FIRST PRINCIPLES CAPITAL MANAGEMENT

Monthly Market Observations

September 2017

Themes

Markets were somewhat mixed through August – U.S. equities wobbled and Treasury yields fell (10-year Treasury yield touched a year-to-date low), as geopolitical concerns and the one-two punch of Hurricanes Harvey and Irma ushered in trepidation. August – typically a slow month – saw a drop in long-term rates thanks to North Korea and U.S. saber-rattling coupled with data-driven declines in inflation expectations.

There were no formal central bank meetings in August, and neither Janet Yellen nor Mario Draghi provided any updated information on monetary policy in their respective speeches at the Fed's Jackson Hole conference.

August non-farm payrolls came in slightly below consensus at +156K with a combined downward revision of 41K for June and July, putting the YTD monthly average at +176K. The unemployment rate ticked up 0.1% to 4.4%, as the number of employeds dropped by 70K in the household survey. In past years, August payroll numbers have typically been revised upward.

Average hourly earnings in August crept up 0.1%, currently +2.5% year-over-year (YoY) for the fifth month in a row. The Atlanta Wage Growth tracker was up YoY by 3.3% – toward the lower end of the range for this measure over the past year. In August, YoY Core CPI increased 1.7% and July YoY Core PCE increased 1.4%, resulting in negligible change from the previous month. There is no sign of increasing wage or consumer price inflation despite ongoing healthy employment gains which indicates that this is structural, not responsive to monetary stimulus.

The Fed is expected to formally announce its System Open Market Account (SOMA) reinvestment reduction program at the September 19-20 FOMC meeting (SOMA is the main portfolio used in conducting open market operations regarding monetary policy). It appears less likely the Fed will raise the fed funds rate in December, as several FOMC members have recently been on the tape indicating reluctance to continue hiking rates if inflation data persists below the 2% target. Moreover, Hurricanes Harvey and Irma will distort U.S. economic numbers for the next couple of months – making it difficult to draw reasonably concrete conclusions in time for the December FOMC meeting. For example, jobless claims have already jumped 60,000 in the week after Harvey, mostly from Texas.

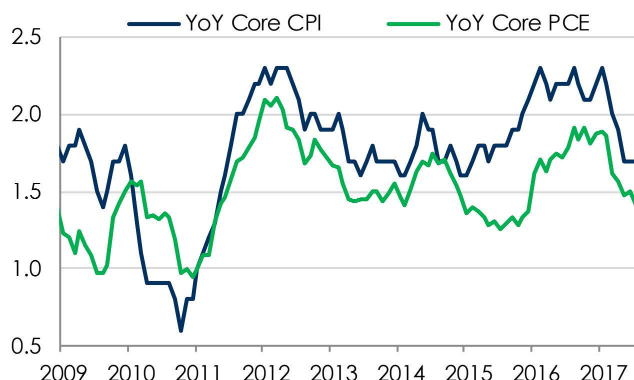
The ECB left its policy rates and QE program unchanged in the September 7th meeting. Further, it lowered the inflation forecast for 2018 by 0.1% to 1.3%, well below the 2% target. ECB President Mario Draghi, during the post-meeting press conference, emphasized: "interest rates, as it is written here, will remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases." With respect to announcing any changes to the QE asset purchase program, he reiterated, "…unless a risk that is not seen today materializes, we should be ready to give the bulk or to take the bulk of these decisions in October." Under the current purchase program pace of €60BN per month, the ECB will run out of German government bonds (Bunds) to buy by mid-2018, given the restriction that they cannot own more than 33% of any single government's debt outstanding.

The German government, including the Bundesbank, is unlikely to support granting a waiver for the aforementioned restriction. As a result, the ECB, in October, will most likely specify the size of the reduction of purchases beginning in 2018. Additionally, the deposit rate is expected to stay put at -0.4% for most, if not all of 2018. The size of the reduction will dictate how much higher the 10-year Bund yield will rise, if at all.

Fed Vice Chairman Stanley Fischer unexpectedly announced his retirement, effective October. Vacancies now amount to four at the Washington Fed, with Randy Quarles awaiting Senate confirmation. Janet Yellen's current term ends February and her re-nomination is highly uncertain, moreover, it looks increasingly unlikely that the presumed front runner, Gary Cohn, will secure the nomination. This means, potentially, there may be: 1) a new, untested chairman, 2) only three of eight remaining permanent FOMC members with any voting history, and 3) four new rotating regional Fed members – only two of whom are known quantities. This dynamic creates a high degree of uncertainty regarding monetary policy going forward.

President Trump and the Democrats pulled together a compromise bill to temporarily suspend the debt ceiling and fund the US Government until December 9, along with authorization of $15.25 BN in relief funds for Harvey and Irma. This simply postpones the budget showdown to later this year or early 2018.

Core CPI vs. PCE consumption expenditures [%]



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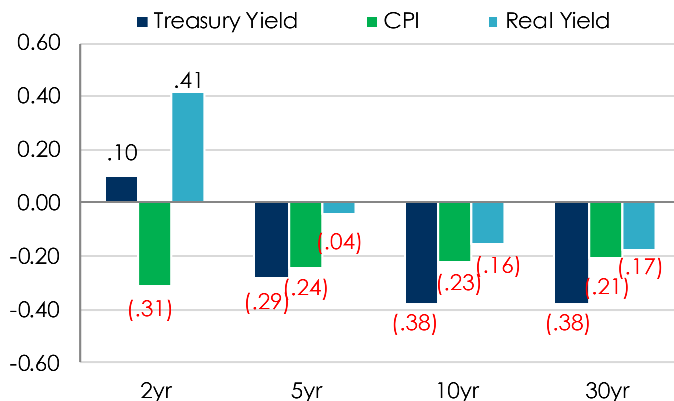
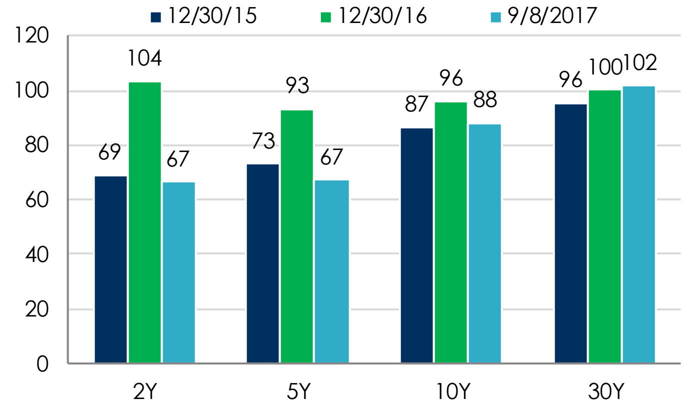
- With regard to the impact of Hurricanes Harvey and Irma on insurance company portfolio holdings - based on past experience with Katrina and Sandy, insurance companies did not sell long-dated municipal bonds. They typically chose to liquidate shorter maturity and taxable instruments such as Treasuries and MBS.
- With the debt ceiling debate pushed until December, states can refund again (they can buy Treasuries with proceeds from new issuance), which may push up supply in the 4th quarter.
- The Home Affordable Refinance Program (HARP) let's borrowers with mortgages originated before May 31, 2009 streamline refinancings. The program was set to expire in December 2016, which was eventually extended to September 2017. This past month, the FHFA announced that HARP was being extended, yet again, to December 2018. While the impact of HARP has been great, the number of eligible borrowers has shrunk and the program has lost relevancy and the market largely shrugged off the announcement.
- Elizabeth Warren sent a letter to Michael Bright, acting President of Ginnie Mae, expressing concerns over the VA loan program, where mortgage originators are churning Veteran borrowers (refinancing borrowers when there is little to no incentive to refinance). Michael Bright replied stating that Ginnie Mae has implemented a program which makes it less profitable for originators to securitize loans that are refinanced within 6 months of origination. However, he notes that this was not as successful as he hoped, and that Ginnie Mae is exploring the issue further. It should be noted that Ginnie Mae simply acts as the securitizing agent for these loans. Fast VA prepayment speeds are well known in the market, and they have weighed on GN/FN swaps. This public discussion of VA churning will likely lead to policy changes – either from Ginnie Mae, the CFPB or VA, which would be a positive for Ginnie versus Fannie MBS.

Monthly charts

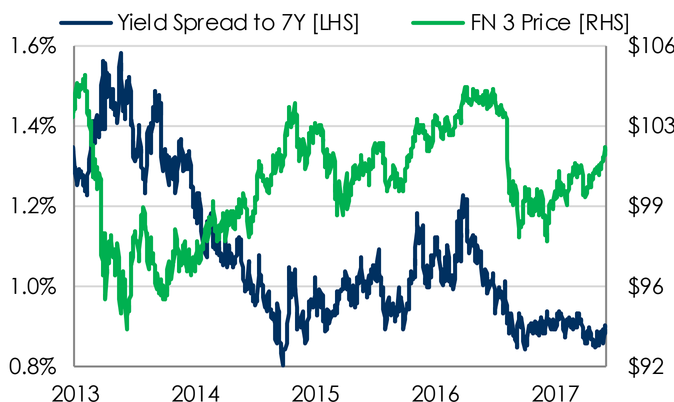
US rates shift [%], 12/30/2016 through 9/8/2017



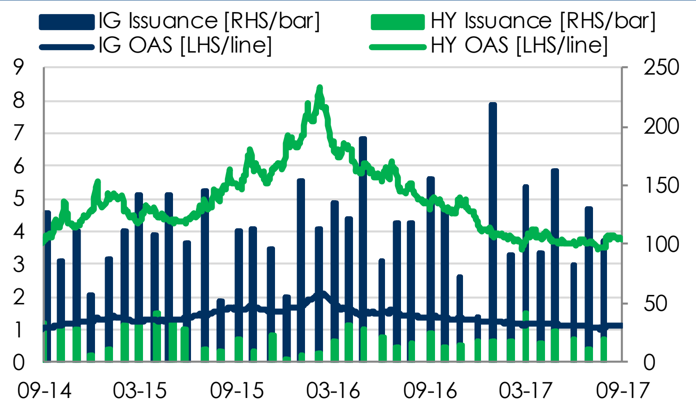
Ratio of AAA GO muni yields vs USTs [%]



MBS TBA spread to UST vs. FN 3 price



Corporate issuance [$BN] and spreads [%]



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Author:

Stephen R. Miller is the Chief Risk Officer of First Principles Capital Management, LLC (FPCM). FPCM is a wholly owned subsidiary of American International Group (AIG).

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