****

**Fourth Quarter Fixed Income Review, February 2017 2016**

***John E. Wolfsberg,*** *Managing Principal*

**Overview**

After bottoming in the first half of 2016, interest rates rose sharply in the fourth quarter following the surprise victory of Donald Trump in the U. S. presidential election. Rates had entered the quarter on a slow upward trajectory as improving economic data suggested that a rate increase would be more likely during the December FOMC meeting. However, following Donald Trump’s victory the market immediately began to price in the anticipated impact of his policy proposals on economic growth and inflation, sending Treasury yields significantly higher in just a few trading sessions. Exacerbating this upward move in yields was continued Republican control of Congress, which suggested that many of the pro-growth policies articulated by Trump during his campaign (fiscal stimulus and tax cuts, in particular) would have a strong chance of being implemented.

As a result of the move in rates, fixed income returns for the quarter were negative for virtually every sector. Treasuries were impacted the most, with the 10yr Treasury losing 6.93% during the quarter (its worst quarterly return since Q3 1980) as its yield rose 85 bps, from 1.60% to 2.45%. Municipal bonds were also impacted as campaign proposals to reduce tax rates caused investor concern that tax-exempt income would lose its value. Corporate credit, while still experiencing negative returns, was helped by spread tightening caused primarily by the post-election risk-on trade. In general, lower rated credits (high yield) performed the best as investors pursued riskier assets in the expectation of a pro-growth environment.

The market’s initial reaction suggested investors believed all of Trump’s campaign proposals would be enacted as articulated resulting in strong growth and increased inflation. As we enter 2017 the market appears to have settled into a trading range with more of a “show me” attitude towards what campaign proposals may or may not become policy. The market now has to decide if the change from monetary stimulus to fiscal stimulus will result in growth signaling the beginning of a secular trend to higher rates.

**Economy, Markets, and FOMC**

While the US election remained a primary focus during the quarter, the US economy quietly put together some of its best economic data in some time. Third quarter GDP came in at 3.5%, a big jump from the approximately 1% growth rate seen in the first half of the year. The labor market remained solid, with non-farm payrolls averaging 176,000/month and the unemployment rate continuing its downward trend at 4.6%. Consumer confidence rose at the end of the quarter with retail sales data showing improvement, an indication that consumption should continue to support growth.

The Federal Reserve raised the federal funds rate by 25 bps in December, a move that was widely anticipated. Current FOMC projections are for an additional three rate hikes of 25 bps apiece in 2017. As has been the case, the Fed will remain highly dependent on economic data in determining the future path of rate hikes. However, the committee may now take into consideration the potential impact of proposed fiscal stimulus on economic growth and inflation, which are primary drivers of interest rates. Both the rise in Treasury yields and the strong dollar are already having a tightening effect on the economy, but nonetheless the trend continues to be one of gradually rising interest rates.

**Taxable Market**

* **The taxable market experienced its worst quarterly performance in over 35 years**
* **Shorter duration instruments outperformed the long-end, as the yield curve steepened**
* **Credit spreads tightened, partially offsetting losses due to rising interest rates in corporate bonds**

Almost all fixed income sectors experienced negative returns during the fourth quarter, as the election results caused the market to reposition itself in anticipation of pro-growth policies and potentially higher inflation. Treasury yields have continued to backup, but are now even more attractive to foreign buyers, which should have a limiting effect on sharp upward moves.

As investor sentiment was one of “risk-on” for most of the quarter, credit instruments (corporate bonds) outperformed Treasuries. While investment-grade corporate bonds still posted losses, their losses were mitigated by spreads compressing as investors added credit risk to their portfolios. High yield bonds were one of the best performers, generating positive returns for the quarter as investors increased their exposure to the sector.

Bonds issued by energy and financial companies were notable outperformers within the corporate market, as both industries are expected to benefit from regulatory changes under the new administration, and in the case of energy, rising oil prices. Going forward, a number of other policy actions proffered during the campaign could have a material impact on corporate debt, such as eliminating the deductibility of interest expense and a tax holiday for companies (many of which are in the tech sector) looking to repatriate overseas cash.



[[1]](#footnote-1)

**Tax-Exempt Market**

* **Higher interest rates and the possibility of an income tax cut put pressure on municipal bonds**
* **Tax-exempt mutual funds saw strong outflows, adding to selling pressure in the market**
* **Entering 2017, tax-exempt ratios continue to suggest municipals are “cheap” relative to Treasuries**

Municipal bonds suffered their worst quarterly loss in over two decades, as the negative effect of rising rates combined with the prospect of lower tax rates forced heavy selling in the sector. As with the taxable market, shorter duration municipals outperformed the long end as the yield curve steepened. Tax-exempt mutual funds experienced outflows for 8 straight weeks following the election (following 54 consecutive weeks of inflows). The selloff in municipals peaked in early December as ratios relative to Treasuries cheapened sufficiently to attract non-traditional buyers such as hedge funds.

Entering 2017, municipals appear relatively attractive on the basis of municipal/treasury yield ratios, but the market will look towards policies emanating from Washington for future direction. While a personal income tax cut would hurt municipal bond prices, there are potential positives, such as regulatory reform in the financial sector that could boost liquidity in the market. In addition, higher interest rates will limit refunding issuance, decreasing supply which could support prices.



**Outlook**

As previously noted, the market appears to have settled in to a trading range taking more of a wait and see approach . . . both to the FOMC and fiscal policy.

While many investors are positioning for higher rates ahead, some feel the backup in rates represents a buying opportunity. The higher rate camp believes that the shift from monetary (FOMC rate cuts/buyback programs) to fiscal stimulus (tax cuts, infrastructure spending, etc.) will result in more growth, wage pressures and ultimately higher inflation. In addition, the increased debt levels required to fund the various fiscal policies proposed would lead to more supply and therefore higher yields.

However, there are those who believe rates can remain at or near current levels as they feel the fiscal policies proposed would meet resistance in Congress due to their potential impact on the U.S. deficit and debt limit. Some also point to the changing demographics of the U.S. population where almost 10,000 people per day turn 65 years of age - a group that typically has a higher allocation to fixed income.

While we feel rates in the short-term could be volatile as headline news from the new administration’s policies is digested by the market, we feel it is too early to conclude that rates will continue to trend upward over the long term. There are just too many unanswered questions at the moment. Can campaign proposals be transformed to viable policies that can be agreed upon by the President and Congress and enacted in a timely manner? Will policy be successful and spur growth/inflation pushing rates higher or will it have a negative effect (trade/immigration) pushing the U.S. into recession and forcing rates to stall or even move lower? Will demand from changes in demographics or lower rates abroad offset selling pressure keeping interest rate moves in check?

**Our Portfolios**

On the taxable side, the shorter duration nature of our portfolios relative to the benchmarks helped performance during the quarter, as did the overweight to corporate bonds for our portfolios. We have made a conscious effort to avoid an allocation to US Treasuries on the intermediate and long-end of the yield curve, as we currently see no value here. In addition, our allocation to multi-sector managers added to performance as these managers were allocated to sectors (high yield, bank loan, preferred equity, etc.) that participated in the “risk-on” trade during the quarter. On the tax-exempt side, we also maintained a shorter duration than the benchmark (in addition to having a small allocation of our model to taxable multi-sector) which helped buoy performance during the quarter. In both the taxable and tax-exempt models we did harvest tax losses during the quarter which were used to offset gains on the equity side. We re-entered these positions in early 2017 after the 30 day wash sale window had expired. We maintained our shorter positioning during the fourth quarter and into 2017 and will be monitoring economic data and the impact of policy proposals closely in determining what (if any) changes to our models should be made.

**Clients of Centerpoint should contact us if there have been any changes to your financial situation or investment objectives, or if you wish to place or modify any restrictions on the management of your accounts.**

Centerpoint Advisors, LLC is an investment advisor registered with the Securities and Exchange Commission. Centerpoint Advisors, LLC provides fundamental investment management services to investors. The views expressed contain certain forward-looking statements. Centerpoint Advisors believe these forward-looking statements to be reasonable, although they are forecasts and actual results may be meaningfully different. Actual events may cause adjustments in portfolio management strategies from those currently expected to be employed. This material represents an assessment of the market at a particular time and is not a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any security in particular. The performance data quoted represents past performance. Past performance does not guarantee future results. Current performance may be lower or higher than the performance quoted. By investing in high yield bonds you may be subjected to greater price volatility based on fluctuations in issuer and credit quality. When investing in bonds, you are subject, but not limited to, the interest rate, inflation and credit risks associated with the underlying bonds. Bonds may be worth less than original cost upon redemption or maturity. All data sourced from Bloomberg and Morningstar Direct.

Centerpoint Advisors, LLC 175 Highland Avenue, Suite 302 Needham, MA 02494 Ph: 781.400.1748

Fax: 781.400.1749 [www.centerpointadvisors.net](file:///C%3A%5CUsers%5CMBarry%5CAppData%5CLocal%5CMicrosoft%5CWindows%5CTemporary%20Internet%20Files%5CContent.Outlook%5CAC9SZ102%5Cwww.centerpointadvisors.net)

1. Fixed income sectors shown above are represented by the following indices: U.S. Aggregate Bond: Barclays U.S. Aggregate Bond; Short-Term Corporates: BofAML U.S. Corps 1-5 YR; Intermediate-Term Corporates: BofAML U.S. Corps 5-10 YR; Long-Term Corporates: BofAML U.S. Corps 10+ YR; Mortgage-Backed: Barclays U.S. MBS; High Yield: BofAML U.S. Corps HY Master II; Bank Loan/Floating Rate: S&P/LSTA Leveraged Loan 100; Global: Barclays Global Aggregate ex-USD [↑](#footnote-ref-1)