Taplin, Canida & Habacht

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Fixed income market update

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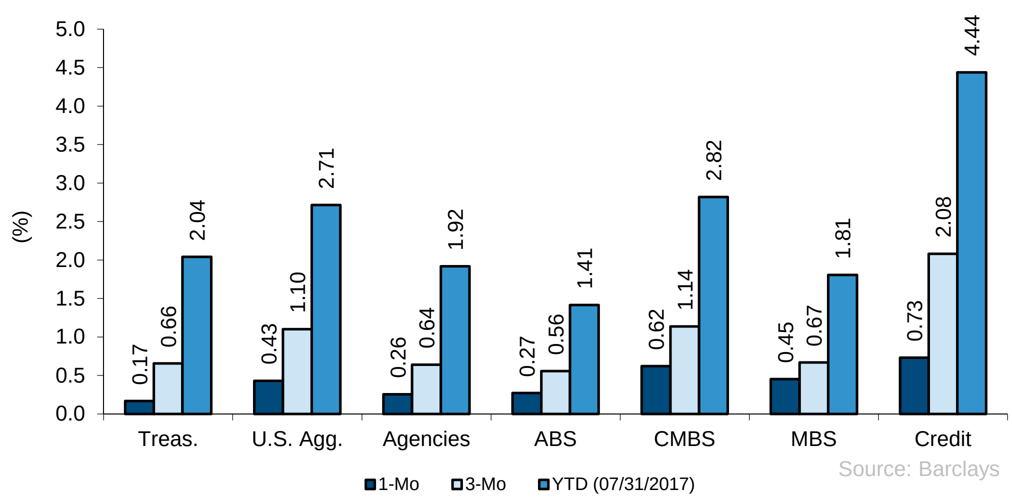
Fixed income market update

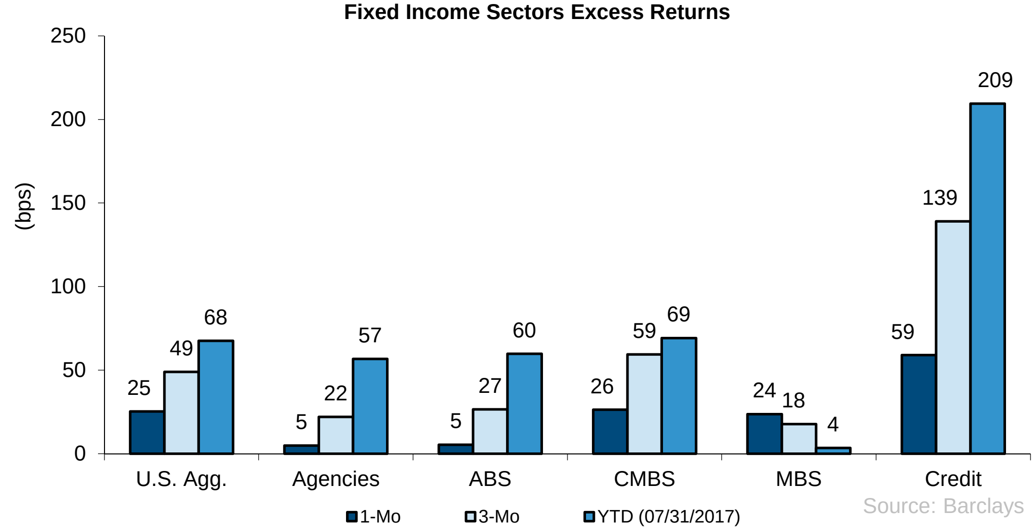
- For the month ended July 31, 2017, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.43%. Year to date, the index has returned 2.71%.

- U.S. Treasuries returned 0.17% during the month as the yield on the 10-year U.S. Treasury declined to 2.29% from 2.30% at the end of June. For the month, long Treasuries (-0.62%) underperformed intermediate Treasuries (+0.32%).

- Mortgage-backed securities (MBS) returned 0.45% during the month, outperforming duration-matched Treasuries by 24 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index tightened 4 basis points to end the month at 28 basis points.



Source: Barclays



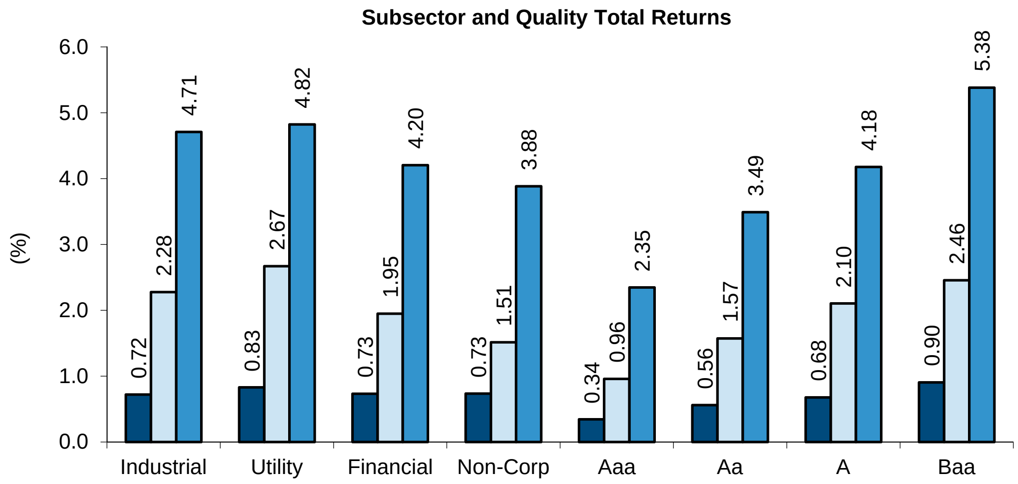
Source: Barclays

Fixed income market update (continued)

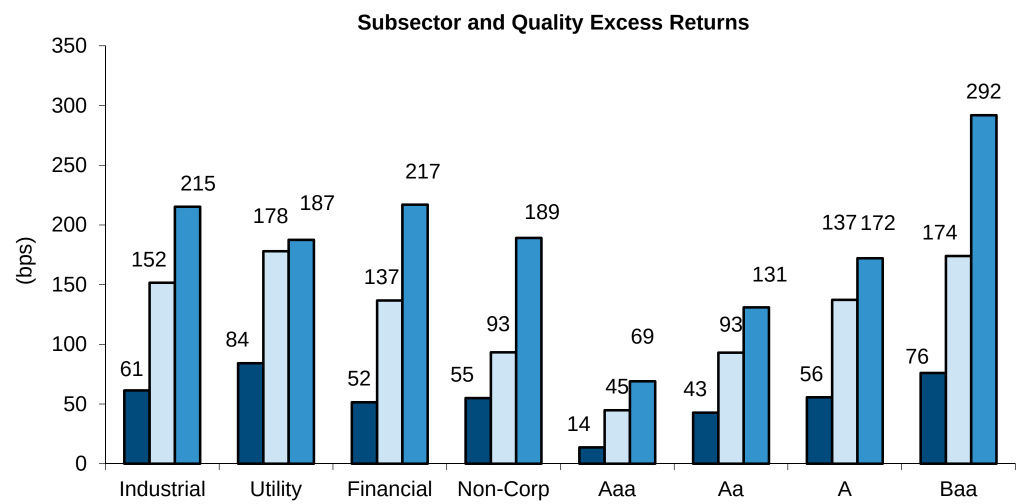
- Credit securities returned 0.73% for the month, outperforming Treasuries by 59 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 98 bps, 5 basis points tighter than at the end of June. For the month, long credit (+0.85%) underperformed intermediate credit (+0.68%) by 76 basis points on a duration-adjusted basis.

- For the month, on a duration-adjusted basis, utilities delivered 84 basis points of excess returns, outperforming industrials, non-corporates and financials by 23, 29 and 32 basis points, respectively.

- BBB rated securities delivered 76 basis points of excess return for the month, outperforming AAA, AA and A rated securities by 62, 33 and 20 basis points of excess return, respectively. High yield delivered 83 basis points of excess return for the month.



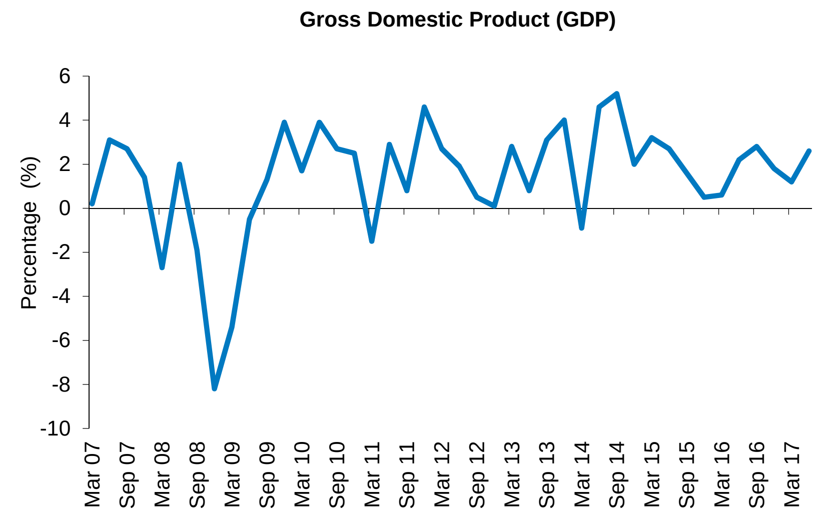
Source: Barclays



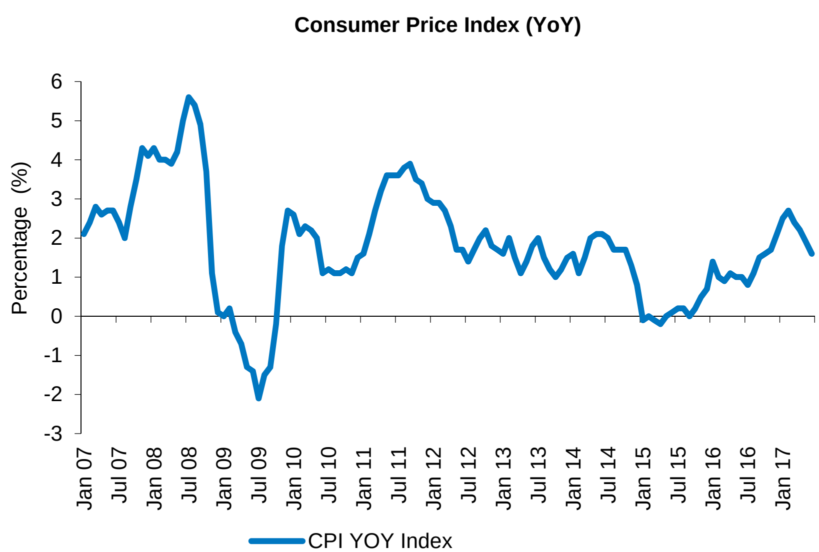
Source: Barclays

Economic update

U.S. gross domestic product (GDP) grew at a 2.6% annualized rate for the second quarter. Growth was driven by strong consumer spending (+2.8%) and the largest increase in business investment in two years (+8.2%), while investment in homebuilding declined the most in seven years (-6.8%.) With second quarter growth, total U.S. GDP passed $19 trillion for the first time. Annual revisions showed growth in 2015 increasing from 2.6% to 2.9%, but decreasing in 2016 from 1.6% to 1.5%.



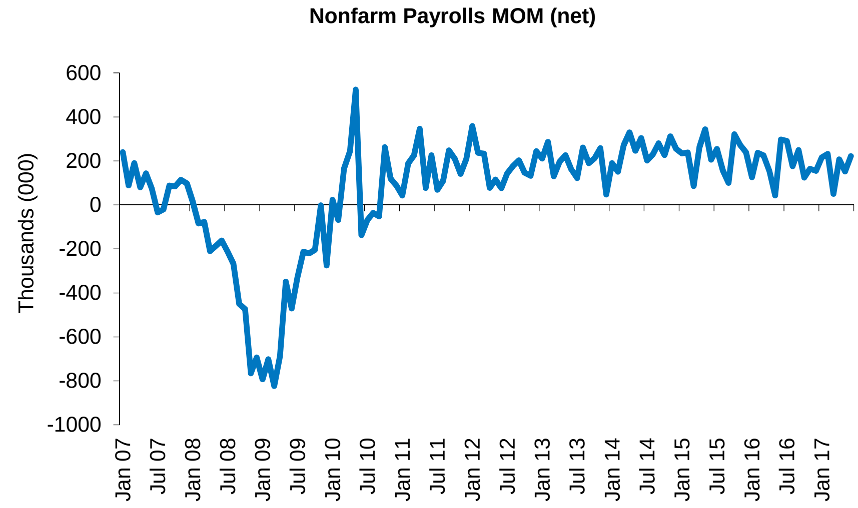
Source: Bureau of Economic Analysis



Source: Bureau of Labor Statistics

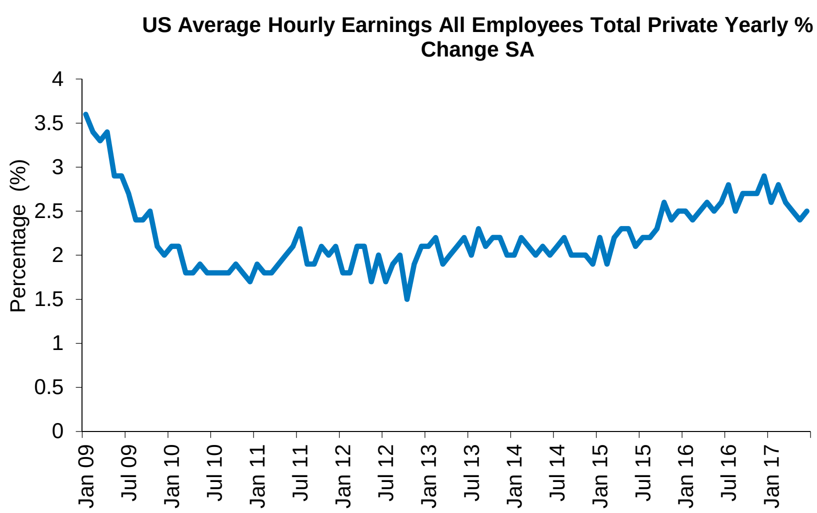
The Consumer Price Index (CPI) remained unchanged in June and rose 1.6% for the past year, a slowdown of over a full percent since the 2.7% increase in February. Core CPI rose 0.1% for the month and 1.7% for the trailing twelve months, unchanged from last month. Core PCE (personal consumption expenditure) increased 0.9% for the trailing twelve months, the slowest rate of increase in two years.

Economic update (continued)



Source: Bureau of Labor Statistics

After a disappointing May report, nonfarm payrolls increased by 222,000 in June, above the consensus estimate of 179,000. Revisions to the prior two months added to job gains by 47,000. The average monthly gains for the first half of the year have been approximately 180,000 versus the 187,000 pace of 2016. The unemployment rate remained unchanged at 4.4%, while the underemployment rate rose from 8.4% to 8.6%. The labor force participation rate increased slightly to 62.8%.



Source: Bureau of Labor Statistics

Average hourly earnings rose by 0.2% for June and 2.5% year over year. The Employment Cost Index (ECI), a broad measure of labor costs, rose 0.5% for the second quarter, a decrease from the 0.8% increase in the first quarter. Over the past year, over 2.3 million full-time jobs have been created, while the number of part-time jobs has declined. The changing composition of employment and reports of employers having difficulty filling vacant roles should support wage growth, but to date, wage growth has remained below pre-crisis levels.

Economic and market perspective

- Plans to repeal and replace ObamaCare dominated U.S. policy news in July. After multiple iterations, ultimately the effort failed in the U.S. Senate after a 49-51 vote against a “skinny repeal.” Pertaining to tax reform, Speaker of the House of Representatives Paul Ryan indicated that a border adjustment tax was no longer under consideration. This decision may ease upcoming debates around tax reform as the border adjustment tax had been one of the most contentious provisions of plans discussed to date. Trump administration members indicated that tax policy will be a significant focus with a target passing the House in October and Senate in November. Despite policy uncertainty, U.S. equity markets each set new highs during the month aided by several major companies announcing strong earning near the end of the month.

- North Korea tested two intercontinental ballistic missiles (ICBM) during the month, prompting further sanctions of the country. The missiles are believed to be capable of reaching the United States, including major metropolitan areas. The most recent test led the U.S. to demonstrate its missile defense system as well as conduct fly-overs of the Korean peninsula in joint military exercises with Japan and South Korea.

- After a 5% decline in June, Oil rose 9% in July, closing above the $50 a barrel level. This increase was partially driven by a decrease in U.S. output and declining U.S. inventories, but was offset by a report that OPEC (Organization of the Petroleum Exporting Countries) members had increased production despite an agreement to reduce output to manage prices. Prior to the increase in the oil price during the month, gasoline prices had hit their lowest level for the July 4th holiday since 2005 with a national average price of $2.23 a gallon.

- The unemployment rate in Europe fell to its lowest level since 2009 at 9.1% for June. Overall inflation was unchanged at 1.3%, the lowest level of 2017. However, core inflation rose 0.1% to 1.3%, the highest level in four years. While the inflation outlook has improved, which gives the European Central Bank (ECB) greater policy leeway, the inflation level remains well below the 2% target the ECB is seeking.

Outlook and conclusions

- With improving economic conditions in Europe, expectations around a change in European Central Bank (ECB) policy are increasing. At the July meeting, policy remained unchanged with purchases of €60 billion per month continuing and a deposit rate of -0.4%. ECB president, Mario Draghi, indicated that the governing council had not yet discussed plans for the tapering off of purchases, but many expect an announcement to come this year and implementation to begin early next year. The Euro rose nearly 4% against the dollar in the month on expectations of monetary policy changes and improved economic data in Europe. The market is pricing in about a 50% chance of a rate hike by the ECB by next July.
- The Federal Open Market Committee left the Federal Funds rate range unchanged in a range of 1.00% to 1.25% during their July 25-26th meeting. This result was highly anticipated and most observers were more focused on whether the Fed would tip their hand regarding the timeline for the previously announced changes in reinvestment policy related to assets maturing from the balance sheet. The Fed tweaked language regarding the time line for the wind-down from “this year” to “relatively soon,” though providing no specific initiation date. Fed Funds Futures imply nearly no chance of a rate hike at the Fed’s next meeting in September and about a 40% chance of an additional hike by the final meeting of the year in December.
- In our view, even with slowing inflation, economic data in the U.S. has generally improved since the Fed first announced its plans to limit reinvestment of maturing balance sheet assets. The Fed has maintained a cautious, market friendly philosophy when reducing support and we expect that approach to continue. With healthcare reform derailed again, an administration pivot to focus on tax policy would be welcomed by the market and provide a tailwind to consumers and corporations. The current environment appears benign for U.S. fixed income even without tax policy changes, with a cautiously normalizing Fed having assuaged some of the concerns for Treasuries and mortgage backed securities. Improved second quarter GDP growth highlighted the strength of the consumer and business investment, furthering a strong corporate backdrop supportive of credit markets.

Fixed income returns as of July 31, 2017

Index Returns as of July 31, 2017				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to- Date	Month-to-Date	Year-to- Date
U.S. Aggregate	0.43	2.71	0.25	0.68
U.S. Treasury	0.17	2.04	-	-
Intermediate	0.32	1.53	-	-
Long	-0.62	4.76	-	-
TIPS	0.45	1.30	-	-
Agencies	0.26	1.92	0.05	0.57
U.S. MBS	0.45	1.81	0.24	0.04
U.S. Credit	0.73	4.44	0.59	2.09
Intermediate	0.68	3.23	0.36	1.59
Long	0.85	7.34	1.12	3.31
Industrial	0.72	4.71	0.61	2.15
Utility	0.83	4.82	0.84	1.87
Financial	0.73	4.20	0.52	2.17
Non-Corporate	0.73	3.88	0.55	1.89
Aaa	0.34	2.35	0.14	0.69
Aa	0.56	3.49	0.43	1.31
A	0.68	4.18	0.56	1.72
Baa	0.90	5.38	0.76	2.92
High Yield	1.11	6.09	0.83	4.54
Floating Rate Notes	0.22	1.42	0.14	1.03

Source: Bloomberg Barclays

Disclosures

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

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