FIRST PRINCIPLES CAPITAL MANAGEMENT

Monthly Market Observations

June 2017

Themes

Inflation expectations in the US declined, along with year-over-year (YoY) measures of actual inflation. The US Treasury yield curve flattened by 29 basis points (bps) in May due to short covering in longer maturities, a growing sense of disappointment regarding stimulus, and expectations that the Fed will continue to gradually increase short rates.

Short-term spreads

Credit spreads in the short-term money markets have tightened over the past several months, reversing last year's widening, triggered by the new US money market regulations. Since that time, foreign (Japanese & European) banks who used to issue short-term US dollar commercial paper (CP) to fund their US dollar assets have largely replaced that with secured financing of US dollar assets in the repo market and with longer maturity debt swapped back to floating Libor through Libor interest rate swaps. These banks have also reduced their US dollar lending activities, thus decreasing the need to raise dollar debt. As short-term rates move higher, investors are becoming more comfortable investing in prime money market funds despite fluctuating NAV and possible withdrawal restrictions. The above described issuer and investor activity can be observed by the widening of the TED spread (3 month Libor over 3 month T-bills) to +70 bps late last year, and the retracement back to nearly +20 bps today (near pre-money market rule levels).

ECB

At its June meeting, the ECB merely eliminated its bias to lower rates and gave no forward guidance on what will happen to its €60BN per month Quantitative Easing (QE) program, which is in place until at least December of this year. More concerning is that the ECB lowered its inflation forecast to 1.5% for 2017, only 1.3% in 2018, and 1.6% in 2019, all below the 2% target estimates, leaving the market to wonder when policy will actually slow, let alone end the bond purchase program.

US Employment

May nonfarm payrolls came in below expectations at +138K, with -66K of downward revisions to March and April. Paradoxically, the unemployment rate decreased 0.1% to 4.3%, a 16-year low, mainly due to a 0.2% drop in the labor force participation. Economists surmise that the lower payrolls number reflects data measured toward the beginning of May, where fewer summer workers joined, thus exaggerating the downward seasonal adjustment. Despite the potential timing quirks in May payrolls, employment growth appears to be slowing and the likely culprit is a lack of trained applicants as job openings for April, as measured by the Government's JOLTS report, came in over 6 million - highest since the inception of this measure in 2000.

US Inflation

US inflation reports have been disappointing. The change for both the 3-month core CPI ending May and the 2-month core PCE ending April registered 0%. Over the comparable YoY period, core measures declined by 0.5% and 0.3% respectively. Wage inflation remains tame, with average hourly earnings in April and May growing at a 2.5% annual rate - lower than earlier this year and late last year - and the Atlanta Fed Wage Growth Tracker at 3.5% in April - up from a low of 3.2 earlier this year, but lower than 3.9% from Oct/Nov of last year.

June FOMC

The June FOMC meeting resulted in unchanged projections for the future path of Fed Funds, with chairman Yellen making the case that the recent slow-down in inflation was temporary, due to "idiosyncratic" effects (cell phone contracts, etc.), and the strength of the labor market - with unemployment at 4.3% (and going lower) - will ensure that inflation moves toward the Fed's 2% target over the medium-term. The Fed also issued an addendum outlining the reduction of reinvestment in its securities portfolio, starting with caps totaling $10BN per month ($6 BN for Treasuries and $4BN for Agency MBS), adjusting up by $10BN per quarter until reaching a combined cap of $50BN per month. The Fed anticipates that this program will commence this year, which means it still needs to announce the actual start date later in 2017. We expect the start date announcement at the September FOMC where there will be the benefit of a press conference.

The bond market is clearly skeptical that recent anemic inflation prints are temporary and that the Fed will follow its projected rate path. Fed Funds futures indicate one and one-half 25 bp moves to December 2018, vs. the Fed projected four moves over that period.

We are in the 9th year of this recovery (economic recoveries haven't lasted more than 10 years in the postwar era), yet the US economy appears to be steady, with a 2% real GDP, robust labor market, and low/moderate inflation; there is no hint of impending recession. At this point, any anomalies - such as persistently low inflation - are structural and no longer attributable to cyclical economic forces. The Fed itself has admitted that monetary policy is inadequate to address structural economic issues. This logic would suggest that the Fed will continue to normalize/raise short-term rates to a point where the short-term real rate is positive (Fed Funds greater than inflation) regardless of whether measured core PCE is closer to 1.5% than 2%.

It has become evident that Congress will struggle to enact the stimulus packages that the market had anticipated from the Administration's earlier rhetoric. The bond market has taken notice; over the last 3 ½ months, future CPI expectations fell 0.73% for two-year break-evens, out to -0.25% in 30 year maturities, while intermediate to longer-term real yields barely moved.

The pace of withdrawal of QE reinvestment will be slow in the US Only 15% of the past year's Treasury reinvestment purchases were in bonds beyond 10 years to maturity. Add to that the fact that the ECB and BOJ are still in portfolio expansion mode and it is hard to see how 10 – 30 year US yields rise significantly in the near-term - even if the Fed raises short-term rates. This likely means continued yield curve flattening. The only wild card would be an unexpected surge in wage inflation resulting from an ever-tightening US labor market.

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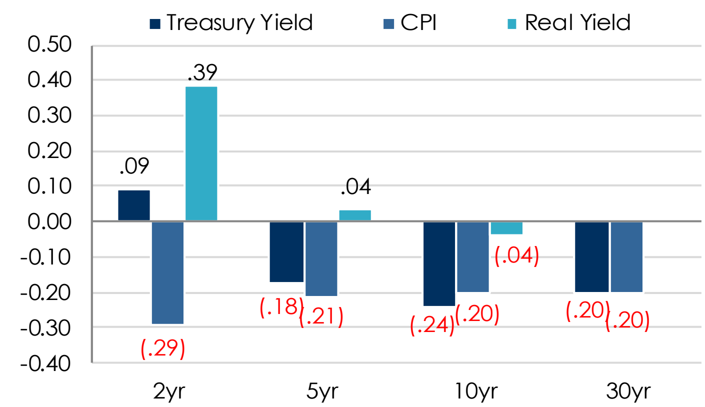
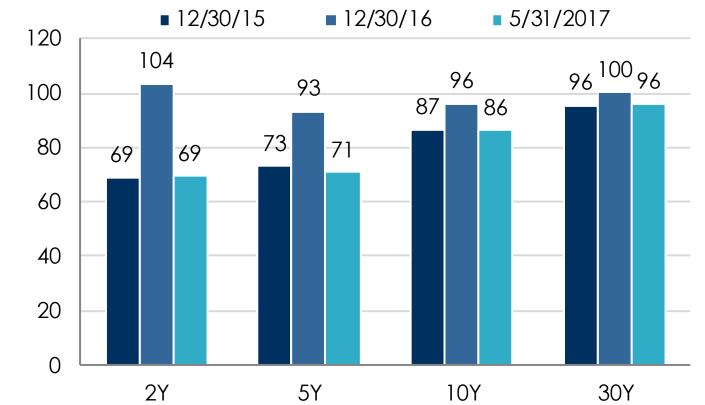
Standard monthly data

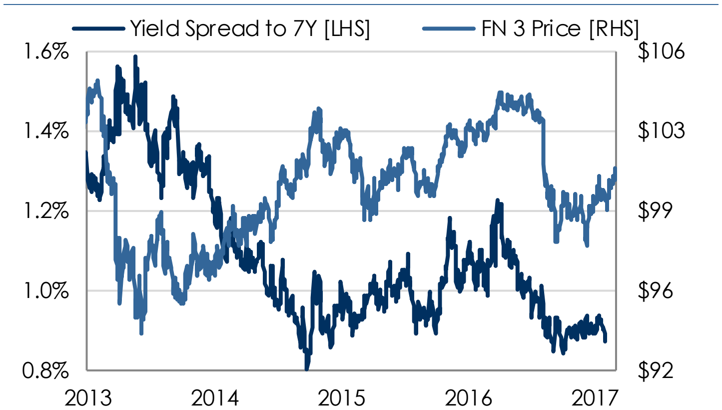
US rates shift [%], 12/30/2016 through 5/31/2017



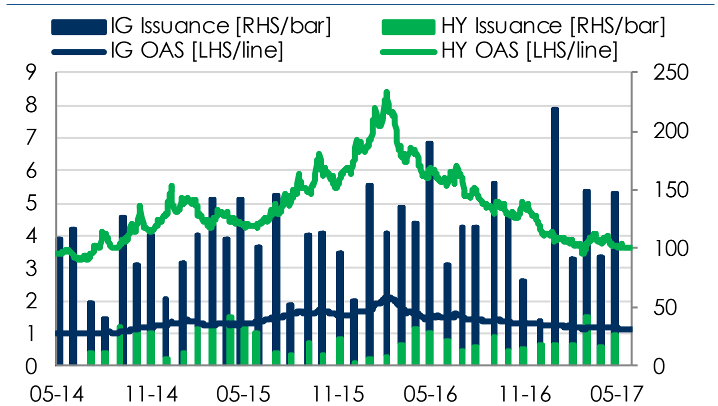
Ratio of AAA GO muni yields vs USTs [%]



MBS TBA spread to UST vs. Fannie Mae 3% coupon price

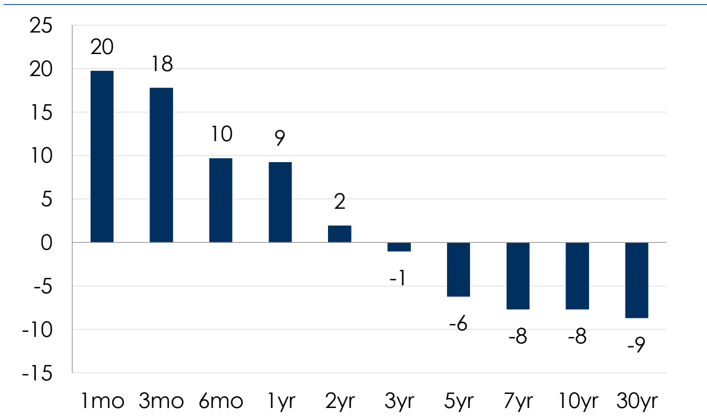


Corporate issuance [$BN] and spreads [%]

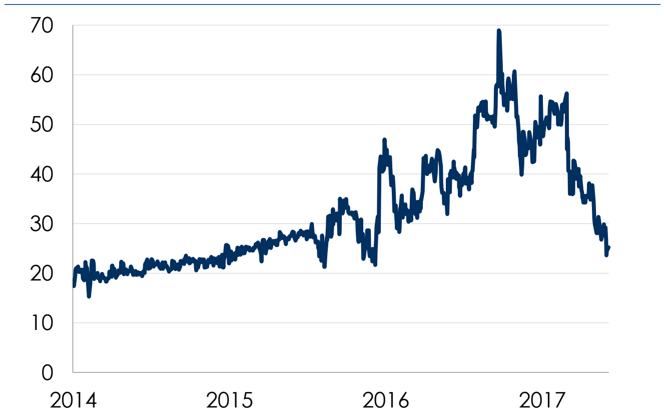


Supplemental monthly data

US yield curve twist [bps], 4/28/2017 through 5/31/2017



3 mo TED Spread [bps]



Author:

Stephen R. Miller is a Managing Director at First Principles Capital Management, LLC (FPCM). FPCM is a wholly owned subsidiary of American International Group (AIG).

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