Fixed Income Outlook: A Tempered Trend for Interest Rates

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Recent history has introduced several different, yet impactful phenomena to the bond market including central bank control, the move to energy independence, and now a shifting political picture. Relative to the stationary interest-rate environment of recent years, anticipation for the 2017 bond market stands to be much more unpredictable and altering.

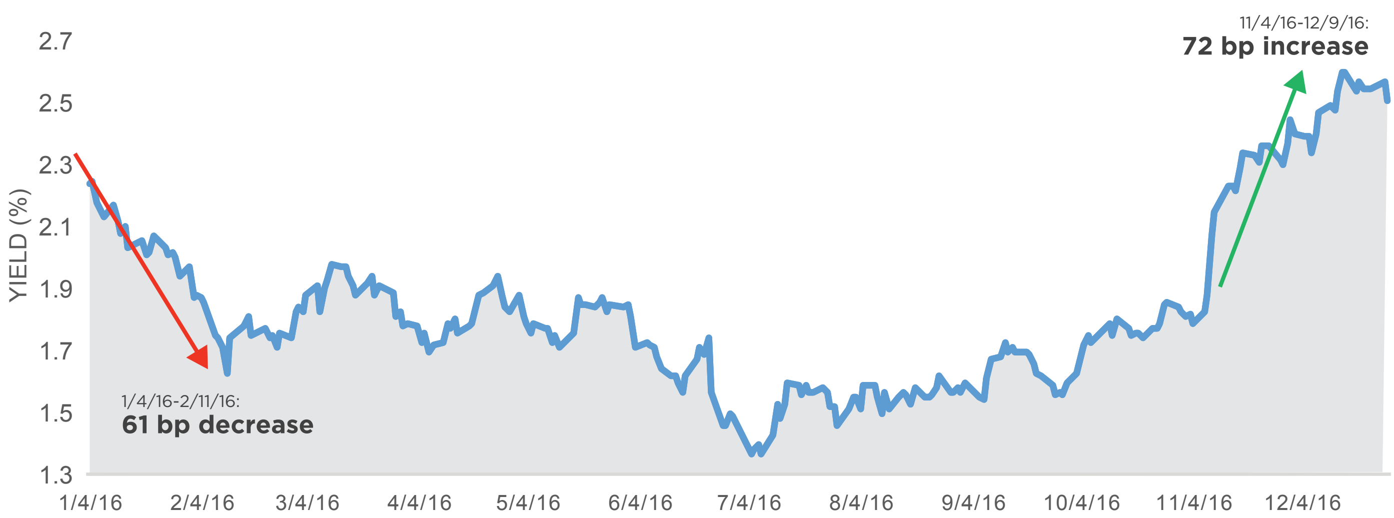
The market has idled on conflicting positive and negative economic data, continued low inflation and slow growth, but has been forcefully influenced by Federal Reserve (Fed) interaction. A marked 2017 political contrast is likely to reformat regulation and fiscal policy affecting many components of the bond market.

THE PRESIDENTIAL ELECTION

A post-election bump in interest rates was anticipated. President-elect Trump has been very clear about his plans to increase spending and decrease revenue via tax cuts, likely increasing the budget deficit and heightening the risks for higher inflation and higher interest rates. In a very short period of time, on the heels of the election, interest rates rose sharply on a percentage basis; however, they merely recaptured the early-2016 rate declines. Still, the expected fiscal policy change, ease on regulatory constraints, inflationary influences and slowly improving domestic economic numbers appear to finally give credence to projecting a trend up in interest rates.

BACK TO SQUARE ONE

2016 DAILY 10-YEAR TREASURY YIELD (Data through 12/28/2016)



Source: Federal Reserve

The Fed will certainly be in an improved position. The markets have depended on monetary policy to assist in controlling money supply and inflation. Inflation has not been a compelling force and, although the Fed ended its last quantitative easing program at the end of 2014, they simply took their foot off the gas pedal and remained in an "ease" position since. 2016 did not experience the Fed rate hikes most experts anticipated. It would take more than a few twenty-five basis point rate hikes to reverse policy from one of ease to one of tightening. A re-evaluation is suitable considering that the current monetary policy will possibly be met with an assist via fiscal policy. If so, the Fed will not have to "go alone" in 2017.

If, as proposed, corporate tax rates are cut to 15%, corporations stand to improve profitability without doing anything. Simplification of the tax code for individuals might reduce the current seven marginal tax brackets down to three. The top tax bracket is intended to drop from 39.6% to 33%, perhaps increasing individuals' disposable income. In the final months of 2016, municipal product spreads widened partly in anticipation of these changes; however, we do not anticipate a significant change in municipal bond demand as some benefits of lower marginal rates will likely be offset by reduced deductions and other allowance changes.

U.S. DOLLAR

U.S. dollar strength will impact demand for U.S. products and influence commodity pricing in 2017. The dollar has been gaining strength versus other currencies throughout 2016. If the Fed moves forward with several 2017 rate hikes, they will further support the dollar's strength. With a stronger dollar, U.S. exports become more expensive, lowering demand for U.S. goods and services overseas and thus hampering U.S. corporate earnings.

RISING INTEREST RATES

Although we anticipate interest rates to trend up, we do not anticipate an over-the-top interest rate shift. There are numerous headwinds tempering interest rate swings; many of which also hindered higher rates in 2016: global market influences such as interest-rate disparity, central bank immersion, demographics, dollar strength and corporate earnings. Additionally, in question is the feasibility of making policy and/or regulatory changes. If these changes do come to fruition, how long will it take those changes to filter into the economy and what impact will they make?

CONTINUED GLOBAL DEMAND

Bonds are likely to see continued demand in 2017. Several active and large global central banks including the European Central Bank (ECB), Bank of England (BoE), Bank of Japan (BoJ) and Peoples Bank of China (PBOC) continued quantitative easing programs throughout 2016. Toward year's end, the ECB started murmurs of slowing down. Global central bank intervention and/or detachment will be a significant influence on the bond market in 2017. We are entering the year with a significant yield disparity among top economic powers that will continue to have mitigating influence on U.S. interest rates until these global rates close the gap.

PORTFOLIO CONSTRUCTION

Our annual outlook would be remiss without the mention of the role of bonds within a portfolio. Most investors do not have endless cash flow or a perpetual means to produce income. The role of individual bonds typically excludes speculation, and strategic bond allocations are thought of in terms of "years" not "moments," virtually eliminating the effects of interest rate movements.

For wealthier investors, investment objectives generally focus on the preservation of wealth and income generation with capital appreciation as a secondary goal. Individual bonds provide continuous cash flow, income streams and return of face value at maturity, while a laddered bond portfolio can help to mitigate interest-rate risk and act as a ballast to equity exposure.

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