The U.S. high grade bond market enjoyed positive performance for the 3rd quarter of 2017, but it endured a large number of conflicting influences along the way. The past three months seemed particularly active with respect to news events impacting bond market sentiment and performance. They include the repeated escalation and de-escalation of diplomatic tensions with North Korea, congressional activity regarding healthcare reform, tax reform, and the debt ceiling, an active hurricane season, and a hawkish policy result from the September Fed meeting. While many of these influences had temporary effects on the bond market, the prevailing theme which ultimately drove performance was one of reflation and economic progress. U.S. and European economic progress and increased inflation in China pushed yield levels higher, particularly over the latter half of September. Over the course of the 3rd quarter, opinion in the market began to build toward a consensus regarding the convergence of tightening central bank policy around the world. While inflation has not become a significant threat, it seems clear central banks are generally leaning toward removing accommodation either in rhetoric, or current policy action.

U.S. Treasury security interest rates moved higher across all maturities in the 3rd quarter and the yield curve flattened. The most pronounced increase in yield occurred in 2 year securities which were 10 basis points higher, whereas 30 year bonds were only 2 basis points higher for the quarter. This type of curve flattening reflects modest economic growth and inflation expectations on the long end of the curve, and the continued removal of monetary policy accommodation by the Fed on the short end of the curve. The September 20th Fed meeting statement was regarded as fairly hawkish and set the stage for the intent to normalize, or reduce, balance sheet holdings through the systematic reduction of securities held, and an additional Fed Funds rate increase in December. In addition to known Fed policy actions, short-term interest rates have also been pressured higher over speculation regarding the potential for a more hawkish successor to Chairman Yellen in February.

Within this backdrop, the corporate and taxable municipal bond sectors performed very well in the 3rd quarter. By the end of the quarter, high grade corporate bond yield spreads, representing the yield compensation for increased risk relative to U.S. Treasury securities, had reached the tightest levels seen since 2014. On average, corporate issuer fundamentals continue to improve with increased earnings and declining leverage ratios across the investment grade spectrum. Improved financials and a consistently positive outlook for the U.S. economy has resulted in the lower tier of the investment grade credit spectrum outperforming higher tiers year-to-date. Corporate bond performance was also aided from a technical perspective by a 5% reduction in bond issuance year-over-year through the end of the quarter. The taxable municipal sector also enjoyed relative outperformance based on significantly reduced new issue supply in the municipal market.

Our outlook for the U.S. economy remains constructive and we believe the U.S. will likely experience gradually increasing rates over the next few years. In our opinion, it is unlikely we will reach yield levels experienced in typical economic recovery and expansion cycles. This was reinforced by the DOT Plot released by the Fed after their meeting on September 20th which indicated the average terminal Fed Funds Target rate expected by board members dropped to 2.75% from 3%. We will continue to position our client portfolios defensively to preserve value in an increasing rate environment and maintain an eye toward opportunities that enhance portfolio yield and better position our strategy as the economic and market environment evolves.