The world of Washington, DC was once again a driving force in the fixed income markets, although it was not President Trump's tweets, but the workings of the Federal Reserve that drove the markets. Persistently low unemployment rates increased concern that inflation, especially wage inflation, might reappear after years of dormancy. The Fed, to be preemptive, raised rates three times during the year (March, June and December), increasing the overnight rate a combined 0.75% to a 1.25 to 1.5% range. The Fed also embarked on a policy to shrink its massive $4.5 trillion balance sheet, although the scope of this plan was initially extremely modest. In the face of this combined effort, inflation remained benign, with CPI falling over the year to the latest release of only 1.7%. Additionally, the Thompson Reuters CRB Commodity Index increased a scant 1.95% over the course of the year, also showing little evidence of inflation. With the Fed raising short-term rates and investors seeing no signs of inflation, the yield curve flattened dramatically. The spread between 2Yr and 10Yr Treasuries declined 69 basis points from 122 to 53 basis points, while the spread between the 2Yr and the 30Yr declined a more dramatic 97 basis points, from 183 to 86 basis points.

While we have previously written that much of the year was characterized by slow but steady growth overshadowed by political turmoil, there were more recent signs of economic acceleration. Though September's jobs report missed expectations, it proved to be a blip, with strong October and November reports showing the US workforce continues to expand. The unemployment rate now stands at 4.1%, a new cyclical low. Business sentiment indices continued to evidence strong investment and confidence, and consumer sentiment seems to be finally catching up. Retailers posted a banner holiday shopping season. Mastercard calculated total US retail spending was up 4.9%, marking the largest uptick in six years. Consumers appeared to be spending on bigger-ticket items as well; December auto sales were better than expected, and existing home sales surged in November for the third straight month to 5.6%, the fastest pace in a decade. With third quarter growth revised to 3.2%, the second and third quarters of 2017 now represent the strongest six-month stretch of growth since 2014.

These economic conditions pose something of a quandary. Businesses are investing, shoppers are spending, and the workforce appears close to full employment. Labor demand remains high, whether you refer to surging employment indices, or the anecdotal refrain about the difficulty in filling jobs made by numerous CEOs during Q3 earnings calls. Yet, as discussed above, inflation remains muted and wage growth sluggish at 2.5%. Against this backdrop, the Republican-controlled Congress passed the largest reduction in US taxes since the Reagan era at the end of December. While much has been written about the minutia of various changes in the tax code, the overall impact may have a considerable aggregate economic impact. This bill represents fiscal stimulus of nearly a trillion dollars over a ten-year period in an economy already showing signs of strong growth. How exactly this impacts the economy will prove interesting.

The consensus outlook for investment grade corporate bond spreads entering 2017 ended up differing significantly from what transpired this past year. Many suggested that the solid performance of credit spreads in 2016 could not continue, as spreads entered 2017 well below the 30-year average. However, spreads surprised skeptics, with Investment Grade spreads ending 2017 at the tightest levels in ten years. The Bloomberg Barclays US Aggregate Corporate OAS index began the year at 122 basis points, which proved to be the 2017 high, and slowly trickled down to end the year at 93 basis points. The path downward was not without some volatility, though, as spreads dropped quickly from 113 basis points to 94 basis points during the period from September through October. This was the largest swing of the year. We also witnessed spread widening in middle of the fourth quarter, as turmoil in Washington drove a sell-off in the Treasury market. At that time, the Senate tax reform bill was being piecemealed together with little detail and a highly uncertain chance of passing. Geopolitical risk seemed to be rising as well, adding to volatility.

It was another strong year for issuance, with a record $1.633 trillion of new investment grade debt added to the market, 1.5% greater than 2016. However, with $306 billion in Sovereigns, Supranationals, and Agencies, total Corporate issuance came in 1% lower than 2016 at $1.327 trillion. In both cases, issuance exceeded analyst estimates. Going into the first month of 2017, there was a flurry of activity; a record setting $227.45 billion was issued on the premise that rates were going to rise and that the uncertainty surrounding the new administration would bolster volatility. Again, the reality proved more sanguine than the expectations. After the January rush, issuance became more balanced, though several jumbo deals were spurred by mergers and acquisitions. A large majority of these occurred in the Technology and Media & Telecom sectors, which includes the third largest deal ever at $22.5 billion, with AT&T intending to use the proceeds to fund an acquisition of Time Warner. However, the deal was later challenged by the Department of Justice. New issuance slowed in the fourth quarter, with only $322.275 billion brought to market. The month of December saw a paltry $30.195 billion, as corporations waited out the tax reform debate in Washington, DC. Supply was again driven by strong demand, historically low rates, and tightening credit spreads. This year's supply is expected to be lighter, as the new corporate tax structure takes hold; coupled with the benefit to corporate balance sheets from tax reform and the impact of strong economic growth on earnings, secondary market demand should remain high. We expect this to support credit spreads at current levels and potentially leading to further tightening.

The Federal Reserve is going to have its hands full in 2018 and beyond. First, new Fed Chairman Jerome Powell, a non-economist and former Investment Banker, will take over from Chairwoman Janet Yellen. While Powell has served on the Federal Reserve Board of Governors and was greeted positively by the markets, his management style is largely unknown. Additionally, President Trump has five openings in the nine-member Board to fill, including a new Chairman of the New York Fed, the branch that oversees all open market activity. Looking forward, does Fed continue with its policy of increasing short-term rates in the face of declining longer-term rates? If so, might the yield curve invert? Or does the Federal Reserve take a wait and see approach until actual inflationary pressures appear before continuing a path to higher short-term rates? With some evidence that consumer spending is rising, there is a risk that the numbers have not yet caught up with quickening wage growth, and stimulus on an already hot economy could cause it to overheat, sharply increasing inflation. How these various factors interact and how the Fed responds to them could become a dominant story in 2018. We will be watching for any changes to the yield curve, inflation, productivity, and fiscal policy that could cause the Fed to diverge from their current path. Overall, we feel that the combination of improving economic conditions and a historically accommodative Fed should provide a constructive environment for fixed income as we look forward in 2018.

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.