PROSPECT BANK
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OUTLOOKS

April 2018

FIXED INCOME OUTLOOK

Summary

The investment-grade bond market delivered positive returns across all sectors for the month of March after experiencing declining values in January and February. The momentum for higher yields seen during those two months stalled out in the later days of February and reversed course in the final few days of March. In between, the bond market experienced an unusually low level of volatility with the 10-year Treasury note closing each day in a 2.80-2.90% trading range for 22 consecutive trading sessions.

The move lower in rates happened even after the Fed's Open Market Committee (FOMC) raised the benchmark overnight rate by 25 bps and had its inaugural meeting under the leadership of new Chair Jerome Powell. While the tone and tenor of the post-meeting press conference was much the same as the former Chair Yellen's emphasis on gradual increases that are data-dependent, the accompanying data signaled the potential for a more hawkish FOMC. The Fed's "dot plots", an indication of each member's belief on the most probable path of the overnight rate, continued to indicate that the consensus expectation is for two additional rate hikes in 2018. New to their outlook was the central expectation for three increases in 2019 and two more in 2020. Previously they had been expecting only two rate hikes in 2019.

Given all of the geopolitical and policy uncertainties confronting the economy, it is difficult to have much clarity for the remainder of this year, let alone 2019 and 2020. Even so, it is hard for us to imagine the need for an overnight rate that is so significantly above the Fed's own target rate of inflation. Given the demographic headwinds confronting most of the world's larger developed economies and the abundance of production capabilities in nearly every industry, we do not believe inflationary pressures are likely to force the FOMC to be that draconian. We still believe rates could move higher with the 10-year piercing 3%, but there is little reason to call for anything resembling a bond rout.

Positives

- Global rates have declined making U.S. yields even more attractive
- Many believe that an overly aggressive Fed will lead to a recession and lower rates
- Credit spreads are attractive given solid credit fundamentals, tax reform and cash repatriation

Negatives

- Treasury borrowings are to increase just as the Fed reduces their balance sheet
- Import prices might increase more as the U.S. dollar stays weaker for longer
- Inflationary pressures could reemerge if trade wars flare

Unknowns

- China's trade policy and retaliation to tariffs
- China could begin to sell holdings of U.S. Treasury debt
- Negotiations with Iran and North Korea could elevate geopolitical concerns

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