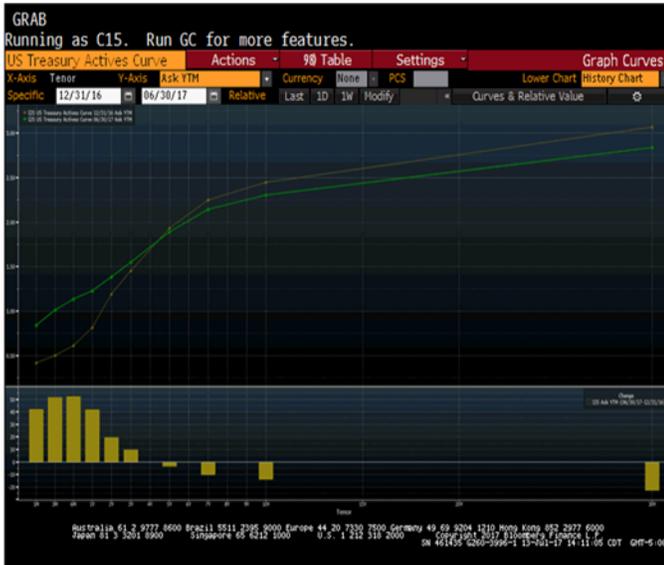
Below to the left is the U.S. Treasury Yield curve as of 12/31/16 and 06/30/17. As you will see, the yield curve has flattened since the beginning of the year. Below to the right is the AAA Municipal Yield curve as of 12/31/16 and 06/30/17. As you will see, the yield curve has flattened since the beginning of the year.

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For the quarter and year, investment grade credit spreads were marginally tighter (7bps for the Quarter and 13bps YTD) and high yield credit spreads were marginally tighter (0bps for the Quarter and 42bps YTD) versus the risk free rate.

Looking forward, the projected GDP bounce in the 2nd Quarter will give the Fed confidence to continue on its path of one more hike this year and the start of its reduction of its balance sheet. Rates should have a bias to rising in the short term. 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 the prospects of higher interest rates.

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