Taxable Fixed Income:
Update on Key Market Themes

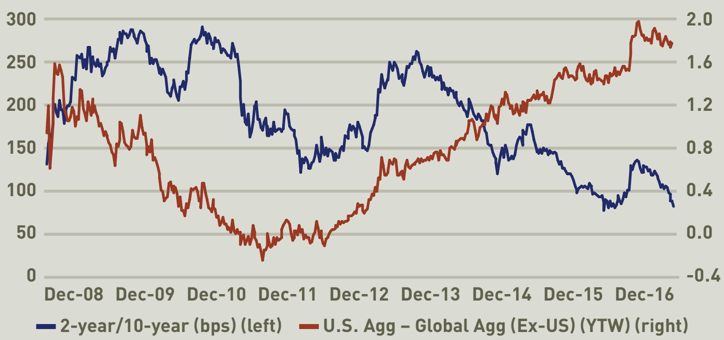
June 2017

As multiple crosscurrents continue to affect fixed-income markets, we want to provide an update to some of the key themes we highlighted in our first-quarter 2017 outlook.

MARKET LANDSCAPE

A weak consumer price index report for May pushed U.S. Treasury rates to new lows for the year. Lower GDP growth forecasts also weighed on yields. While GDP is expected to rebound in the second quarter, we believe it is unlikely to exceed the 2% to 2.5% run-rate seen over the last several years, absent any meaningful stimulative fiscal policies. In addition, U.S. rates remain anchored by accommodative global central bank policies and low yields among high-quality sovereign alternatives. The U.S. Treasury yield curve has flattened considerably this year, with the slope of the 2-year to 10-year curve breaching last year's third-quarter cycle lows. Despite this flattening, the yield differential on the Bloomberg Barclays U.S. Aggregate Index and the ex-U.S. Global equivalent remains near a post-financial crisis high.

U.S. Treasury Curve Flattening, But Yields Remain Attractive Globally



Source: Bloomberg

With generally good risk sentiment across most spread sectors, the Bloomberg Barclays Aggregate Index has returned nearly 2% thus far in the second quarter.

KEY THEMES

❶ The path to fiscal policy implementation extends even further

Given the environment of heightened partisan acrimony – plus no shortage of distractions coming from Washington – tangible progress across the administration's broad policy agenda has been challenged. Despite renewed hope following a successful House vote on legislation to replace the Affordable Health Care Act, the Senate has yet to draft its version of the bill. Senate leadership hopes to present a revised bill prior to the August recess. Tax reform and infrastructure spending bills would presumably help boost economic growth, but will be difficult to advance through

Congress. The budget proposal will need to be addressed before the September 30 fiscal year-end and may result in either a continuing resolution or a government shutdown. After hitting the debt ceiling in mid-March, the U.S. Treasury can operate using "extraordinary measures" until early October, but the debt limit will need to be tackled to avoid a U.S. government default. Market-based indicators of economic growth expectations and inflation expectations have reversed after dramatically repricing post-election.

	Dollar Index	Inflation Expectations (basis points change)	Treasury Curve 2-year/10-year (basis points change)
Post-Election	4.4%	+24	+25
YTD 2017	-5.2%	-25	-46

Post-election represents November 8, 2017 to December 30, 2017
YTD 2017 represent change through June 14, 2017

Source: Bloomberg

❷ The Fed stays the course – One more rate hike likely this year, plus details for a balance sheet strategy

While the June rate increase to a range of 1% to 1.25% was a near certainty, the market continues to significantly discount further policy tightening over the next 12 months. However, in conjunction with the June meeting announcement, the Federal Open Market Committee provided updated projections suggesting an additional rate increase this year is likely; this was interpreted as being slightly more hawkish. The Fed's projections did not include potential fiscal stimulus measures, so Washington's delays did not meaningfully affect its forecasts.

Somewhat surprisingly, the Fed announced a strategy to adjust the reinvestment plan for its $4.5 trillion balance sheet of Treasuries, agencies, and mortgage-backed securities. While maintaining flexibility on when implementation will begin, the Fed's plan outlines a gradual reduction that calls for continued purchases as long as they exceed a set of pre-defined caps on maturities, interest payments, and paydowns:

- U.S. Treasury Securities: Initially, $6 billion per month, which rises by $6 billion every three months to reach a maximum of $30 billion after one year.
- Agency Debt and Mortgage-Backed Securities: Initially, $4 billion per month, which rises by $4 billion every three months to reach a maximum of $20 billion after one year.

The Fed has not indicated a target size for its securities portfolio other than to suggest it should be lower than the current balance, but higher than it was prior to the financial crisis. With economic growth, inflation, and unemployment expected to remain consistent with the Fed's forecast, we would anticipate the Fed initiates tapering in the second half of 2017.

❸ Market-based inflation indicators deteriorated; the Fed is watching closely

Recent economic reports indicate a weakening of inflationary pressures among core components. Signs were particularly acute in autos, apparel, and wireless communications. While housing-related inflation remains above 3%, other key sectors have moderated, which could dampen measures of overall inflation in the near term. Oil prices have been volatile and generally in a downward trend since early 2017 and weakness among non-oil commodity prices could create additional headwinds. Year-over-year comparisons will become more difficult due to the oil price recovery we saw in the second half of 2016.

Market-based measures of inflation are also lower and the break-even spread curve for U.S. Treasury Inflation Protected Securities has steepened. With diminishing expectations for impactful fiscal policy, break-even spreads are approaching levels seen just prior to the election.

OUTLOOK

We continue to expect the economy will expand at a moderate pace akin to the Fed's projected 2%. The domestic yield curve is anchored by the projected path of Fed policy at the short end, and low global yields at the longer end, supporting our neutral duration position relative to respective benchmarks. We maintain an overweight to the Credit sector, but continue to move toward a more defensive orientation, as the option-adjusted spread on the Bloomberg Barclays Credit Index is approaching the lows of mid-2014. Selection (both issuer and sub-sector) is becoming increasingly important. Recently, our preference has shifted in favor of shorter-duration securities and an increased allocation to utilities. Our strategies continue to emphasize sectors offering the best risk-return attributes based on our macroeconomic outlook. We maintain high-quality, liquid portfolios that we believe allow us to both protect client portfolios from episodic volatility and capitalize on opportunities as they arise.