McDONNELL INVESTMENT MANAGEMENT

Fixed Income Market Commentary ✧ April 2015

Market Overview

Ripple effects from last year's plunge in energy prices continued to roll through fixed income markets as a fresh dose of rate volatility induced markets to chop sideways before ending the quarter mostly higher. Dominating returns was a ratcheting lower of inflation expectations brought about by the collapse in energy prices as well as a broad selloff across most commodity markets worldwide. It is important to note that the commodity selloff is closely interrelated to dollar strength. A reversal from a 2-year low in the dollar preceded the energy collapse by two full months, and intermarket moves became increasingly inversely correlated as they gained momentum. As evidence of the stark impact of these moves, headline inflation rates have moved to zero across the US, the Eurozone and the UK. Central bankers are concerned that highly levered regional economies are treading dangerously close to deflation, and policymakers are desperate to avoid self-reinforcing downward economic pressures should deflationary forces take hold. Debt burdens become more onerous and difficult to service in an economic environment beset by deflation. The most recent example is Japan which has been trying to escape the clutches of deflation for nearly two decades during which time its Debt/GDP ratio has risen from the low 80's to more than 225% of GDP currently.

- Domestic bond markets traded mostly higher in volatile trade as sentiment swings reflected expectations of a Fed rate rise amid declining inflation expectations.
- The dollar continued to rally against most major market currencies in anticipation of a directional change in monetary policy.
- The European Central Bank (ECB) announced an expanded asset purchase program designed to help counter deflationary pressures and disappointing economic activity across the Eurozone. ECB Quantitative Easing is expected to reach €1.1T and last at least until September 2016.
- Harsh weather and a significantly stronger dollar combined to restrain US economic growth during the quarter, although underlying fundamentals appear sound.

The pace of US growth likely slowed during the first quarter as severe weather and a surging dollar combined to dampen economic momentum. Fundamentals appear sound, however, as the recovery advances toward embarking on year 7 by the end of this quarter. The labor market continues to heal and the topline unemployment rate fell to 5.5% from 6.6% one year prior. This overstates the recovery in the employment picture, however, as part of the reason that headline unemployment has fallen sharply has been a steadily declining Labor Force Participation Rate which dropped to the lowest reading since 1977. While it is likely that the declining participation trend is being influenced by both economic and non-economic factors, it has nevertheless a depressive impact on economic growth as idled potential workers fail to participate fully in the production and consumption of economic resources. While the total number of employed workers now exceeds the pre-recession high by 3MM, the total number of full-time employed workers is still 850K short of the previous record. An expansion of part-time employment in all likelihood is helping to restrain wage growth at the margin.

Central bank policymakers have been at the helm in guiding the course of the recovery both here and abroad, as fiscal policies have largely acted as a drag on growth for much of the past four years. As such, central bank actions loom large across markets as the anticipated policy divergences begin to evolve. Monetary accommodation is being expanded in Japan, the Eurozone, China, Canada and other countries as efforts to combat weak growth and dangerously low inflation take hold. The Federal Reserve is facing a different challenge as it contemplates moving from its zero lower-bound interest rate policy, which has been in place since December of 2008, toward something modestly higher. Based on its March 2015 policy statement, the Fed is communicating that it anticipates moving rates, "when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term." Market prices are reflective of investor expectations of a modest boost in the Federal Funds Rate target toward the latter part of the year. It is also worth noting that Fed officials highlighted concerns about the dampening impact of recent dollar strength on growth and inflation. Finally, we believe that any moves toward policy 'normalization' will be aimed at gradually reducing the pace of monetary accommodation as distinct from a move toward tightening monetary conditions. The Fed will likely be keen to provide enough room for the recovery to continue moving forward as the healing process from the Great Recession is far from complete.

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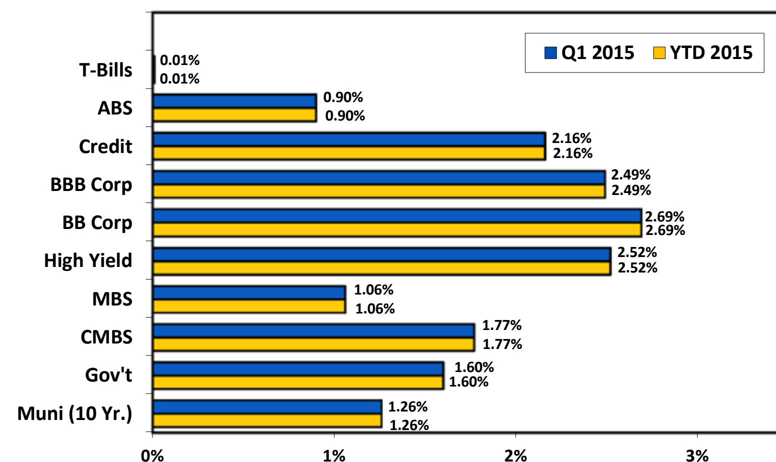

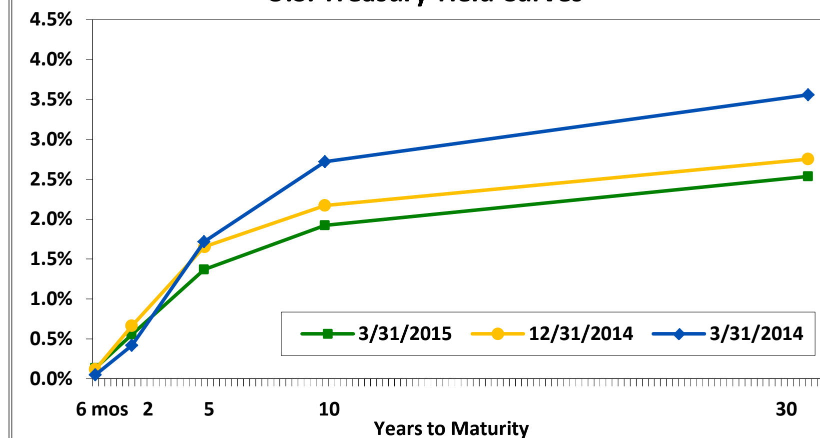

All indices shown reflect Barclays Indices, except where noted.
*Sources: Barclays; *Merrill Lynch; Bloomberg; Federal Reserve.*
Please refer to the Notes and Disclosures on the reverse side for additional information.

Guiding Portfolio Strategies

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Taxable Market Overview

The Treasury market rallied and the yield curve shifted with the largest declines in yields occurring in the intermediate portion of the curve. Curve performance was influenced by changing investor expectations for Federal Reserve interest rate policy changes. Consensus expectations had begun to center around a mid-year boost in rates, but the March Policy Statement reflected heightened concerns about low inflation, and Fed Chair Janet Yellen subsequently noted the dampening effect on inflation that continued dollar strength was likely to exert over the near-term. These statements, combined with a downward revision of growth and inflation forecasts from the Fed, caused market participants to push back the likely start date of any rate policy implementation toward later in the year rather than sooner.

Negative sovereign rates in Europe continue to exert an influence on the US bond market as rate differentials are at or near record highs versus major European countries. The combination of higher US rates and an appreciating dollar continue to be supportive factors. The ECB's €1.1T Bond Purchase Program will wield a heavy influence on Eurozone Sovereign Rates which are negative out to 5 years for many stronger issuers, and negative out to 7 years for the strongest sovereign issuers. Whether US rates can break free from this low rate orbit, and whether such an event could occur without creating major fissures across the capital market landscape, remain front burner issues going forward.

Spread markets were mixed during the quarter with strong nominal returns across the spectrum and generally strong relative returns for Intermediate Credit and the CMBS and ABS sectors. The Mortgage-Backed sector generated positive returns but failed to keep pace with sharply rallying Treasuries.

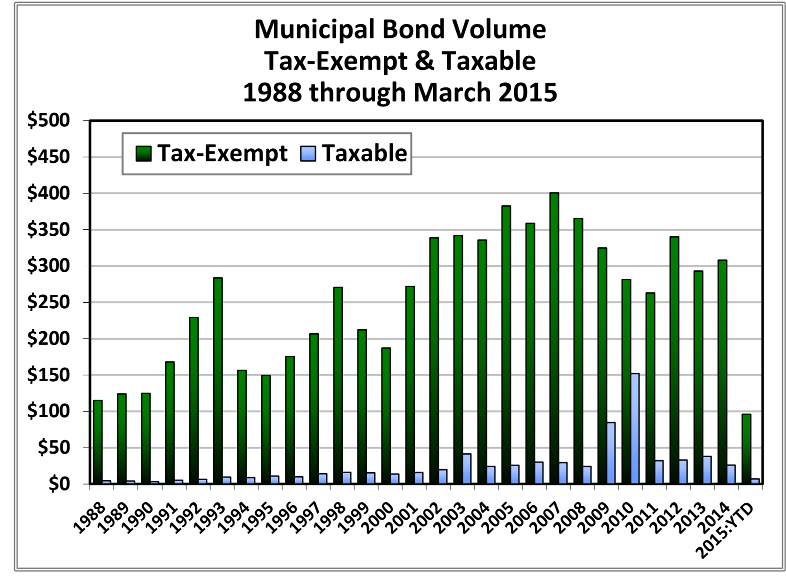
- The Treasury curve rallied and flattened in volatile trade as investor sentiment was buffeted by collapsing headline inflation amid expectations of the first boost in Fed interest rate policy in more than 6 years.
- Credit performance was positive, particularly in the intermediate sector of the market.
- Valuations in Energy Sector credits recovered strongly as the steep decline in oil prices stabilized somewhat.
- Corporate issuance continued at a blistering pace as issuers tapped both the US and increasingly the European market where ultra-low yields and narrower credit spreads afforded unparalleled opportunity to lock down borrowing costs.

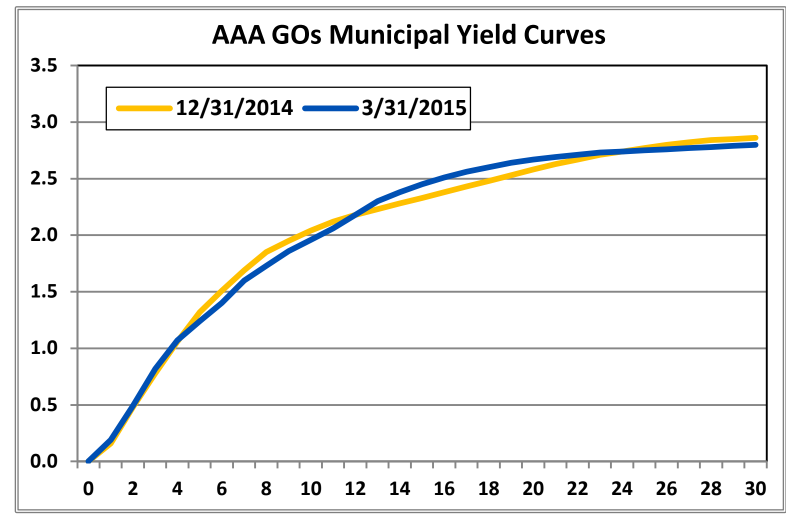
Municipal Market Overview

The municipal market produced positive nominal returns across the maturity spectrum but underperformed Treasuries for the second consecutive quarter. Relative performance was strongly impacted by surging new issue volume which ran nearly 60% ahead of last year's slow pace. The sharp increase in volume was driven entirely on the back of a wave of Refunding Issuance which began building late last year as rates continued to fall. Demand remained healthy as municipal mutual funds registered their 5th consecutive quarter of positive flows. Demand from Commercial Bank Portfolios also featured prominently in the new issue market. Credit spreads continued to contract; reflective of continued improvement of credit fundamentals as the economic recovery continues apace as well as 'reach for yield' behavior on the part of investors stretching for incremental income. This warrants a cautionary note as the desire for incremental yield can result in a rising tide lifting the value of undeserving credits alongside those more fundamentally sound. Finally, pension and healthcare liability underfunding is increasingly in the headlines. Isolated spread-widening is starting to impact some states and cities that have been serial 'under-funders' for some time running. This bears close attention as a potential bellwether for broader valuation developments going forward.

- Municipals registered modest gains across much of the curve with the exception of the 12-20 year area where yields rose slightly in response to heavy new issuance.
- Municipals underperformed Treasuries for the second consecutive quarter leaving valuations relatively attractive by historical ranges across the yield curve.
- Credit performance was positive in the municipal market with lower quality credit registering the strongest relative performance.
- New issue municipal supply ran nearly 60% ahead of last year's pace with Refunding Issuance accounting for all of the increase.

Municipal valuations versus Treasuries remain attractive, particularly across the longer-end of the intermediate curve, while U.S. yields, in general, are historically attractive relative to other major sovereign issuers.





Notes and Disclosures:
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Sources: The Bond Buyer; Municipal Market Data; Thomson Reuters

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