Quarterly Commentary

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Second Quarter 2017

Uncertainty remained the watchword of the markets in the second quarter of 2017. Congress has failed to pass any meaningful legislation during the Trump Administration, and the United Kingdom's path to independence from the European Union became murkier after the latest general election. Fortunately the Federal Reserve's monetary policy position has become clearer, with more detail on balance sheet reduction beginning to emerge, though the timing is still up in the air. This prevailing uncertainty was reflected in the yield curve flattening on the quarter, with six-month rates increasing by 24 basis points while 10-years rallied by 12 basis points. The long-end rally in particular boosted the total return on the Bloomberg Barclays Aggregate Index to 1.45% on the quarter (5.92% annualized).

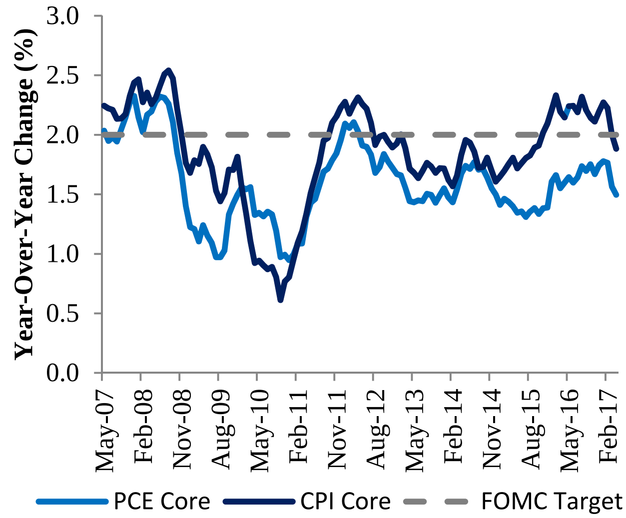
Significant reform has yet to materialize in Washington

More than five months into the Trump Administration, Congress has yet to pass any meaningful legislation on the Republican agenda. Healthcare reform was a clear goal, but after multiple delays we are no closer to determining what the final outcome may be. As we mentioned last quarter, the idea that the President will not get everything he wants from a Republican-controlled Congress, from tax reform to greater infrastructure spending to a border-adjustment tax, has put a damper on inflation expectations and subsequently on long-term interest rates.

International events paint a mixed picture

The election of Emmanuel Macron as President of France over the far-right populist Marine Le Pen was largely viewed as a victory for centrists, and a blow to the populist wave of the past year. Angela Merkel's strong poll numbers in Germany over the left-wing parties is another example of this. One outlying event, however, occurred when UK Prime Minister Theresa May's decision to call an election to increase her majority in Parliament yielded the opposite result, which has led to uncertainty regarding the UK's path to Brexit. We continue to monitor the situation in Europe in relation to our overall view on corporate credit.

Exhibit 1: Measures of core inflation (excludes food and energy) are trending below the Fed's stated inflation target



Source: Bureau of Labor Statistics, Bureau of Economic Analysis

All eyes are still on the Fed

Much like in the first quarter, the biggest non-political news in the fixed income markets involved the Fed raising rates again. The probability of a move by the Fed in June became viewed by the markets as more and more likely throughout the quarter, and came to fruition at the latest meeting. The hike was coupled with the announcement that reinvestment of Treasury and MBS securities which the Fed keeps on its balance sheet would be slowed later this year. The Fed's commitment to this tightening of monetary policy flies in the face of persistently low inflation, with key indicators continuing to show core inflation remains below 2%.

Regardless, the labor market continues to exhibit strength, with unemployment falling to 4.3% in May. Consumer confidence and small business optimism remain high, reflected in the S&P 500 Index moving 2.6% higher on the quarter. GDP growth did come in low (1.4%) in the first quarter, as expected, though consensus is that it will pick up in the second quarter.

Concluding remarks

In spite of the prevailing uncertainty, we believe the fundamental economic picture remains solid, and continue to expect low-to-mid 2% GDP growth in 2017. 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. This has fueled growth in personal consumption which should translate to GDP growth. This environment in turn is conducive to corporate earnings growth. If Washington fails to deliver on most of Trump's promises, there is lower risk of the economy overheating, meaning the Fed would not be pressured to aggressively raise rates. All of these factors make us comfortable with our portfolio position going into the latter half of the year.

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