Carty &
Company, Inc.
Research & Strategies

2017 in Perspective & Q4 Outlook:

We came into 2017 riding the Trump Reflation Trade which propelled 10-Year U.S. Treasury yields 60 basis points higher after the presidential election. Many predicted President Trump to pass meaningful policies that would reform both Healthcare and Tax policy, as well as introduce infrastructure spending relatively quickly. Large banks such as Goldman Sachs and J.P. Morgan forecasted 10-Year yields to reach 3.00% during 2017 and the momentum of these expectations pushed the 10-Year Treasury yields as high as 2.64%.

In a reversal of expectations that duration trades were set to unravel, disappointing U.S. inflation and the Trump administration's roadblocks of passing legislation spurred bonds to rally in defiance of the Federal Reserve's hawkish posture. This would not be news to Carty & Company clients. In our Year Ahead 2017 Market Preview released back in January we said this:

- ✓ **"The dominant view is that President-Elect Trump will swiftly enact pro-growth policies when he enters the White House in January. This would bolster riskier assets, like stocks and speculative-grade bonds, which have both been going gangbusters in recent weeks and would cause yields in Treasuries to continue climbing."**

- ✓ **"However, President-Elect Trump could find it incredibly difficult to enact meaningful initiatives within his first few months on the job. President-Elect Trump's first 100 days in office will include many major initiatives; reducing corporate / individual tax rates, reducing cumbersome regulations for business, modifying existing healthcare laws and possible changes to U.S. trade policy. Each initiative is no small task and will take time to propose and get approved through Congress. It is our view the effects of these positive changes will not be felt until later in 2017 or the beginning of 2018."**

Why inflation remains so well-contained has been the subject of much debate during the past three months, with disagreement among economists as to why inflation remains stubbornly low. Earlier in the second quarter, Fed Chair Yellen said inflation was low because of a price war going on in the mobile phone industry, but by the end of the third quarter, it was clear there was more to it than that. Year-over-year price comps also helped to hold down inflation. Digging into the most recent CPI data, we see services ran an annual rate of 2.5%, but apparel prices declined -0.6%. Automobile prices were down -0.7% and medical care price inflation was a tame 1.1%.

According to the most recent Bloomberg Survey, economists see the 10-Year U.S. Treasury yield at 2.42% at the end of 2017 and 2.96% at the end of 2018. We concur with the consensus opinion that the 10-Year U.S. Treasury could be at or near 2.42% at the end of 2017. However, 2.96% at the end of 2018 seems like a stretch. For this to happen, inflation pressures would have to build and the Fed would have to let them. However, recent comments by Fed Chair Yellen say otherwise.

Below is a list of Firms and their year-end prediction for 10-Year U.S. Treasury Yields:

Bank	End of Year Prediction
HSBC	1.90%
CartyCo	2.50%
Wells Fargo	2.55%
Allianz	2.70%
ING	2.70%
Bank of America	2.85%

10-Year Treasury End of Year Predictions – CartyCo / Bank of America / HSBC

Source: Bloomberg

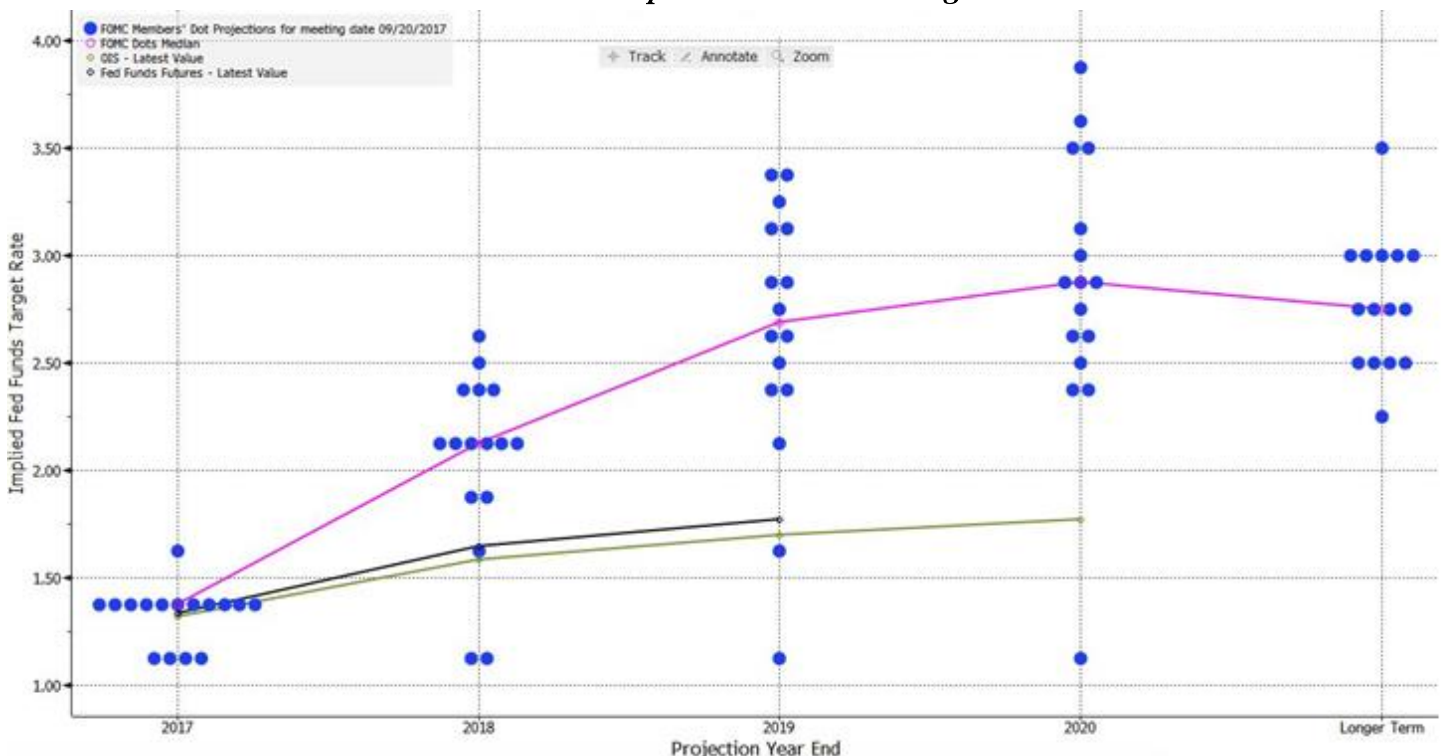
Fed Funds and Dot Plot:

In the last meeting, Janet Yellen stated it is prudent to tighten monetary policy, even with the Fed's favored measure well below their 2.0% target. The Fed Chair appears to be conceding inflation might be structurally lower than it was in the past and that normal monetary policy has to be normalized sooner rather than later.

What might "normal" monetary policy look like? According to the Fed's latest "Dot Plot", the Fed Funds Rate is expected to crest at 2.875% by the end of 2020, before retreating to 2.75% by the end of 2021.

The Fed's dot plot assumes the economy does not experience a slowdown or recession before 2020. Although that scenario could play out, most economists believe the U.S. economy may experience a recession before the end of 2020. That would/could cause the Fed to pause/halt monetary policy tightening before the Fed Funds rate reached 2.875%. Remember, Fed Funds Rate hikes are intended to be disinflationary. Thus, higher Fed Funds Rates could put the brakes on rising long-term rates or even send them back down. This is why the yield curve tends to flatten when the Fed is in tightening mode.

Fed Dot Plot – Implied Fed Funds Target Rate



Source: Bloomberg

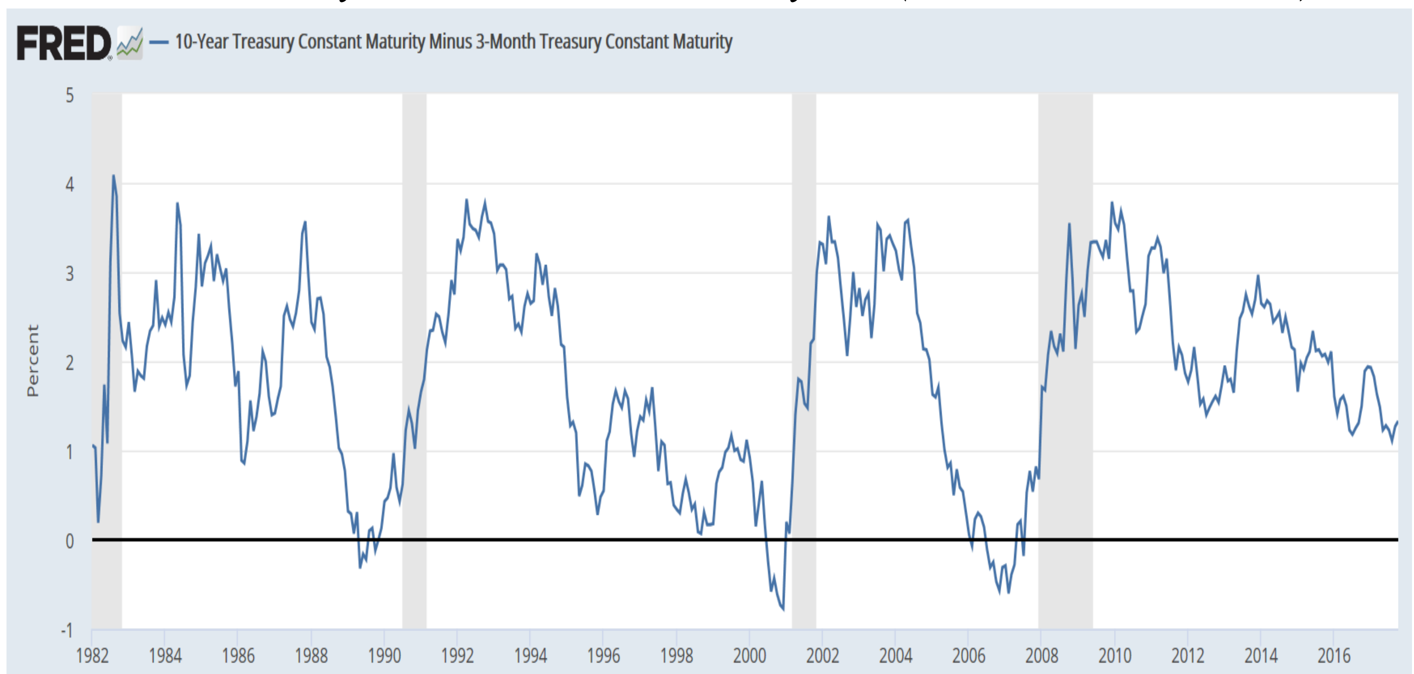
Predicting the Next Recession:

A good predictor of recession is the 10-Year Treasury rate minus the 3-Month Treasury rate. During normal expansion, term-premium for longer dated bonds remain high. When the curve becomes inverted and short-term bond yields exceed long-term bond yields, a U.S. recession has occurred 7 consecutivet times dating back to the 1970's.

At the beginning of 2017, the yield spread between 10-Year and 3-Month Treasury rates was 1.95%. That has since been reduced to 1.33%, or a 32% spread compression. If the Federal Reserve continues to raise the Fed Funds rate while economic growth and inflation remain subdued, expect the spread to contract further as the Treasury Curve flattens.

If the 10-Year minus 3-Month Treasury rate eventually inverts, this will be the precursor to the next United States recession.

10-Year Treasury Yield minus 3-Month Treasury Yield (Shaded Areas = Recessions)



Source: Federal Reserve Bank of St. Louis

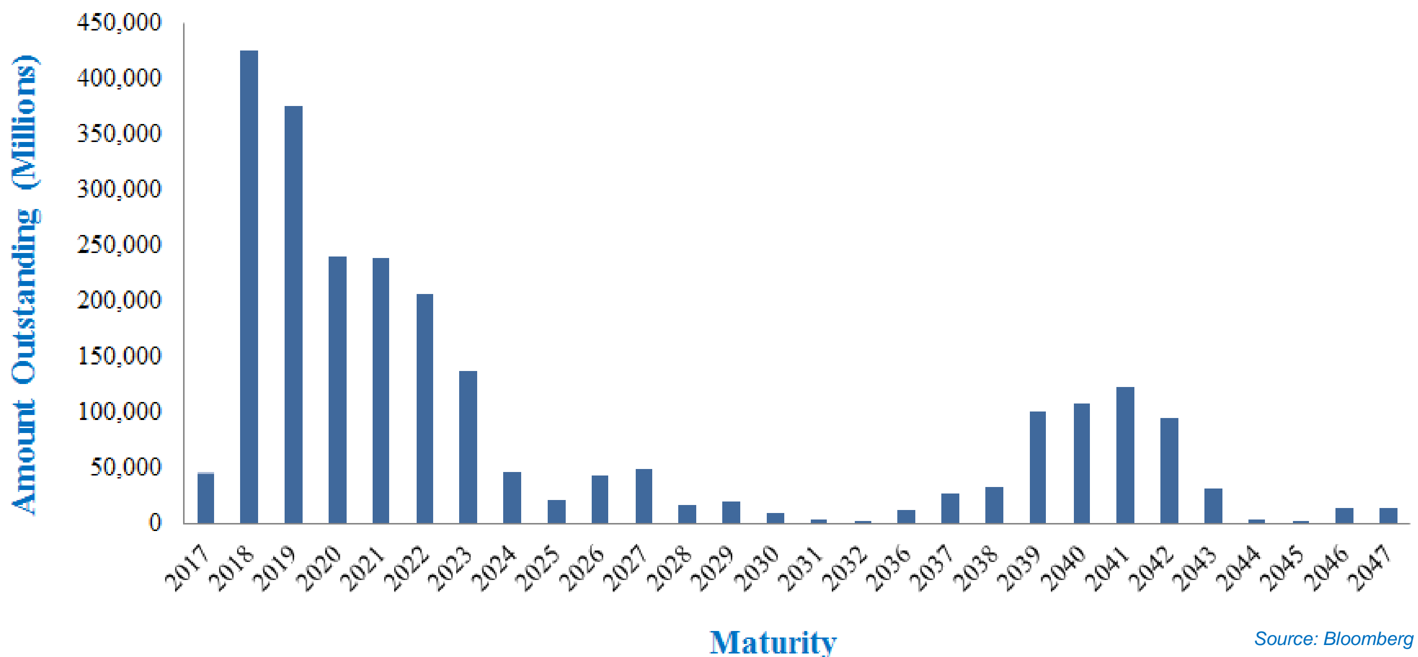
Fed Balance Sheet Reduction:

What about balance sheet reduction? Couldn't that push long interest rates higher as the bond market gradually loses a larger buyer of U.S. Treasuries? There are two problems with this theory. For one, the Fed does not own much nor been buying many bonds on the 10-Year area of the yield curve. This means there should not be significant upward pressure on 10-Year, or even 30-Year U.S. Treasury yields from Fed balance sheet renormalization.

The greatest upward pressure from balance sheet renormalization should come where the Fed was buying most actively, the 5-7 year area of the curve. This should be followed by rising short-term rates from traditional Fed Funds Rate hikes. The result should be a flatter yield curve.

It must also be understood that balance sheet reduction is, at least in theory, quantitative tightening. Thus, it could be considered anti-inflationary. The result could be that U.S. Treasury yields on the 10-30 year portion of the yield curve do not rise materially. Fed tightening, traditional or quantitative, should augur for a gradual flattening of the yield curve.

Composition of Fed's Balance Sheet



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