Quarterly Commentary 1Q17: Bond Bulls in China Shops

As the Trump administration comes upon the sunset of its first 100 days in office, the bond bulls, once put out to pasture, have renewed reasons for optimism. Recent macro events, including disappointing employment figures, reduced GDP expectations, the Syrian missile strike, rising tensions with North Korea, and softening Fed language have equity investors facing trepidation that the post-election rally may have been overblown.

Markets perceived the November election results as a potential boom for businesses with lower taxes for individuals and corporations. Expectations which follow such thinking are faster economic growth and increased inflationary pressures, combined with lower tax rates. This, in combination with the potential of heavy new issuance due to an aggressive infrastructure plan, has put increasing pressure on the bond market. With the failure of the attempted Affordable Care Act repeal and replacement, concern has grown that the administration's next focus, tax reform, may too get bogged down in the complexities of the task.

Globally, economic signs have begun to show consistent growth. With the UK triggering Article 50 of the Lisbon Treaty, the two year Brexit countdown signifying the UK's exit from the European Union, has commenced. While this is not unexpected, it does shine some light on France's upcoming elections. A nationalization fever, which was also present prior to the UK's Brexit referendum, is apparent in France as well. In what has become a polarizing election cycle, the potential for far-right or far-left viewpoints to prevail is evident. If the far-right is victorious, the potential for a referendum to exit the EU would not be out of the question. In the event this happens, the EU's viability would come into question. Subsequently, a spike in the US dollar would seem likely. Such events could prove damaging to US exports.

Tensions abroad have given the bulls even further room for exuberance. While the Trump administration's response to the Syrian use of chemical weapons was widely applauded, it brought up the uncertainty surrounding the US stance on Syria. Russia and North Korea's strong rhetoric has also brought international relations to the forefront. While Trump has changed his stance on the usefulness of NATO, and seems to be painting a picture of China having a role in dealing with North Korea, a clear international policy stance may quell some of the uncertainty.

Resiliency is the best term to describe the municipal market during the first quarter. Municipals limped into the end of 2016 due, in part, to the surprising election results. With promises of lower taxes, heavy infrastructure spending and the potential reexamination of the tax-exemption of municipal bonds, the market reacted harshly. Lower demand equates to higher borrowing costs for municipalities; and, could serve to place fiscal strain on localities which are finally experiencing revenues surpassing 2008 pre-recessionary levels. The prospects of lower taxes for corporations could weigh on the muni market as well. Over the past seven years banks and insurance companies have been the largest purchasers of municipal bonds. If corporate tax rates are significantly reduced, the demand for municipals may wane.

Municipals exhibited strength in the first quarter as a prolonged January effect pushed municipal rates lower on the front end of the yield curve. Taxable bonds outperformed in longer dated maturities as tax-exempt buyers focused on shorter dated maturities. Overall municipals outperformed their taxable equivalents as a municipal supply/demand imbalance aided in the outperformance. From a quality standpoint, AA rated municipals slightly outperformed their AAA rated counterparts. With the outperformance, relative value between municipals and US Treasuries has contracted again. Ratios on the short end of the yield curve are now trending around historical norms while longer dated issues continue to reflect ratios in excess of 100 percent.

US Treasury Yields			
	12/31/2016	3/31/2017	Change
1 Year	0.84	1.02	18 bps
3 Year	1.52	1.57	5 bps
5 Year	1.96	1.94	-2 bps
10 Year	2.51	2.45	-6 bps
20 Year	2.86	2.83	-3 bps
AAA Municipal Yields			
	12/31/2016	3/31/2017	Change
1 Year	1.00	0.85	-15 bps
3 Year	1.43	1.22	-21 bps
5 Year	1.80	1.58	-22 bps
10 Year	2.35	2.26	-9 bps
20 Year	2.88	2.93	5 bps

The bond bulls have found reason to come in from the pasture as macro developments have given the equity markets reason for pause. These events, coupled with dwarfed municipal issuance, have once again pushed municipal rates lower. With ever growing concerns that the gridlock in Washington may hamper the Trump administration's capacity to push through their agenda, the bulls may continue to dance for the time being. Given the fragile nature of the global outlook, even the bulls understand that if you break it, you buy it.

All the best,

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