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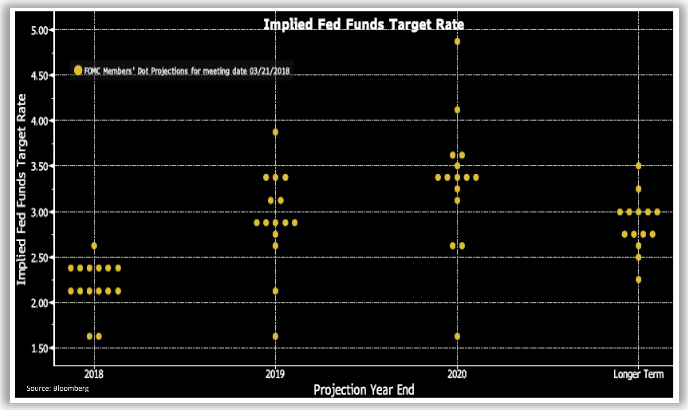
Short Term Investment Overview – March 2018

In the U.S. market, it has been a very interesting start to 2018. Credit spreads have come under pressure over the past couple of weeks thanks in part to concerns about the pace and quantity of Fed rate hikes this year, a jump in net new Treasury Bill issuance, fears of potential selling by U.S. corporations, and a recent surge in new issue supply.

FOMC

In line with expectations, new Fed Chairman Jerome Powell and the FOMC announced another 25 basis point rate hike at their March meeting which marks the sixth such hike since late 2015 and takes the Fed Funds target range to 1.50%-1.75%.



Post meeting, the Fed's "dots plot", which displays the committee's view on the appropriate path of policy, showed a moderate shift upwards in their view, but the maintained the expectation for 3 total rates hikes this year with Chairman Powell reiterating the data dependence of policy.

It is worth noting though that the number of FOMC officials anticipating 4 rate hikes in 2018 doubled from 3 to 6. The committee noted an improved outlook, upgraded its growth and employment forecasts, projected an inflation overshoot in 2019-2020, and raised its rate path for 2019 and 2020 more than what most market participants probably expected. We expect to see the committee's views on monetary policy and rates continues to evolve with the data and changing financial conditions.

Libor-OIS Movement

Leading up to 2008 most market participants paid little attention and limited importance in the Libor-OIS spread. The lack of attention was mainly because the spread was historically very tight. The ensuing financial crisis changed all that when Libor aggressively spiked wider in relation to OIS. As a result, the Libor-OIS spread is now considered a gauge of health in short-term funding and credit stress in the market. So far, 2018 has seen close to 25 basis points of widening in the Libor-OIS spread. Initial reactions would lead you to believe that stress in the US funding market is rising, however, in the current scenario the driving factor is much more generic due to a shift in the supply-demand balance of short-term debt.

Simply put, Treasury bill and commercial paper (CP) are the main culprits driving the Libor-OIS spread wider. Commercial paper yields have been pressured higher on the heels of increased supply, while the overall level of demand has remained roughly static. In addition to the increase in CP supply, the Treasury has significantly increased T-bill issuance recently and is expected to push net new bill

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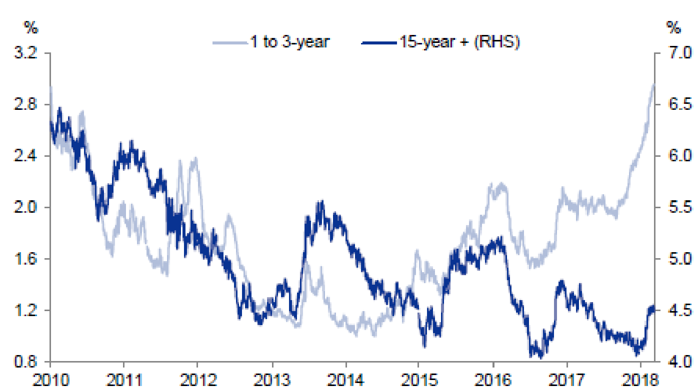
issuance above $500 Billion for 2018 marking highest total in recent years. As a result, yields in the T-bill space have been forced higher above OIS swaps, and therefore naturally elevating CP yields as well. On the demand side of the equation, money market funds are the traditional and largest buyer of commercial paper. While CP issuance has increased YTD, prime money fund assets have remained relatively flat. The combination of unchanged demand coupled with increased CP and T-bill issuance is a major catalyst driving the Libor-OIS spread wider so far this year, and *not* an impending credit concern. However, with 3 Month Libor currently at 2.25%, Libor settings are slowly grinding higher towards levels that haven't been seen since 2008. And while investors, *for now*, are largely unruffled about the blowout in borrowing costs, strategists are starting to caution against the rising risks of a tightening of U.S. financial conditions going forward.

Yield Curve Movement

The purpose of the "yield curve" is to compare and gauge interest rates at varying maturities ranging from overnight out to 30 years. Historically, 10 Year yields have been the markets gauge on the strength and forecast for growth as well as the outlook for inflation. However, when focusing on the front end of the curve, market outlook and inflation expectations are mainly tied to expectations for Federal Reserve policy rates.

A flattening yield curve is a bearish indicator for the economy. As we stand today, there are plenty of theories and explanations for why the yield curve is flattening. The simple and obvious contributing factor is that the Federal Reserve is expected to continue increasing short-term rates through 2019 and into early 2020 due to the US economy's ongoing moderate growth at a reasonable pace. Additionally, inflation, which is one of the Fed's dual mandates, is still slogging along below expectations keeping pressure on yields at the long end and keeping them unchanged.

Exhibit 2: Short-dated IG bond yields are at post-crisis highs
IG bond effective yields



Source: ICE-BAML, Haver Analytics, Goldman Sachs Global Investment Research

We are currently in one of the longest expansionary business cycles in U.S. history. Yet, many are starting to grow concerned that we are due for a correction and an impending economic slowdown. Low inflation expectations have helped to keep 10 Year yields in check. Declines in yields on longer maturities largely reflect strong foreign buying (European Central Bank & Bank of Japan) and demand from institutional investors like pension funds, insurers, etc. who are seeking to hedge. Both scenarios drive up long end bond prices, lowering yields and pushing the curve flatter. As yields rise and spreads widen, we believe it is a good opportunity to be buyers of front end credit.

The Fed has expressed their expectation for 2 more rate hikes in 2018 and at least 3 in 2019. If the current 2nd longest expansionary cycle in history is in fact coming to an end, and investors begin to prepare for a slowdown, the result will be a further flattening of the yield curve, putting curve at risk of inversion where short term yields are higher than long term yields. Historically, since WWII, every US recession has been preceded by an inverted yield curve. Stay tuned.

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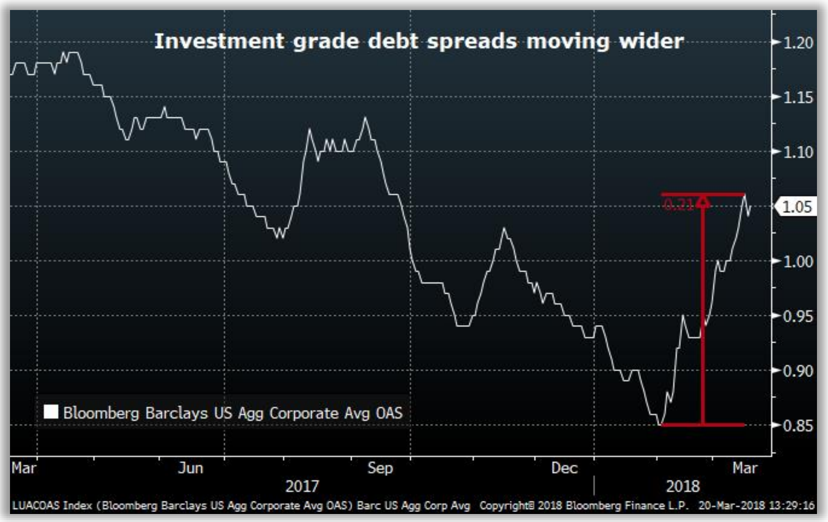
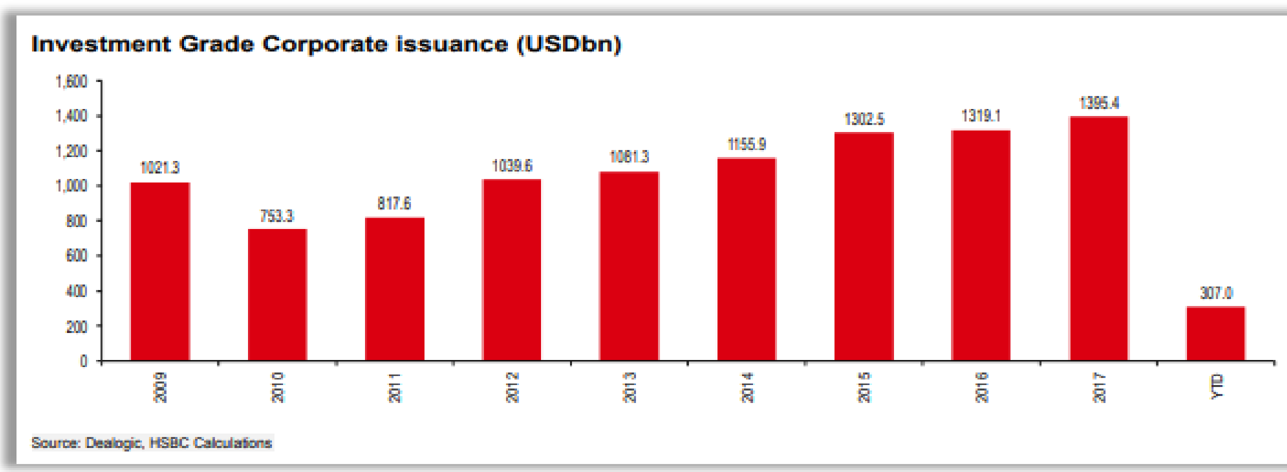
Investment Grade Market

The pace of Investment grade new issue supply has picked up the past few weeks and is getting back on track with last year's historical issuance totals. Strong corporate daily trading volumes persist. Already this year we have seen 5 of the top 10 highest trading volume days since early 2005, and daily volume remains above all the moving averages YTD.



Since the beginning of February, IG spreads have widened about 20 bps and demand remains strong in the IG sector as investors are still looking for yield. Undeterred by the demand, the gluttony of new issue supply seems to be winning the battle and as the new issue supply totals grow, it's likely that the technical pressures will continue in the near term, keeping spreads trending wider.

In the face of a significant amount of re-leveraging this sector has experienced since the crisis, corporate earnings strength should persist through 2018 and current credit fundamentals do remain steady. Issuers have been taking advantage of the low interest rate environment to benefit from cheap funding levels over the past few years. Despite the Fed being in the midst of a rate hiking campaign, rates are still low on a historical basis and we expect to see another healthy and robust year of issuance. As mentioned new issue supply is creeping back on pace to surpass last year's record total. CVS is the leader in the club house with their $40 B deal early in March which closed as the 3rd largest single issuer corporate bond deal in history. Additionally, the new tax reform and structure should stimulate a busy year of M&A activity which will be a driver of new issuance as well.



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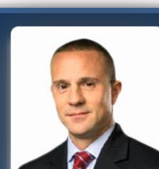
What's Ahead

A lot of variables and global uneasiness are clouding the landscape right now. At the forefront is the impending fiscal changes of new tax cuts and increased spending which is more than likely to boost the economy...as well as the deficit. Monetary policy uncertainty remains as the FOMC continues its tightening campaign. Following the Fed's March meeting, we expect to see a Fed Funds futures market with two more hikes priced in for 2018 and slightly elevated rate expectation for 2019 and 2020. A key factor to watch is how the FOMC handles the shift from a focus on a max accommodation monetary policy to a more normalized policy. The market is predicting three total rate hikes of 25 bps this year with the upside risk for a fourth. Despite the increases in volatility in most other sectors, the front end of the curve has operated smoothly year to date and we expect that to continue. One other element to consider is the new voting members of the FOMC. Jerome Powell replacing Janet Yellen as the Fed Chair is the headline, but there are several other new voters which is expected to lean the Fed slightly towards the hawkish side. Coupled with a robust economy and new fiscal policies and you have a recipe for monetary policy uncertainty.

Investment Strategy

- Duration – recommend staying neutral to short in the front end. Use near term supply increase and yield backups in Treasuries to manage duration.
- Money Market Sector - Overweight 9 month and shorter CP & YCD to take advantage of supply/demand imbalance.
- Investment grade bonds – Overweight financials vs. non-financial IG bonds, and floating rate structure vs. fixed to reduce interest rate risk. Floating-rate notes should benefit from further Federal Reserve tightening this year.
- Quality - Front end spreads slightly wider vs. long end causing the curve to flatten. Recommend owning higher quality and higher rated names right now as the risk is skewed towards spreads continuing to move wider which would negatively affect lower-rated bonds more so than higher rated bonds.



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