Taplin, Canida & Habacht

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Fixed income market update

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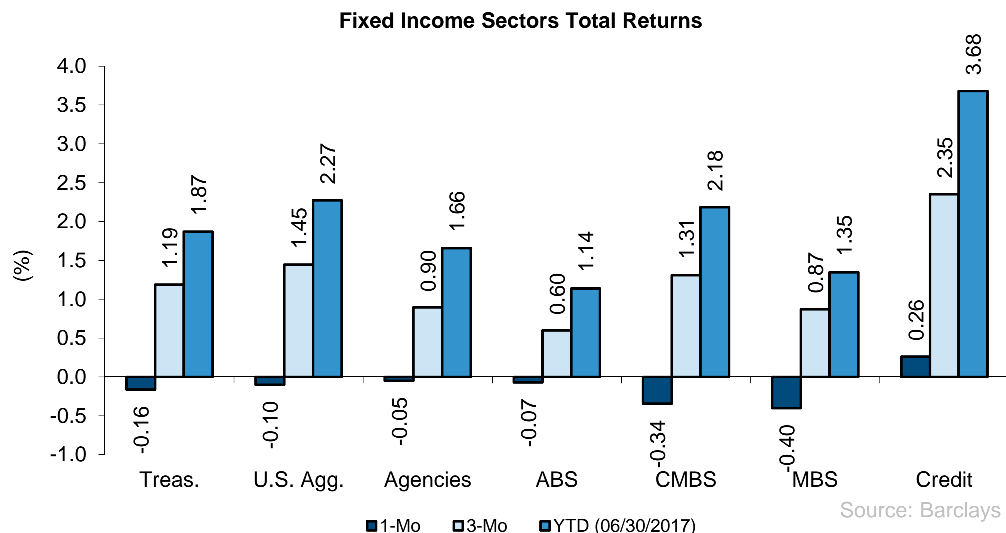
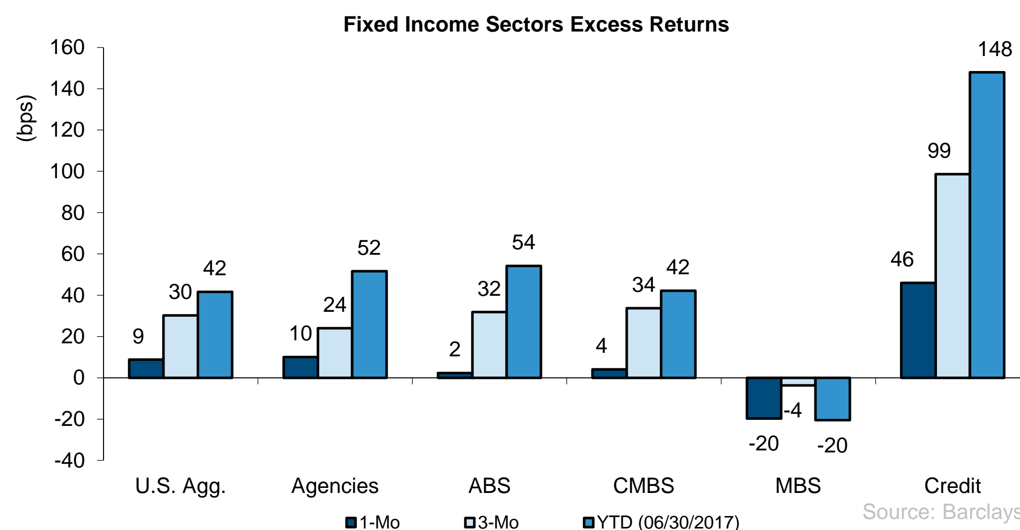
Fixed income market update

- For the quarter ended June 30, 2017, the Bloomberg Barclays U.S. Aggregate Bond Index returned 1.45%.
- U.S. Treasuries returned 1.19% during the quarter as the yield on the 10-year U.S. Treasury declined to 2.30% from 2.39% at the end of March. For the quarter, long Treasuries (+3.96%) outperformed intermediate Treasuries (+0.66%).
- Mortgage-backed securities (MBS) returned 0.87% during the quarter, underperforming duration-matched Treasuries by 4 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened 5 basis points to end the quarter at 32 basis points.





Past performance does not guarantee future performance

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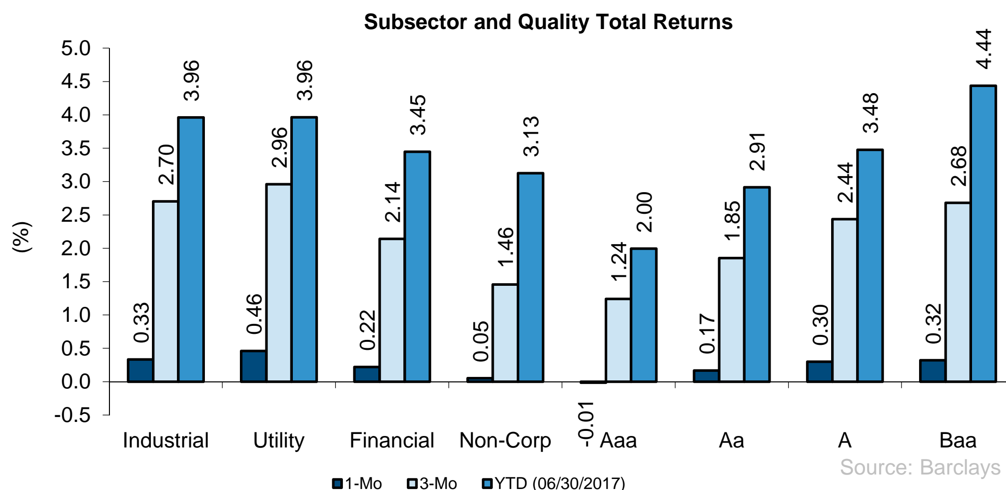
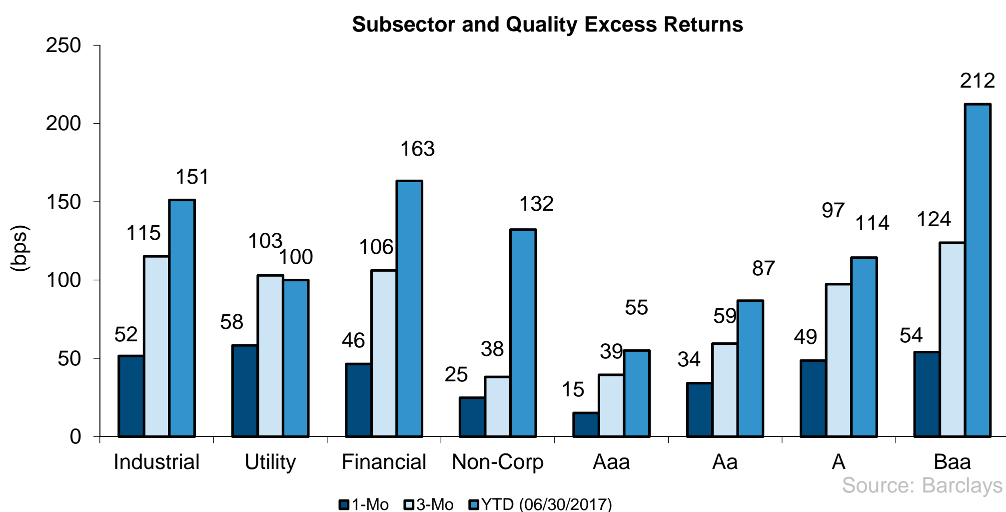
Fixed income market update (continued)

- Credit securities returned 2.35% for the quarter, outperforming Treasuries by 99 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 103 bps, 9 basis points tighter than at the end of March. For the quarter, long credit (+4.70%) outperformed intermediate credit (+1.38%) by 109 basis points on a duration-adjusted basis.
- For the quarter, on a duration-adjusted basis, industrials delivered 115 basis points of excess returns, outperforming financials, utilities, and non-corporates by 9, 12 and 77 basis points, respectively.
- BBB rated securities delivered 124 basis points of excess return for the quarter, outperforming AAA, AA and A rated securities by 85, 65 and 27 basis points of excess return, respectively. High yield delivered 146 basis points of excess return for the quarter.





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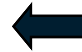
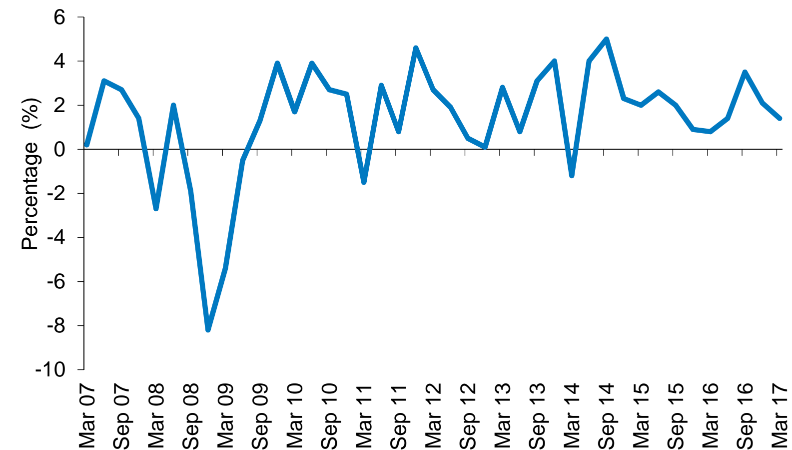
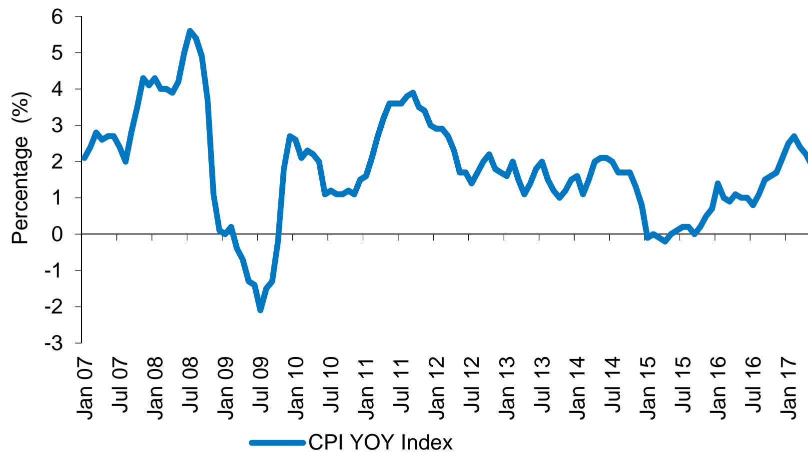
Economic update

U.S. gross domestic product (GDP) grew at a 1.4% annualized rate for the first quarter, a 0.2% increase from the prior estimate. Consumer spending and exports were revised higher to 1.1% and 7%, respectively. Nonetheless, consumer spending grew at its slowest pace in over three years. Consensus expectations for second quarter GDP growth are approximately 3%, while the Atlanta Fed's GDPNow forecasts 2.7% growth for the second quarter. The International Monetary Fund (IMF) cut full year 2017 U.S. growth expectations by 0.2% to 2.1% and by 0.4% to 2.1% for 2018.





Source: Bureau of Economic Analysis

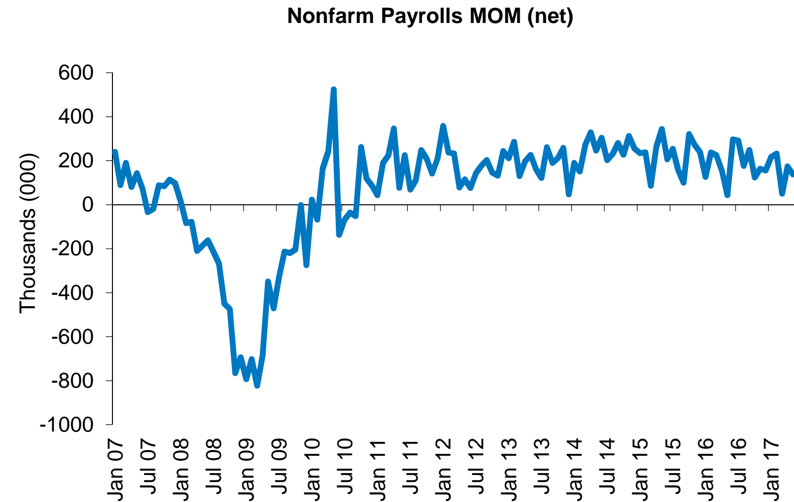


Source: Bureau of Labor Statistics

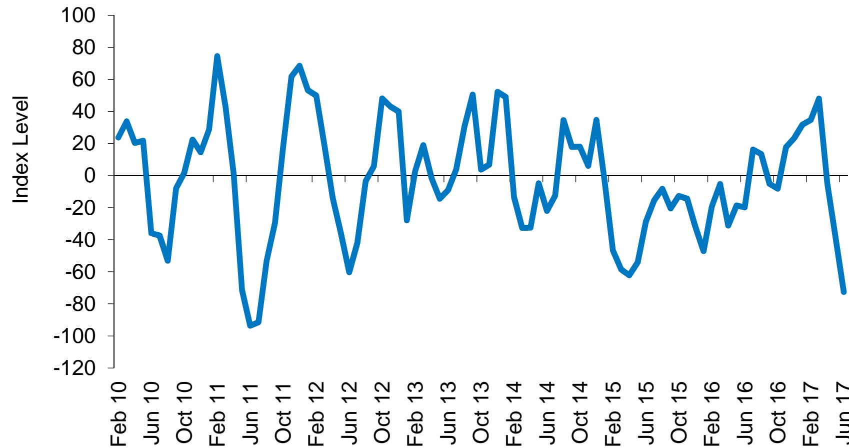
The Consumer Price Index (CPI), declined 0.1% in May and rose 1.9% for the trailing twelve months. Energy was the chief driver of the May decline; core CPI, which excludes energy and food, rose 0.1% in May and 1.7% for the trailing twelve months. The Fed's preferred inflation metric, core personal consumption expenditures (PCE), rose 0.1% for the month, but slowed to 1.4% for the trailing year. Trailing twelve month Core PCE had risen as high as 1.8% pace earlier in the year, before slowing to the current rate.

Economic update (continued)

Nonfarm payrolls increased by 138,000 in May, below the consensus estimate of 185,000. Revisions to the prior two months reduced job gains by 66,000. The unemployment rate declined 0.1% to 4.3%, the lowest rate since 2001 and 0.4% below the end of last year. The decline in unemployment was largely due to the work force participation rate falling 0.2% to 62.7%. Average hourly earnings rose by 0.2% for May and year over year wages grew 2.5%, the same as in April.



Source: Bureau of Labor Statistics



Source: Citigroup

The Citi Economic Surprise index, which measures the results of a suite of economic data relative to expectations, fell to a level of -72.6 in June. The June level is the lowest level since the European debt crisis in 2011 as the index level has fallen 120 points from its recent high of +48 in March. While known as a volatile measure, the recent declines reflect economic data broadly failing to live up to heightened expectations.

Economic and market perspective

- The Federal Open Market Committee (FOMC) raised the Federal Funds rate range by 25 basis points at their June 13-14 meeting to a range of 1.00% to 1.25%. The move was highly anticipated with both Fed language long hinting at the increase and the market pricing the expectation into Fed Funds Futures. The June hike marked the third consecutive quarter with a 25 basis point rate increase in the Fed Funds rate and the fourth overall in the current cycle. The Fed noted that inflation "is expected to remain somewhat below 2 percent in the near term." As of month end, Fed Funds Futures project slightly below a 50% chance of an additional hike this year.
- More significant from the FOMC meeting was the language pertaining to the Fed's $4.5 trillion balance sheet. The committee clarified its intentions related to the wind-down of the quantitative easing program. We had long anticipated a moderate as opposed to abrupt wind-down and the Fed delivered a more moderate approach than many anticipated. The Fed will institute a system of monthly caps, limiting the amount of Treasuries and mortgage bonds that can roll off the balance sheet in any given month. For Treasuries, the initial cap will be $6 billion per month, which is set to increase by $6 billion each quarter until reaching $30 billion. For U.S. Agency debt and agency mortgage backed securities, the initial cap will be $4 billion, set to increase by $4 billion per quarter until reaching $20 billion a month. Balance sheet holdings maturing in excess of those caps will continue to be reinvested, providing a stable and transparent path to balance sheet reduction. The total balance sheet run-off in the first year would approximate $300 billion. Though no official target has been released for the final size of the balance sheet, several Fed governors have suggested a range of $2 to $2.5 trillion. Prior to the 2008 crisis, the balance sheet was approximately $800 billion. No formal start date has been announced, with Chair Yellen only stating it would be being "relatively soon." Most expectations are for the late third quarter or fourth quarter of 2017 for the program to begin.
- All of the institutions subject to the Fed's supervisory bank stress tests passed for the first time since the program began in 2011. Speaking in London, Chair Yellen noted that with banks "very much stronger" another financial crisis is unlikely "in our lifetime."

Economic and market perspective (continued)

- After the House of Representatives passed healthcare legislation in May, Republicans in the Senate released their plan in June. Originally intended to be voted on or before July 4th, the bill has encountered early opposition from within the party and a vote is now expected to be delayed and the bill possibly reworked and reintroduced. Long discussed tax reform and infrastructure plans have yet to be introduced.
- Elections in the United Kingdom were closely watched for indications of how Brexit would proceed. Prime Minister Theresa May had called the snap elections with the expectations of gaining a stronger majority in parliament and easing her Brexit negotiations with Europe. Though May's Conservative party won the largest number of seats and will remain in power, the margin of victory was significantly narrower than expected and the Conservatives lost the overall majority they had enjoyed prior to the election. The election result has increased speculation of a "soft" Brexit now that May's party is weakened.
- The Institute of International Finance issued a report showing that global debt to GDP had exceeded 300%, noting that China had reached the same threshold. The official Chinese manufacturing Purchasing Managers' Index (PMI) of 51.7 and services PMI of 54.9 in June both rose from May levels and first quarter GDP grew at a 6.9% annual pace, ahead of expectations.
- Japanese first quarter GDP was 1%, significantly below the preliminary estimate of 2.2% and the expectation of 2.4%. Bank of Japan Governor Haruhiko Kuroda indicated that the annual pace of asset purchases has been closer to ¥60 trillion than the guidance of ¥80 trillion. Despite the slower than expected purchases, the BOJ balance sheet has grown to nearly 100% of Japanese annual GDP ~¥540 trillion.
- Eurostat released first quarter GDP figures showing quarterly growth of 0.6% for the Euro area. This figure exceeded expectations. While unemployment in Europe has dropped to the lowest level since March 2009 at 9.3%, European Central Bank (ECB) vice president, Vitor Constancio highlighted that the European equivalent of U-6 underemployment is closer to 18%. Eurostat inflation data showed inflation in Europe declining to 1.3% for June, the lowest level this year. However, core inflation rose to 1.1% from 0.9% in May, exceeding estimates.

Outlook and conclusions

- The European Central Bank (ECB) kept policy unchanged at their June 8th meeting, indicating that rates would "remain at their present levels for an extended period of time." Of note was the change to remove language that suggested rates could continue to decline. While removing that language, the Governing Council also reinforced that the asset purchase program could be increased or the nature of assets changed if the economy began to weaken again.
- Despite seemingly cautious intentions, ECB President Mario Draghi's speech at the ECB forum in Portugal appear to have shifted market expectations with the language that "as the economy picks up we will need to be gradual when adjusting our policy parameters." As of month end, markets are pricing in a 90% probability of an ECB rate hike within twelve months, a stark contrast to recent expectations.
- Reflecting the shifting expectations of international monetary policy and slowing U.S. economic data, the U.S. dollar declined over 3% as measured by the Bloomberg Dollar Spot Index in the second quarter. This decline followed a slightly larger decline in the first quarter and left the U.S. dollar at approximately the same level it began the fourth quarter of 2016, prior to president Trump's election.
- In our view, when the Fed begins its long awaited balance sheet reduction plan, the deliberate and methodical approach should ease the direct impact to Treasuries and mortgage backed securities, though implementation should be monitored closely. U.S. fixed income has benefitted from significant international flows, a continuing support given yield differentials. Those factors notwithstanding, Treasury markets have priced in moderating economic data to a greater degree than other asset classes and sectors. Whether credit, priced near historical median levels, or Treasuries are better reflective of near term economic outcomes will help define the second half of the year for fixed income investors. As markets respond to U.S. fiscal policy and global monetary policy shifts, we see opportunities and risks across the spectrum of fixed income sectors and expect sub-sector and security selection opportunities to be important drivers of returns in the second half of 2017.

Fixed income returns as of June 30, 2017

Index Returns as of June 30, 2017

	Total Return (%)			Excess Return (%)		
	Month-to-Date	Quarter-to- Date	Year-to- Date	Month-to-Date	Quarter-to- Date	Year-to- Date
U.S. Aggregate	-0.10	1.45	2.27	0.09	0.30	0.42
U.S. Treasury	-0.16	1.19	1.87	-	-	-
Intermediate	-0.27	0.66	1.21	-	-	-
Long	0.40	3.96	5.41	-	-	-
TIPS	-0.95	-0.40	0.85	-	-	-
Agencies	-0.05	0.90	1.66	0.10	0.24	0.52
U.S. MBS	-0.40	0.87	1.35	-0.20	-0.04	-0.20
U.S. Credit	0.26	2.35	3.68	0.46	0.99	1.48
Intermediate	-0.06	1.38	2.54	0.23	0.67	1.21
Long	1.01	4.70	6.44	1.00	1.76	2.12
Industrial	0.33	2.70	3.96	0.52	1.15	1.51
Utility	0.46	2.96	3.96	0.58	1.03	1.00
Financial	0.22	2.14	3.45	0.46	1.06	1.63
Non-Corporate	0.05	1.46	3.13	0.25	0.38	1.32
Aaa	-0.01	1.24	2.00	0.15	0.39	0.55
Aa	0.17	1.85	2.91	0.34	0.59	0.87
A	0.30	2.44	3.48	0.49	0.97	1.14
Baa	0.32	2.68	4.44	0.54	1.24	2.12
High Yield	0.14	2.17	4.93	0.35	1.46	3.65
Floating Rate Notes	0.19	0.53	1.19	0.12	0.34	0.88

Source: Bloomberg Barclays

Past performance does not guarantee future performance

Disclosures

All investments involve risk, including the possible loss of principal.

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