FIXED INCOME OUTLOOK: For now, we're playing the waiting game

We're now three months into the new Trump administration and what have we learned (besides where to find Fox News and CNN instead of Bloomberg and CNBC on our TVs and radios)?

Taxes, infrastructure and regulations matter—maybe health care, too, to the extent it affects people's opinions of the other three. What doesn't matter to the markets? Travel bans, the Supreme Court, Russia tweets.

All that's pretty much been noise to the markets—so far. It's almost as if when Treasury Secretary Steve Mnuchin came out in late February and said we're going to deal with tax reform in August, it gave a free call option to the risk markets.

Who wants to be short risk assets until we know how big the tax plan is going to be? But how patient will the market be as it relates to any deviance from this pro-growth agenda?

Will it care if it takes longer and is more painful to achieve than expected, i.e., politics as usual, or is the ultimate result all that really matters? We may have gotten a taste of the market's thinking on this when the potential repeal-and-replace health-care legislation was pulled last month before a vote.

The surprise move added only minimally to a modest risk-off trade, as the market appeared to all but ignore the breathless political dissections. It may well be we're in a buy-the-rumor, sell-the-news environment. Until we see what's in the news, the rumor can be pretty powerful.

This has the fixed-income market playing a waiting game while it watches for policy clarity. The first quarter saw a consolidation of gains made in last year's fourth quarter, when the market re-priced, with November's election serving to intensify macro trends already in place. Since mid-December, when the Federal Reserve raised its target range 25 basis points, the 10-year Treasury has been trading in a relatively narrow band between 2.30-2.60%. Credit spreads have similarly been holding to a tight range.

Even the past month's second Fed increase in three months and minutes that show policymakers may start trimming the balance sheet late this year have had little impact as the central bank—once the market's focal point—finds itself overshadowed by the "great disruptor" in the White House.

Underweight on MBS, overweight on corporate credit

Looking ahead, we are watching volatility very closely. We're surprised it has remained so low but expect it will pick up at some point as we get details on policy moves or as the market's patience potentially starts to wear thin.

We have moved to an underweight in mortgage-backed securities (MBS), where in addition to potential Fed balance-sheet reduction, supply has picked up and rate swings either way would be bad. We remain at very modest overweights in high-yield and investment-grade corporate sectors. The tension between the hope of what's in the tax package versus investors' patience is at the core of the credit debate, and in a somewhat perverse sense, the failure at the first crack at replacing Obamacare likely bought more time for this trade. Fundamentals, i.e., corporate earnings, and macroeconomic conditions remain supportive, but spreads have fallen to levels where there's not a lot of value beyond the coupon.

Emphasizing tactical moves in duration and yield curve

As we believe more of the opportunities will be coming from the rate side as opposed to the spread side (where yield spreads relative to comparable-maturity Treasuries have narrowed below historical medians), the fixed-income team's focus has been on rate-sensitive duration, yield-curve and currency positioning.

In the past 12 months, for example, duration adjustments just prior to market-moving events—Brexit, the November election, the Fed March hike—helped lock in and/or add to gains.

It currently is short of neutral on expectations the bias on rates is up, while the yield curve is neutral on the long end but underweight the belly—3- to 7-year maturities—where we have seen and expect to continue to see rates rise faster relative to the rest of the curve. The currency bias is neutral to the dollar but with a focus on specific themes like overweighting commodity countries and underweighting the euro.

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