Quarterly Commentary

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First Quarter 2017

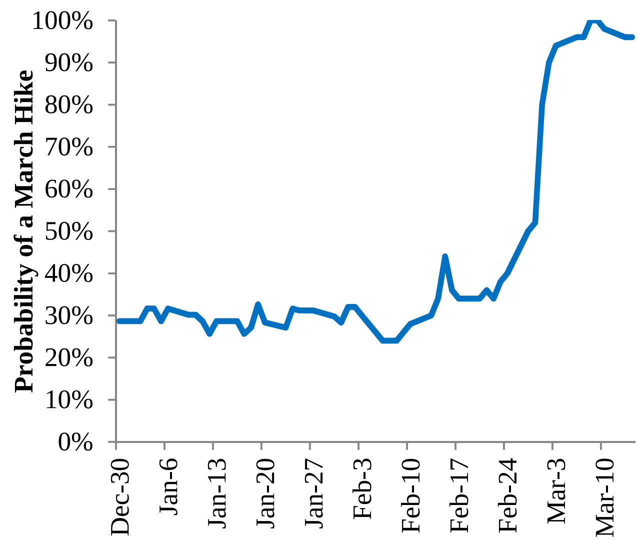
After a fairly tumultuous fourth quarter, bond yields hardly budged in the first quarter of 2017. On the surface one might think not much happened, and that is true except for President Trump taking office, the Fed raising interest rates in rushed fashion, the UK giving formal notice of its exit from the European Union, and equities rallying strongly in the face of rising consumer and business optimism. As a result of relatively stable yields, total return as measured by the Bloomberg Barclays US Aggregate Bond Index was a respectable 0.82%, mainly driven by income.

The simple message

Tongue-in-cheek aside, the first quarter was relatively uneventful in economic terms but for the quick follow-up to December's rate hike. Even in late February, the market was not expecting a Fed rate hike in March, but a quick series of Fed interviews served notice to the market that a hike was imminent and it came about on March 15. During Yellen's post-meeting press conference, she stated that "the simple message is the economy is doing well." While that is true, real-time economic activity proved less robust than feared (bond investors tend to fear good economic news for the inflation that typically accompanies it) during the quarter even though the sentiment indices* continue to display multi-year high readings. Indeed, most economists now expect first quarter GDP to be on the low end, perhaps around 1.5%, in similar fashion to the last several years and for no apparent reason. This may have been why the Fed decided to rush into the next tightening move, ahead of the weak GDP report, in order get ahead of any excuses not to raise rates.

The labor market remains in solid shape and consumers have the means to increase spending, but they continue to exhibit restraint when it comes to debt-financed spending. Real personal consumption was down in both January and February, although much of this was due to warm weather and weak utility spending. In fairness, much of the weakness in the first quarter is likely due to some of the same factors that have stymied GDP for the last few years --- weakness in government spending (~70% is state and local, the remainder is federal) and business investment spending.

Exhibit 1: The market was not expecting a March rate hike until a number of Fed interviews in late February



Source: Bloomberg

Checks and balances may limit Trump's agenda

A great many words have been written about politics since the election, but the big story affecting the bond market that emerged this quarter is that President Trump apparently will not get everything he wants even with a Republican-controlled Congress. If Trump can't dictate the terms of every major policy initiative, then perhaps all the things bond investors feared will not come to fruition (namely, a growing deficit, faster growth and inflation from major tax cuts, infrastructure spending, and less regulation, along with a trade war that could have also ignited inflation). Possibly because of this realization, bond investors have paused in their rush for the exits after the election and interest rates are now once again range-bound. Even the rushed manner in which Fed officials scrambled to raise rates in March did not do any real damage to Treasury yields beyond the one year term. Of course, money market yields did climb a bit but yields on the long end of the curve actually declined this quarter.

Valuations remain stretched

Even though the Fed is now removing monetary accommodation, the markets remain distorted by the massive amount of quantitative easing that has occurred since the Financial Crisis. Bond yields remain quite low by historical standards so investors have clamored to buy spread product, leaving spreads fairly tight across all segments of the market. Equities have also benefited from low rates as investors have sought higher returns, so price-earnings multiples are also on the high end relative to long term averages. All of this leaves us tepid on adding to spread product, particularly as Fed officials are beginning to talk about altering their balance sheet activities later this year or early next (meaning they will stop reinvesting in MBS and Treasuries and may then begin selling). Therefore, we are being very selective while still trying to maintain a yield advantage over the benchmark.

Concluding remarks

Looking ahead, we still believe the economy will grow in the low-mid 2% range this year irrespective of any policy initiatives from the new Administration. The economy is operating at near full employment, energy prices are low, real estate and equity values are at or near record highs, the banking system is healthy, and confidence measures are at very high levels. Monetary policy, although moving toward a tighter stance, remains accommodative and other economies around the world are also performing better. If it weren't for the secular trends of aging demographics, low productivity, and slow growth of the working age population, there might be cause for much greater optimism on growth. Still, there is a positive side to slow growth, namely the lack of major imbalances that tend to build up during economic recoveries, which has already enabled this recovery to continue longer than the average modern-day recovery.

IMPORTANT INFORMATION

*ISM Manufacturing and Non-Manufacturing indices, University of Michigan and Conference Board consumer confidence indices, National Federation of Independent Small Business Optimism Index

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