

U.S. FIXED INCOME: "WON'T GET FOOLED AGAIN"

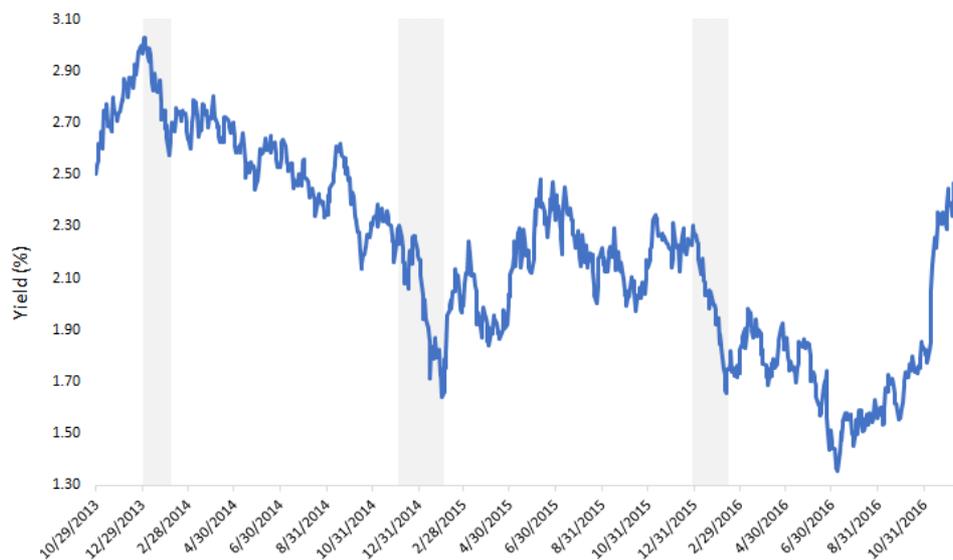
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01/04/2017

Here we are, ready to begin a new calendar year. Economic and rate forecasts filled the just finished holiday season, but the question now becomes: Will these prognostications actually prove accurate? Remember, it is a long way to December 31, and as we have seen in the last few years, a lot can happen between the opening days of January and New Year's Eve.

There seems to be very little doubt that the lion's share of market participants are beginning 2017 under the assumption that economic growth will improve, [inflation](#) expectations will increase and, of course, [interest rates](#) will be on the [rise](#). We're not about to debate any of these assumptions, but the journey on the rate front that we begin on New Year's Day does not often go according to script. The last three years offer a clear illustration of this phenomenon, and we "won't get fooled again" if recent history tries to repeat itself.

What exactly is this phenomenon we are referring to? At year-end 2013 through 2015, the [U.S. Treasury \(UST\) 10-Year Yield](#) finished with an upward bias, only to reverse course and visibly decline the following January and February. To provide some perspective: on average, the 10-Year Yield declined by nearly 60 [basis points \(bps\)](#) between the end of December and the first half of February in each of these instances.

U.S. Treasury 10-Year Yield



Source: Bloomberg, as of 12/22/2016. Past performance is not indicative of future results.

Given its similarities in terms of [Federal Reserve \(Fed\)](#) policy to today, let's look at last year's experience. In both cases, the Fed lifted its target range for [Fed Funds](#) by a $\frac{1}{4}$ point and forecast additional increases for the following calendar year. Accordingly, the UST market recalibrated its thought process to allow for this development, pushing the 10-Year Yield higher. However, sentiment shifted rather quickly once the calendar turned and the money and bond markets doubted the Fed would [tighten](#) quite that aggressively as new headlines hit the news. Indeed, concern began to grow about China's economy, oil prices plunged, [eurozone](#) bank issues surfaced, and here at home, growth was once again underperforming rather noticeably. As a result, the expectation of four rate hikes in 2016 was reduced to one single increase. For 2017, the Fed's median forecast is for three rate hikes, but the [futures](#) market is already discounting that

number down to only two, as of this writing. For the record, my base case is for two Fed rate increases as well.

Conclusion

In the post-election fixed income environment, investors appear to be fixated on the prospect of fiscal stimulus and how that will lead to the Fed raising rates and, in turn, UST yields heading higher as well. This “student body right” mindset does not seem to allow for any negative news that might emerge to cause history to repeat itself in the New Year. Some food for thought on that note: Incoming data is suggesting a slower pace of growth for Q4 real [GDP](#), and core goods inflation in the November Personal Consumption Report had the fourth-largest decline since 1959. Even if history were to repeat itself in 2017, if some form of fiscal stimulus and regulatory relief is delivered later this year, Treasury yields would most likely reverse course. While we will have a new leader in the White House, from a Fed perspective, it’s a case of: “meet the new boss, same as the old boss.”

Unless otherwise noted, source is Bloomberg, as of 12/22/2016.

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DEFINITIONS

Inflation : Characterized by rising price levels.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

10-year government bond yield : Yields on the 10 year government debt security.

Basis point : 1/100th of 1 percent.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Fed tightening : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Futures/Futures Contract : Reflects the expected future value of a commodity, currency or Treasury security.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.