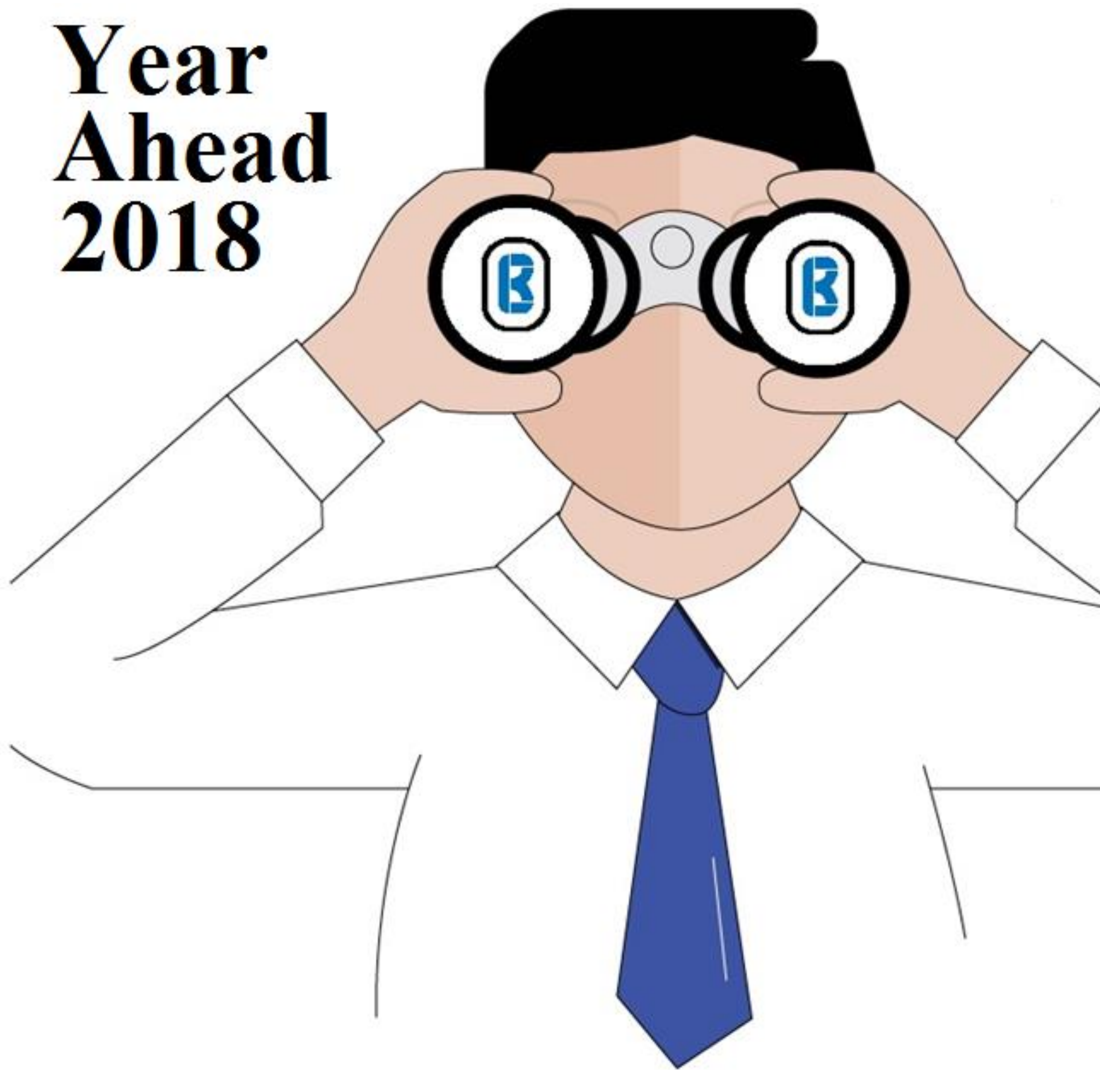
Carty & Company, Inc.
Research & Strategies

Year Ahead 2018



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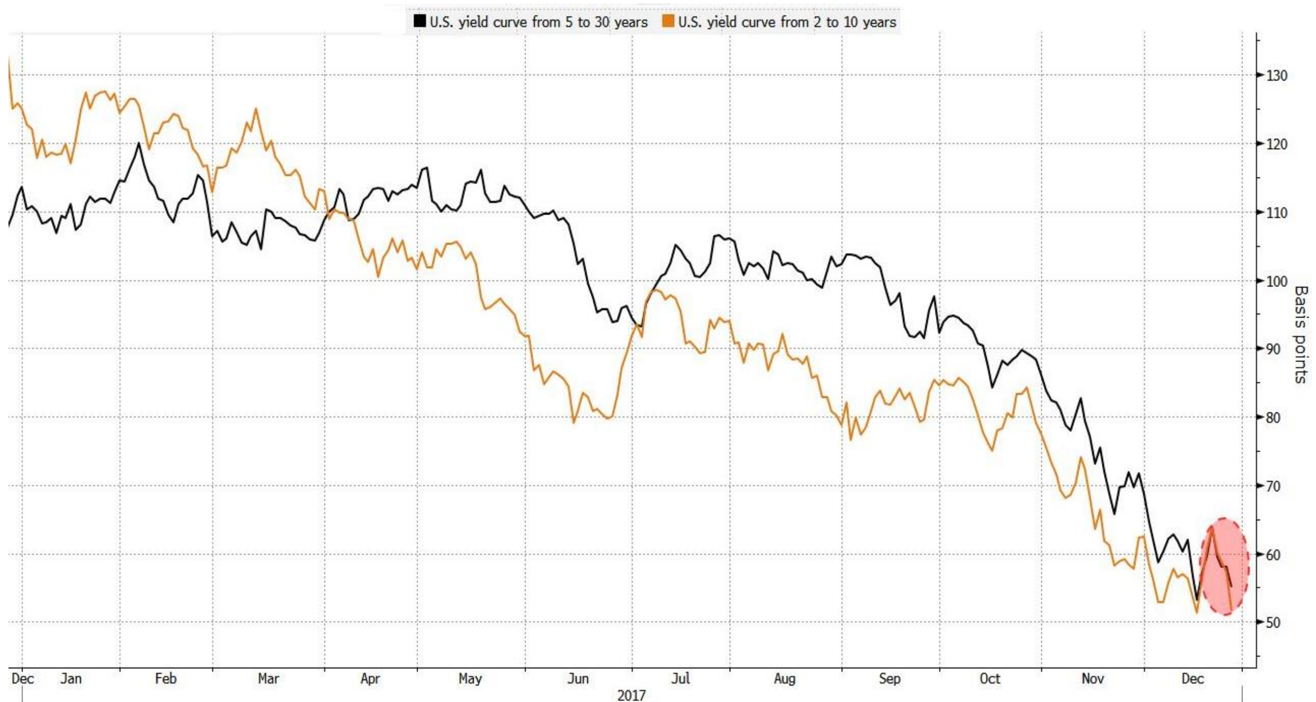
2017 Markets in Perspective:

Following the 2016 Presidential election, many investment firms were calling for soaring long-term interest rates and a steeper yield curve. Currently, long-term rates are lower and the yield curve has flattened to the narrowest spread since 2007. This flattening is usually a late-cycle phenomenon but these are unusual times. Low growth and inflation expectations, coupled with insatiable global demand for income, have held down long-term yields across the world.

We see no imminent economic threat in today's flat curve despite the spread between yields on 2-year and 10-year U.S. Treasuries narrowing to just 50.6 basis points to end the year. Our work suggests the U.S. yield curve flattening has gone beyond what would be implied by lower inflation expectations alone. Easier monetary policies in other countries and high global savings have played a part. However, the flattening has been mostly driven by rising short-term rates in anticipation of Fed moves, not drops on the long end over concerns of weaker growth and inflation.

Lack of volatility in the Treasury market was a key theme in 2017 as it dropped to record lows. The 10-year U.S. Treasury yield was locked between 2.01 percent and 2.63 percent -- a narrow 62 basis points. That is the tightest trading range since 1965 and less than half the annual average span of 175 basis points.

Yield Spreads at Tightest Levels in a Decade

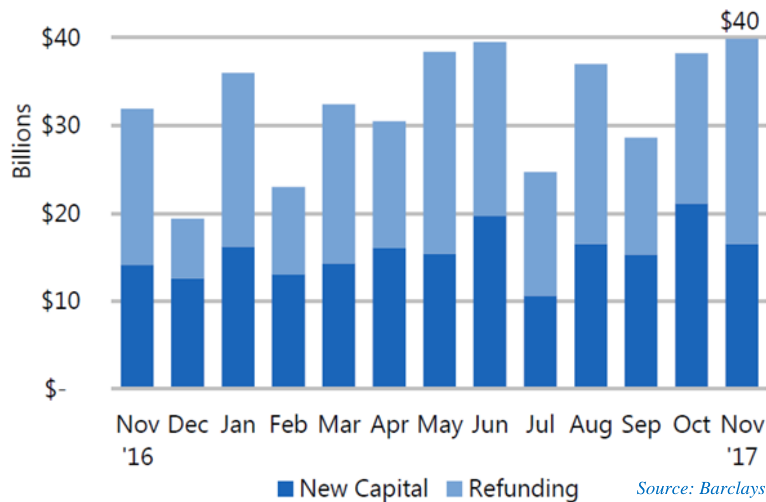


Source: Bloomberg

While 2017 was an off-cycle election year for many state and local seats, voters were asked to weigh in on $25 billion in municipal bond issuance. More than $20 billion of these measures passed.

Texas ballot measures accounted for $11.8 billion in debt. Six of the ten largest bond measures came from school districts in the state, including Austin, Spring Branch and Fort Worth. In Houston, voters approved $1 billion of pension obligation bonds to help shore up its police and municipal workers pension funds. Moody's subsequently raised its rating outlook for the city, which it rates Aa3, to stable from negative.

Municipal Market 2017 Monthly Issuance



Source: Barclays

Coming into 2017, many predicted President Trump to pass meaningful policies that would reform both Healthcare and Tax policy, as well as introduce infrastructure spending relatively quickly. 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 2017 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."

Since 2010, the first full year of economic recovery during this cycle, GDP growth has averaged 2.1 percent annually. With the economic expansion continuing to be limited by low productivity growth and restricted labor force expansion, we are on track for 2.2 percent GDP growth in 2017.

The current cycle has been unique in a number of ways. One key feature is wage growth and core inflation remaining relatively muted. While idiosyncratic factors have been a drag more recently, structural factors such as technological change and globalization have likely put a cap on underlying price pressures.

Despite low inflation, the Federal Reserve forged ahead with tightening in 2017, delivering three hikes and beginning the reduction of its $4.5 trillion balance sheet. With each hike, financial conditions have become easier, telling policymakers that: (a) monetary policy may have been too loose, and (b) easy financial conditions should underpin economic growth going forward.

Back-Testing 2017 Predictions:

Many pundits and financial firms are quick to make projections coming into a new year but do not back-test how their projections actually performed for clients. Our general forecast for 2017 was for the U.S. Treasury yield curve to “bear flatten”. A bear flattener is a yield-rate environment in which short-term interest rates are increasing at a faster pace than long-term interest rates. This causes the yield curve to flatten as short-term and long-term rates start to converge.

At the beginning of 2017, the 2-year U.S. Treasury was yielding 1.19 percent. Pricing in Fed rate-hikes and a subsequent rise in the front end of the yield curve, we anticipated the 2-year Treasury yield to raise 61 basis points and end 2017 at 1.80 percent. This forecast was nearly spot-on with the current 2-year Treasury yield standing at 1.89 percent - its highest level since October 2008.

We predicted inflation would remain tame with President Trump’s pro-growth policies running into political hurdles. With this in mind, our forecasts for 10-year Treasury yields were lower than most peers. Even then we over-shot estimates, with 10-year Treasury yields currently at 2.43 percent.

2017 Year-End Treasury Yield Projections

Bank	2-Year Yield Projection
HSBC	1.00%
Nomura	1.50%
Raymond James	1.72%
RBC	1.80%
CartyCo	1.80%
Actual Yield	1.89%
Goldman Sachs	1.90%

Bank	10-Year Projection
HSBC	1.35%
Nomura	2.00%
Actual Yield	2.43%
CartyCo	2.85%
RBC	3.00%
Goldman Sachs	3.00%
Raymond James	3.24%

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Forecasting Federal Reserve Policy:

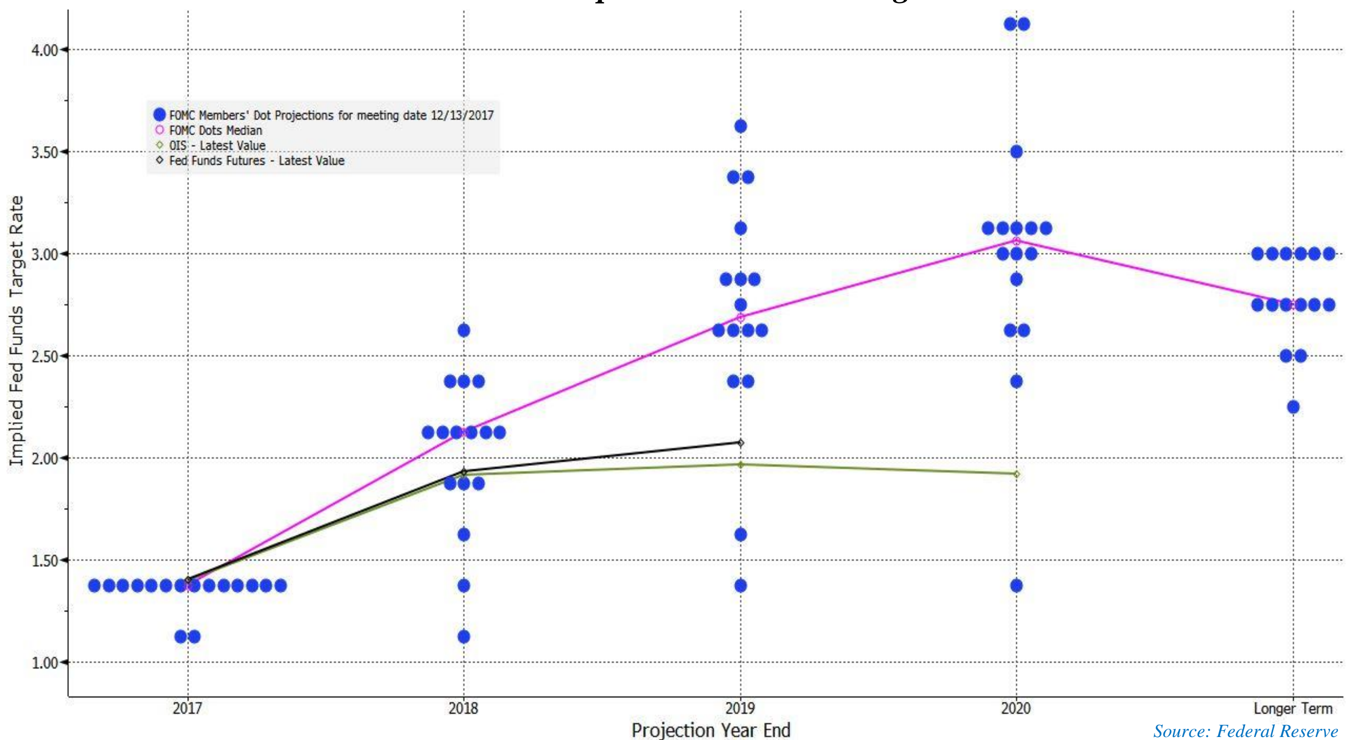
In the last meeting, Janet Yellen stated it is prudent to tighten monetary policy, even with the Fed's favored measure well below their 2.0 percent target. She also suggested lower individual tax rates could actually increase the supply of labor. The Fed Chair appears to be conceding inflation might 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 3.05 percent by the end of 2019, before retreating to 2.75 percent by the end of 2020.

The Fed's Dot Plot assumes the economy does not experience a slowdown or recession before 2020. Although that scenario is a possibility, most economists believe the U.S. economy may experience a recession before then, causing the Fed to pause or halt monetary policy tightening before the Fed Funds rate reaches 3.05 percent.

Keep in mind that 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 lower. 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: Federal Reserve

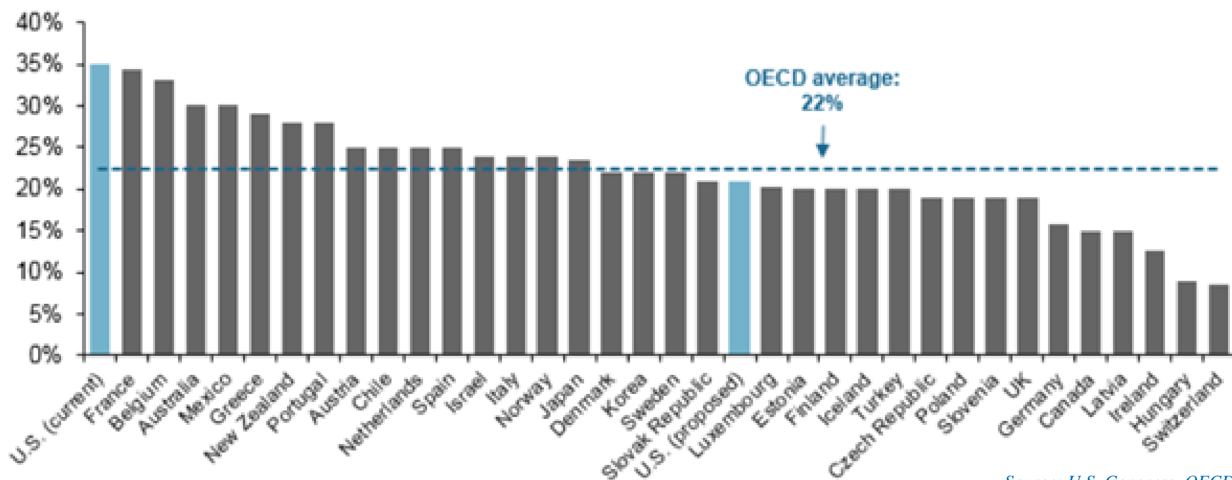
2018 Economic Projections:

The Philadelphia Fed Manufacturing Survey ended 2017 on solid footing, pointing to healthy economic momentum heading into 2018. Expectations for the next six months paint an even rosier outlook for the New Year with the Federal Reserve raising its 2018 GDP outlook from 2.1 percent to 2.5 percent.

Expectations of stronger business conditions in the future are an indication that business investment spending will play a greater role in GDP growth over the next several quarters. Although the tax plan still holds out the likelihood of a stronger 2018, we remain on the low side of expectations as we see slippage between receiving tax relief and it generating real GDP growth. A lower U.S. corporate tax rate along with 100% expensing of capital spending should boost investment, although with the repatriation of overseas earnings flowing primarily to shareholders, the total impact on capital spending could be limited.

Won't tax cuts make businesses move money and jobs back on shore, resulting in hiring? Not likely. Most businesses which fled the U.S. merely changed where they were domiciled. They relocated few jobs. Money coming back home is likely to fuel dividend increases, fund share repurchases or if rates do rise, trim debt on bloated corporate balance sheets.

2017 Corporate Income Tax Rate by OECD Country



Source: U.S. Congress, OECD

In Janet Yellen's last meeting, she suggested the relationship between the shape of the yield curve and the business cycle may have changed. We tend to agree. Although a flat or inverted curve would most likely shut down corporate and consumer lending, the current 2-10 year Treasury curve of 50 basis points might not be all that restrictive. Thanks to efficiencies and less risk on their books (more conservative business models), businesses can profit with narrower net interest margins versus the past. Since lenders have not opened the credit floodgates to lend to subprime borrowers, except in the auto

loan sector, a flatter yield curve may not curb lending and economic growth as much as it has in the past.

On the inflation front while many want to talk about wage gains, medical care, or mobile phones as sources of upcoming inflation or temporary deflation, these are specific goods and services competing for a fixed amount of income. To get inflation, the money supply must rise faster than the underlying supply of goods and services. In the post-Volker era, that happened because the Federal Reserve responded to rising loan demand by creating money to defend a targeted interest rate. In the post-QE period, the Federal Reserve has already created the money and it sits in banks as excess reserves awaiting borrowers.

We are watching consumer debt and mortgages for signs that workers are spending more than they earn. The reason for this is because earnings are a measure of the value for what consumers produce. When borrowing rises, we expect inflation. However, the most recent data suggest that lending and inflation are slowing. We see inflation remaining tame with Core CPI and another strong indicator of consumer inflation, rent prices, both trending lower.

Core CPI (Black) and Rent Inflation (Blue) Both Declining

Source: Federal Reserve

Our 2018 forecast for the U.S. economy is core inflation to average 2.00 percent and GDP to average 2.40 percent.

2018 Interest Rate Projections:

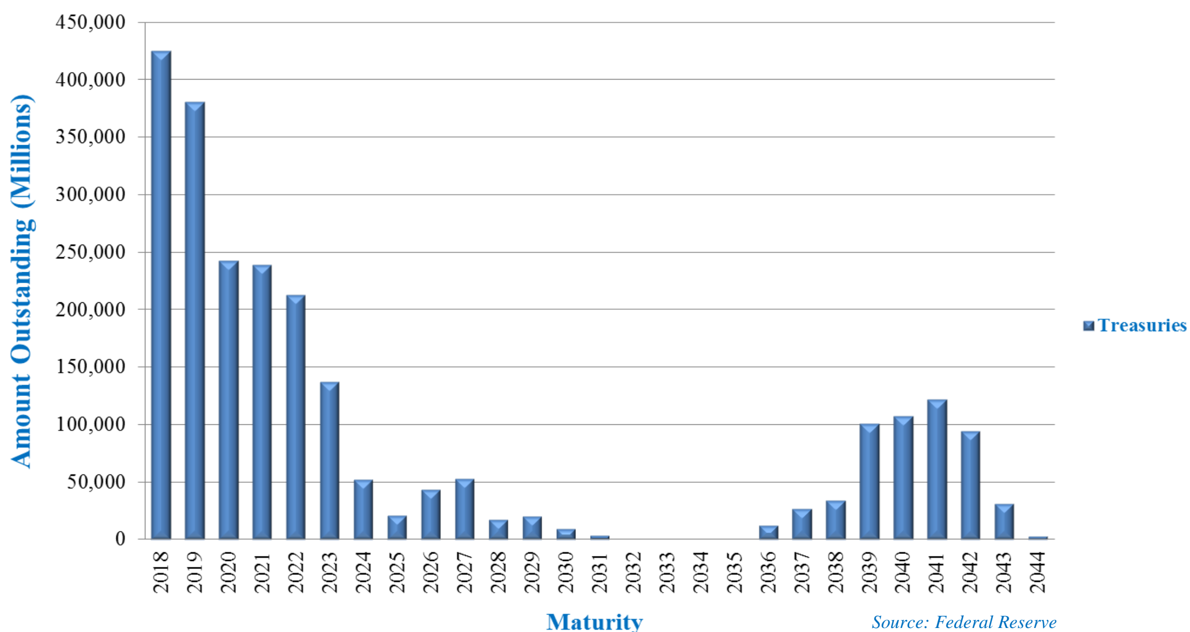
When discussing future interest rates, the topic of the Federal Reserve balance sheet reduction often comes up. It is important to note the Fed is not selling any bonds. They are letting bonds mature and reinvesting $20 billion less monthly than they have been, allowing their balance sheet to slowly run off.

Couldn't lower reinvestment push long interest rates higher as the bond market gradually loses a larger buyer of U.S. Treasuries? With a current total of $2.45 trillion in Treasuries on the Fed's books, $20 billion less in monthly reinvestment is not a significant policy reversal. Also, 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 6 year and shorter area of the curve. This should be followed by rising short-term rates from traditional Fed Funds rate hikes. The result will most likely 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 long end of the yield curve is and always has been directly tied to inflation expectations. The result could be that U.S. Treasury yields on the 10-30 year portion of the yield curve do not rise materially from current levels. Fed tightening, traditional or quantitative, should continue to augur for a gradual flattening of the yield curve.

Composition of Fed's Balance Sheet

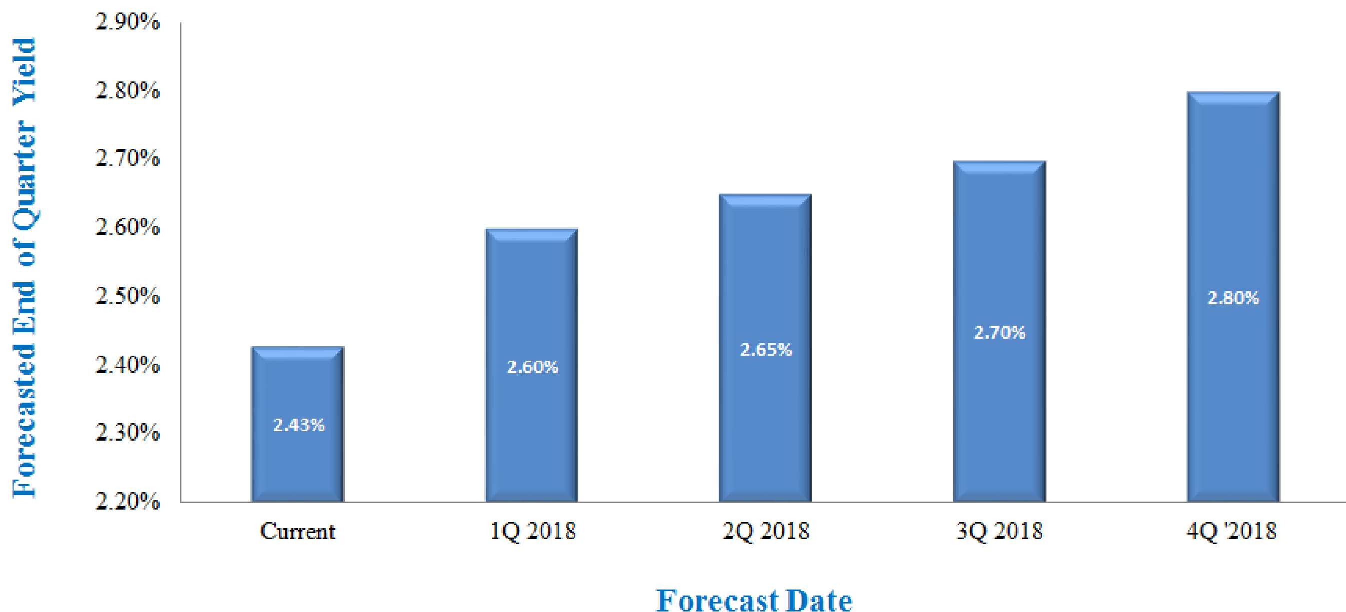


A gradual bear flattening is our base case for the balance of this economic cycle. Inflation pressures should be persistent enough to keep the Fed renormalizing, but not so robust as to cause long-term rates to soar in the face of strong fundamental demand for long-dated U.S. Treasuries. In our opinion, it is unlikely we see the 10-Year U.S. Treasury yield breach 3.00 percent again during the current economic cycle. For this to occur, inflation pressures would need to mount and the Fed would have to allow it. Recent comments by Fed Chair Yellen suggest this will not happen.

However, we do believe there is political incentive to front load corporate tax cuts and if so, the U.S. deficit and net issuance of U.S. Treasuries would likely grow in 2018. This, coupled with balance sheet unwinding, could mean an increase in net supply of U.S. Treasuries that the market would have to absorb during the first quarter of 2018. As a result, we believe 10-year Treasury yields will make their most significant leg up to 2.60 percent in 1Q 2018 and drift higher toward 2.80 percent by the end of 2018.

It is not assured that we see a 3.00 percent 30-year bond yield before the current economic cycle turns. If the Fed does raise short-term Fed Funds to 3.00 percent by 2019 year-end, as their Dot Plot suggests, the Treasury curve would possibly be inverted at that time. In spite of our low rate views, we could see a 25 to 50 basis point rise on the long end of the U.S. Treasury yield curve.

10-Year U.S. Treasury Yield Forecast



Our 2018 forecast for the 2-Year U.S. Treasury yield is to end the year at 2.55 percent and the 10-Year U.S. Treasury yield to end the year at 2.80 percent.

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