OPPENHEIMER INVESTMENT MANAGEMENT

Not So Fast...
Fixed Income and Economic Commentary

Our portfolio managers discuss their economic expectations for 2017, the implications for fixed-income investors and the impact of the Trump administration's policy proposals.

The yield on the 10-year U.S. Treasury bond sent investors on a wild ride in 2016. But for all of its ups and downs, it ended up at 2.44% at year-end, just 0.17% above where it began the year. We saw its 2016 low—and all-time low—of 1.36% in early July and the high for the year, 2.6%, after the November election. All of this volatility made for great headlines in the financial press, which was a much-needed diversion from the unrelenting and downright ugly presidential campaign. We are glad the election is over and look forward to an interesting 2017.

Our long-term clients know that we don't react to short-term trends and eye-catching headlines. Rather, we focus on intermediate- and long-term trends while staying nimble enough to seize attractive opportunities. In 2016, our disciplined investment process, which relies on credit fundamentals and economic trends, rewarded investors with attractive fixed-income returns. We accomplished these results, in part, due to our economic forecast last year.

Corporate Earnings and Capital Expenditures

Our analysts are forecasting modest earnings growth during 2017, citing pro-business regulatory and tax reforms under the new administration. However, we suspect the impact on the economy will occur in the first half of 2017. The gains should be tempered by the higher value of the dollar, which makes U.S. exports more expensive, and President Donald Trump's potential trade policy changes.

On the capital investment side, we anticipate mid-single-digit growth with a continued focus on cost and productivity improvements, particularly automation that reduces staffing needs. Tax policy changes allowing the repatriation of foreign earnings could provide a boost to capital investments, which have been sluggish in this recovery.

Modest Pickup in Economic Growth

In 2017, we anticipate that U.S. real GDP growth will exceed 2.5%, a modest improvement over what we've seen in each of the past five years. The first half of the year could be stronger than the second half, marking a reversal from prior years when there was slower growth during the first and second quarters followed by robust growth in the third and fourth quarters. It is possible that positive consumer and business sentiment may weaken, as many of Trump's pro-business policies are slow to be implemented or scaled back.

In the labor market, we see the unemployment rate dropping to 4.3% to 4.4% from the current 4.7% rate. The participation rate should remain steady or rise modestly as the prospect of higher wages draws more people into the workforce. However, there's still enough slack in the labor market from the under-employed and individuals not in the labor force to keep a lid on inflation.

Overall, the U.S. labor market remains structurally challenged. Many skilled and semi-skilled positions remain unfilled due to an available labor pool that does not match employers' needs. As we have stated in the past, we would like to see more government-sponsored job training and employee-relocation programs.

Slow Grind to 2% Inflation

During 2016, inflation found a floor and began to rise modestly. We expect inflation to continue its modest pace higher in 2017. We anticipate that the personal consumption expenditures rate, a key measure of inflation for the FOMC, will continue to grind toward the Federal Reserve's 2% inflation target.

A Measured Approach to Monetary Policy

The Fed continues to be consistent in its message and actions. The FOMC's December rate hike and guidance was in line with our expectations. As such, we expect the Fed to remain data-dependent and to take a measured approach to policy in 2017. While the Fed has sent a clear signal to the markets that it wants to raise rates (up to three times during 2017), it also does not want to tighten too quickly and dampen the moderate economic expansion. With further Fed tightening remaining data-dependent, we are reluctant to anticipate any more than one or two rate increases during 2017. Clearly, this outlook will also be influenced by the new administration's stimulus programs.

The Skinny on Interest Rates

We anticipate continued volatility in Treasury yields in 2017, with the 10-year Treasury yield ultimately ending the year in a range of 2.65% to 2.85%. The yield curve will likely continue to modestly flatten as shorter maturity Treasury yields will be influenced by any Fed tightening moves. Also, Treasury supply may increase if stimulus programs lead to larger U.S. deficits.

Portfolio Positioning and Fixed-Income Forecast for 2017

From a big-picture standpoint, we remain constructive on credit, as corporate credit fundamentals have remained strong. We encourage investors to clip coupons. We anticipate only modest tightening in credit spreads in 2017. Similar to 2016, credit selection could be the key to achieving respectable returns as we expect event risk and merger and acquisition activity to drive dispersion across sectors and issuers. Our focus remains on short to intermediate maturities given the Fed's tightening expectations. Portfolio duration also remains important as we attempt to balance the pace of the Fed's tightening and rising rates with the lower yields of carrying bonds with very short maturities.

For 2017, we remain focused on producing income, not over-reaching for yield, and taking advantage of market opportunities. Generally, we're underweighting commodities and cyclicals and overweighting consumer and defensive sectors in credit. We continue to underweight the Treasury, agency and mortgage sectors due to a lack of relative value. We believe corporate bonds offer the most attractive opportunities based on stable credit fundamentals and market technicals, notably, less supply and potential debtholder-friendly policy changes out of Washington D.C.

But the environment is not without challenges. We see increased deficits as the biggest risk to the bond market in 2017, resulting in increased supply of Treasury bonds with less foreign demand from trading partners such as China. However, patient investors who buy investment-grade and high-yield corporate bonds when the U.S. Treasuries are oversold should benefit.

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The Rise of Protectionism in Trade

Inflationary forces will increase during 2017 if import border taxes are imposed and protectionist measures are enacted. We expect continued bantering on trade but little real action when it comes to policy. Republican and Democrats alike have historically been supportive of global trade because of the improvements in the standard of living for the entirety. Protectionists tend to forget that while many Americans workers are impacted by global trade, we are all consumers. Free trade is good for consumers because it holds prices down and benefits businesses by opening new markets.

In the long run, free trade is a positive development for workers too. Have workers been displaced? Yes. But there are feasible solutions. The Department of Labor's Trade Adjustment Assistance, or ATT, program, has been underutilized since it was founded in 1962. The ATT program was specifically designed to assist workers who were displaced by foreign trade through job training, relocation and other services. The angst felt by the working middle class is real, but can be alleviated by improving their skills and employment prospects. Finally, excess dollars earned by our trading partners often come back to U.S. markets through buyers of U.S. stocks and bonds.

The Fate of the Affordable Care Act

"Repeal and replace" should prove to be far more challenging than it sounds. Approximately 20 million Americans have health insurance as a result of the Affordable Care Act. It is far from perfect and needs modification. The baseline premise that all Americans are required to have insurance or pay a penalty, a significant point of contention for Republicans, will be difficult to eliminate. Both practical and budgetary constraints will lead to a modified plan that relies upon state Medicaid programs to provide coverage, either through income credits or plan participant contributions. Uncontrolled governmental spending on the healthcare safety net needs to be modified in an effort to manage healthcare inflation. These efforts are increasingly important as the baby boomers reach peak healthcare spending years.

Thank You

On behalf of Oppenheimer Investment Management, thank you for your business during the past year. We look forward to helping you and your clients navigate the ever-challenging financial markets. Remember, our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, which affords us confidence in the risk-reward trade-offs in our portfolios. While market fluctuations can cause short-term underperformance, our long-only style of investing has delivered positive results with reduced volatility over the long term.

If you have any questions on the strategy, performance or business development, please contact us:

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