Fixed Income **Insights**
2017 Outlook

Welcome to 2017: A year of transition

Over the past few years, periods of increased volatility throughout the fixed income market have become more significant and frequent in nature. In this regard, 2016 did not disappoint, with two notable periods of increased volatility that were the largest since the taper tantrum of 2013. During the year, the impetus for such periods varied in nature, from the sharp decline following the unexpected outcome of the Brexit referendum through the quick shift in the U.S. political climate, and by extension, a rapid change in the expectations for U.S. fiscal policy.

Having been stagnant for years, the market expectations for potential changes to U.S. infrastructure spending, trade policies and tax reform have increased steadily following the election. While markets are focused on these drivers as we enter 2017, we anticipate next year will be a year of transition, where even with bouts of volatility, the realities of policy implementation, underlying global macroeconomic conditions, and a data-driven Federal Reserve will anchor U.S. fixed income markets, suggesting we end the year very similarly to how we start it.

The Fed's path forward

As widely anticipated, at the conclusion of its December meeting, the Fed increased its benchmark interest rate 25 basis points to a range of 50 to 75 basis points, the central bank's first such increase in 12 months. Though the Fed forecasted as many as four increases throughout the year, the committee spent much of the year talking down its interest rate outlook. A number of factors ranging from instability within other major economies and some soft patches in the U.S. central tendencies contributed to the FOMC's adjusted views.

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Looking ahead to 2017, the Fed's "Dot Plot" showed an increase in both the 2017 and longer term median forecast for the Fed funds rate to 1.375% from 1.125% and 3.0% from 2.875%, respectively, as committee members now anticipate three increases during the year, compared to two in September. During her December 14th press conference, Janet Yellen commented, "Some of the participants, but not all of the participants, did incorporate some assumption of a change in fiscal policy into their projections. And that may have been a factor that was one of several that occasioned these shifts. But I want to emphasize that the shifts that you see here are really very tiny." Our view is similar, these increases are not very significant. The market now expects the next increase in the Fed funds rate around mid-2017, and while this pace is slower the Fed's own estimates, this too is a non-factor as this market implied Fed funds targets have been consistently below the Committee's for some time.

In our view, what stood out during this December's meetings was the shift in the Fed's stance towards fiscal stimulus. Following the Fed's directive, former Fed Vice Chair Alan Blinder commented that Fed officials, which includes both Janet Yellen and her predecessor Ben Bernanke, had been "practically begging" for fiscal-side assistance to further the U.S. economic recovery; however, in her comments following the December meeting, Chair Yellen approached the topic of fiscal stimulus quite cautiously. While prudent in our view, especially when it comes to commenting on very specific (and perhaps politically charged) aspects of policy, Yellen added:

> "I believe my predecessor and I called for fiscal stimulus when the unemployment rate was substantially higher than it is now. So with a 4.6 percent unemployment rate, and a solid labor market, there may be some additional slack in labor markets, but I would judge that the degree of slack has diminished. So I would say at this point that fiscal policy is not obviously needed to provide stimulus to help us get back to full employment."

While the above comment suggest that the Fed may respond to what former vice chair Blinder calls a "sugar high by fiscal expansion," with additional rate increases, in our view, there is still sufficient slack underneath the dual mandate—full employment and stable inflation—to absorb a fair amount of stimulus before the U.S. economy is truly at risk of overheating. While headline unemployment and inflation data have moved into fuller territory, factors such as low labor market participation, tepid wage growth, poor monetary velocity and the ever-present risk of the economic weakness abroad seeping into the headlines, in our view, it is unlikely that the neutral Fed funds rate has shifted much higher, recall as Yellen stated, "the shifts you see here are very tiny."

Bloomberg velocity of money M2

Source: Bloomberg

We anticipate that fiscal policy, and specifically the market expectations thereof, will be the dominant force for U.S. benchmark interest rates.

The changing landscape

While the Fed may view the U.S. economic recovery as satisfactory, both the results of the U.S. presidential election and the comments made by President-elect Trump and his proposed cabinet suggest that view is not universally shared. We anticipate that fiscal policy, and specifically the market expectations thereof, will be the dominant force for U.S. benchmark interest rates. While the term reflation is generally applied to the initial phases of an economic recovery, it has nonetheless been applied toward the current, extended period of this recovery. In short, the incoming administration's assessment of potential U.S. GDP is considerably higher than that of the U.S. central bank as well as global institutions such as the International Monetary Fund (IMF). While there are few concrete details for markets to analyze regarding plans for tax reform, financial and environmental regulations, and trade and foreign policies, with Republican control of Congress and the White House, markets have priced in that a transition from monetary shouldering much of the recovery to that which is driven by fiscal stimulus may be underway. To be sure, following the November election, higher equity markets, higher interest rates and a stronger dollar all reflect the expectation for fiscal stimulus and pro-growth policies over the near-term.

Another potential area to observe is the changing composition of the U.S. financial engine. Headlines regarding the composition of the Fed continue to circulate, though in our view, the current leadership will likely remain intact through 2017. We continue to view Chair Yellen as the leader of the Fed at least through the end of her appointment in 2018. Accordingly, we do not foresee any unanticipated changes to the Fed's reaction function until that time, at the earliest, but it does bear mention that President-elect Trump may nominate as many as 6 new board members, including a new Chair over the next two years.

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Again, noting a lack of clarity at this point on potential nominees, this could represent a meaningful change in the Board's composition from its current more dovishly inclined makeup. On the fiscal side of the engine, we believe that most of the policies being discussed are likely to increase the current deficit, and therefore increase the need for government financing. Treasury Secretary nominee, Steven Mnuchin, is believed to favor longer term securities to meet the government's funding needs. This would represent a departure from the current Treasury practice which has favored the issuance of Treasury bills. A marked increase in the supply of duration could further pressure long term rates, in our view.

U.S. Treasury average maturity

Source: Bloomberg

If an acceleration of a pro-growth agenda and an increased supply of longer maturity Treasuries are potential catalysts for higher Treasury rates, what would then constitute a retracement in benchmark rates towards their post-Brexit lows? In short, we view it very much as the usual suspects. For starters, given our view that certain underpinnings to central tendencies remain softer than we would like to see, if U.S. benchmark interest rates rise too quickly, and the U.S. dollar strengthens too aggressively, they risk getting ahead of potential stimulus effects which would threaten U.S. growth. Make no mistake, the expectations for tax reform and regulatory relief are quite high. Following the Brexit experience, investors will monitor closely the election results in Europe including France (April), Netherlands (March) and Germany (October). Unexpected outcomes and a general distrust of polling data could concentrate pockets of volatility around such periods. Lastly, geopolitical risk remains high, and potentially has become somewhat underappreciated yet again. Furthermore, a number of the nations involved are deeply influential to a number of risk factors. We are principally concerned about the continued entanglement and contradictory policies between the U.S. and Russia concerning our joint involvement in Syria. Additionally, tensions regarding the South China Sea and the subsequent militarization of the area carry with them significant implications for not just global tensions but also trade.

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Sector and positioning outlook

Rates: While Treasury yields have increased substantially from their post-Brexit lows (e.g., the 10 year U.S. Treasury is 120 basis points above its July 1, 2016, close of 1.36%) benchmark yields remain meaningfully below their 2013 taper tantrum highs. By comparison, certain measures of inflation expectations have increased to a point that we feel are not reflected in market interest rates. Balancing our views on the potential for accelerated fiscal policy implementation and a Fed that will still err on the side of caution when it comes to further rate increases, we are comfortable entering 2017 carrying a below benchmark duration for most of our strategies. Similarly, we steadily softened our barbell yield curve positioning throughout the year. While the yield curve has generally flattened during a Fed tightening cycle, the U.S. Treasury 2 year/30 year curve does not seem meaningfully steep to warrant extending at this time.

10 year U.S. Treasury vs. German bund yield spread

Source: Bloomberg

It is important to stress that even though our general outlook is that benchmark yields, on balance, may rise further, we are far from calling for a runaway U.S. interest rate market. For instance, we anticipate that volatility will resurface around the elections in Europe. Furthermore, the health of the European banking system continues to be a concern as there are now reports that Italian banks may require as much as 52 billion euro ($54 billion) in order to sure up their capital ratios. For this reason, we expect key sovereign bond spreads, such as that between the 2 year German Bund and the U.S. Treasury, will likely remain near their all-time wide. Our rational being that the growth prospects for the U.S. remain on firmer footing while any potential backslides in U.S. inflation appear unlikely. Furthermore, we do not foresee any significant changes to the European Central Bank's current level of policy accommodation during the course of these political referendums. Accordingly, the substitution effect caused by yield starved investors turning to global interest rate markets will likely persist throughout 2017.

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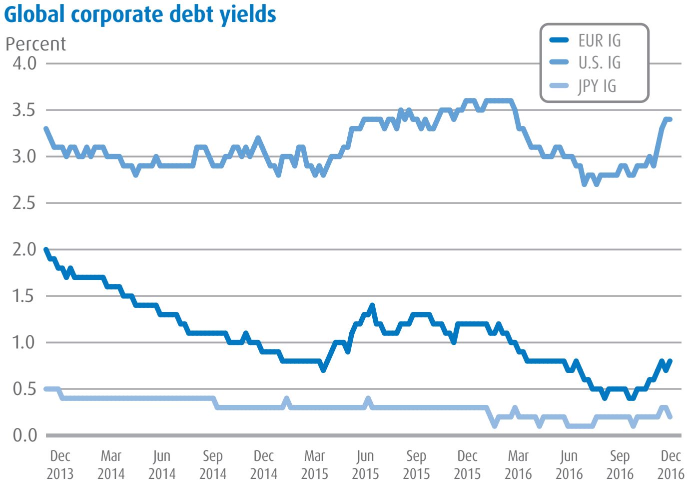
Credit: At this time last year, the option-adjust spread (OAS) for the Barclays U.S. Credit Index was 155 basis points (bp), having widened steadily throughout 2015. By comparison to other fixed income sectors, U.S. credit offered the best relative value heading into 2016, in our opinion. Our conviction was tested initially as spreads widened significantly on concerns that the global growth conundrum may seep into the U.S. and potentially spoil our expansion, a view we did not share, and instead, viewed this as an opportunity to locate sectors and issuers where any potential degradation in the U.S. growth outlook was being overpriced into credit spreads. We were rewarded for doing so as credit in general performed very well throughout the subsequent quarters of 2016 with the OAS tightening to 118 bp as of this writing. As the recovery in credit markets gained momentum, we opportunistically reduced credit risk and generally lowered our overall spread duration.

Turning to 2017, in our view, compelling relative value opportunities are still present throughout credit markets despite the significant tightening in broad/index level spread measures. Perhaps due to the general increase in spread volatility over the last decade, our analysis consistently shows that for a number of issuers, the relative value between their securities remain mispriced compared to their underlying risks and this is the area where we are focusing within credit.

Along the lines of our comments on the sovereign interest rate substitution effect, the yield differential between U.S. corporate bonds and those issued globally is equally compelling. Accordingly, we anticipate that interest in U.S. credit from overseas will persist in 2017 and be supportive of corporate bond spreads. On balance, we remain constructive on credit and will continue our focus on bottom-up relative value opportunities where we view dispersions in credit spreads, or spread curves to be mispriced.

Global corporate debt yields



Sources: Bloomberg, TCH

Within beta sectors of credit, high yield markets have also seen a significant rally throughout 2016 as the OAS for the Barclays U.S. High Yield Index narrowed from over 800 basis points to 400. Accordingly, as the U.S. economic expansion continues, we favor a more selective approach which complements our exposures within investment grade as opposed to broad high yield exposure. We are particularly cautious on issuers for which current valuations do not reflect what we view as heightened exposure to late business cycle risks within the domestic economy, or geopolitical concerns globally. Emerging market debt (EMD) faces higher uncertainty in the wake of the U.S. election though the subsequent pullback in EMD spreads kept valuations at attractive levels for yield-seeking investors. Positively, emerging market fundamentals have shown continued improvement with declining default rates and commodity price recovery. As a result, emerging market growth in 2017 is expected to rise to the highest level since 2014, easily outpacing developed markets.

Mortgages: U.S. agency mortgage backed securities (MBS) have played an important role in our positioning the past few years. We have found the high quality and liquid nature of these securities to be an important diversifier in markets where credit spread volatility and liquidity conditions would ebb and flow. Throughout 2016, we emphasized the use of large cohort pools as a means of rebalancing the overall risk characteristics of certain strategies. For instance, as credit spreads tightened, and the opportunity set within high quality credit narrowed, we viewed the sector rotation into MBS as the appropriate relative value trade; however, later in the year, spikes in volatility and benchmark interest rates caused MBS to underperform as the OAS for said securities widened on fears that the expected average life for existing MBS pools would extend. In our view, following their underperformance toward the end of the year, MBS pools have priced in our base case for interest rates; however, given that we expect additional spikes in volatility, we do not anticipate a significant change in our holdings within this sector to begin the year. Importantly for our existing positions, we do not foresee any changes to the Fed's reinvestment schedule over the near-term; we anticipate the central bank will continue absorbing a large portion of net new issuance. In our view, this lends a significant amount of support to the sector despite these concerns.

Conclusions

On balance, as we head into 2017, we remain encouraged about the opportunities within U.S. fixed income. To be sure, we are likely heading into a year of transition, whereby both monetary and fiscal policy are likely to evolve concurrently. Accordingly, we do expect some bouts of volatility, and perhaps further pressure on U.S. interest rates, history has proven that this asset class has a propensity to bounce back. Most importantly, however, we do not view the evolution on either front negatively, and are prepared to greet any potential bumps over the short-term as an opportunity to generate alpha over the long.

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

Keep in mind that as interest rates rise, prices for bonds with fixed interest rates may fall. This may have an adverse effect on a portfolio.

Foreign investing involves special risks due to factors such as increased volatility, currency fluctuation and political uncertainties. High yield bond funds may have higher yields and are subject to greater credit, market and interest rate risk than higher-rated fixed-income securities. Keep in mind that as interest rates rise, prices for bonds with fixed interest rates may fall. This may have an adverse effect on a Fund's portfolio.

Investments cannot be made in an index.

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