FIRST PRINCIPLES CAPITAL MANAGEMENT

Monthly Market Overview

December 2017

Themes

In November, the US Treasury yield curve continued to flatten as yields rose in anticipation of Fed tightening, the S&P 500 index powered to new highs, and the US dollar dropped vs. other major currencies. The Senate successfully passed their tax bill which, despite some differences, was consistent with the House bill in cutting the corporate rate to 20%, while eliminating a number of deductions for individuals – particularly in higher tax states. The non-partisan Joint Committee on Taxation estimated that Senate bill would add $1trn to the national debt over 10 years even after factoring in economic growth benefits.

Meanwhile, US real GDP has been running above 3% for the past two quarters and is forecast to exceed 3% in Q4 by both the NY and Atlanta Fed models. November non-farm payrolls added a higher than expected 228K. Unemployment remained at 4.1%, a 17-year low, the 4-week moving average of new jobless claims continue below 250K, and job openings in the US JOLTS report continue come in at or above 6 million, with September revised up to 6.2 million – an all-time high. Moreover, the share of employed US prime age labor force (25-54 year olds) is up to 79% and continues to climb. Given this strong economic backdrop, several economists have questioned whether the timing of these tax cuts is more likely to cause the US economy to overheat, finally pushing inflation higher, and thus spurring faster rate increases by the Fed –ultimately hastening the next downturn.

The actual measured rate of inflation has stayed subdued, with both core CPI and PCE below the Fed’s 2% target, and average hourly earnings coming in at 2.5% year-over-year. A recent paper from the Federal Reserve bank of San Francisco made the case that acyclical components of core PCE, particularly health-care services, have depressed that measure by roughly 0.3% on average since the recession as a result of lower Medicare payments due primarily to the Affordable Care Act (ACA) and other legislation.

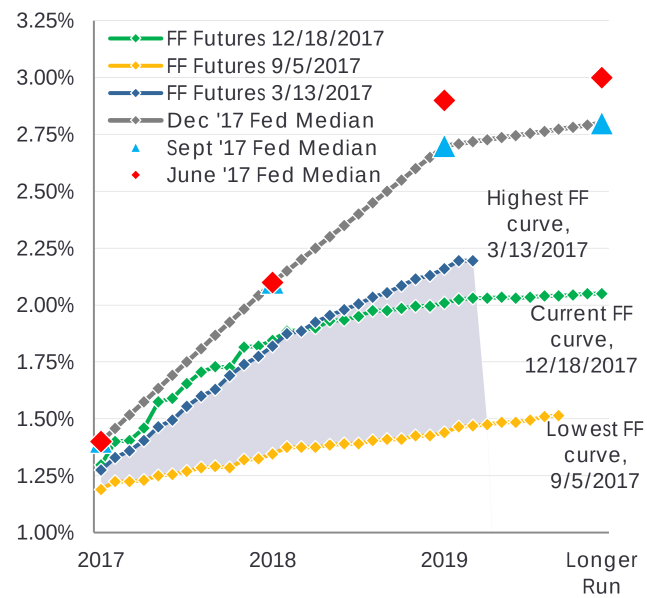
As illustrated in the “Projected fed funds rates and futures estimates” graph, market estimates for the path of the fed funds rate near the highest level over the past year. The FOMC raised their short-term rate by 25 basis points in the December meeting and maintained the median September fed funds projection for three moves in 2018, with the market pricing in two more such moves next year. Several large dealer strategists are calling for four moves next year which is looking more likely given impending tax cuts. Thomas Barkin, a former chairman of the Atlanta Fed’s board and McKinsey Chief Risk Officer, has been named as the Richmond Fed president and will be a voting member of the FOMC in 2018. His background as neither an economist nor a banker makes him even more of a mystery with respect to his views on monetary policy.

With the prospect of removal of tax-exempt status for municipal advance refunding and private activity bonds, there has been a torrent of Municipal bond issuance in December to take advantage of a closing window before year-end, where any new tax provision would become effective. Surprisingly, that large supply was met with equally large demand, bringing yield ratios lower as investors seemly sought to buy ahead of lower issuance (tighter spreads) next year. The final draft bill retains tax-exempt status for private activity bonds, so it remains to be seen whether that demand wanes as investors assess the relative richness of municipals to Treasuries and corporate bonds.

In the long end of the US yield curve, there has been more stripping of Treasury securities (to own more long maturity zero coupon bonds) and purchases of longer maturity high grade corporate bonds by US corporate pension plans. These pensions have accelerated their contributions this year, motivated by higher PGBC fees for underfunding, and to take deductions in the current tax year vs. next year when corporate tax rates will fall by as much as 15%. This has taken some pressure off of 30 year Libor swap spreads which have risen from -35bps at the beginning of September to -20bps.

With strong employment gains leading to an ever-tighter labor market coupled with tax cuts next year, one would expect to see higher wage inflation. Questions still remain as to how much of the tax savings and repatriated earnings will go directly to shareholders in share buy-backs, dividends, and acquisitions vs. capital expenditures, which would promote higher growth. So far, inflation break-even expectations, the difference between nominal Treasury yields and Inflation linked Treasury (TIPS) real yields, have remained stable to lower at modest levels- with more than 100% of the inversion in Treasury yields over the past month coming from changes in real yields (US rates shift graph). Some commentators have mistakenly suggested that the move towards inversion of the US yield curve is foreshadowing a U.S. recession. In reality, inversion has been driven by technical forces; the Fed’s normalization of their policy rate combined with the Treasury’s decision to issue more in maturities 5 years and under, and an increased demand for longer maturity bonds by US corporate pension plans.

Projected fed funds rates and futures estimates



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Observations

Rates

- The Alternative Reference Rate Committee (ARRC), formed in November 2014 by the Federal Reserve, has selected a broad Treasury repo financing rate (BTFR) as the new alternative to LIBOR. The BTFR includes a broad set of repo market transactions including transactions across tri-party repo, general collateral finance (GCF) and bilateral trades cleared by the Fixed Income Clearing Corporation (FICC). The Fed publishes the rate on a weekly basis and expects to post daily rates by June 2018.
- Due to the recent yield curve flattening, there are tighter basis point differentials between shorter maturities – term premia – that furthers the need for thoughtful consideration regarding risk (duration) vs. reward (yield).
- There are also questions whether a flatter yield curve, historically an indicator of impending recession, will be the case during the current extended cycle. Current conditions, such as absolute yield levels around 2%, as well as proposed fiscal policy stimulus, may counter the normally accepted recessionary indicators from a flat yield curve.
- Expected corporate repatriation of profits incentivized by the proposed tax bill is expected to lead to selling of Yen and Euro currencies – impacting currency swaps and sending basis spreads into further negative territory.

Credit

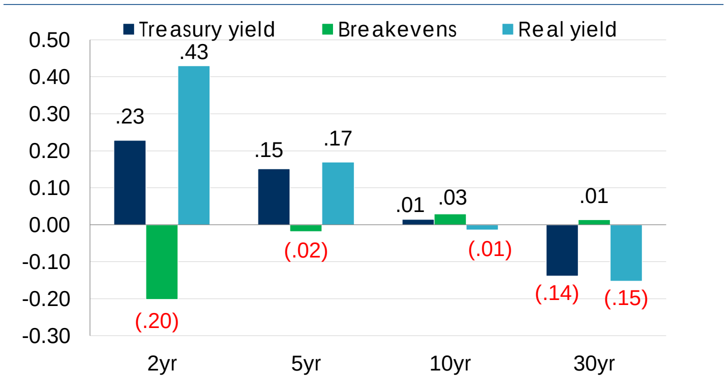
- High yield credit spreads recently experienced a sharp widening due to an unfavorable technical backdrop and, specifically, 3-4 telecom names' (Sprint, Broadcom, Qualcomm). This related M&A activity contributing to roughly 50% of the selloff. Though the move was not broad-based, we are still not constructive on HY.
- Investment grade levels have remained stable.

Munis

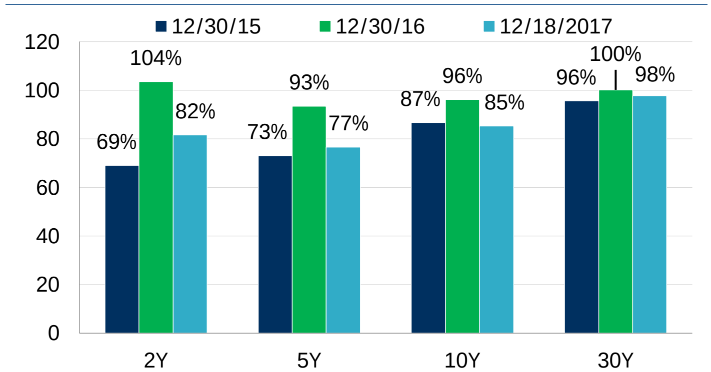
- December is typically a very volatile month for municipal bond prices, and this year is no exception. Volatile price movements have been exacerbated by issuance being pushed ahead in anticipation of the impending tax bill and related uncertainties. Therefore, issuance beginning in 2018 should be relatively muted.

Monthly charts

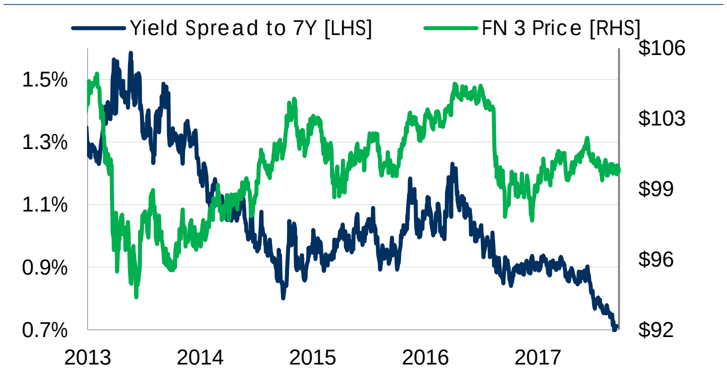
US rates shift [%], 10/31/2017 through 12/18/2017



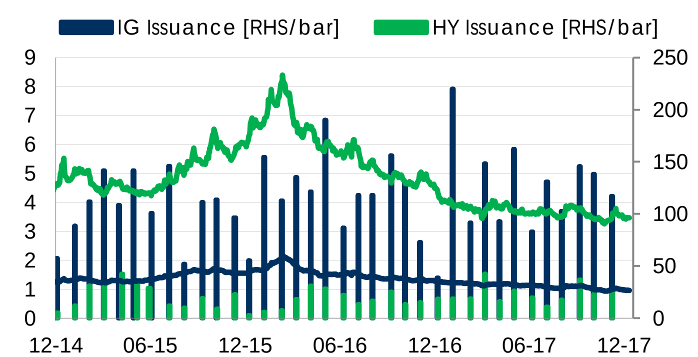
Ratio of AAA GO muni yields vs USTs



MBS TBA spread to UST vs. FN 3 price



Corporate issuance [$BN] and spreads [%]



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