FIRST PRINCIPLES CAPITAL MANAGEMENT

Monthly Market Overview

March 2018

Themes

In February the US equity market continued to recover following a nearly 10% correction. Daily volatility remains elevated amid questions of whether the steel and aluminum tariffs and the resignation of Gary Cohn are the beginning of a larger protectionist agenda by the administration. US yields were higher by 11-20 basis points over the month as a result of stimulus and significantly higher anticipated net new supply of Treasuries.

After its March 1 meeting, the ECB unexpectedly removed language from its statement pledging to accelerate bond purchases again if the Eurozone economy "outlook becomes less favorable." This was interpreted as implicit confirmation of winding down its €30BN Quantitative Easing program in Europe in September.

Nonfarm payrolls in February were surprisingly strong at +313K, well above consensus of +200K, with combined upward revisions of +54K to January and December. Despite strong job gains, the unemployment rate remained at 4.1%, as the labor participation rate moved up by +0.3% to 63% – the largest single month jump in 8 years. As illustrated by Chart 1 (source: FRED, BLS), prime labor force participation (workers aged 25-54, which strips out the baby boomer retirement bias) is at 82.2%, continuing the trend towards meaningfully reducing labor slack.

Given the congressional testimony of chairman Powell and other FOMC members' rhetoric, the Fed will, barring some unforeseen crisis, raise rates by at least 25 basis points in March and again in June. The market is currently pricing in a third 25 basis point hike before year-end and several banks and some economists expect a fourth increase.

As anticipated, the change in Average Hourly Earnings (AHE) for February was lower at +0.15% month-over-month (MoM) from +0.26% in January due to the weather-related distortions mentioned in last month's commentary. AHE is widely followed by market participants looking for signs of wage inflation but is a somewhat flawed measure. Consumer prices in February were quiescent with CPI at +0.2% month-over-month for both headline and core measures.

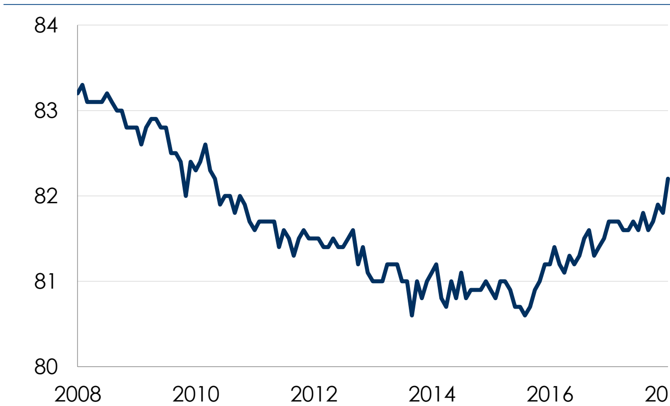
Every maturity US Treasury yield is near multi-year highs with the exception of the 30-year bond, which is still below the March 2017 level of 3.21%. US corporate defined benefit pension plans have until September 15th this year to deduct contributions to their underfunded plans for tax-year 2017 at 35% rather than 21% – the new corporate tax rate. Concurrently, the Pension Benefit Guarantee Corporation (PBGC) is raising insurance premiums every year as a percentage of the dollar amount of unfunded liabilities in underfunded plans. This has (and will) encourage companies to contribute to their plans and immunize the liabilities by selling equities and buying longer maturity investment grade corporate bonds over the next 6 months. That should limit the rise in 30-year yields and put downward pressure on longer dated corporate spreads.

Conversely, on the short end of the curve, the Treasury is issuing a flood of T-Bills. Simultaneously, corporations are beginning to repatriate overseas profits held in shorter maturity corporate bonds and Treasuries because of the opportunity afforded by the new tax bill. Corporate cash accounts have been major buyers of shorter maturity paper in past years which means that there should be little buying of those US corporate notes – in fact, moderate selling by these accounts has already begun.

At the same time banks, particularly foreign banks, need to borrow dollars in the form of short-term commercial paper to support their dollar liabilities. As a result, Libor and commercial paper yield spreads over riskless rates have risen substantially, illustrated below by the 3-month spread of Libor minus the 3-month Overnight Interest Rate Swap (OIS).

US tax legislation and Treasury issuance patterns are causing a technical situation where not only is the Treasury yield curve flattening, the corporate yield spread curve is flattening (inverting) as well and could well continue to do so through the 3rd quarter of this year.

Chart 1: Prime age, 25-54yr old, labor force participation [%]



3-month LIBOR minus 3-month OIS swap [bp]

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Observations

Rates

- In recent testimony, new FOMC Chairman Jerome Powell sounded optimistic about future US growth. The market initially interpreted it as hawkish rhetoric, projecting more than three hikes this year. But subsequently, even the more hawkish members of the FOMC commented that the Fed should tolerate a moderate overshot of inflation above the 2% target, which adjusted market expectations back to a more-aligned three hikes for 2018.
- Treasury supply is expected to increase this year from the confluence of tax cuts, material budget increases, and Fed tapering.
- The bid/cover ratio is an indicator of investor demand; the higher the ratio, the stronger the implied demand. 10-year treasury bid/cover ratios have averaged around 2.5 historically and have been as high as 3.5 in 2011 and as low as 1.2 in 2003. The latest auction saw a bid/cover ratio of 2.4. It is worthwhile for investors to keep an eye on this ratio to gauge when supply is overwhelming the market.

Credit

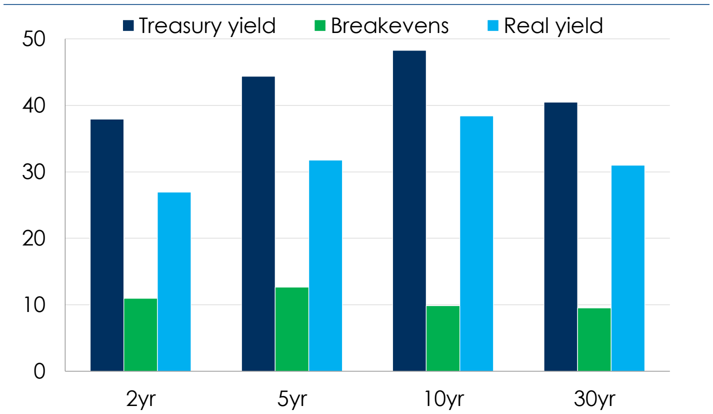
- Investors have made use of credit default derivatives as flexible macro hedges for corporate credit risk in cash bond portfolios, rather than selling or shorting individual bonds, by buying protection (selling short) through index credit default swaps.
- IG credit spreads are 10bp wider than year-end 2017 and HY remains close to levels seen coming into 2018.

Municipals

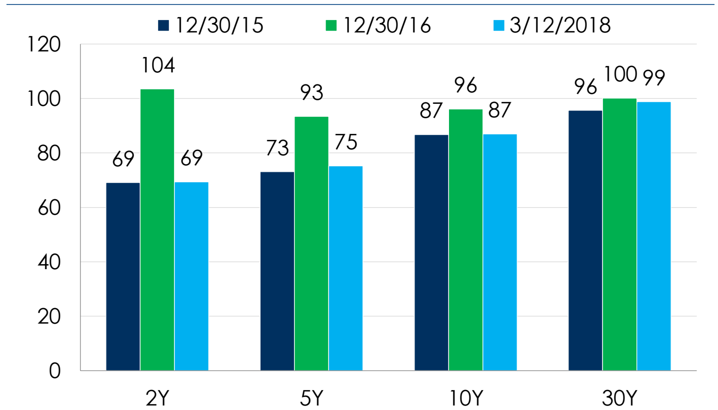
- There has been very little volatility and trading activity in the municipal market, and we believe this reflects apathetic demand from money managers as well as dealers' defense of their inventory positions leftover from 2017 – supply should start to increase in the second quarter. With this, the market should wake from its current stupor and realign to where the fair market level should be.

Monthly charts

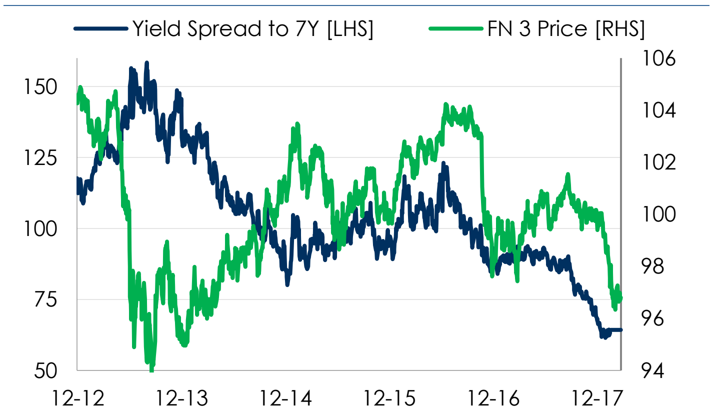
US rates shift [bp], 12/29/2017 through 3/12/2018



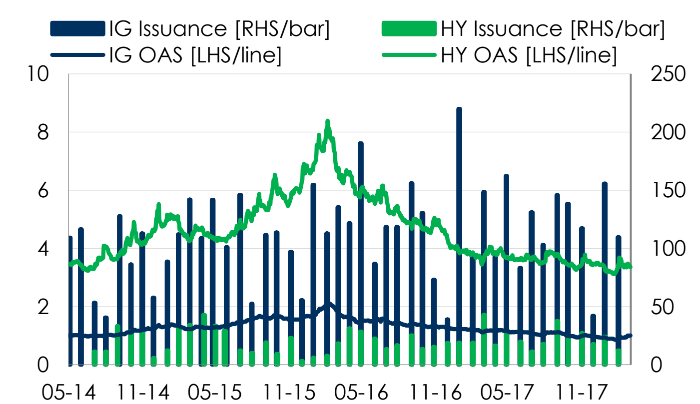
Ratio of AAA GO muni yields vs USTs [%]



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



Corporate issuance [$bn] and spreads [%]



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