FIRST PRINCIPLES CAPITAL MANAGEMENT

FPCM

Monthly Market Overview

June 2018

Themes

May brought more turbulence to the markets with the Italian political coalition of 5-Star and the League raising the possibility of new elections which could become a referendum on whether to leave the European union. Emerging market countries such as Argentina, Brazil, and Turkey experienced a major drop in the value of their local currencies and an increase in credit spreads on dollar debt due to the prospect of higher rates and deficits in the US. Despite this, US equities rallied, especially tech stocks, with the Nasdaq hitting all-time highs – up nearly 11% year-to-date.

US fundamentals continue to look strong as 223K non-farm payroll jobs were added in May, bringing the year-to-date (YTD) monthly average to +207K -- even higher than the 2017 average of +182K. The unemployment rate was down 0.1% to 3.8%, an 18-year low, and the U6 underemployment measure was down to 7.6%, lowest since 2001. Job Openings were up to 6.7MM, the highest level since inception in 2001 -- more than the number of people unemployed.

With the supply of workers this tight, one would expect wage pressure in short order. May core inflation, as measured by CPI, came in +2.2% YoY, while April PCE was +1.8% YoY – close to the Fed's 2% target, which means that there is no reason for them to pause quarterly increases to Fed funds.

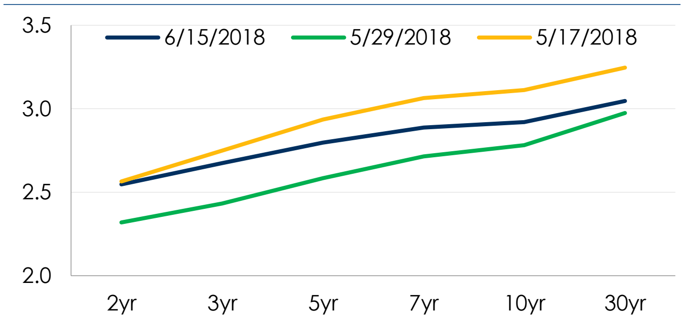
As expected, the Fed raised the fed funds rate in the June 12-13th FOMC meeting. Interest on Excess Reserves ("IOER") was raised only 20 basis points rather than the usual 25. Raising IOER has been one of the tools used by the Fed to raise fed funds and has represented the top of a 25 basis point range, expecting fed funds rate to trade in the middle of that range. In reality, the effective fed funds rate had been at 1.7% -- only 5 basis points below the previous IOER, which was at 1.75%. The hope is that by raising the ceiling by only 20 basis points this one time, fed funds will move closer to 1.875% rather than 1.95%. So far this has worked with fed funds effective rate at 1.91% post FOMC. Some market participants have made the case that the reason fed funds is trading higher than the middle of the range is that the Treasury issued a large amount of new T-Bills, roughly $400BN, in the first quarter. Due to the last year's dearth of T-Bills and demand for dollars by foreign borrowers, central banks and market participants created T-Bill replacements in the form of Treasury repo, FX swaps, and agency discount notes, all of which now compete for investor dollars in a market where US overseas corporate cash accounts are repatriating their cash, lessening demand for T-Bills. Thus, it is likely that higher T-Bill rates will push the fed funds rate higher and lowering ceiling IOER will have little or no effect -- in fact this may lead to fed funds trading higher than the IOER "ceiling."

Treasury yields moved dramatically intra-month as the trading range was over 30 basis points from high-to-low on 10-year Treasuries (graph opposite) as concerns of an eventual Italian exit from the Eurozone increased, including probable default on Euro denominated government debt, caused a flight to quality.

As of now, rather than holding a new election, the coalition has chosen Giuseppe Conte as prime minister and proposed lower taxes and more domestic spending on "citizen's income" for the poor. The cost of these measures is estimated to be €126BN in the first year which would cause Italy to breach certain fiscal requirements for EU members. Capital markets view this as a more benign situation, and the cynical view is that this coalition will not last more than a few months and there will need to be new elections.

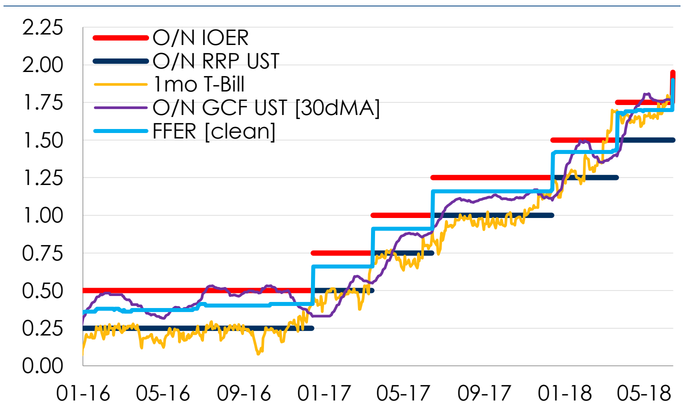
Initially, the market speculated that the Italian populist coalition government issue would force the ECB to prolong its €30BN per month QE bond purchase program beyond September to quell any market disruption. In its June 14th meeting, the ECB Governing Council announced that it will halve QE bond purchases to €15BN per month in September and end new purchases altogether at the end of the year, adding that short term rates would be kept the same "at least through the summer of 2019." This statement pushed the Euro lower vs. the dollar and caused German bonds to rally. The ECB will continue to reinvest any-and-all maturing principal in the portfolio. By pushing back the beginning of short term rate rises, the ECB successfully announced the end of the QE program this year without the taper tantrum that the US suffered when the Fed announced the beginning of the end of its QE program in 2013.

U.S. Treasury yield curves [%]



Source: Bloomberg

Fed bands [%]



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Observations

Rates

- The Fed and accompanying policy has been a key focus for the markets. Recent Fed comments have been mixed, striking a dovish/hawkish tone. The Fed recently used "symmetric" language for the first time and has indicated a need for vigilance as economic indicators remain strong, which was dovish. Alternately, the Fed's four hike expectation for 2018 is hawkish.
- Median expectations for Fed funds are now at 3.25%-3.5% by the end of 2019.
- Along with higher short maturity yields, the yield curve is expected to continue to flatten. Forwards markets show 20 bps for the 2-10 spread by early 2019 (vs. 35 bps today). The question is whether expectations will change vs. current forward yields. Short maturity TIPS, in our view, are attractive to equivalent nominal treasuries, as increases in core realized inflation begin to materialize.

Munis

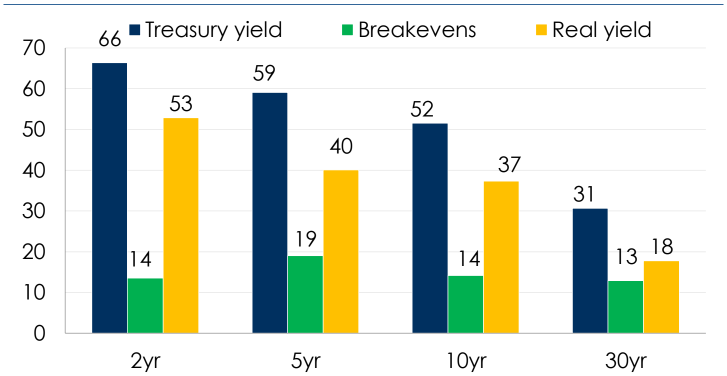
- Municipal bonds continue to be rich vs. other high quality fixed income sectors. Dealer inventories are still high and banks continue to be sellers. However, with supply low, there is little catalyst for municipals to cheapen. On the other hand, money continues to pour into municipal bond funds. This supply/demand imbalance should last through the summer, helping municipals to maintain their relative richness.

Mortgages

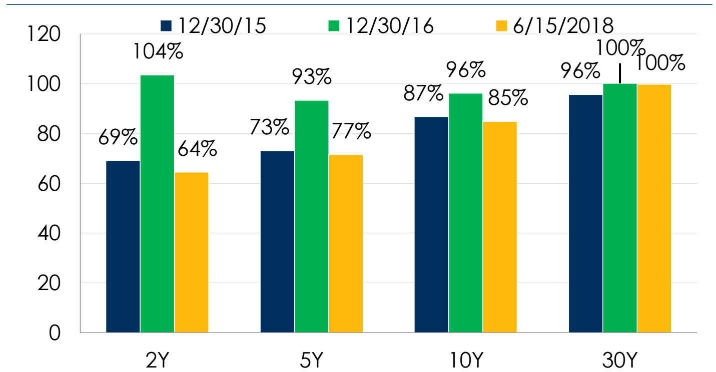
- Mortgage spreads to Treasuries ended May roughly unchanged. Prepayment speeds on Agency MBS were 9% faster due to seasonal factors and an increase in day count (i.e. more days to close loans in May vs April). Prepayment speeds continue to be high relative to the level of rates, though this could normalize in the months ahead.
- The VA announced changes to their mortgage program making it more difficult for originators to churn borrowers (refinance borrowers who have little incentive to refinance). VA loans are securitized into Ginnie Mae MBS, which rallied on the back of this news.
- Mortgage derivatives widened due to heavy sales from hedge funds.

Monthly charts

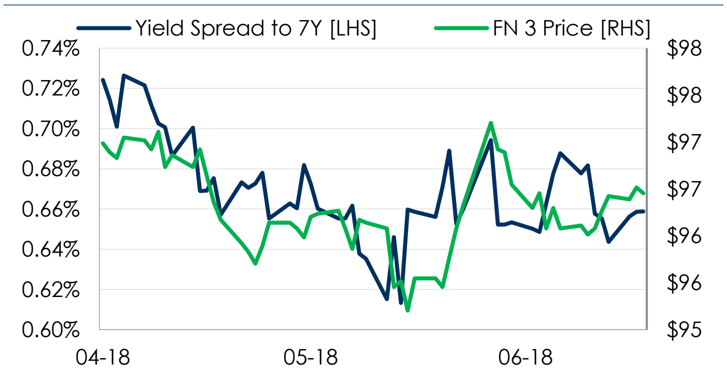
US rates shift [bp], 12/29/2017 through 6/15/2018



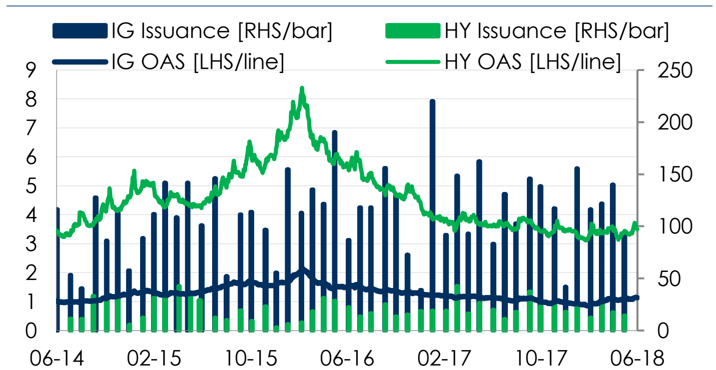
Ratio of AAA GO muni yields vs USTs



MBS TBA spread to UST vs. FN 3 price



Corporate issuance [$BN] and spreads [%]



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