Monthly Market Overview

November 2018

Themes

Equity markets observed renewed volatility in October with all US indexes reaching correction territory. Both WTI oil and wholesale gasoline declined over 20% since the beginning of the month on fears of future economic slowdown and higher supply.

Uncharacteristically, interest rates were virtually unchanged amidst the carnage and actually are up for the month as a whole – a rare month wherein both stock and bond markets suffer negative returns. Despite solid Q3 earnings growth, markets began to focus on the future trajectory of earnings, a more hawkish Fed, as well as tariffs.

Along with energy, overall inflation expectations, as expressed by "breakevens", have dropped across the yield curve since summer, leaving real yields as the sole driver of the increase in nominal Treasury yields through this volatile period. The 30-year real yield moved as high as 1.36% -- the highest since March 2014 just after the "Taper Tantrum."

The Treasury announced increases of $2 billion each for 2yr, 3yr, 5yr notes and $1 billion for 7yr, 10yr, 30yr in Q4. The so-called quarterly refunding (3yr, 10yr & 30yr) moved up to $83BN, the highest level since 2010. Although no surprise to the market, it is a reminder that supply is increasing.

US employment figures continued their strong streak in October adding 250K jobs, with net zero revisions for August and September, keeping the YTD average above +200K.

Unemployment held at 3.7%, and underemployment ticked back down to 7.4%. Job openings are still above 7 million, and the "quit" rate in September remains at a 17+ year high – a sign of work confidence.

Average hourly earnings rose 0.2% in October, leaving the 3-month annualized increase at 3.4% closely in line with the 3.5% year-over-year (YoY) change in the Atlanta Wage Tracker. Core consumer prices increases remain around the Fed's 2% target.

The November FOMC meeting left rates unchanged, as expected. The post-meeting statement was little changed from that of September, made no mention of equity market volatility, and conveyed the impression that the Fed will likely raise rates again in December. Fed funds is currently at 2.2% -- above the midpoint of 2 – 2.25% -- and is bumping against the level of interest on excess reserves (IOER). The Fed is expected to raise IOER by only 20bps as compared to a 25 basis point increase in the lower end of the target range to keep fed funds closer to the middle of that range.

For the first time ever, the European Union (EU) rejected Italy's draft budget which estimated a 2.4% of GDP budget deficit for 2019. Italy's debt to GDP is at 130%, well above the EU's 60% ceiling. The latest figures showed real GDP growth was flat and unemployment moved up in Italy indicating that the deficit could be worse.

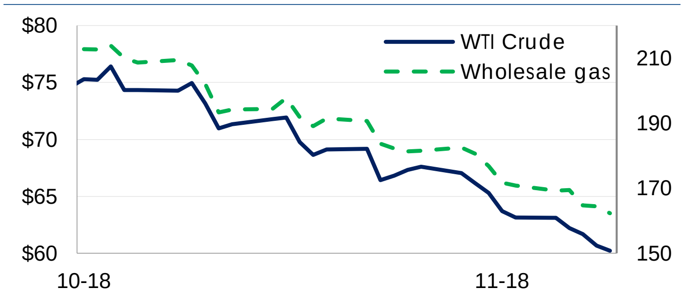
Core inflation in the EU rose 1.1% YoY while headline inflation was up 2.2%, driven mainly by energy. The general concern is that Eurozone growth is slowing and core inflation is still well below target. Nonetheless, the ECB has not indicated any change in their plan to cease new QE purchases after this year.

The Bank of Japan Governor Kuroda recently acknowledged that; "Japan's economic activity and prices are no longer in a situation where decisively implementing a large-scale policy to overcome deflation was judged as the most appropriate policy conduct as was the case before" and that the central bank "fully recognizes" that continuing monetary easing could affect financial stability and the functioning of financial intermediation -- once again intimating that the BoJ will have to pay more attention to the damage that lower rates are doing to Japanese financial institutions.

The difference with the current stock market correction is that equity investors are seeing a peak in earnings growth 1–2 years from now after the effects of the recent stimulus wear-off following 10 years of economic recovery – expected to be the longest in US history. Although 3rd Quarter change in real GDP was a healthy +3.5%, business investment was tepid at +0.8%, and within that a 7.9% contraction for investment in business structures further adding to concern that the economy will begin to slow as business investment declines.

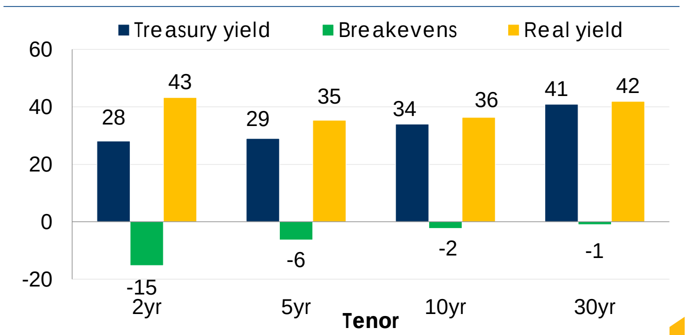
The bond market selloff in longer maturities appears to be a buyer's strike, not one characterized by speculative selling. As the ECB recedes from purchases in the market and the cost of hedging FX risk in US Treasuries and Corporates increases, one would expect less foreign demand for US bonds, helping to explain reduced buying by fundamental investors. If the US is approaching an economic slowdown in 18 months as we reach the end of the cycle, long maturity real yields are probably close to their highs and may decline going forward.

WTI Crude [$] & Wholesale Gasoline [cents]



Source: Bloomberg

US rates shift [bp], 8/31/2018 through 11/5/2018



Source: Bloomberg

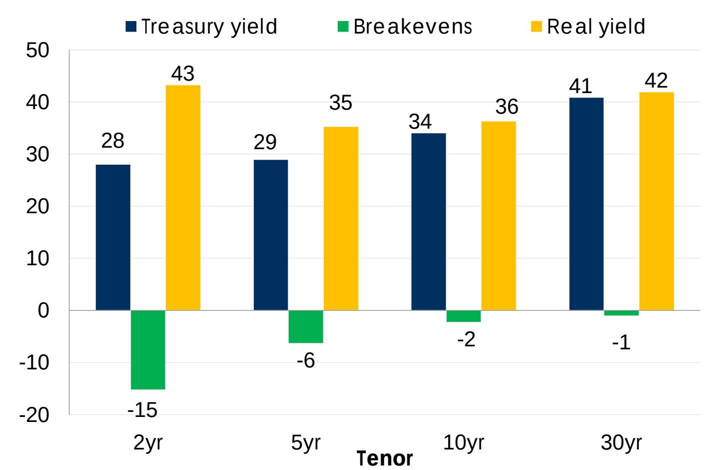
Observations

Rates

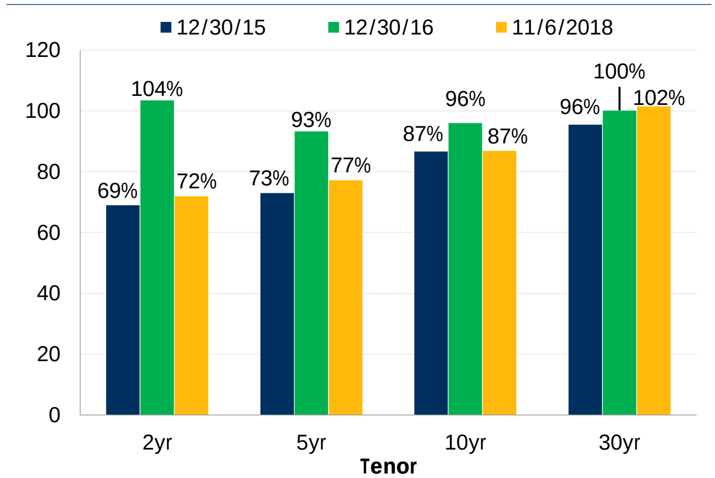
- Short-maturity rates should sell off as supply comes to market, and prospectively, near-term, the market will be dominated by front end supply – primarily to finance recently enacted fiscal stimulus.
- With another economic downturn, US Treasury supply will have to increase further for stimulus that will then be required to support financial conditions.
- Current USD Libor curves indicate a peak rate in early 2020, signaling curve inversion and resulting reestablishment of accommodative monetary policy.

Monthly charts

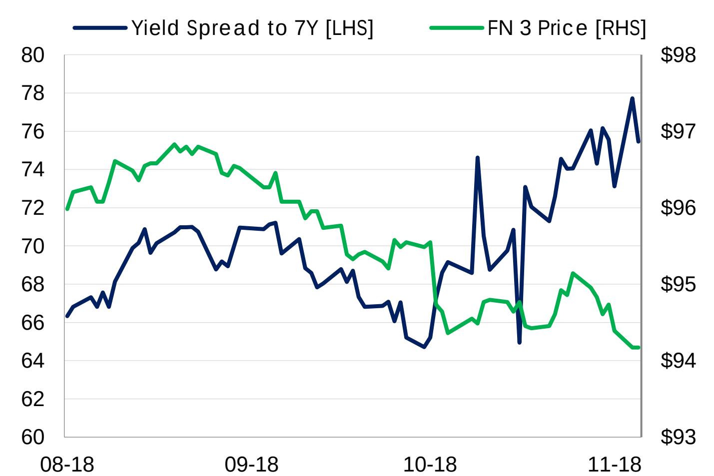
US rates shift [bp], 12/29/2017 through 11/5/2018



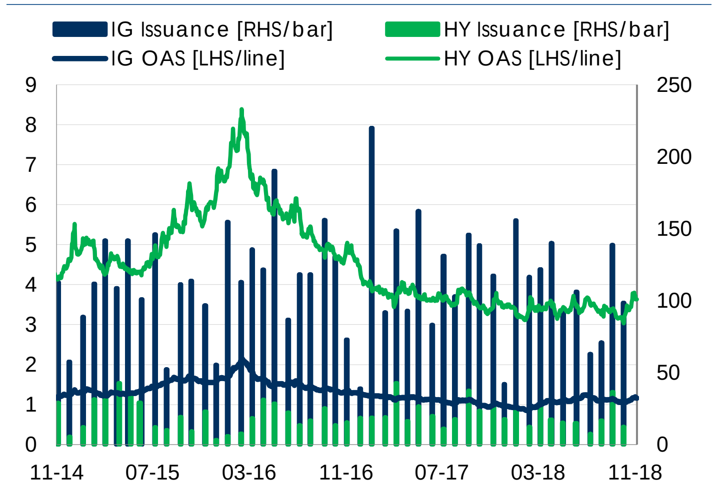
Ratio of AAA GO muni yields vs UST



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



Corporate issuance [$BN] and spreads [%]



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