Monthly Market Overview

August 2018

Themes

In July US stocks vacillated with several Tech bellwether stocks dropping precipitously as Facebook announced lower earnings on longer-term increased spending to improve privacy. Oil dropped back below $70 a barrel along with other commodities as nervousness related to emerging markets, particularly Turkey, led to currency depreciation. The Yuan legged back down to late 2016 lows when China spent roughly $1 trillion of foreign reserves and implemented capital controls.

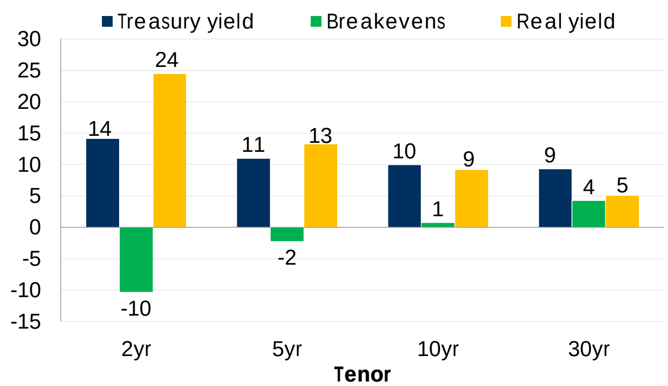
The combined increase in July nonfarm payrolls of +157K and +59K in upward revisions to May and June numbers signaled the continuation of solid job growth. As anticipated, the jobless rate dropped 0.1% to 3.9%, and more impressive was the 0.3% drop in the underemployment rate (U6), taking it to a 17-year low of 8.5%. New jobless claims 4-week average is now running below 220K.

CPI was up 0.2% in July for both headline and core measures with year-over-year numbers at 2.9% and 2.4% respectively -- solidly above 2% on an annualized basis. June core PCE was 1.9% year-over-year (YoY) and wage inflation close enough for the Fed to signal a continuation of short-term rate increases.

The rise in yields over the month was primarily attributable to increases in real yields which would be consistent with Fed hiking and a +4.1% rate of 2nd quarter real GDP. Several things to consider; there will be two more Q2 GDP revisions which could result in the final number being different by 1% or more, and most market economists believe that Q2 may well have been a temporary blip due to recent stimulus, with real GDP declining for the remainder of 2018 into 2019 as the effects of fiscal stimulus wear off.

There was a brief steepening of the US Treasury yield curve near the end of July on speculation that the Bank of Japan (BoJ) was going to change its 0% 10-year JGB target to relieve pressure on domestic banks and insurance companies suffering under a low interest rate environment, with little steepness to the yield curve. That speculation turned out to be incorrect as the BoJ simply relaxed the band around the 0% target from +/-10 basis points to +/-20 basis points and reaffirmed their ¥80 trillion annual purchase level for JGBs. There seems to be a small but growing debate inside the BoJ regarding the effectiveness of Quantitative Easing (QE), particularly the effectiveness in raising the rate of inflation vs. the cost of undermining the strength of financial institutions, which could impact longer-term US yields. Increasing nervousness regarding Emerging Markets and a possible slowdown in the Chinese economy due to tariffs is having the opposite effect, suppressing longer-term US yields.

US rates shift [bp] for July 2018



Source: Bloomberg

FIRST PRINCIPLES CAPITAL MANAGEMENT

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Observations

Inflation-linked sector

- We are constructive on the 7-year sector of the inflation-linked securities market and see some interesting optionality afforded to investors.
- In the event tariffs cause increases in realized inflation, one participates via holding inflation-linked securities.
- In the event the economy is vulnerable to a weakening, real yields will decline, leading to capital gains.
- The 7-year part of the curve is somewhat of an inflection point in balancing the potential for realized inflation and volatility from longer dated holdings.

Yield curve

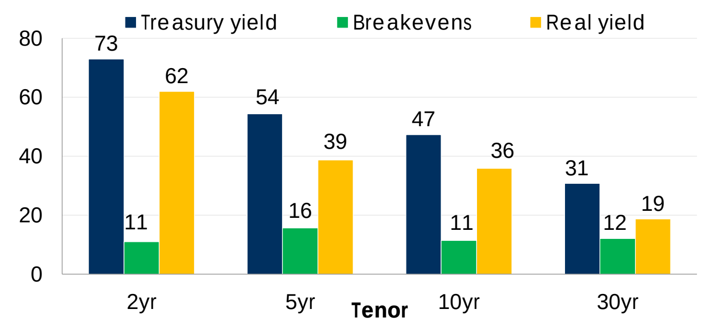
- We remain in the camp expecting that flattening will persist.
- Front-end dynamics continuing to push short rates higher, and a persistent bid continues on the long end of the curve, due to attractive relative value of US yields vs. other developed countries and continued demand from the retirement complex (a bid which we expect to have legs beyond the Sept 15 pension funding date, when corporations can take advantage of deductions at the 2017 35% tax rate).

Mortgages

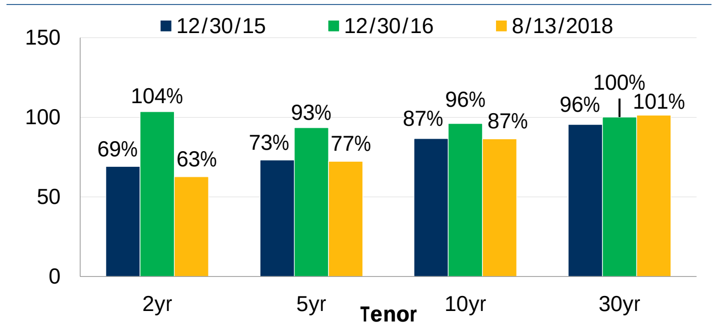
- Under the direction of the FHFA, Fannie Mae and Freddie Mac have created a joint initiative to develop a single security for fixed-rate mortgages – as opposed to issuing separate securities. This new uniform mortgage-backed security (UMBS) is targeted to begin trading in the first half of 2019.
  - Existing holders of Fannie Mae and Freddie Mac MBS will be able to exchange their securities for UMBS.
  - One notable difference between current Fannie Mae and Freddie Mac MBS is that Fannies have a 55-day payment delay while Freddies have a 45-day delay, so Freddie investors receive their cashflows 10 days earlier than Fannies.
  - The new UMBS will adopt the Fannie Mae convention and have a 55-day delay. In order to have investors to convert Freddie MBS into UMBS, Investors will be compensated for the delay difference (likely 1-5 ticks). Overall, this should be positive for mortgages as it will increase liquidity.

Monthly charts

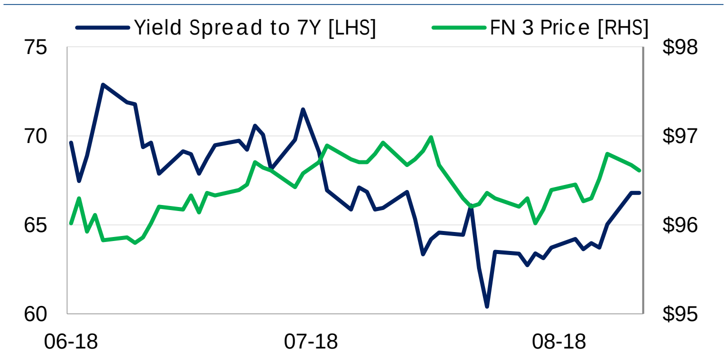
US rates shift [bp], 12/29/2017 through 8/13/2018



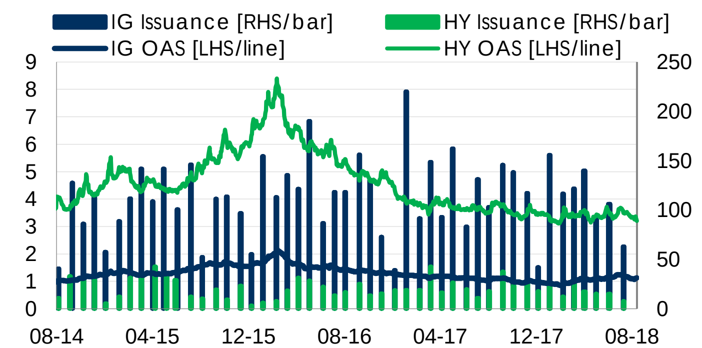
Ratio of AAA GO muni yields vs UST



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



Corporate issuance [$BN] and spreads [%]



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