Monthly Market Overview

January 2019

Themes

U.S. equity markets had their worst month since 2009 as the S&P 500 came within a whisker of a bear market, 20% correction from the peak, and Treasury yields fell roughly 30 basis points across the curve as flight-to-quality and sharply lower oil & gasoline prices lowered inflation expectations. The markets took the view that the US economy will slow later this year prompted by an apparent slowdown in the world economy, particularly in China where the trade war is beginning to have real effects on Chinese consumption.

As expected, the Fed raised their policy rate range up by 25 basis points, only 20 basis points for Interest on Excess Reserves (IOER). Despite telegraphing the move, the stock market took this as evidence that the Fed may well go too far in raising rates and push the economy into recession. Trump further destabilized the market by criticizing the Fed and intimating that he might fire Chairman Powell, something that would be have been catastrophic if not for other administration officials and congressmen who pointed out that the Chairman of the Federal Reserve could only be fired for cause, meaning something criminal.

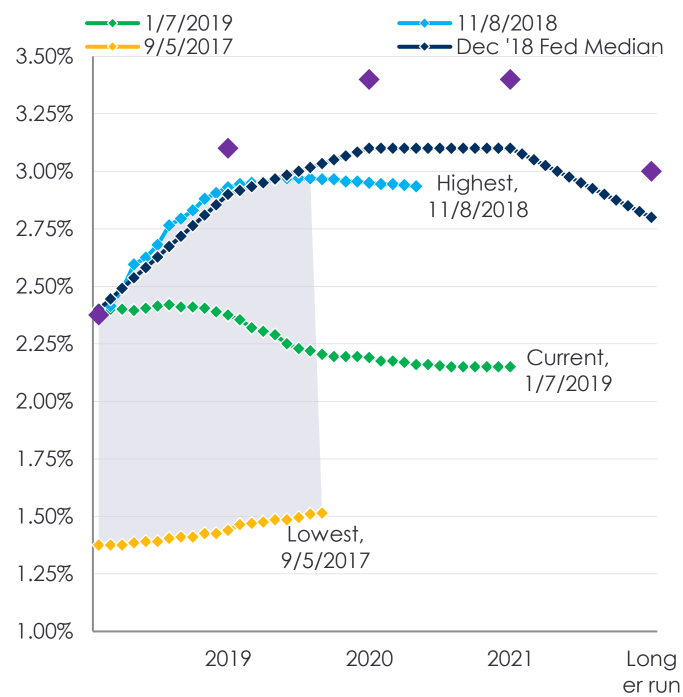
The growing dichotomy between the real economy which is humming along, with average monthly payroll gains of 220K in 2018 coupled with solid holiday sales, and financial assets, stocks, investment grade corporates and leveraged loans was dramatic. Markets are focusing on so-called leading indicators such as a slow-down in housing, auto sales, ISM manufacturing index, and foreign consumption of US products. Apple's announcement that iPhone sales would be materially lower than projected in the 1st quarter, something that hasn't happened in decades, was a very visible example of how even the best US tech companies are threatened by the trade war and the associated slowdown in China.

The median Fed predictions for the policy rate released after the December FOMC were 25 basis points lower for 2019 and 2020. In January, in recent speeches and answers to questions, Fed governors, including Chairman Powell, have changed their rhetoric *from* regular hikes as long as employment and growth are sustained *to* patience before raising rates in light of volatile markets and tightening financial conditions. Most recently regional governors Rosengren and Evans, both voting FOMC members in 2019 and considered hawkish by many Fed watchers, have altered their message, indicating that they would be inclined to pause until they have seen more evidence that the economy was overheating in the form of higher inflation. Fed funds futures currently predict no more increases in rates in 2019, followed by a decrease in 2020. There has been mention in the most recently released FOMC minutes of a possible change in the current rate of balance sheet normalization, but nothing seems imminent.

The December employment report was surprisingly strong with +312K nonfarm payrolls and even the increase in the unemployment rate to 3.9% was explained by 412K new entrants to the labor force, driving labor participation up 0.2%. Average hourly earnings were up a robust 0.4% in December which was the only sign of potentially higher inflation to come as core CPI in December came in at 2.2% YoY, +0.2% for the month. It will be interesting to see if companies, when faced with increasing costs due to higher wages and tariffs feel emboldened to raise prices or be forced to accept narrower margins/profits.

The Fed is nearly done raising rates, absent any surprise surge in wage inflation, we would anticipate one more increase at the most in 2019. Add to that the structural uncertainty/volatility in equity markets concerned about shrinking growth and profits later this year and it is hard to see a structural material increase in U.S. yields from here even factoring in growing budget deficits. Equity market volatility will continue to keep investment grade corporate spreads where they are or higher in 2019 where issuance is only predicted to be marginally lower than 2018, and dependence on leverage in the dominant BBB category will eventually lead to coverage stress and downgrades for non-financial companies in a slower economy.

Federal Reserves versus market estimates



Source: Bloomberg

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FIRST PRINCIPLES CAPITAL MANAGEMENT

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Observations

Rates and the economy

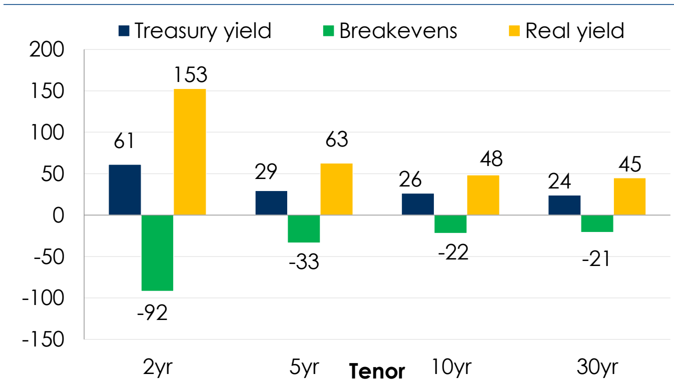
- Current market inflation expectations, as reflected in TIPS breakeven spreads, have priced in considerable economic softness. With the potential for continued growth, these slow-growth expectations may be overdone. Given current levels, we are constructive on TIPS versus nominals.
- Market discovered the "Powell put" following the December dislocation in equity markets and subsequent rebound due to a changed market view on anticipated Fed interest rate trajectory
- Robust Treasury issuance could be a headwind on fixed income generally.
- With domestic and global liquidity coming under pressure, it is an increasingly important factor to remain cognizant of.

Credit markets

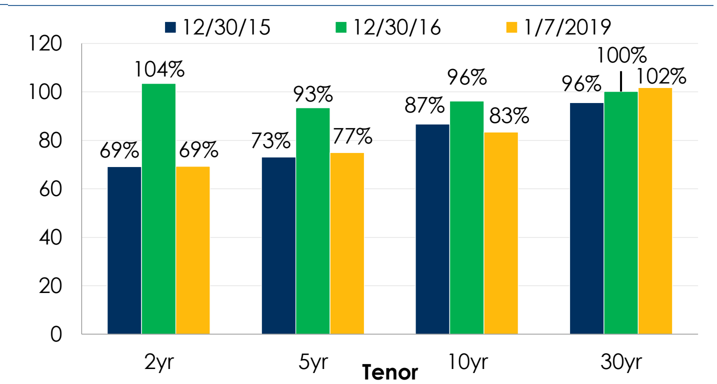
- Skews in the options market representing different parts of the volatility market are higher, reflecting the desire to protect against corporate spread widening.
- Recent changes in interest rate path expectations (toward lower future rates) has softened the persistent bid for floating rate securities. Many floaters now offer less spread than fixed rate bonds. As a result, liquidity has declined when compared to earlier this cycle.
- With regard to the current credit cycle, market consensus is that the cycle will not end in 2019, however spreads unlikely to tighten meaningfully longer term. The CDX derivatives index, representing broad IG credit is currently at 72.5, the bottom end of a 2-month range, but meaningfully wider than September levels at 55 bps. FPCM is defensive on credit with upside not very compelling. We are, however, slightly more sanguine on high yield and loans considering the dearth of supply and current levels.

Monthly charts

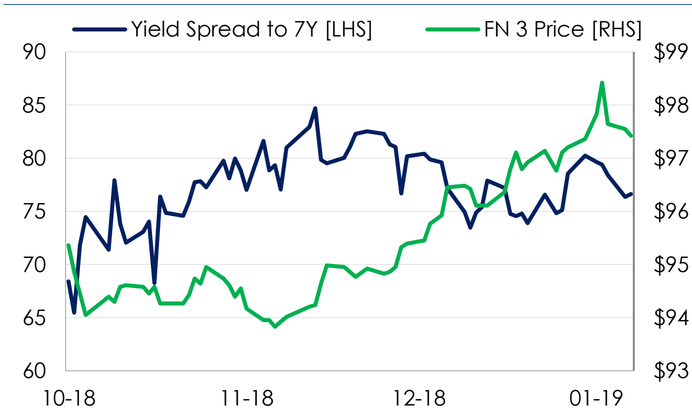
US rates shift [bp], 12/29/2017 through 1/4/2019



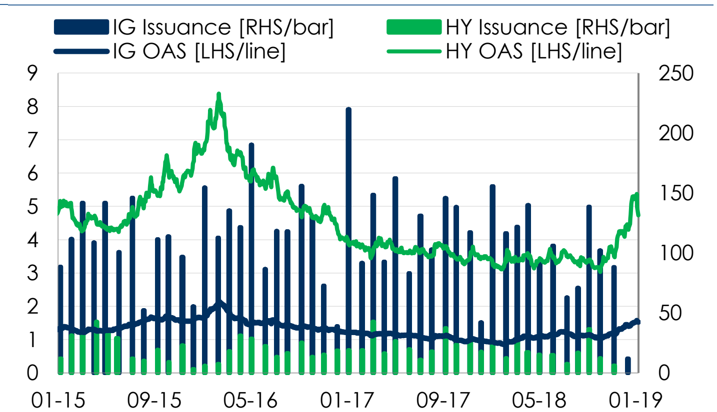
Ratio of AAA GO muni yields vs UST



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



Corporate issuance [$BN] and spreads [%]



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