Portfolio Whitepaper | February 2017

2017 Bond Market Outlook

Baird Funds

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We Expect Some Upward Pressure on Interest Rates in 2017 Accompanied by a Flatter Yield Curve.

We agree with the market's consensus that President Trump and the Republican Congress' pro-business agenda increases the prospects for U.S. GDP growth, but secular headwinds, which have impeded economic growth for the past several years, still exist and will limit the pace of acceleration. Accordingly, while better growth will likely push inflation to or slightly beyond the Fed's 2.0% target, the strong disinflationary implications of aging populations in developed nations and continued displacement of labor by technological advances will keep wages and inflation from surging. We believe the implications of a strong U.S. dollar are under-appreciated and further limit the prospects for global growth as well as the Fed's ability to accelerate tightening of monetary policy – we expect the Fed will implement two or three 0.25% moves in 2017. While short-term yields will rise in line with the Fed's moves, strong demand for long-duration bonds should limit the increase in long rates. In our opinion, a key question confronting the bond market is: Has the swift increase in yields since the middle of 2016 scared investors away from bonds, or has it attracted more interest from yield-starved investors? Both may be true, but we believe strong demand from yield-starved investors (e.g. pension plans and life insurance companies) will keep interest rates from surging in 2017. While many have extrapolated the sharp increase in yields from early July through December (of last year) and project a sharp increase in yields along that steep trajectory, we believe extrapolating the overall increase in yields in 2016 leads to a more reasonable path going forward and see 3.0% (or even less) as a realistic expectation for the 10-year Treasury yield in 2017.

We See Corporate Yield Spreads Remaining Firm With Some Additional Tightening Likely.

Despite an increase in leverage, fundamental credit conditions in the investment-grade bond market remain solid overall and reduced supply and significant overseas demand in 2017 should provide a positive technical backdrop for firm to tighter yield spreads. Strong demand for long credit will keep the back end of credit curves flat and we see the most attractive relative value opportunities in short and intermediate maturities. High-yield bonds ran fast and hard last year as investors hungry for more yield pushed credit spreads tighter. We are cautious on high yield after last year's equity-like performance and remain concerned that the daily liquidity provided to investors in mutual funds and ETFs could prove challenging to this less-liquid sector if and when flows begin to reverse.

Don't Bet Against Volatility in 2017.

The markets were very volatile in 2016 with interest rates and yield spreads both covering a lot of ground. Last year's volatility reflected high levels of uncertainty on many fronts (e.g. elections, changes in central bank policies, geopolitical issues, etc.) and those same uncertainties (and more) abound in 2017. Here in the U.S., President Trump and the Republican-controlled Congress are very busy enacting plans for change. In Europe, key elections are coming up (e.g. France and Germany), and their results could challenge the very existence of the European Union going forward. Geopolitical tensions persist across much of the Middle East and Asia and, in light of the wide range of potential outcomes for all these considerations, we expect volatility to remain elevated throughout this year.

One sector in particular that suffered from the pronounced volatility in interest rates last year was Agency mortgages (viz. FNMA, FHLMC and GNMA mortgage pass-throughs). Increased refinancings as interest rates plummeted in the first half of the year cut mortgage durations in half, only to have durations extend in the back half of the year as higher rates brought refinancings to a screeching halt. As it always does, this duration drift (negative convexity) worked against investors and led to underperformance for the sector in 2016. Mortgage spreads are historically tight (a direct and lasting result of the Fed's massive QE bond buying initiative). Further duration extension is possible if rates continue to rise and potential tapering of the Fed's reinvestment of its principal and interest payments is on the horizon. Given these factors, we continue to underweight this sector and see better relative opportunities in non-Agency mortgages, super-senior CMBS (commercial mortgage-backeds) and consumer ABS (primarily credit card and auto loan asset-backed). Municipals have also been subject to heightened volatility given the uncertainty over potential tax reform and we believe current valuations reflect this level of uncertainty.

We Forecast Moderate but Positive Returns in 2017.

Upward pressure on interest rates will likely work to reduce fixed income returns in 2017, but we still expect positive total returns for the year. However, the range of potential outcomes on numerous issues is as wide as we have seen it and we anticipate considerable volatility again this year. We advise investors to control what they can control and caution against straying beyond their normal risk parameters at this time. For our investors, we believe our bottom-up portfolio management style focused on risk control is particularly well-suited for this extremely uncertain environment.