Monthly Market Overview

December 2018

Themes

November revisited the extreme equity market volatility of the previous month with the Russell 2000 small cap index down well over 10% from peak, and Treasury rates fell as markets were anticipating economic slowing in the coming year. Oil prices continued to fall, with WTI below $50 per barrel, and investment grade corporate spreads widened another 20 basis points against the backdrop of low liquidity and leverage concerns.

Chairman Powell softened his language to “just below” the neutral range from a “long way” from neutral after the September FOMC which had a powerful effect on bond and equity markets which drew the conclusion that he is not as hawkish as previously thought. As expected the FOMC raised the fed funds range by 25 basis points to 2.25% - 2.5% in December, with interest on excess reserves (“IOER”) moving up by 20 basis points to ensure that the policy rate stays closer to middle of that target range. More important the median dot-plot interest rate projections shifted down 25 basis points for 2019 and beyond signaling 2 interest rate hikes next year. The December post meeting message is that the policy rate has begun to enter the neutral range where the Fed will be more data driven, but if real growth is still above 2% and unemployment is at or below the current level, the Fed could raise rates even if inflation stays roughly where it is now (at or just below target).

November’s retracement of Treasury yields was entirely due to a shift down in inflation expectations, as reflected by nominal and inflation linked treasuries (TIPs), largely due to the drop in oil/gasoline prices which affects headline inflation. Beginning in December we saw the Treasury yield curve invert, 2yr yield above 5yr, for the first time reflecting the market’s view that the Fed will cease raising rates in 2019 as the economy slows.

While energy prices left CPI unchanged in November, core, ex-food and energy, was up 0.2% for the month, up 2.2% year-over-year (YoY), very consistent with recent inflation numbers and the Fed’s target. Average hourly earnings were up 0.2% for the month, 3.1% YoY, while Atlanta wage growth tracker for October was 3.7% YoY, a two-year high. Wage inflation is now solidly in the 3% -4% range, still a question of whether it will move higher.

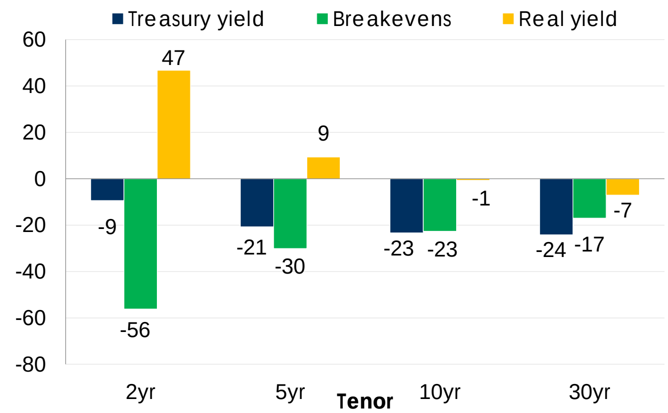
Despite a disappointing +155K November payrolls gain unemployment remained at 3.7% and Job Openings broke above 7mm again in October. Most economists have been expecting a slower expansion of payrolls in an increasingly tighter labor market where the US only requires +80K per month to maintain the current level of unemployment.

Housing activity continued to slow by any measure as existing home sales were down over 5% YoY and new home sales down by 12%. Affordability, in the form of 1% higher mortgage rates and average annual home price appreciation of +7% over the past 6 years (as measured by S&P Case Shiller), is the main culprit. Moreover, a shortage of construction workers (at higher wages) coupled with increased costs of materials is making it unattractive to build affordable single-family homes. Housing was a leading economic indicator of this recovery and may well be again with respect to a future slowdown.

Investment grade corporate bonds yield spreads widened substantially as buyers disappeared, most notably foreign institutional buyers, redemptions were up in mutual funds and ETFs, and dealers stepped back from providing liquidity approaching year-end. There have been $17BN in redemptions since the beginning of October, $3.5BN of which come in the last week of November causing IG credit ETFs to trade below their NAV due to lack of liquidity. In addition to equity market turmoil, investors are concerned about increased leverage where 50% of investment grade bonds outstanding are in the BBB range, heading into a slower economy.

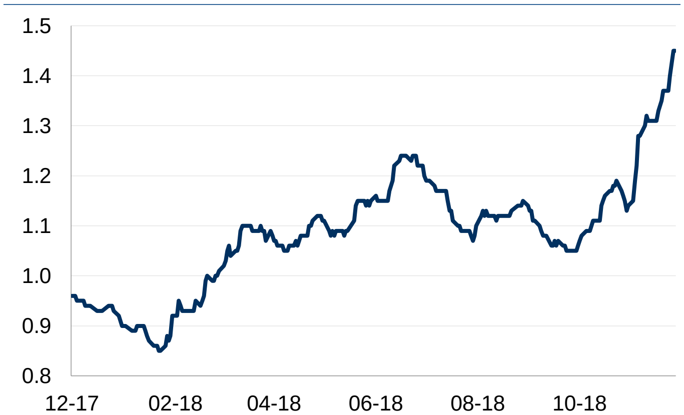
Given overall concerns about impending slowdown in US and world growth as we head beyond 10 years of U.S. recovery, coupled with higher corporate leverage, it is hard to see longer term yields rising substantially from where they are now. There will continue to be volatility in equities and corporate spreads may widen further.

US rates shift [bp], 10/31/2018 through 12/12/2018



Source: Bloomberg

US Investment Grade Corporate OAS [%]



Source: Bloomberg

FIRST PRINCIPLES CAPITAL MANAGEMENT

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Observations

Rates

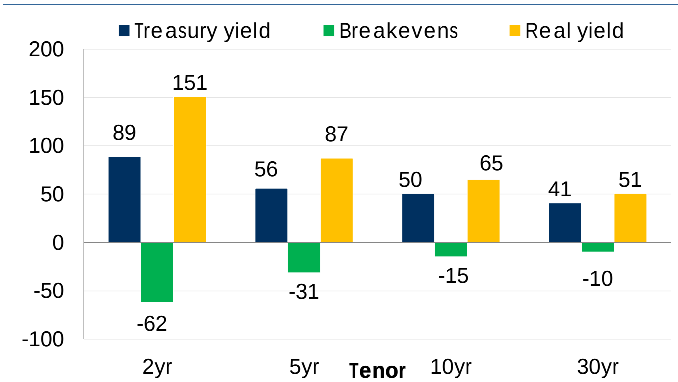
- Fed Chair Jerome Powell's most recent comments were interpreted as dovish, due largely to the "just below" the neutral rate comment, and the market will continue to look for clues on future policy – especially in the face of recent, broad market gyrations
- Rising and flattening Treasury curve, with inversions in some tenors (2yr vs 5yr) beginning to emerge -- current USD Libor curves indicate a peak rate in early 2020, signaling curve inversion and resulting reestablishment of accommodative monetary policy.
- Have yet to see an inflationary spike, and expect this to remain the case as demographics, workforce dynamics, and technological advances contribute to muted levels
- Specter of planned trade tariffs and potential trade wars increasingly weigh on markets causing a fresh wave of market volatility following the G-20 summit – kicking the can from both sides it seems, we expect a tactful strategy out of China countering the US administration's rhetoric driven pressure

Credit

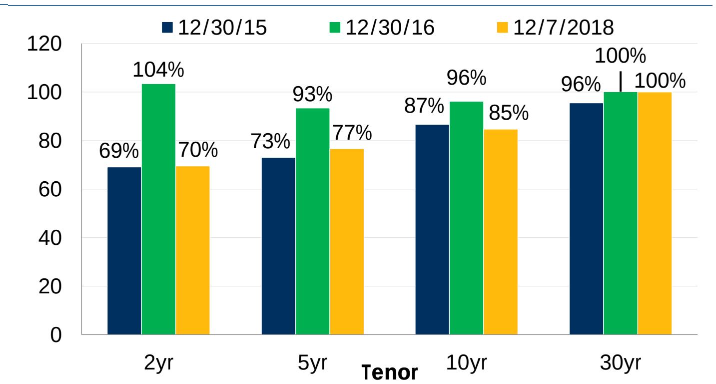
- FPCM is not sanguine on corporate (IG and HY) spreads for 2019 – on top of peaking fundamentals, technical forces add to headwinds with prohibitively expensive FX hedging costs contributing to waning foreign corporate paper demand
- High yield could be a particularly painful area in the market considering the credit cycle, leverage ratios, and low oil prices

Monthly charts

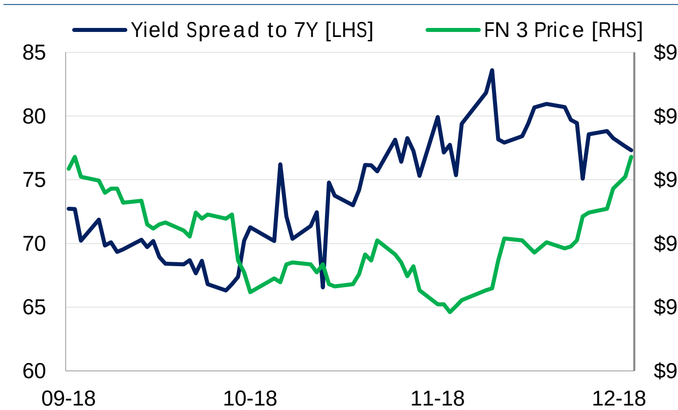
US rates shift [bp], 12/29/2017 through 12/12/2018



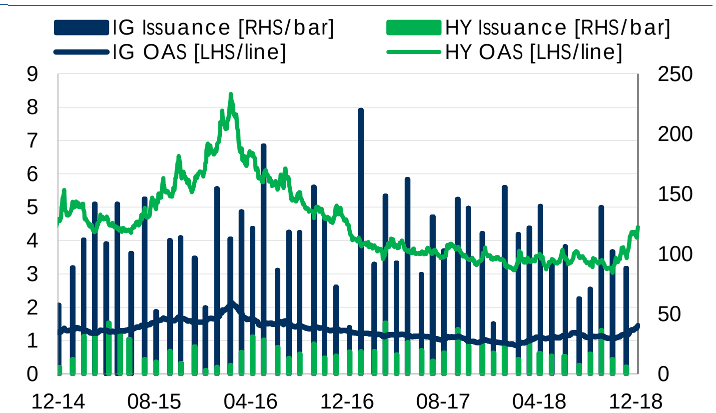
Ratio of AAA GO muni yields vs UST



MBS TBA spread to UST [bp] vs. FN 3 price



Corporate issuance [$BN] and spreads [%]



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