The first quarter of 2017 was a period of remarkable political turmoil in the United States, as President Donald Trump surprised Washington and the markets with a whirlwind attempt to deliver on campaign promises, only to be met by staunch opposition from both Democrats and Republicans, as well as the courts. Stories about Washington political machinations dominated the wires, cumulating with March's surprise collapse of the Affordable Care Act "repeal and replace" bill. Despite this turmoil, the markets remained remarkably calm all quarter. The stock market brushed off uncertainty and steadily rose on the prospect of the stimulative effects of deregulation and tax reform, with the S&P 500 closing the quarter up 6.07%. Meanwhile, following the bond market's abrupt selloff in November, the first quarter of 2017 was unexpectedly sedate. The 10Yr Treasury traded inside a tight 31bps range (and would have been 22bps without the brief spike in the five trading days leading up to the Federal Reserve's March 15th rate hike), and ultimately closed the quarter 3bps lower, at 2.42%. The 2Yr came in slightly further, dropping 11bps to 1.14%, as the curve steepened 8bps between 10Yr and 2Yr maturities. Market-based measures of inflation were essentially unchanged, hovering just below the Fed's 2% target. At a first glance, this relative calm seems hard to reconcile with the significant uncertainty radiating from Washington.

Given a disconnect this large, it's useful to take a step back and look at the economic fundamentals. While the 4th Quarter GDP growth rate of 2.1% is somewhat lackluster, it does represent a continuation of recent slow, but stable growth. Despite a poor March number released in early April, jobs growth remains reasonably solid, with 216,000 and 219,000 jobs added respectively in January and February. Unemployment is at cyclical lows of 4.5%, while the labor force participation rate ticked upwards by 0.3% over the quarter, indicating little remaining slack in the marketplace. This is echoed by average hourly wage increases, which have continued to accelerate. Wages were up 2.7% year-over-year in March's jobs report, and remain close to post-recession highs. Housing numbers have been relatively strong as well; new housing starts, while slightly off their 4th quarter peak, are currently at their second-highest reading since the Great Recession. Overall, the underlying health of the US economy should provide some downside protection for equities, and the fall in rates after the Fed Funds hike on March 15th suggests that Janet Yellen currently has the market's trust to manage inflation. No one would call this a 'Goldilocks' economy, but the markets do seem to be rightfully tuning out the noise from Washington.

The uncertainty of the political landscape and the prospect of rate hikes going into 2017 ramped up the enthusiasm of debt issuers to take advantage of lower interest rates and strong investor demand. This led to a very robust quarter of Investment Grade issuance in the Corporate Bond markets, with the $510.375 billion issued being the highest quarterly total on record and marking an 11% increase on a year-over-year basis. Much of that issuance was front loaded. The month of January hit record territory, with $227.45 billion issued, accounting for nearly 45% of issuance for the quarter. Technology companies led the way with jumbo deals from Microsoft ($17 billion), Broadcom ($13.55 billion), Verizon ($11 billion), and AT&T ($10 billion). It is important to note that SAS (Sovereigns/Agencies/Supranationals) issuance accounted for about $120.45 billion (24%) of the quarter's total and when stripping that out the year-over-year volume is up near 8%. Investment Grade credit spreads were incredibly stable over the quarter. According to Bloomberg Barclays US Corporate bond index, the quarter closed an Option Adjusted Spread of 118 vs 122 to begin the year. The 122 level would actually prove to be the wides over the 3 month time period, with 111, the tightest, representing a level that has not been seen since October 2014.

Our positioning within the Technology & Electronics sector surpassed the Banking sector as our largest absolute sector weight this quarter. Under current US tax policy, sectors with modest capital spending needs relative to operating cashflow (such as Technology) have an incentive to accumulate overseas cash, thereby avoiding taxes due on repatriation. These balances are sizable, in some cases; Apple's overseas cash holdings are famously larger than the GDP of several mid-sized countries. One way firms have unlocked the value of this cash is by issuing debt in domestic markets and then using that to finance share buybacks. While we generally consider corporate activity intended to benefit shareholders a credit concern, we feel that this situation is somewhat different. Corporate issuance tends to be driven by firms that require liquidity, and, therefore, tends to be biased towards lower credit quality: Here, we have an opportunity to buy bonds from firms that technically speaking don't need liquidity, but rather are seeking to access cash in a different jurisdiction than where it's held. As a result, the names we approve in this sector as of current writing actually have more cash than they do debt outstanding.

This situation poses two primary opportunities for our strategy. First, it allows us to purchase high quality bonds at yields that, while tight, still offer attractive spreads over Treasuries. Second, we see the potential for scarcity value in these bonds; if the current Congress manages a tax reform bill, it is likely to include either a repatriation holiday or some sort of change to the tax treatment of overseas earnings, and we would expect to see issuance in this sector fall.

Our Intermediate Taxable strategy composite outperformed its benchmark by 14bps in the first quarter, 0.78% to 0.64%. In a relatively quiet interest rate environment, credit and sector spread carry were the primary drivers of excess return. Our overweight exposure to "A" rated credits added approximately 15bps, while overweights to "AA" and underweight to "AAA" added a further 5bps and 6bps, respectively. Sector positioning was also a broad contributor, with our underweight sovereign positioning adding nearly 7bps, Telecom contributing a further 4bps, and Financial Services and Basic Industry contributing a further 3bps each. Detractors were largely related to security selection, with Telecom underperformance being the largest, detracting 7bps from excess return and "A" rated credits as a whole detracting 10bps.

Going into the first quarter of 2017, the markets hoped for a continuation of the "Trump Trade." As a candidate and President-Elect, Trump laid out an aggressive agenda, but failed to anticipate the political battle he would face in Washington once inaugurated. Since the election was so contested, we expect this battle will only continue. With this as a backdrop, bond yields continued to maintain a tight trading range while the Fed hiked the short-term rate. While this hike was expected, the statement accompanying this increase was comfortingly dovish and helped keep longer-maturity yields stable. While we face near term challenges, we continue to set our eyes on the horizon and actively manage the strategy for future rate cycles and the political and economic uncertainty we are currently experiencing. It is our intention to remain well positioned for uncertainty by maintaining a high quality, liquid, and broadly diversified portfolio. Our team knows that the future changes out of Washington (regulatory, taxes, policy) may have a significant impact on our markets, and we will be closely watching, while remaining focused on indications of underlying economic health.

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.