Bond Market Update

As of March 31, 2017 / Volume 6, Issue 1 / FFTAM.COM

The 1st Quarter of 2017 for the fixed income market saw the inauguration of our 45th president, Donald J. Trump and a Federal Reserve that raised short term interest rates. Total returns were positive as the market digested the overreaction in the 4th Quarter of the pro-growth, less regulation, and lower taxation agenda of President elect Trump. The Federal Reserve (the Fed) reinforced its communication of gradualism with the caveat of a possible balance sheet reduction later this year. The U.S. economy continued its slow and bumpy growth trajectory. The GDP forecast for the 1st quarter is projected to come in at 0.60%. For the quarter, the AAA taxable yield curve flattened and the tax-exempt yield curve steepened.

Total returns for taxable and tax-exempt investments were positive. For the 1st quarter, the Barclays Aggregate Bond Index recorded a total return of 0.82% and the Barclays Muni Index recorded a total return of 1.53%. As mentioned above, the economy continued its slow and bumpy growth trajectory as 4th quarter GDP came in with a final growth reading of 2.1%. 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 4.5% from 4.7% and the participation rate edged up slightly to 63.0% from 62.7%. The quarterly average growth in jobs produced on average 178k a month. Average hourly earnings dropped to a 2.7% year over year pace.

While the inauguration of our new president marked the beginning of a new administration with a vastly different agenda from our prior POTUS, the main event in the 1st quarter was the actions by the Federal Reserve. At the March meeting, the Fed raised the short term overnight rate by 25bps (as expected) to a range of 0.75% to 1.00%. Expectations for the remainder of 2017 are for two more hikes. In addition, the minutes from the March meeting revealed that the Fed is getting very close to possibly starting the process of reducing their balance sheet. Per the minutes, the preferred way to accomplish this is by not reinvesting principal cash flows from their $4.5 Trillion portfolio.

Below to the left is the U.S. Treasury Yield curve as of 12/31/16 and 03/31/17. As you will see, the yield curve has flattened slightly since the beginning of the year. Below to the right is the AAA Municipal Yield curve as of 12/31/16 and 03/31/17. It experienced a slight steepening since the beginning of the year.

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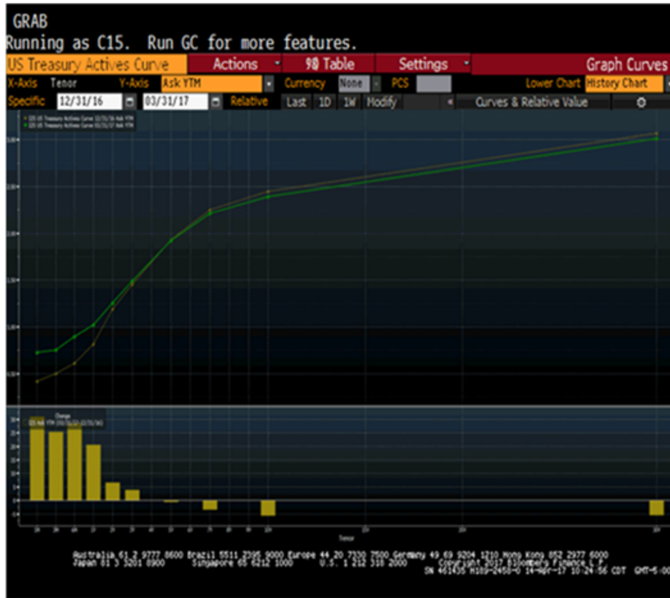

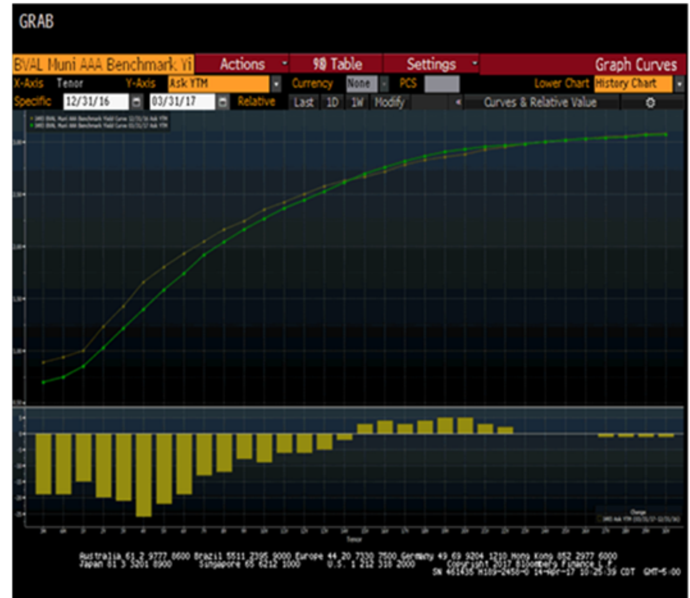

For the quarter, investment grade credit spreads were marginally tighter (5bps) and high yield credit spreads were marginally tighter (27bps) versus the risk free rate.

Looking forward, rate projections will continue to 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 has increased. 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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