McDonnell Investment Management

Fixed Income Market Commentary ✧ January 2015

Market Overview

Crude oil staged a stunning collapse, declining by more than 40% in the fourth quarter alone, capping a year of broad based commodity price weakness. This represented only one of four strong, interrelated trends that occurred during the second half that greatly influenced fixed-income returns in 2014 and set the stage for the capital markets in 2015.

- U.S. bond market rallied impressively across most maturities and the yield curve flattened sharply.
- Broad based selloff in commodity prices led by a stunning decline in crude oil and related energy market prices.
- Longer-term inflation expectations ratcheted lower as investors reacted to near deflationary conditions in the Eurozone and renewed recession in Japan.
- The dollar moved higher against all major market currencies in anticipation of a directional change in monetary policy.

Underlying the dynamics of these relationships has been the divergence of economic growth between the United States and the rest of the world. Global growth has been decelerating while U.S. economic growth strengthened, laying the groundwork for divergence not only of economic performance but of central bank policy as we move forward. This dominant trend drove asset market returns in 2014 and may well play a key role in market development in the year ahead, as we are perhaps approaching a policy inflection point whereby the U.S. raises rates while other major central banks ease policy. The U.S. dollar, as the major reserve currency in global finance, occupies an outsized role not only in trade, but also in capital market valuations and returns. The likely difference of monetary policy regimes has put significant upward pressure on the dollar versus nearly all other currencies. The rapidly strengthening dollar places the capital markets at a potential crossroads as investor behavior resolves whether the expansion of currency volatility will ultimately serve as the transmission mechanism for injecting greater volatility across the 'risk' market spectrum. To date, the impact has been felt in the energy and commodity markets. In turn, commodity price weakness has negatively impacted many emerging market currencies. The dynamics of these interrelationships have intensified in recent years as widespread monetary accommodation has been extraordinarily supportive of the capital markets broadly and 'risk' markets specifically. Whether global markets have fully discounted diverging monetary policy objectives or whether these trends have further room to run will be critical to market evolution going forward.

The outlook for the domestic economy remains sound in our view. The recovery, now in its sixth year, appears to be strengthening as employment growth improves while inflation remains quiescent. A reduction in fiscal drag at the Federal as well as the State and Local levels, is helping to bolster prospects for the year ahead. The headline unemployment rate has improved dramatically in recent months, but closer readings of the health of the labor market indicate that all is far from well. The total number of full-time workers remains nearly 2 million workers below the pre-recession peak. Further, the broader reading of 'underemployment' rests uncomfortably high at more than 11%. Elevated numbers of part-time workers are likely a contributing factor to relatively weak wage growth overall. Against this backdrop, market prices currently reflect a consensus expectation that the Federal Reserve will engineer a modest change in monetary policy by boosting short-term interest rates around mid-year. We believe that the Fed will seek to move off the zero lower bound rate policy at some point over the coming year, but with inflation decelerating and global growth slowing, the anticipated hike in short-term rates could prove to be more of a 'token' move rather than a sustained march higher in rates as the year unfolds. The outlook for the longer-end of the U.S. bond market continues to look relatively benign amid a low-rate, low inflation global backdrop.

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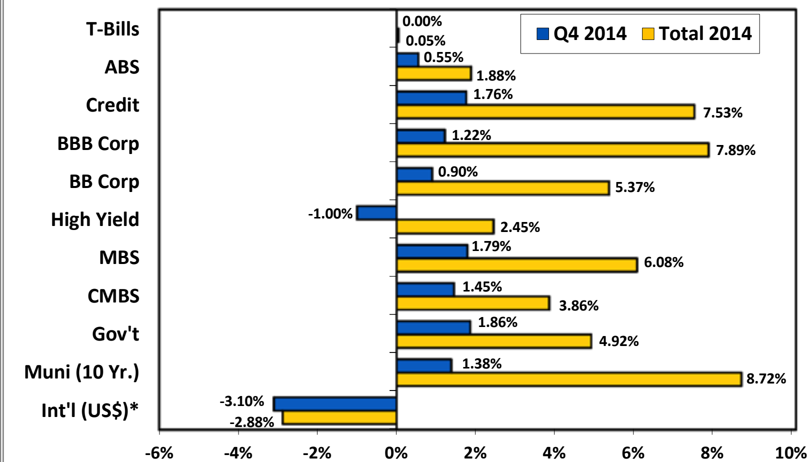

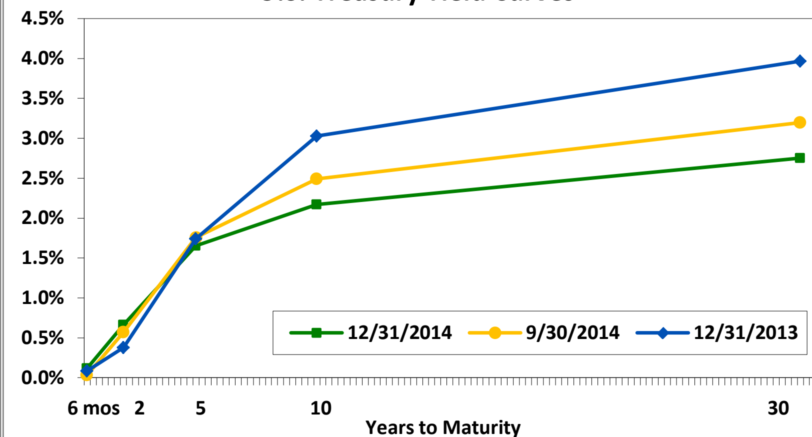

All indices shown reflect Barclays Indices, except where noted.
*Sources: Barclays; *Merrill Lynch; Bloomberg; Federal Reserve.*
Please refer to the Notes and Disclosures on the reverse side for additional information.

Guiding Portfolio Strategies

McDonnell Investment Management, LLC

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Taxable Market Overview

Treasury yields moved lower across most of the curve and the yield curve flattened sharply. The trend in yields during the quarter was reflective of market behavior throughout the past year, during which time the domestic markets rallied strongly beyond 5 years and yield curves flattened. Market activity was heavily influenced by liquidation in the crude oil market and a steady march lower in sovereign rates in the Eurozone and Japan. Low sovereign yields had served as an anchor tethering U.S. rates from rising despite a strengthening U.S. economy. However, the spreading deflationary environment in Europe and elsewhere turned the anchor into a millstone threatening to drag U.S. yields even lower as a dramatic shift in the global rate structure settled even lower. The collapse in crude oil prices negatively impacted credit during the quarter as energy-related credits dragged spreads wider across the corporate market. Most segments of the credit sector produced negative excess returns for the full year as well, with the exception of the High Yield and Intermediate Credit sectors which held on to some of their gains from earlier in the year. Structured Product fared better and was neutral to positive for the quarter, producing positive excess returns for the full year.

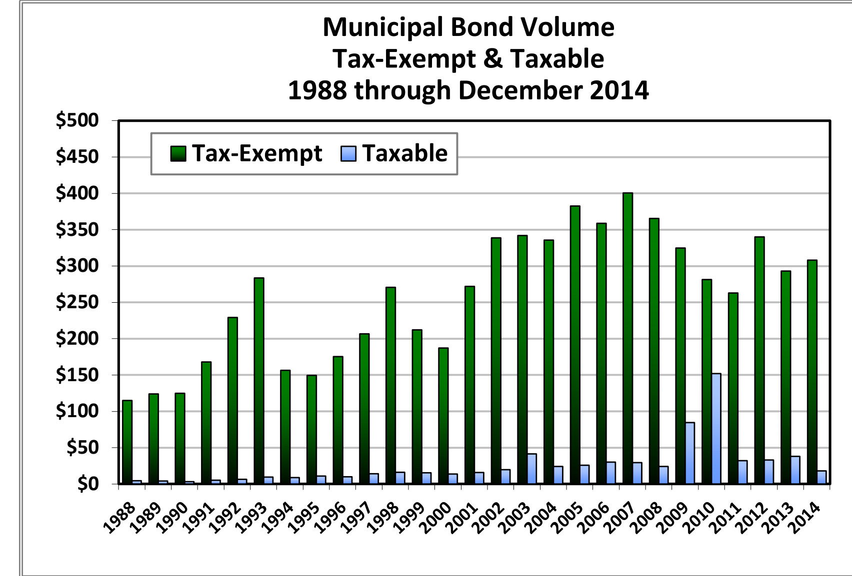
- The Treasury curve flattened sharply amid stronger domestic growth combined with falling inflation expectations as the collapse in crude oil prices continued unabated.
- Credit performance was bifurcated for the year as intermediate credit outperformed on a relative basis while longer credit underperformed as the Treasury curve flattened.
- U.S. Treasury Inflation Protected Securities (TIPS) underperformed similar duration nominal Treasuries as inflation expectations ratcheted lower in response to falling energy prices.
- Credit is the only major sector that experienced strong issuance, finishing the year with a record $1.46T in total issuance.

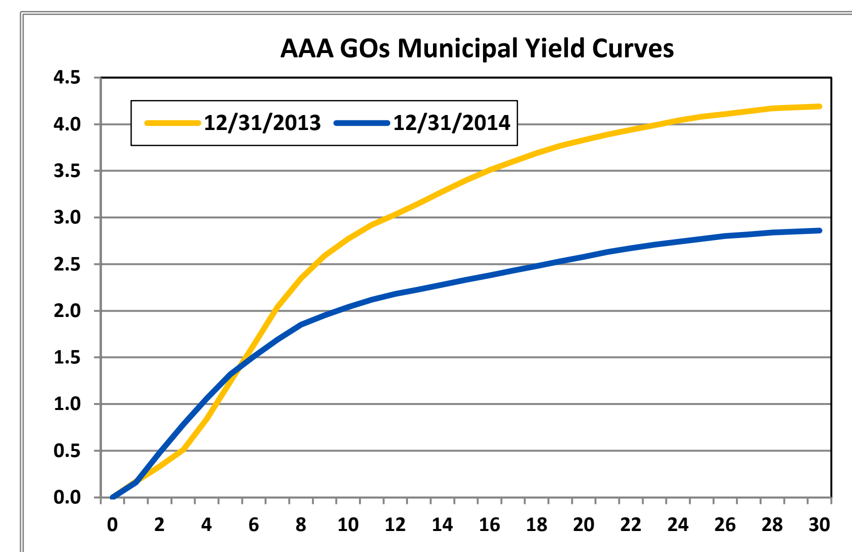
Municipal Market Overview

The municipal market finished both the quarter and the year with strong gains across much of the yield curve, while rates 5 years and shorter rose modestly. The pivoting of the yield curve last year resulted in a significant flattening with the spread between 2-year and 30-year AAA municipals narrowing by nearly 150 basis points. On the supply front, new issue volume staged a stealthy recovery as the second half progressed. After a steep drop in issuance at the beginning of the year, an increase in Refunding Issuance during the second half brought new issue volume totals back to even versus last year's pace. Going forward, we expect an uptick in volume this year, aided by a continuation of higher Refunding Issuance. Demand remained remarkably consistent throughout most of the past year. Mutual fund flows were positive with nearly $28B of net inflows (following $60B in outflows in the previous year.) The credit quality of most state and local issuers continues to gradually improve, as the economic recovery bolsters tax receipts and helps improve property valuations. Longer-term challenges surrounding pension and healthcare funding remain a credit concern.

- The municipal yield curve flattened sharply as strong demand and declining inflation expectations helped drive longer-term yields lower.
- Intermediate municipals modestly underperformed Treasuries and municipal quality spreads tightened.
- New issue volume recovered during the second half to finish even versus last year's pace.
- Mutual fund flows into the municipal market were consistently positive throughout the past year.

Municipal valuations versus Treasuries remain relatively 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.





Sources: The Bond Buyer; Municipal Market Data; Thomson Reuters

Notes and Disclosures:
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