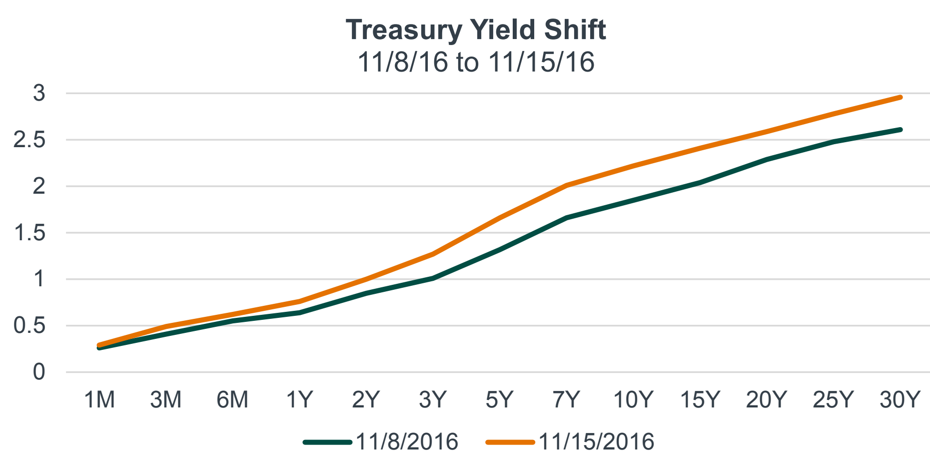
Fixed Income Market Comments

November 18, 2016

Perspectives on the Bond Markets Under President Trump

Bond markets have had a strong negative reaction to Donald Trump winning the presidential election on November 8th. Following the election, yields on 10-year U.S Treasury bonds climbed more than 40 basis points (0.40%), setting a new yield high for 2016 at 2.32% and marking the strongest short-term sell-off in Treasuries since 1990. While yields have dropped slightly off their post-election highs, rates have risen significantly in all maturities from 3-month Treasury Bills to 30-year bonds. Intermediate-term bonds have shown the greatest weakness, with the largest yield spikes in five to 10-year maturity range. The markets for investment-grade corporate bonds and municipal bonds have followed Treasuries higher, though to a lesser degree.



Source: Bloomberg

Ascent believes that markets are overreacting to the near-term uncertainty presented by the transition to a Trump administration. Given the nature of the presidential campaign and the absence of a political track record for President-elect Trump, it is difficult for investors to evaluate the economic path of the country. As a result, many seem to be taking a "worst-case scenario" approach to risk assessment.

We do not believe that the election results and market reactions should change investors' approach to their fixed income allocations. Though rising rates certainly affect the current market value of bond investments in the short-term, bonds that are held to maturity will not experience losses. Conservative, income-focused investors holding portfolios of individual bonds are therefore insulated from the short-term effect of rapidly rising rates. In fact, rising yields present a welcome opportunity for these investors to put interest payments and maturing principal back to work at higher yields – just what yield-starved investors have been seeking in the recent low-yield environment.

What is Driving Market Reaction?

Bond markets' reactions are being driven by a wide variety of assumptions regarding what U.S. fiscal and monetary policy will look like under a Trump administration, some of which seem contradictory. The explanations for the weakness in bond markets have included:

- President-elect Trump's infrastructure plans will add $500 billion of new borrowing, which will increase the supply of bonds and drive inflationary pressures in the economy.
- The Federal Reserve will come under increasing political pressure to tighten monetary policy, possibly pushing rates higher. There has also been speculation that the Republican Congress, with President Trump's cooperation, could seek to replace Fed Chairwoman Yellen and significantly limit the political independence of the Fed.
- President-elect Trump's job growth focus could stoke economic growth enough to push inflation significantly above current levels.
- A changing stance toward international trade could have significant implications for the strength of the U.S. dollar and the demand for U.S. Treasury bonds from foreign investors.
- Alternately, some fear President-elect Trump's economic and trade policies will trigger a recession. Given the Fed's continuing low-rate policy and the (presumably) limited ability for Congress to significantly expand spending, there will be few tools available with which policy markets could react.

We acknowledge that the incoming administration will likely pursue significantly different policies than those the market has become accustomed to over the past eight years. This is true every time the party holding the White House changes hands, and today is amplified by the fact that Republicans will hold not only the Presidency but also both houses of Congress. While a Trump presidency presents more unknowns than previous transitions of power, the issues markets face remain the same. Investors are rarely well served by taking dramatic action in response to short-term market shifts. This is especially true of fixed income investors. The limited liquidity and wide bid-ask spreads in corporate and municipal bond markets increase the cost of trading for individual investors, adding significant risk to a market-timing trading approach.

Our view continues to be that yields will rise off of the recent lows and move toward historical levels over time. Since the Financial Crisis and recession, markets have become so dominated by Fed policy and political management that changes in monetary or fiscal policy, or a lack of clarity on the policy process, could have outsized impacts on bond market performance over the short term. It is also important to acknowledge, however, that markets have been widely anticipating rising rates for the past three years. While the past nine days have seen rates moved meaningfully higher, bond markets experienced similar volatility in 2013 and 2015, only to see yields resume their downward trend. Whether this is the beginning of a larger shift in the yield environment, or merely another market overreaction, remains to be seen. Rather than react to events, we believe investors are better served by structuring a portfolio designed to best weather whatever twists and turns the markets present.

Rather than change tactics in response to sudden market moves, Ascent believes that risk management is best executed by structuring portfolios from the outset to manage market and credit risk. High credit-quality, moderate duration, laddered portfolios produce reinvestment opportunity in rising rate environments without the need for selling holdings at losses or into weak markets. Investors who exercise careful credit selection and long-term focus can take comfort that rising rates will provide the long-awaited opportunity to enhance yields and income generation.

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