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2017 Mid-Year Market Update

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."***

Q1 and Q2 of 2017 have revealed slower than expected GDP growth along with lower inflation numbers. This subsequently drove yields to their 2017 low of 2.12% on June 14th. After hitting the trough of 2017, yields rebounded to close Q2 higher based on news that Central Banks around the world are following suit behind the U.S. Federal Reserve in reducing easy monetary policies and becoming more hawkish toward inflation. We believe this will continue as there has been no justification for the divergent policies in the U.S. versus Europe given economic fundamentals.

On the long end of the curve, 30-Year U.S. Treasury yields have now breached their 50- and 200-day moving averages, approaching 3.00%. As yields are now surpassing key technical marks that could trigger a flush out of long-end bulls, the risk is building that Treasury yields go even higher.

It will be interesting to see how tighter monetary policy, which decelerates economic growth, will affect a slowing economy in the later stages of this expansionary cycle. This is the counter weight to the long end of the yield curve increasing significantly further in the short term. 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 straight times dating back to the 1970's.

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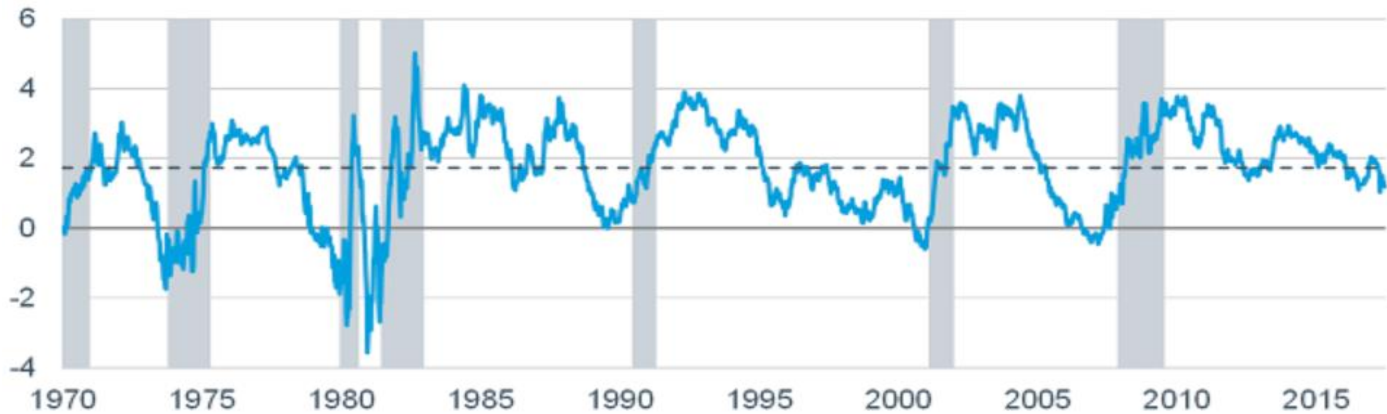
At the beginning of 2017, the yield spread between 10-Year and 3-Month Treasury rates was 1.95%. That has since been reduced to 1.29%, or a 34% spread reduction. If the Federal Reserve continues to raise the Fed Funds rate while economic growth and inflation remain subdued, expect the spread to contract further as the Treasury Curve flattens. If it eventually inverts, this will be the precursor to the next United States recession.

10-Year Treasury Yield minus 3-Month Treasury Yield (Dotted Line = Average Spread)

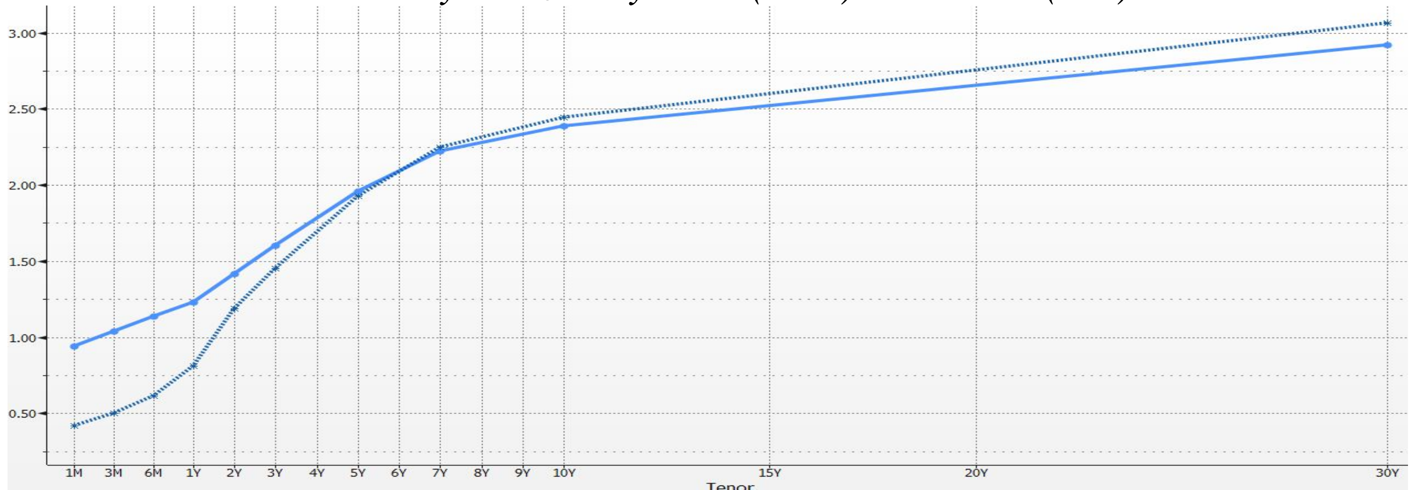


Source: FactSet. Gray-Shaded Areas Indicate Recessions

The first half of 2017 has seen a substantial flattening of the yield curve with the Federal Reserve hiking the Fed Funds Rate two times to a target of 1.00 – 1.25%. This has driven the short end of the curve higher by more than 50 basis points as the longer end of the curve has fallen by 20 basis points.

The yield spread between the benchmark 10-Year and 2-Year Treasury has contracted by 31 basis points over the first half of the year making short term borrowing more expensive and long term lending less profitable. 30-Year yields now sit just five basis points shy of their 100-day moving average and a breach could prompt a renewed wave of selling. Curve positioning may also fuel liquidation in the long end as traders start to unwind overcrowded flattener trades. The long end of the yield curve is tied to inflation, so although long dated yields have recently increased, it will be temporary unless inflation escalates.

U.S. Treasury Curve January 1st 2017 (Dotted) versus Current (Solid)



Source: Bloomberg

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Where Does The Fed Go From Here?

According to the minutes from the latest Federal Open Market Committee meeting, the Fed indicated it plans to continue raising rates. The Fed considers the muted inflation levels to be temporary and likely to rise over the long run, ultimately reaching their 2% target. They also outlined plans to reduce their $4.5 trillion balance sheet of bond holdings. September could be the start date and when implemented, they believe it will lead to long term rates increasing.

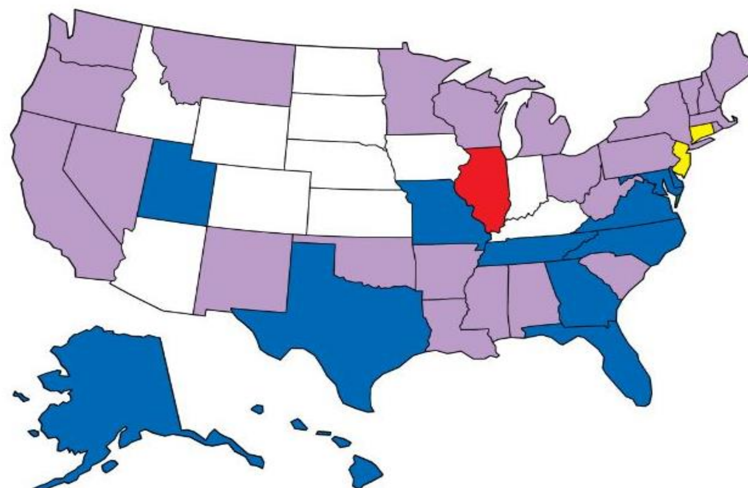
The markets have priced in a 52% probability of a December rate-hike. We believe despite economic indicators not warranting this, the Fed is collecting ammunition to combat the next recession as they recognize it being on the horizon within the next 24 months.

Credit Risk:

Credit risk is too big to ignore and something we continue to educate clients on. Moody's Investors Services has said Illinois is at risk of becoming the first junk-rated U.S. state on record even as lawmakers overturned Governor Bruce Rauner's veto and enacted a budget for the first time in two years. The state's rating, one step above speculative grade, is "under review for possible downgrade" after Illinois's leaders failed to enact a "timely budget". Moody's cites potentially optimistic revenue assumptions and the massive retirement fund debts as reasoning for a possible downgrade in the coming months.

Illinois is not alone as fiscal stress faces more and more U.S. states. Almost a decade after the Great Recession, revenue growth for states is chronically sluggish while expenses are climbing, especially for nondiscretionary items such as pensions. The federal government helped states during the past two downturns but it is less likely that aid is forthcoming now, given the Trump administration's intentions to shrink federal spending and push authority (and financial obligations) onto the states. The stress already unfolding throughout the state sector is likely to intensify if some of these policies that are currently under consideration came to fruition.

S&P General Obligation Bond Ratings



Source: Bureau of Labor Statistics

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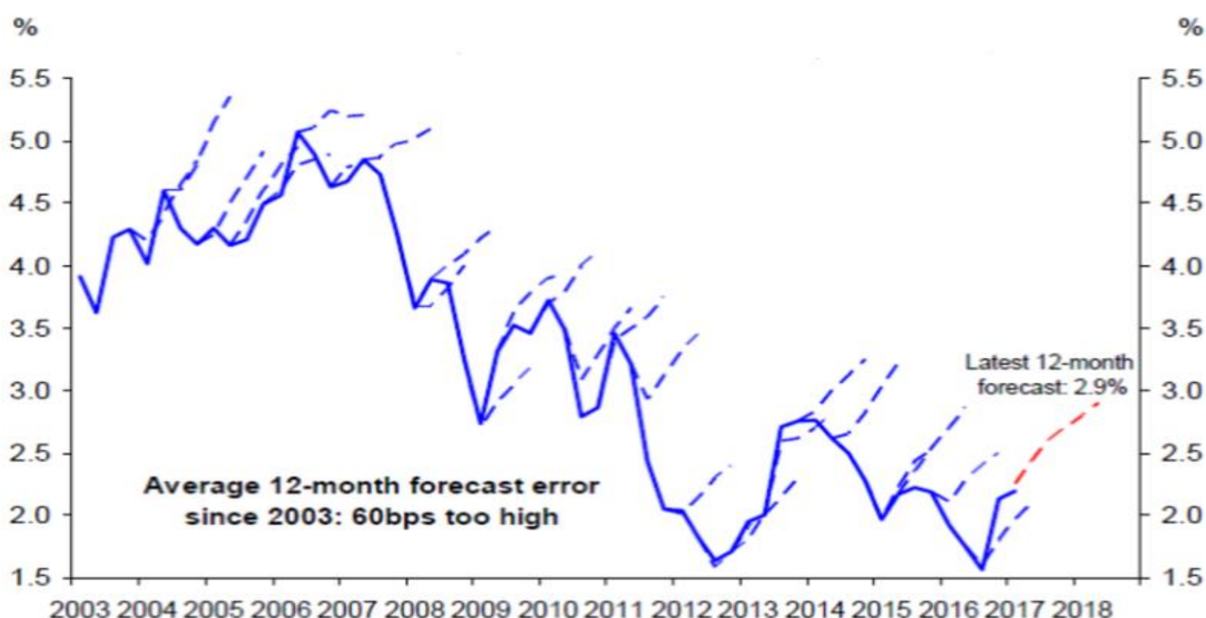
Second Half of 2017:

Wall Street economists have been consistently too optimistic in their forecasts for the 10-Year rate during the past 15 years. At the beginning of the year, most Wall Street banks forecasted a 3% or higher 10-Year Treasury yield while Carty & Company predicted 2.85%. They have since reduced their estimates while we are maintaining our 2.85% call.

10yr Treasury Yield (Solid) with Forecasts from the Fed's Quarterly Survey of Professional Forecasters (Dotted)



Source: FRB, FRBPHIL, DB Global Markets Research

At the beginning of the year we also predicted the 2-Year Treasury note would end 2017 at 1.80% (currently 1.40%). We are maintaining this prediction as well. We are tapering back our expectations for GDP and inflation, however. Our estimates were some of the more conservative on the street to begin the year and we now believe even those were too high. GDP growth for Q1 was a dismal 1.40% and Q2 is projected at 2.60%, so we are projecting a slightly higher average than to two combined taking into consideration good summer weather and holiday spending. We are revising core inflation down to 2.00% to take into consideration lower oil prices and a December Fed rate-hike that will have an anti-inflationary effect.

	Beginning of Year Forecast	Mid-Year Revised Forecast
Fed Funds Rate	1.25% with 2 Fed Rate Hikes	1.50% with 3 Fed Rate Hikes
2-Year UST Note Yield	1.80%	1.80%
10-Year UST Note Yield	2.85%	2.85%
Core Inflation Average	2.20%	2.00%
GDP Average	2.50%	2.20%

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How We Help Clients:

With uncertainty regarding Fed policy and credit quality getting more publicity, we believe the second half of 2017 could lead to more market volatility. The Fed is attempting to gently raise rates from the prior zero bound, while soon also shrinking its gigantic $4.5 trillion balance sheet. Success would be if the Fed can gracefully divert the excess liquidity it has created from financial assets into the real economy.

Carty & Company's call for a general yield curve flattening has come to fruition during the first six months of 2017 that has reinforced our conservative duration extension philosophy in client portfolios. Active portfolio management with a focus on price and credit risk remains our priority with clients. To help with this, Carty & Company Research provides excellent tools to monitor portfolio performance and credit trends.

Interest at Risk Performance Report – This report determines which bonds in a portfolio are paying a healthy amount of yield compared to the investment's price risk. This report takes the guesswork out of where strengths and weaknesses lie in a portfolio. By combining yield and price risk into a single ratio, it shows the true efficiency of a bond. We then sort every bond by sector from lowest performer to highest so that you can quickly identify your top performers. This is a powerful tool for Portfolio Managers to have during times of uncertainty and volatility.

Municipal Issuer Credit Review – This report transparently provides Portfolio Managers the most recent financials of every municipal issuer in their portfolio. It analyzes financial trends of the municipality, if they are balancing their budget, the total general fund balance and more. Staying ahead of credit issues before they unfold is going to become more critical as this cycle of easy monetary policy comes to an end.

We are a partner in education. Please let us know if you would like an updated Interest at Risk Performance Report or Municipal Issuer Credit Review.

Ryan R. Coombs, Vice President of Research & Strategies

Bradley K. Gentry, MBA / Institutional Fixed Income

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