Quarterly Commentary

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Fourth Quarter 2016

Dramatic changes occurred in the bond market during the fourth quarter as market yields rose sharply following President-elect Trump's victory. This shift occurred as investors contemplated Trump's proposals for expansionary fiscal policy which could produce faster inflation and higher deficits, both anathemas to bond investors. Due to this yield change, bond prices moved lower over the period, leading to a total return for the broad market as measured by the Bloomberg Barclays Aggregate Index of -2.98%.

A new year, a new paradigm

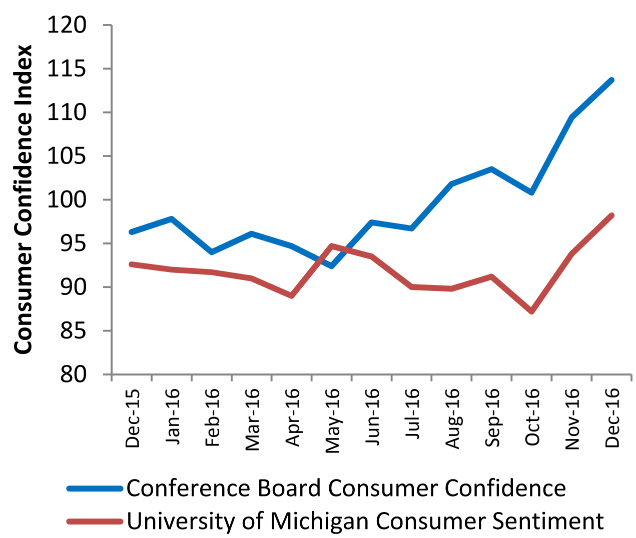
While change is normal when a new Administration takes over, the changes now being considered may constitute a real paradigm shift like no other in recent memory. Part of this owes to Trump's lack of prior political experience while part owes to his pairing with a Congressional majority. Still another element is the voter angst and rising populism that characterized this election, along with numerous other examples around the world such as the Brexit vote, which may result in massive changes to previously sacrosanct policies and norms since Trump has declared nothing off-limits. Some of those changes could include major personal and corporate tax reform, immigration reform, trade policy, and foreign policy, just to name a few. Even if only some of these reforms are achieved, the effects on economic growth, inflation, and fiscal outcomes could be significant.

While the change in yields over the quarter was large, the year-over-year change was much smaller: most points on the yield curve rose by less than 25 basis points, leaving full year total returns in positive territory (income less some price deterioration). Last year was marked by:

- A clear slow-down in the economy partly due to the significant spending cuts in energy and mining, coming on the heels of the first Fed rate hike of this cycle, which caused market yields to fall as the Fed paused its plan to raise the overnight rate further.
- An escalation in quantitative easing by central banks that still feared deflation, which also caused market yields to fall
- Major political change which caused market yields to fall in the case of Brexit but, in the case of Trump's win, now has caused yields to rise

As a result of those developments early in the year and the Brexit vote, yields reached extremely low levels that had never been witnessed by most market participants. Now that real change appears to be looming that could shake the economy out of its doldrums, the market is undergoing a reversal and yields are reverting to more realistic levels.

Exhibit 1: Consumer confidence measures improved after the U.S. election



Source: Conference Board, University of Michigan

Confidence measures are up big

Economic data during the fourth quarter showed a real firming in the manufacturing sector, the segment of the economy that has been the weakest, as well as a clear improvement in both consumer and business sentiment following Trump's election. Other reasons for optimism include a healthy labor market, growing wage gains, low commodity prices, and few signs of any major imbalances in the economy.

On the other hand, there are issues warranting caution, chiefly the somewhat fragile condition of economies in Europe, Japan, and China. In addition, the prospect for major domestic policy change that could affect several key industries such as auto manufacturing and healthcare is another reason for caution. Indeed, a trade war over tariffs could seriously dampen the current level of enthusiasm in the equity market, spark inflation, or disrupt global supply chains, and it could invite a backlash as key foreign holders of US Treasuries dump them in retaliation.

Income and total return results

Figures from the Bloomberg Barclays US Aggregate Bond Index, comparing each sector to duration-equivalent Treasury securities, show that corporate bond performance was positive again this quarter: excess return for the broad credit sector (across the full maturity spectrum) was 188 basis points. The RMBS sector suffered as rising market yields caused duration extension: excess return was - 41 basis points for Agency RMBS. Meanwhile, CMBS and ABS produced modest excess returns of 42 and 2 basis points, respectively.

The above mentioned performance of the corporate bond market leaves us lukewarm about adding to the sector. With valuations stretched and potentially big changes coming for at least some industries, we expect bouts of spread volatility in 2017 and would use those to add exposure in issuers we favor. This opportunistic approach is in line with our tactics over the last several years. For more detail regarding our thoughts on each sector, please see our latest "Perspectives" piece sent in early January.

Closing comments

For all the excitement expressed in equity prices since the election, it is ironic that financial conditions (higher interest rates and a stronger dollar) have tightened due to the bond and currency market reactions, which could act as a brake on economic growth. Both market reactions may have been a bit extreme given the few policy details available, but they are a reminder that markets remain distorted by the policies of the last few years.

Looking ahead, we plan to maintain a long term perspective in our investment process while carefully evaluating the new Administration's policy changes. Thank you for the confidence you place in us and best wishes to you and your families for a healthy, productive new year.