Redstone Advisors

Economic and Market Review

First Quarter 2018

The first quarter of 2018 was marked by a reemergence of volatility into financial markets. At the beginning of the year, the market was figuring out what the full impact of the new tax law would be on the economy and whether it might force a more aggressive Federal Reserve policy. Later in the quarter, concern shifted to US trade policy, as tariff threats were exchanged between the Trump administration and other countries, notably China. The markets grew concerned that the tough talk and saber rattling could possibly escalate into a full-blown trade war with significant and wide-ranging consequences.

Treasury yields at the short end of the curve rose steadily through the quarter. On March 28 the 1-year Treasury closed at 2.12%, which was the highest level since September 2008. Short term Treasury yields have been steadily rising the past few months as traders have taken cues from the Fed which has been committed to increasing rates as it tightens monetary policy. Longer term Treasury yields rose in January and February before declining a little in March. The 10-year Treasury failed to break through the much-discussed 3% threshold and finished the quarter at 2.75%. For the quarter, Treasury yields finished higher across the yield curve. Throughout March the trend was a flatter yield curve, as long-term yields declined in response to reduced expectations for growth and inflation. The spread between the 2-year and 10-year Treasury narrowed to just 45 basis points (bps) by quarter end. Meanwhile, the 2/30-year spread narrowed from 82 bps to 68 bps over the course of the 1st quarter. Both the 2/10-year and 2/30-year spreads finished the quarter at their narrowest levels since October 2007. A flattening yield curve suggests that the bond market is skeptical of any reflation forecasts,

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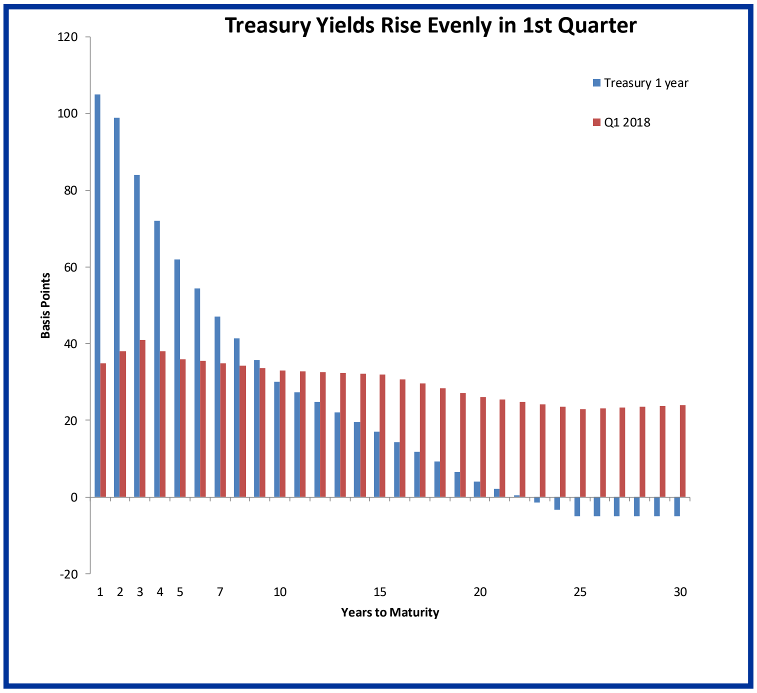
seeing little risk of accelerating growth and inflation in the future. The change in Treasury yields for the quarter and latest 1-year period can be seen in **Figure 1**.

Figure 1



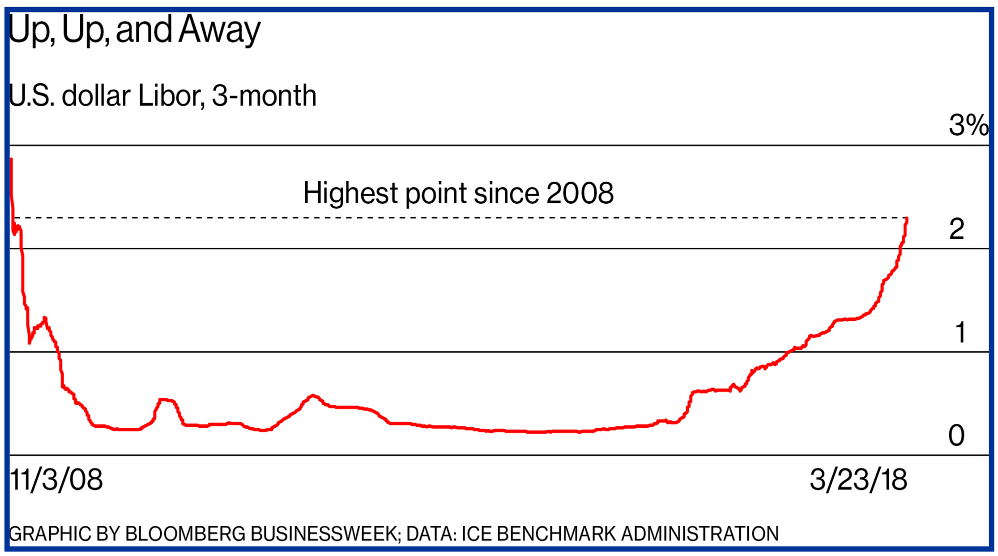
In late March, President Trump said the U.S. is planning to impose tariffs on approximately $50 billion of imports from China, in response to what the American government considers unfair trading practices. The $50 billion figure is equivalent to about 10% of US imports from China. The National Retail Federation put out a statement in response, *"Holding China accountable for refusing to follow global trading rules is important and necessary. But instead, the tariffs proposed by the administration will punish ordinary Americans for China's violations."* Earlier in March the Trump administration announced targeted tariffs on steel and aluminum. The 25% steel tariff and 10% aluminum tariff had some key countries exempted, including Mexico, Canada, South Korea, Argentina, Brazil, Australia and European Union nations. Essentially that means the steel and aluminum tariffs will apply to only three main exporters: China, Russia and Japan. There are those that may recall, in a weekly radio address back in 1985, President Reagan said, "*some of us remember the 1930s, when the most destructive trade bill in history, the Smoot-Hawley Tariff Act, helped plunge the nation and the world into a decade of depression and despair. If the ghost of Smoot-Hawley rears its ugly head in Congress, if Congress crafts a depression-making bill, I'll fight it."*

The vast majority of economists oppose tariffs, arguing that they increase prices, limit choices, and reduce competition. The Chinese government was very critical of the U.S.'s planned policies. A Commerce Ministry statement said, *"China absolutely won't sit back and allow its legitimate rights and interests to be harmed and will take all necessary measures to protect them.*" In early April, China retaliated against proposed tariffs on its goods by targeting specific high-value American exports, ranging from planes and SUVs to various commodities. Prominent in China's retaliatory actions are agricultural products from American farm states ranging from beef and pork to soybeans and sorghum, reflecting the political rather than economic nature of China's response. Chinese government officials characterized China's response as defensive and said there is hope of engaging the U.S. in talks to ease the two countries' trade grievances. It should be noted that neither the U.S. nor Chinese tariffs will go into effect immediately. Chinese Finance Vice Minister Zhu Guangyao said that whether or when China will enforce its tariffs would hinge on the outcome of negotiations between both sides. Mr. Zhu referred to a principle set by President Xi Jinping that "*nobody should expect China to swallow bitter fruit."*

Under the Trump administration's plan, U.S. companies have until May 22 to raise objections to the proposed tariffs, and the U.S. government then has at least 180 days to determine whether to proceed, providing considerable time for negotiations. Still, the brewing trade war has rocked already volatile markets. Tariffs increase uncertainty for global financial markets, as supply chains are disrupted and costs increase for consumers and producers. Some analysts say it is hard to see a comprehensive policy framework behind the Trump administration's interventions into the economy, making it difficult to predict what might come next. As the old saying goes, "markets hate uncertainty". Others have described the administration's controversial trade approach as mercantilism, a government effort to boost exports and restrain imports in pursuit of trade and financial surpluses. The full scope and effect of the tariffs now seem dependent on key negotiations with trading partners likely to occur in the coming weeks and months.

A measure of volatility in the U.S. stock market had one of its biggest quarterly rises in recent history, signifying growing investor worry about interest rates and global trade tension. The Cboe Volatility Index, known as VIX, surged about 80% during the first quarter after a period where it had been declining for about three mostly calm years. Another measure to keep an eye on is Libor, the London interbank offered rate, which measures the cost for banks to lend to one another. About $350 trillion worth of global financial assets are pegged to Libor. It is the key interest rate used as a baseline for many types of bonds, corporate loans and home mortgages. "*Libor is still the most important reference rate*," notes Christoph Rieger of Commerzbank AG. The three-month Libor rose to 2.29% in the U.S. in late March, its highest level since November 2008. The recent rise in Libor can be seen in **Figure 2**. Libor has been moving higher for the last 2.5 years as the Fed has increased its benchmark policy rate. In mid-March, the Fed raised rates by a quarter point to a new target range of 1.50% to 1.75%. Some analysts are concerned that higher short-term interest rate costs could potentially complicate businesses' plans to borrow for the future, build factories, and buy equipment, activities that help the economy hum along. Part of the reason behind Libor's recent rise seems to be

Figure 2



increased issuance of Treasury bills by the US government. This deluge of Treasury bills has crowded out commercial paper, which some companies use to meet their short-term cash needs. Companies selling commercial paper have needed to offer higher rates to lure investors. Those higher rates ultimately figure into Libor calculations.

Another area of concern is within the investment grade corporate bond market. According to a recent report by Morgan Stanley, there is $2.5 trillion in outstanding U.S. debt rated BBB, an increase from $1.3 trillion five years ago and $686 billion a decade ago. That amount is the most ever for companies rated BBB, which is the lowest notch of the ratings ladder for investment-grade bonds, above more speculative "junk" or "high-yield" bonds. The rise in BBB debt over the past several years can be seen in **Figure 3**. Since early February, the yield premium that investors demand to own BBB rated bonds relative to Treasuries has risen to 134 basis points from 108 basis points, according to Bloomberg Barclays data. The International Monetary Fund recently underscored the BBB risk in a report on financial stability that warned about "a buildup of financial balance sheet" debt. "*When markets start restricting access to capital in a downturn or a bear market, we tend to find that leverage levels matter a lot,"* a Morgan Stanley credit strategist warned.

Figure 3