After the sedate close to 2017, a combination of embedded market expectations and new-found policy and political risk brought volatility roaring back in the First Quarter of 2018. Concerns about a potential intentional devaluation of the US Dollar caused the bond market to trade off sharply, with the 10Yr treasury climbing 32bps over the course of the month. Next, came a stronger-than-expected 2.9% increase in January average hourly earnings. The stock market, already uneasy about inflation after December's tax cuts, plummeted on the news, with the Dow setting an all-time intraday record drop of 1,600 points. These inflation concerns temporarily pushed bond yields higher, with the 10Yr treasury peaking at 2.94% on February 21st, 54bps above its December close.

In the face of a steady rise in Treasury yields, the steepness of the curve increased in January, as the spread between the 2Yr and 10Yr rose from 51 to 67 basis points. The curve steepened somewhat more before the Treasury's decision to upsize February's shorter maturity auctions, citing a larger-than-expected funding gap after the passage of the December tax bill. As we moved into the latter part of February, yield curve steepening reversed and the trend turned into a bear flattener that continued for the rest of the quarter. The 2Yr – 10Yr spread decreased to 47 basis points and the differential between 2Yr & 30Yrs dropped to 70 basis points to end the quarter.

The US Treasury has recently been boosting its supply of new debt at an aggressive pace, as well, to fund budget gaps resulting from changes in the Federal tax code. As we began the year, total UST debt outstanding was $20.492 trillion, a figure that quickly increased by more than $600 billion to $21.113 trillion during the first quarter. It is now estimated that an additional $480 billion will be needed by the end of the year to fund an estimated $1 trillion fiscal 2018 deficit. The timing could not be worse as interest rates are on an upward trajectory, increasing the cost of borrowing as well as putting pressure on the dollar and inflation. These are issues we will closely monitor given the potential impact to the bond market.

Amid all the turbulence, Jerome Powell's first Humphrey-Hawkins testimony on February 27th was a relative moment of calm. Powell's commitment to a gradual increase in short-term rates is essentially unchanged from Chairperson Yellen's, and the March 21st rate hike was largely a foregone conclusion. The Fed increased the Fed Funds target rate to 1.50 – 1.75%, with an accelerated pace of increases anticipated. Forward expectations are arguably of greater interest to market participants, and the futures market implied likelihood of a Fed Funds rate hike in June increased from 61.1% at the end of January to 69.1%, before receding to 60.9% as the quarter ended. Median Fed Governor's expectations now call for a Fed Funds rate of 2.10% by the end of 2018, 2.90% by the end of 2019, and 3.40% at year-end 2020. Fed policy will ultimately react to economic developments and forward expectations, both of which are increasingly being influenced by an uncertain public policy environment. We expect, at most, two further short-term rate increases this year and are not in the camp that foresees a more hawkish Fed.

Volatility remained elevated as March arrived, with President Trump igniting a fresh sell-off by announcing an intention to implement a series of trade tariffs. China and the EU promptly threatened to follow suit, igniting fears of a full-blown trade war. It is difficult to ascertain how Trump's intention to impose stiff tariffs on imported steel and aluminum will ultimately play out. Tariffs add considerable economic risk and uncertainty, including the likelihood of provoking retaliatory measures that could harm global growth. China has already answered, at least verbally, by stating an intention to respond in a proportional manner. At the same time, we have seen signs of political and economic backlash that may help moderate a highly uncertain eventual policy outcome. Once again, strong economic fundamentals are balanced against considerable public policy risks, the latter of which were illustrated in March by the resignations of Gary Cohn, a free trade advocate, and Secretary of State Rex Tillerson a week later.

The new Trump tax laws curtailed Investment Grade Corporate debt issuance during the first quarter of 2018. More specifically, the $120.275 billion issued in January was 33% less than last year's record breaking January when uncertainty surrounding the new Administration fueled a rush to the market. This year, it appears that lack of issuance is tied to a new US tax code allowing corporations to repatriate cash held overseas at a much lower rate of 15.5% vs. the previous 35%. The law's impact on capital allocation influenced corporate treasury decision-making and issuance remained weak, ending the quarter at just $320.50 billion, down 20% year-over-year.

Investment Grade credit spreads spiked to 2018 wide levels as the month of February ended. The selloff was in response to a broad rise in volatility across asset classes, fueled in large part by tariff and associated trade fears, uncertain future Fed monetary policy, and speculation concerning the path of short-term rate increases. IG spreads, while still tight relative to historical averages, ended the quarter 16 basis points wider than at the end of 2017. That isn't a huge move, but softening was apparent as volatility seeped into the credit markets. This is something that we have not experienced for quite some time given stable credit markets and persistent demand for yield. Once again, we fall back on strong underlying corporate fundamentals, and while an investment grade credit dislocation event is not evident, global trade conflict is a risk that cannot be ignored.

After much anticipation, CVS jolted the market to life in March with a $40 billion deal aimed at financing its acquisition of Aetna. The size was initially rumored to be upwards of $50 billion, the third largest bond deal on record behind the $49 billion Verizon deal in 2013 and the $46 billion InBev offering in 2016. Investors stepped up once again, as the CVS deal was very well received, with three times as many orders ($120 billion) for bonds as were available. The market watched the deal very closely given its size and impact (36% of March issuance) on the credit markets, but the offering failed to stabilize spreads. In an interesting reversal, the IG new issue market has slowly turned from a sellers' to a buyers' market, as new issue concessions continue to be on the rise. Despite a double-digit decline in the first quarter of 2018, new debt issuance relative to the same time-period in 2017, investors are demanding more of an incentive to buy corporate bonds. This trend is most evident further down the credit spectrum. Over the past few years, the cost of issuing debt has been very low, and issuers have capitalized. However, many companies have arguably gone too far, and leverage is once again becoming a concern. The ratings agencies have taken note, and the amount of BBB-rated bonds in the secondary markets now accounts for nearly 50% of the overall IG credit space. We believe that maintaining our strong preference for higher rated, more liquid investment grade bonds will prove to be prudent over the long term.

Nonetheless, strong fundamentals do provide a basis for optimism. Consumer confidence remains high, in part driven by low unemployment, while workforce participation is rising, and companies continue to hire. After an unnerving month of February when the stock and bond markets fell in sync, the market began behaving more normally in March, with the 10Yr Treasury yield dropping and bond prices rising in the face of equity market declines. The irony of the first quarter's volatility may be that it happened despite a strong economic foundation. We see other potential areas of concern. Unusually high levels of turnover in the Trump Administration have created policy instability, and the new administration is more likely to pursue a hawkish foreign policy abroad and more deficit-financed tax cuts at home. We do not currently see significant inflation, but remain vigilant to the risk of it picking up later in the year, as that would likely force the Fed to hike short term rates faster than the two additional increases we,and the market, expect before year-end. While the bull case is that Trump's trade rhetoric is merely staking out an extreme position before negotiating towards the center, there would appear to be a real risk that he means what he says on trade, or that events unfold in a manner not anticipated by the Administration. Either scenario runs the risk of drawing us into a destructive trade war. However, at present, we see an economy that looks stronger than it has in some time, and one that could continue to grow for a prolonged period absent external shocks.

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