FIRST PRINCIPLES CAPITAL MANAGEMENT

FPCM

Monthly Market Overview

November 2017

Themes

US equities continued their relentless climb in October on the back of increases in Q3 earnings and revenues, optimism on prospective tax cuts, and further signs/projections of global growth. WTI oil moved up to year-to-date (YTD) highs, approximately $55, and continues to rise on the back of increasing tensions between Saudi Arabia and Iran. The US Treasury yield curve flattened over the month on continued expectations of year-end monetary tightening. US investment grade and high yield corporate spreads ground down to multi-year lows in October, as global demand for higher yielding US securities continued. A quick backup followed in early November due to indigestion caused by heavy issuance and concerns about the Telecom/Media sector.

Congress, essentially Republicans, passed a 2018 budget resolution which is estimated to create a $1.5 trillion deficit increase over the next 10 years – the pre-requisite for using "reconciliation" (simple majority vote) to pass a tax bill primarily designed to cut the corporate tax rate from 35% to 20% and marginally lower taxes for middle/lower income households. The recently passed House tax bill and Senate draft, pays for the corporate cut, in part, by implicitly raising taxes on a number of individuals – mostly or completely by eliminating state and local tax deductions and limiting the mortgage interest deduction. To make those tax cuts permanent, the resulting cumulative projected deficit increase (due to the tax bill) must stay within the $1.5 trillion limit beyond 10 years. It also limits the corporate interest paid deduction to 30% of earnings before interest, taxes, depreciation and amortization (EBITDA). The combined effect of this and the lower rate of 20% will make new debt less attractive for numerous corporations, thus likely decreasing new issuance of corporate bonds, given these provisions are preserved in a final bill.

The House bill and Senate draft also would end allowance of municipal bond advance refunding issues to be tax-exempt, with the House version also eliminating private activity, tax credit, and stadium finance bonds from eligibility. These measures could materially reduce tax-exempt municipal issuance in 2018/19. The immediate effect is that issuers of these tax-exempt municipal bonds would rush to issue before year-end as any changes would be effective as of January 1st.

This could mean that both investment grade corporate and tax-exempt municipal yield spreads tighten ever further next year as issuance declines (as a result of these tax provisions).

October nonfarm payrolls came in below expectations at +261K, but combined August/September revisions were +90K. The unemployment rate fell to 4.1% – lowest since December of 2000 – with underemployment (U6) down 0.4% to 7.9%, matching the pre-recession 2006 low. Although the average monthly increase in nonfarm payrolls has decreased over the past 2 years from roughly +250K to +150K, both measures of unemployment/underemployment are at historic lows which means that we should see more wage pressure in the near-future.

Jerome Powell was nominated to replace Janet Yellen as Fed Chairman in February which indicates some continuity for monetary policy. On the other hand, Bill Dudley, head of the NY Fed, announced his retirement effective mid-2018, roughly six months earlier than expected. Janet Yellen announced that she will not to stay on as one of the Washington Governors which means that the Fed will have to fill five new FOMC member slots in 2018 to join Randall Quarles (recently confirmed by the Senate), and two new rotating regional members – Bostic and a yet-unnamed Richmond Fed Governor. This confluence of unprecedented turnover and lack of FOMC experience and/or voting history – at a crucial point in the monetary policy cycle – should create more volatility in interest rates over the next several months.

As anticipated, the ECB announced that it will cut its QE bond purchase program in half, from €60BN to €30BN per month, starting in January of 2018 through September, with the option to continue purchases beyond September if conditions warrant. ECB President Mario Draghi reiterated the ECB will continue to reinvest any maturing principal from bonds held, and will wait until the end of the bond purchase program before considering raising the policy rate. Despite the announced cut, the 10-year German government bond (Bund) yield fell as a result of Draghi's dovish tone on a possible extension of the program beyond September of next year.

To put things in perspective, at €60BN per month, the ECB is buying, on average, six times the total net issuance of Eurozone government debt – the Fed never came close to buying the total net US Treasury issuance at the height of US QE. By halving their purchases with the prospect of ceasing new purchases in September, the market may well take 10-year yields higher thus relieving US bond market pressure.

The yield curve flattened even further in the first half of November, with the 2-year/10-year yield spread narrowing an additional 20 basis points to a 10-year low of 58 basis points. This is reflective of the ongoing demand for longer maturity US bonds from the retirement complex and foreign investors, coupled with the expectation of ongoing fed funds rate normalization (to at least a level slightly above the current rate of inflation). Fed funds futures currently reflect over a 60% chance of two 25 basis point increases by March 2018 – one of which would be this December. Other factors driving curve flattening are skepticism that Senate Republicans will be successful enacting tax legislation as currently proposed this year, Mnuchin's statement that research concluded insufficient demand for ultra-long Treasuries, and the Treasury Borrowing Advisory Committee's quarterly meeting minutes, which called for increased issuance in T-Bills, two, three and five-year notes which will lower the average duration of US debt issuance.

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Observations

Interest rate and Treasury market observations:

- The US Treasury announced it will increase issuance in short-dated maturities (Bills and coupons < 5 years), thereby decreasing the duration of the Fed's portfolio as the prominent buyer of Treasury issuance.
- Longer-dated Treasury maturities and STRIPS have been well bid by pension LDI-based buyers.
- We expect front-end of yield curve (0s/5s) to flatten, while long rates will be bound by inflation.
- Yield curve inversion may not be a certain indicator of recession as in past considering current, extraordinary circumstances.

Municipal market observations:

Based on current proposals from Tax Cuts and Jobs Act

- State and local tax ("SALT") deduction will be limited to property taxes with a $10,000 cap. This effectively raises state taxes, and should help richen municipal bonds from states with high taxes as state tax-exemption becomes more valuable. However, from a credit perspective, we think this is negative for states with high taxes, as their ability to raise taxes further in the future, to balance budgets, would be curtailed as the cost on voters would increase.

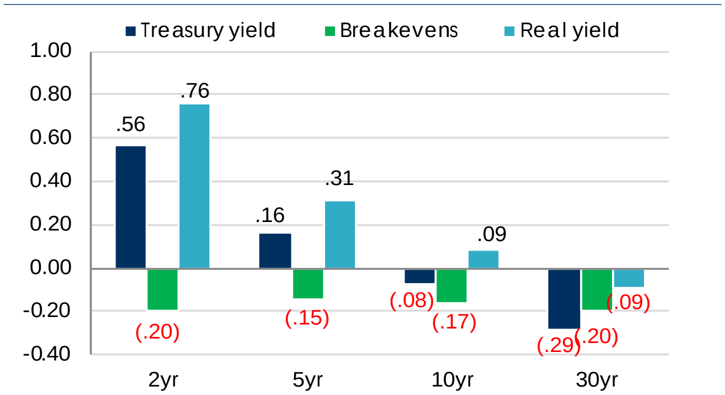
Corporate credit observations:

A tale of two cities

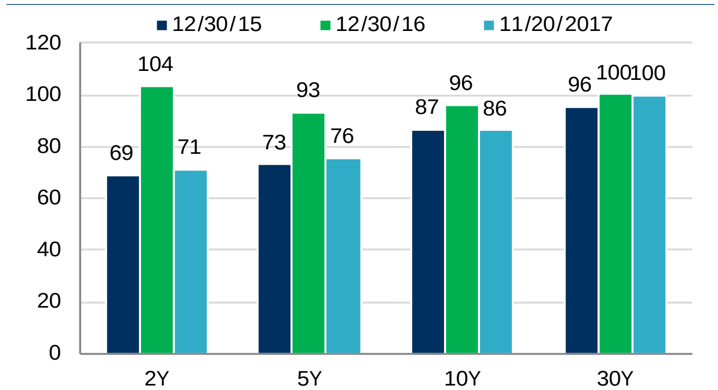
- Credit default swap indices on investment grade credit are around the lowest level since 2008 crisis reflecting bullish sentiment on corporate earnings, the reflation narrative, global growth expectations, and market momentum.
- While…there are Idiosyncratic pockets of weakness amongst a broader HY selloff of 40bps since last week of October. About half of the sell-off can be attributed to weak performance of a few names in the Telecom sector.

Monthly charts

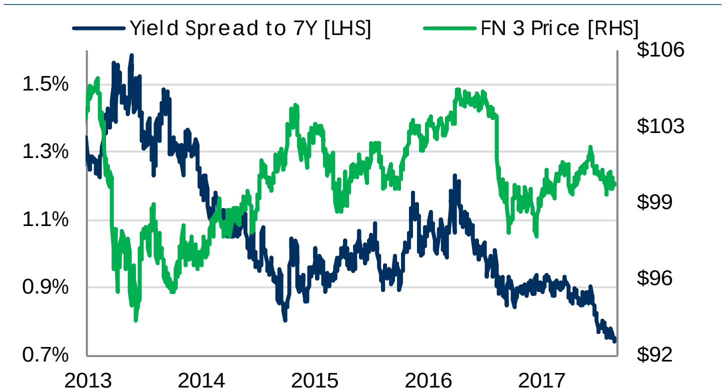
US rates shift [%], 12/30/2016 through 11/20/2017



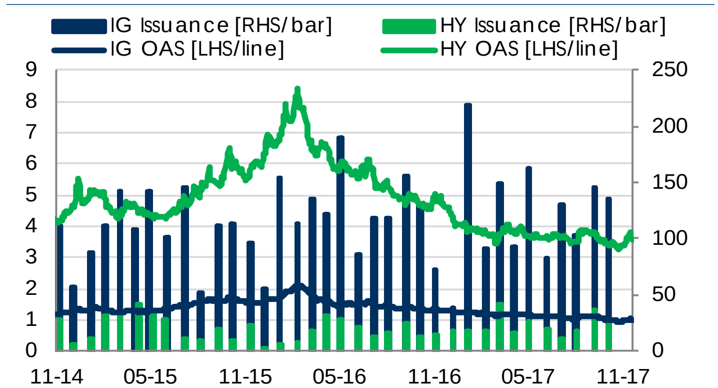
Ratio of AAA GO muni yields vs USTs



MBS TBA spread to UST vs. FN 3 price



Corporate issuance [$BN] and spreads [%]



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