CONGRESS ASSET MANAGEMENT COMPANY

Fixed Income Outlook

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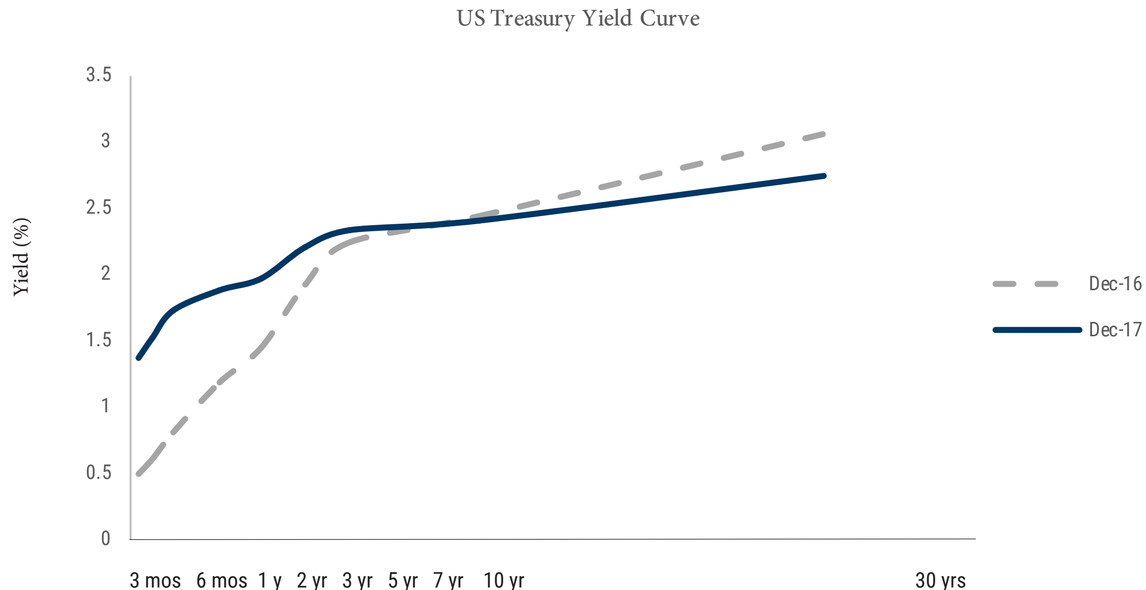
Market participants who were expecting higher yields in 2017 were disappointed. The 10-year U.S. Treasury note yield remarkably remained unchanged over the year despite modest but encouraging economic growth. Inflation has not kept pace with growth, fueling uncertainty within the marketplace. In spite of low inflation readings, the Federal Open Market Committee (FOMC) has repeatedly increased short term rates as their expectations of future inflation have risen. These conflicting paths of measured inflation and forecast expectations are one of the main explanations for the change in shape of the yield curve – flatter but not higher.



Source: Bloomberg Barclays

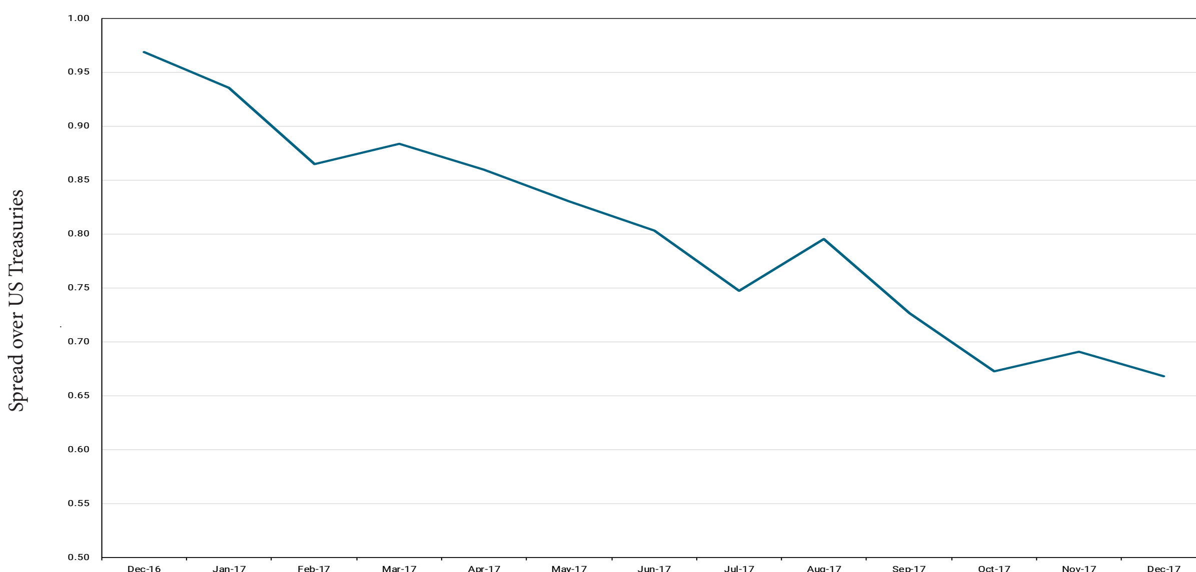
The performance of the domestic economy in 2017 was far from robust but was reasonably well paced. For example, GDP growth accelerated as the year progressed with the third quarter peaking at 3.2% (fourth quarter data is not expected until early 2018). Similarly, unemployment has been grinding steadily lower and ended the year at just 4.1% compared to 4.7% at year-end 2016. Strangely, inflation has been minimal and actually decelerated over the year, with the Core Personal Consumption Expenditure deflator moving from 1.9% to 1.5% by the November month end. Overall, it was a firm but not spectacular year for the economy.

The FOMC increased short-term interest rates three times over the course of the year without tangible evidence of inflation. Instead the Fed acted proactively, citing their expectations of growing inflation in the future. Nevertheless, fixed income investors shrugged off the rate hikes and continued to invest at the long end of the yield curve. This was not without risk as longer maturity issues are more sensitive to changes in interest rates. These investments in part helped to keep longer term rates low and keep the shape of the curve flat.

Global investors investing in U.S. Treasury issues also played a part in the flattening the yield curve. Low yields abroad, and in some cases negative yields, made U.S. Government issues attractive to non-U.S. investors. Struggling economies in Europe and Japan left investors in those countries seeking the safety and security of U.S. Treasuries, with the added bonus of higher returns than they could receive in their local currencies. Adding in the specter of geopolitical disruptions emanating from North Korea and Syria, as well as seemingly frequent incidents of terrorism around the world, the global appeal of U.S. Treasuries cannot be dismissed.

US investors interestingly appear more concerned with garnering higher yields than safety of principal. Lower quality issues in the Credit markets prevailed as the most sought after investment over the calendar year. Credit spreads, or the additional yield investors require to compensate for default risk, shrank over 2017 to levels close to those seen in 2006 and 2007. While this alone is not a sign of imminent danger, it is worth noting how investors have reduced this margin of safety to near record levels. New corporate debt issues continue to be met with strong demand, making it easier for companies to refinance existing debt or issue new debt to pursue acquisitions, stock buybacks, or dividends. Shareholder friendly actions seem to vastly outnumber debtholder friendly actions in 2017.

Intermediate Credit Spreads



Source: Bloomberg Barclays

Performance figures for the full year mirror those from the previous quarters, building on market momentum. As our regular readers might expect, Corporate issues handily beat out U.S. Treasury and Agency issues over 2017. Returns remained positive despite higher short term yields, boosted by shrinking Credit spreads and long-term yields falling slightly. Lower-quality issues continued to outperform higher-rated issues while performance across the Financial, Industrial, and Utility sectors was fairly consistent.

Looking ahead, 2018 may be a pivotal year with questions stemming from many areas. Will the FOMC continue on its path of rate hikes in the face of data contradicting inflation growth? Will there be more fiscal stimulus following the recently enacted tax package? Will Credit spreads maintain their current rich levels or will they grind even lower? Will foreign central banks cease their accommodative monetary policies?

Our view of the future is expectedly cloudy, but we surely have our leanings. We expect the FOMC to press on, but would not be surprised if there was a pause based on recent meeting minutes showing members seeking a respite between hikes. Additional large-scale fiscal stimulus appears unlikely in the early part of the year given the bipartisan acrimony present in Washington. Credit spreads will likely hold steady as tighter market levels would make many Corporate issues unattractive relative to risk-free Treasuries. The foreign central bank question is the largest wildcard as there is no clear cut policy change on the horizon, making the status quo more probabilistic.

For our clients, we believe that high quality remains the safest and strongest ground. In the face of elevated Credit valuations, particularly those at the low end of the quality scale, the risk of reversal could mount. At the same time, we recognize that resisting the temptation to “re-risk” and reach for higher yields at this stage of the market cycle is difficult due to momentum. We believe that sacrificing marginal gains in yield do not warrant venturing into riskier assets. In the long run our clients are best served by holding high-quality, investment-grade bonds in their portfolios. Our strategic goal remains the construction of portfolios that provide liquidity, carry high-quality ratings, and favor principal protection.