FIRST PRINCIPLES CAPITAL MANAGEMENT

FPCM

Monthly Market Overview

February 2018

Themes

January saw the dramatic reemergence of volatility with higher bond yields sparking a major stock market correction – down roughly 10% from January's peak, not dissimilar to what occurred in January of 2016, except with different causes. The specter of higher US wage inflation appeared in the form of a 2.9% YoY increase in January Average Hourly Earnings, including a 0.34% rise in January and an upwardly revised 0.4% increase in December.

The net issuance of US Treasuries in 2018 is expected grow to $1.4 TN – more than double the $550BN in 2017 – a figure that figure includes only the first year's effect of the tax-cut. The Treasury announced auction sizes with increases in monthly auctions over the quarter of $2BN for each 2 and 3-year notes, and $1BN for each 5, 7, 10, and 30-year nominal coupon notes/bonds. Most of the increases in fixed nominal securities will be in T-Bills and notes below 5-years to maturity. Congress passed an 11th hour budget deal which funds the government until March 23rd, giving Congress time to detail the 2018 fiscal budget. It raises the combined caps on military and domestic spending increases by $300BN over the next three years, and suspends the debt limit until March 1st of 2019. With this, the 2019 fiscal budget deficit beginning this September is projected to be $1.2TN – the same order of magnitude as deficits during and immediately following the great recession.

The Fed left the fed funds rate unchanged in its January FOMC meeting as expected, but the press release was interpreted as more hawkish:

"The Committee expects that economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate…"

Non-farm payrolls increased by a better than expected 200K in January and the unemployment rate remained at 4.1%. The sharp increase in Average Hourly Wages caught bond and equity markets' attention as it appeared long-awaited wage inflation has begun to set in. Upon further inspection, January increases were largely due to severe weather, which reduced the number of low-wage earners – supervisory/management and higher paid workers made up a materially larger proportion of the sample group. This dynamic artificially lifted average wages, thus most economists expect that effect to be reversed in the upcoming February number.

That said, US CPI for January came in at +0.5%, with core at +0.35% – both well above expectations, bringing the core number to +2.5% annualized over the past six months. At this pace, the Fed could possibly hike rates four times this year.

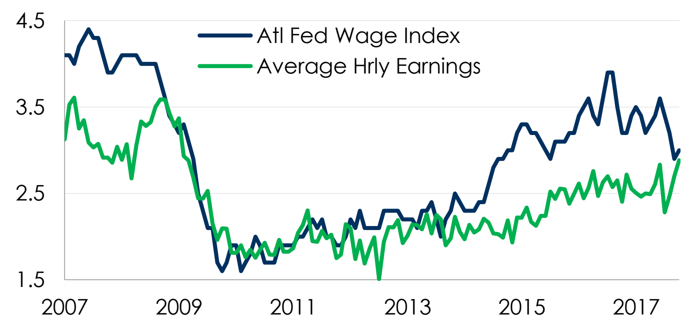
Since year-end 2017, US Treasury yields have been moving up (especially in the longer maturities), mostly in the form of increases in real yields, although inflation break-even expectations did widen some as well. A combination of reduced Quantitative Easing by the Fed and the ECB, and a growing concern that a strong US economy with new tax-stimulus accompanied by materially higher deficits and borrowing means investors will require higher real yields and more of a term premium to invest in longer maturity Treasuries. We don't anticipate much of an increase in long-term (10 - 30 year) inflation expectations going forward, so any increase in nominal yields will likely come in the form of further increases in real yields.

If anything, the recently passed budget deal only adds more upward pressure on longer term real yields.

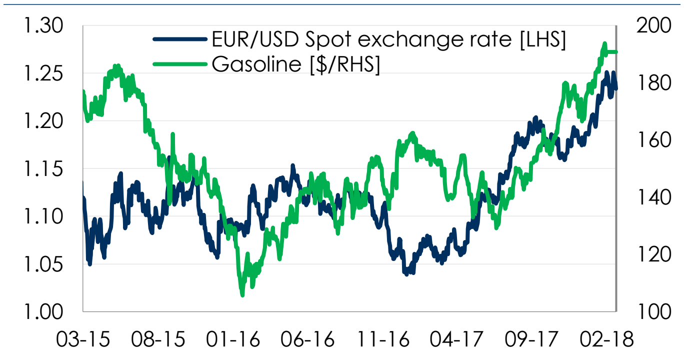
As far as near-term inflation, things could heat up as result of the initial effects of the tax cut, dollar depreciation, higher commodity prices, and tight labor markets. The dollar could well depreciate further if net investment flows out of the US and into Europe/EM persist in tandem with an already robust US trade deficit.

It is worth mentioning that the current equity market correction is largely due to two factors: 1) as Treasury real yields rose, the expected return on all assets (including equities), needed to increase, leading prices to drop given the same outlook for future earnings; 2) an unprecedented phenomenon in number of investors short options/volatility so that as soon as equities began to fall, the effect was magnified as option sellers scrambled to hedge their positions, thus exacerbating the daily, and intra-day moves in the stock market in both directions. There is no fundamental US economic reason (such as an impending recession) for the stock market to have fallen so quickly, simply the fact that it moved up too far too fast and now has to correct. Market volatility will remain higher until those who are short options are flushed out of the market by closing their positions.

ATL Fed Wage Tracker vs Avg hourly earnings [%/YoY]



Gasoline vs EURUSD



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Observations

Rates

- Last year, equities rallied and the yield curve flattened. This year, the correlation still exists, but works oppositely: when equities sell off, the yield curve steepens. Some attribute this behavior to risk parity trading strategies – when realized volatility is low, buy equities and buy long-maturity Treasuries; when realized volatility is high, sell equities and sell long-maturity Treasuries.
- Though the Fed is expected to hike, global central banks will continue accommodative posture, seeking low rates at risk of inflation -- as long as fed funds remain below 250bp, there should remain a bid on risky assets.
- Longer maturity real yields are still low compared to historical levels.

Credit

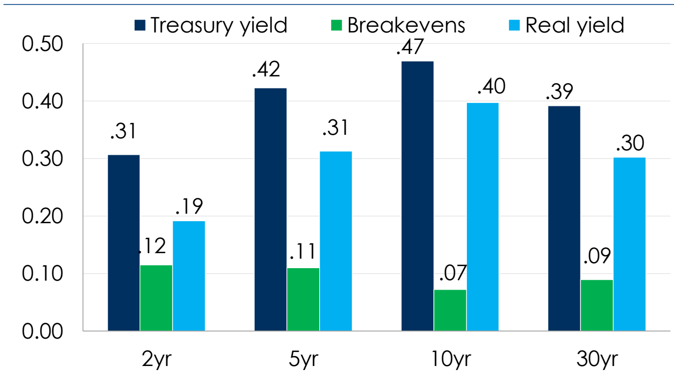
- Investment grade credit has seen inflows and spread tightening, as technicals remain strong. High yield, though not facing imminent weakness, has seen outflows and widening spreads. There has been strong issuance, though not quite as high as 2017, in both asset classes.
- Expect constructive credit environment to persist.
- Currently, corporations are repatriating cash – this provides three potential negative impacts:
    - With corporates liquidating short-dated corporate bonds, most being fixed rate, spreads will widen.
    - Since these corporates are also holding short-dated Treasuries, selling these holdings will also drive short-term rates higher.
    - These participants, who have been buying and holding short-term paper, will not buy as a result of repatriated cash.

Munis

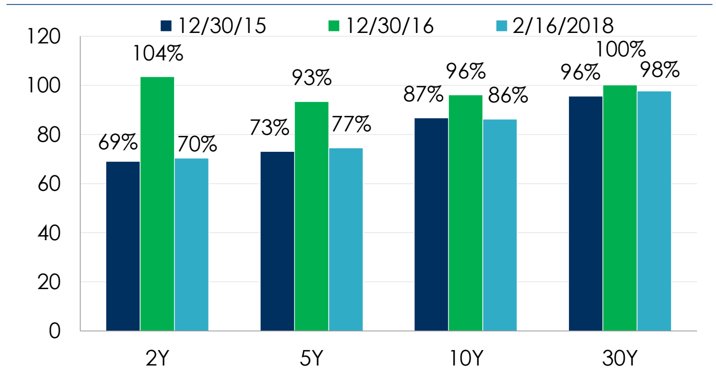
- As most inventory is currently parked on dealer balance sheets, dealers are anxious for demand to materialize. Dealer inventory is near a record high in anticipation of reduced issuance first quarter of 2018. Thus far in 2018, demand for municipals has been muted.
- Keep credit risk to a minimum, given tight credit spreads.
- Munis appear rich for maturities longer than 20 years.

Monthly charts

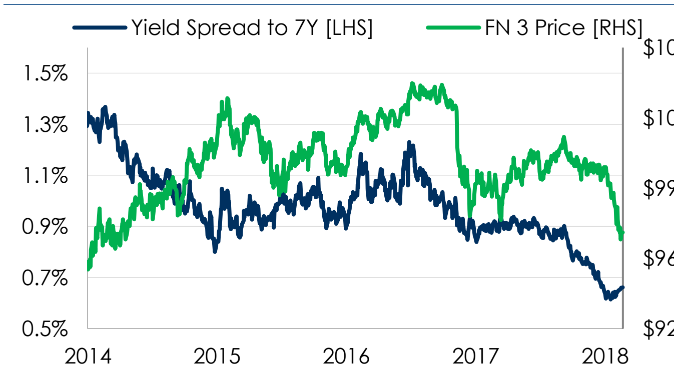
US rates shift [%], 12/29/2017 through 2/16/2018



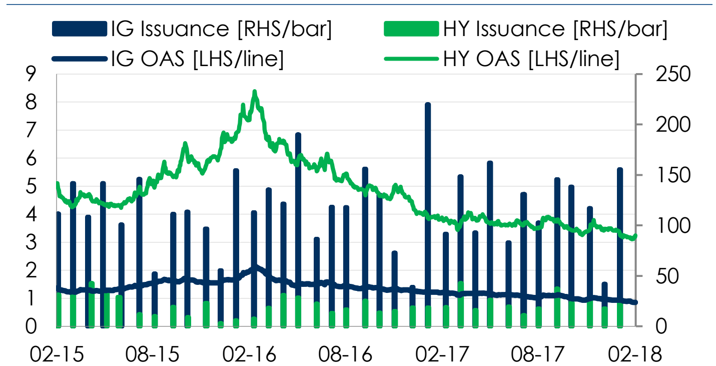
Ratio of AAA GO muni yields vs USTs



MBS TBA spread to UST vs. FN 3 price



Corporate issuance [$BN] and spreads [%]



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