CONGRESS ASSET
MANAGEMENT COMPANY

Fixed Income Outlook

John Beaver, CFA | Jeffrey R. Porter, CFA

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The past year will be remembered foremost for a divisive Presidential race while other details will be forgotten. Yet those other details influenced more of the year than the results of the election. Surely the first three quarters of the year were the norm while the last quarter was more chaotic. We will briefly look back at 2016 and review the drivers of fixed income performance and then look to the future and examine expectations for 2017.

Monetary policy was divided around the globe in 2016. The Federal Reserve (FOMC) hiked US short term interest rates once, moving its target band from 0.25% - 0.50% to 0.50% - 0.75% late in the year. The European Central Bank (ECB) undertook quantitative easing programs to resuscitate a dormant Eurozone economy. The Bank of Japan embarked on similar programs of buying stock and bond issues in conjunction with monetary actions designed to head off deflation. Both the ECB and Bank of Japan ventured into policies designed to spur spending over savings, policies that include negative interest rates, a most extreme form of monetary policy implementation.

International conflicts in Syria, Iraq, Iran, and Eastern Europe caused investors to seek comfort in US Government guaranteed bonds, pushing the 10-year Treasury yield below 1.50% by mid-year. Yet these clashes have dissipated and the growing strength of the Dollar appears to have slowed additional flows into US securities. Late in the fourth quarter of 2016 longer term interest rates rose erratically, pressured higher by both the US election results as well as the FOMC action in December. The 10-year US Treasury note began the year at 2.27% and ended the year at 2.44%. This year over year change masks an intra-year high of 2.61%, reflecting the quixotic nature of the Treasury market at the tail end of the calendar year.

It was a banner year for Corporate bond issuance in 2016. New investment grade bond sales hit an all-time high as Corporate borrowers sought to take advantage of cheap funding. The total funds raised was around $1.3 trillion, about $22 billion over the amount raised in 2015. At the same time the risk premiums on investment grade Corporate bonds began the year at 1.55% and ended the year at 1.18%, reflecting confidence in the ability of issuers to repay their debts. The risk premium is the yield required by investors to compensate them for default risk or non-payment of interest, where lower values indicate less risk while higher values indicate a higher risk.

Performance drivers in 2016 for fixed income investors started and ended with Corporate bonds. Corporate issues easily outperformed comparable maturity US Treasury and US Agency bonds by a factor of over 3 times. Despite record issuance levels, investor demand for these bonds propelled them all the way through the year, including the more tumultuous fourth quarter. Treasury and Agency bonds did post positive returns for the year but lagged as the yield curve rose and steepened in the fourth quarter, muting their calendar year performance. We continue to believe that Corporate bonds offer better value than Treasuries and Agencies, yet we remain enamored with the liquidity profile of US Government guaranteed issuers.

What will the bond market do in 2017? It would be easy to blurt out that will it "be a bloodbath" or we will face "nuclear winter" in the coming year as interest rates rise. In fact this is complete nonsense, a fabrication emanating from media hyperbole and a misunderstanding of the fixed income marketplace. Bear with us as we examine some primary faults of such inflammatory statements.

First, one can expect bonds to react differently depending on which part of the yield curve rises (e.g., the short, middle, or long areas). For example, rising interest rates have a larger impact on longer maturity bonds than short maturity bonds. To say that rates are headed higher, one must be more specific about which maturities will be impacted rather than making a sweeping forecast. And speaking of forecasts, anyone claiming to accurately predict the future path of interest rates is either a liar or the wealthiest person on the planet. Future yields are notoriously difficult to forecast on a short term basis, much less over the long run. Even the "experts" on the FOMC are repeatedly incorrect.

Second, most media outlets speak as though there is only one bond market or that all bonds are the same. At the risk of over emphasis, this is clearly not the case. There are multiple markets and sub markets within the world of fixed income. Many of these markets are not directly comparable as their behaviors deviate strongly when put under stress. For example, a US Treasury bond is markedly different than an investment grade Corporate bond, which is different than a below investment grade Corporate bond. Even from these examples it is another far leap to other more risky sectors such as Leveraged Loans, Emerging Market Debt, or non-Dollar denominated bonds.

These differences in interest rate sensitivities and market dynamics will ultimately play into valuation as market events arise. Higher quality, intermediate maturity bonds will be less volatile than Junk bonds primarily due to better liquidity found in the investment grade space. As a reference US Treasury bonds constitute one of the most liquid markets in the world, if not the

most liquid over all. Attempts to cast the entire fixed income market as one cohesive unit is disingenuous and dangerous for investors.

Looking ahead, we expect the markets in 2017 to be similar to those of 2016. We see little inflation and thus no quantitative driver for the Fed to raise rates. Unless there are exogenous impacts or geo-political events, we do not see yields trending upwards with any momentum. While a stronger US Dollar may curb international investors from pushing down rates, we do not see a standout economic impetus that would vault the US to greater levels of inflation in the near term.

The markets are pricing in several FOMC rate hikes for the year, however this was also the presumptive case heading into 2016. The last two calendar years have witnessed one rake hike each year due to ambiguous economic data points. We expect once again for the Fed to be cautious around future near-term hikes as they lack demonstrable data that inflation is on the rise. As in the past the FOMC projections show expected inflation, yet we are skeptical that these forecasts will come to fruition.

In closing, we continue to urge our clients to maintain a fixed income portfolio that is based on high-quality bonds. A long term allocation to this strategy should serve as the base on which to build investments into riskier assets. Maintaining a long term strategy that begins with building block allocations is critical for liquidity and safety of principal throughout the investment cycle.

We wish all a happy and prosperous New Year.