While the second quarter was all about the Federal Reserve and BREXIT, the third quarter saw the Presidential election season and little else. The sentiments associated with this election season extended itself into the markets, as there was nothing that would move the needle. Interest rates gradually drifted upwards over the summer. After touching an all-time low of 1.36% on July 5th, the 10Yr Treasury recovered and, barring a fleeting spike and retrenchment after the ECB meeting, traded in a remarkably tight range for the rest of the quarter to close at 1.60%. With Treasuries range bound, corporate spreads remained in a tight band, as well. Globally, US sovereigns hover near historically low yields and remain attractive compared to the debt of many of our trading partners, which continues to trade at lower and, in some instances, negative yields.

Amidst the range bound rate environment in Q3, there is an interesting phenomenon taking place in the short-term rates market. As the Federal Reserve and other central banks continue to keep rates low, the market for 3-month LIBOR climbed from .62% at the end of June to hit .87% recently. The increase in LIBOR is related to a change in rules that govern the management of money market funds, a $3 trillion industry. These changes came about as a result of the Reserve Money Market Fund "breaking the buck" back in 2008. Under these new rules, which went into effect on October 14, 2016, the vast majority of current money market funds will no longer be allowed to maintain a constant $1.00 Net Asset Value (NAV) and will now have a floating NAV. The only exceptions to this rule are retail money funds (limited to individual investors) and Government funds (holding only Treasury and Agency Securities). As these rules go into effect, many fund management companies are changing their product offerings, most notably with the elimination of single state municipal funds and Prime taxable funds. Most market participants do not want to be in a floating NAV product, and, as a result, they are selling their current money market funds and purchasing either Government money market funds or individual securities. With this large dislocation, short-term securities, Variable Rate Demand Notes (VRDN) and Commercial Paper (CP), are trading at yields that are 40 to 60 basis points higher than they were just six months ago. The increase in LIBOR is the result of it being used as a hedge by the issuers of these short-term instruments. The surge in LIBOR is also impacting corporations, as most floating rate loans are pegged to three-month LIBOR. The money market fund industry was a multi-trillion dollar industry, and clearing the current inventory will take time. With that said, the length of this dislocation remains unclear, but could be impacted by either increasing rates continuing to attract non-traditional buyers or by product inventories shrinking through issuers restructuring their funding profiles. Most likely, it will be a combination of these two factors.

LIBOR was not the only short-term rate benchmark in the spotlight, as Federal Reserve officials were relentless in their attempt to talk a good game during the quarter. Market participants were non-believers, and their expectations of any Fed action receded due to continued weakness in the economy and uncertainty surrounding the Presidential election season. Although candidate Trump has attempted to paint the Fed as political in keeping rates low to support the current administration and its candidate, the reality is that it would have been extremely unlikely for the Fed to act during such a political season. Beyond the Presidential election, many Congressional races are hotly contested, and this political uncertainty could be a potential risk to 4th quarter growth. While there are rare areas of agreement between the major parties, there is also uncertainty over the specific policies the next president may pursue. Both major candidates appear interested in infrastructure spending (which we consider a positive for growth), however, both share opposition to trade deals (which we consider a negative). Although it has garnered less attention here at home, abroad, the Italian constitutional referendum in December is another wild card that could destabilize a still-weak European Union.

The range bound theme spilled over into the Investment grade credit market, as spreads were steady for most of the quarter. In the last five weeks of the quarter, the Bloomberg Barclays US IG Corporate Bond Index OAS remained unchanged at 138. The tight mark for the year was 135. Issuance, on the other hand, was very robust. The $437.385 billion that came to market did not quite top the last two quarters, but more issuers came to market this quarter than during Q1 or Q2. Low yields, tight spread, and incredible demand have made conditions ideal for companies to take on more or refinance debt. The record issuance of 2015 has already been reached in 2016. In fact, the $1.33 trillion issued so far this year outpaces 2015 totals by 10%. We anticipate a slight slowdown heading in to the balance of the year as investors may have be suffering from a slight bout of exhaustion, but the reach for yield should continue to spark interest.

The rally in high-yield or "junk" bonds continued its torrid pace, as the chase for yield continues to be aggressive. High-yield spreads have tightened over 400 basis points since the February lows, and currently stand at a 15-month low. The tone towards junk is likely being driven by (i) the recovery in the energy sector and (ii) likely interest in higher yielding assets from abroad. With oil recovering into the $50 per barrel range and signs OPEC may finally cooperate on production cuts, spreads in the energy sector recently hit a 22-month low; this represents a nearly 1,400 basis point recovery from all-time wides seen in February. Both investment grade and particularly junk corporate bonds are attractive on a relative basis, with many global markets trading at lower or even negative yields. We expect flows into junk to continue as long as global central banks focus on easy monetary policy. Though investment grade did not see the price action that High Yield has, we are still optimistic about our focus on high quality credit. Given the gap between investment grade and junk spreads, the modest pace of economic expansion, record corporate margins, and growth in balance sheet debt of U.S. corporations, we feel investment grade offers a much better risk-return profile.

As we press ahead towards the 4th quarter, we cannot help but continue to think that we will remain in a range-bound (in both spreads and in yields) bull flattening trend. Although the Federal Reserve has made no policy changes recently, the Jackson Hole meeting in late August saw discussion of “alternative” policies, including negative short term rates and higher inflation targets, subjects that had previously been considered taboo. Taken together, central bankers seem concerned that they may be running out of firepower. Inflation still remains below the Fed target, and the spread between the Treasury and TIPS 10Yr yield (a common measure of market inflation expectations) increased from 1.40% to 1.60% over the quarter, suggesting the Fed had made some progress towards their inflation mandate. Further, after years of stagnant wage growth, the recovery is finally making itself felt in middle class American households. With all that being said, the FOMC appears on course to hike the Fed Funds Rate at their December meeting, and with the Fed Funds futures market implying a 62% probability of a hike at that meeting, the market seems prepared for such a rate move. All in all, the outlook for the US economy is seemingly stronger than it has been in some time, despite central banking wariness and global headwinds.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives. Appleton is on Twitter: follow us at @AppletonPtnrs.