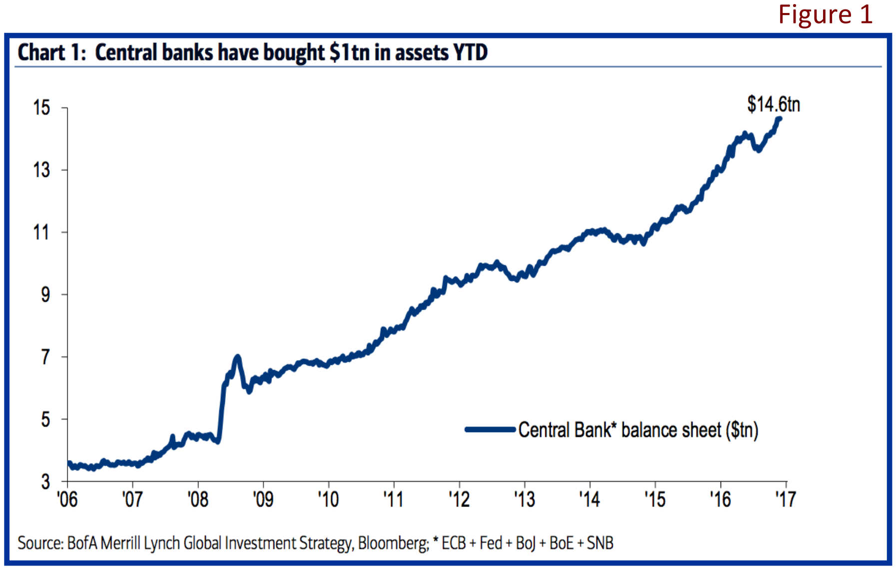
Redstone Advisors

Economic and Market Review

Second Quarter 2017

The second quarter of 2017 saw another continuation of the modern era of low rates, low inflation, weak growth, and extraordinary monetary policy. Our opinion is that the first half of 2017 has bolstered the argument that following the "Trump Tantrum" of late 2016, fundamentally nothing has changed regarding the long-term trajectory of the economy. As the structural issues around subpar growth remain unaddressed, the markets are very likely to be stuck in a low-rate environment, longer than many on Wall Street ever anticipated. Regarding monetary policy, as of late April, central banks including the European Central Bank (ECB), Bank of Japan (BoJ), and the Swiss National Bank (SNB) had already purchased $1.5 trillion in assets, putting them on pace for about $3.6 trillion in purchases in 2017, the most since the start of the global financial crisis in 2007. In fact, this past quarter saw the ECB's and BoJ's respective balance sheets surpass the size of the Federal Reserve's mammoth $4.5 trillion balance sheet.

Figure 1



This unprecedented central bank intervention has been a major factor in holding down long-term bond yields and supporting equity prices. The massive amount of financial securities added to central

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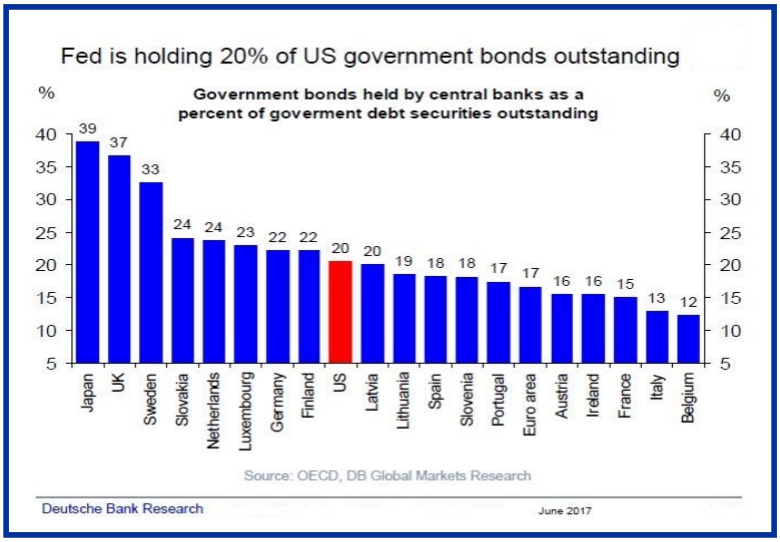
Figure 2



banks' balance sheets is widely seen as the one flow that matters in the markets. Cumulative asset buying since 2007 by the five major central banks alone (ECB, BoJ, Federal Reserve, Bank of England & SNB) totaled roughly $14.6 trillion as of April, as illustrated in **Figure 1.** Another way to view this huge central bank influence in the bond market is to look at government bonds held by central banks as a percent of total government debt outstanding. A recent report from Deutsche Bank shows that the Fed owns about 20 percent of the U.S. Treasury market, the BoE owns 37 percent of the UK gilt market and the BoJ owns a little less than 40 percent of the Japanese Government Bond market. These figures can be seen in **Figure 2**.

This past quarter saw the Treasury yield curve flatten considerably, with 1 and 2 year rates on the short end rising and rates at the long end moderately declining. Rates at the short end have risen as they adjust to the Fed's projected tightening path while longer rates have fallen on diminished views on long-term growth and inflation. This continues the flattening trend from the first quarter of this year. The spread between the 2-year and 10-year Treasury narrowed from 114 basis points at the end of March to 92 basis points at quarter end. In mid-June, the 2-yr/10-yr spread was just 78 basis points, bringing it within range of the flattest levels in about a decade. Another measure of the curve, the 5-yr/30-yr spread, narrowed from 109 basis points to 94 basis points, the lowest level since November 2007. A flattening yield curve suggests that the bond market is skeptical of any reflation forecasts, seeing little risk of accelerating growth and inflation in the future. Many analysts see it as a sign of diminished confidence in the economic outlook.

Other analysts, however, believe that this time, the flattening yield curve isn't necessarily sending out a negative signal for the economy. They believe the flattening has been largely driven by international flows into the Treasury bond market due to its relatively attractive yields compared with most other developed government bond markets. While short-term rates are influenced by the Federal Reserve's monetary policy, longer-term bond yields are driven partly by inflation expectations and are more sensitive to fiscal policy and overall economic growth. The Fed's preferred inflation index, the PCE (personal consumption expenditures), has fallen in recent months to about 1.5 percent rather than converge to the Fed's desired target of 2.0 percent. In addition, so-called core prices, which exclude the often-volatile categories of food and energy, were up just 1.4 percent, the lowest level since December 2015. These inflation measurements going back to 2008 can be seen in **Figure 3**. Meanwhile inflationary expectations, as measured by the market for Treasury Inflation Protected Securities (TIPS), have also declined. Back in December 2015, before the Fed's first rate

Figure 3

hike in nine years, the 10-year Treasury yield was about 2.27 percent. Four rate hikes and 1.5 years later, the 10-year yield sits at roughly 2.32 percent as of the end of June, essentially flat. This defies the consensus Wall Street forecast of much higher yields and higher inflation made at the end of 2016, and many times before that.

The market in 2017 has been forced to revise expectations regarding the scope and timing of tax reform and other fiscal proposals on President Trump's agenda. The GOP effort in Congress to reshape the nation's tax system has moved quite slowly. The dark realities of political gridlock and intraparty divisions, even with single-party control of both the White House and Congress, squashed any dream of quick action that would theoretically boost growth and drive inflation higher. Simply put, the clear winner has been the status quo. The reality is that people's assets, including their homes and retirement plans, are tightly woven to tax preferences, making voters and industries resistant to any change. As we alluded to last quarter, tax reform is a complicated and thorny issue, where the devil is in the details. Tax reform, which involves winners and losers, pits powerful and deep-pocketed interests against one another. The tax code is filled with special-interest provisions and deductions enacted over decades. Popular tax breaks for individuals such as the mortgage interest deduction and charitable giving deduction account for huge amounts of revenue. President Trump has recently promised to protect both of these tax breaks.

In mid-June, in a widely-expected move, the Federal Reserve raised their benchmark federal funds rate to a target range of 1.00 percent to 1.25 percent. This was the third such quarter-point rate hike in six months. In a statement, the Fed indicated their intention for one more rate hike this year if the economy performs in accordance with their expectations. Historically, the Fed has typically raised rates to "remove the punch bowl from the party", slowing down growth and dampening inflation. However, currently growth and inflation are not running hot by any measure. Instead, the Fed seems concerned that their easy-money policies are fueling a seemingly endless rally in riskier assets. Also, it appears they have a desire to get the fed funds rate to a historically normal level so that they have ample room to lower rates next time a recession strikes. The Fed is currently forecasting three more quarter-point rate hikes in 2018.

The Fed is in a tight spot. It is attempting to normalize monetary policy during a time of sluggish growth, while its fellow central bankers in Europe and Asia are keeping very accommodative monetary policies, pushing global investors hunting for yield into less-creditworthy bonds and other assets. Many worry that the extended period of ultra-loose monetary policy has not only dissociated asset prices from fundamentals, but also conditioned investors to take excessive risks based on the assumption that central banks will intervene if danger pops up in the market, i.e., moral hazard. In recent years, Fed officials have faced a recurring dilemma where they indicated a desire to tighten policy, only to back off after the economy disappointed or global factors interrupted. Regarding normalizing policy, at its June meeting the Fed laid out its intention to very gradually start shrinking its $4.5 trillion balance sheet of bonds and other assets at some point this year, likely September. For a little more than 3 years now, the Fed has been reinvesting the proceeds of maturing assets in its portfolio to keep the central bank's holdings steady.