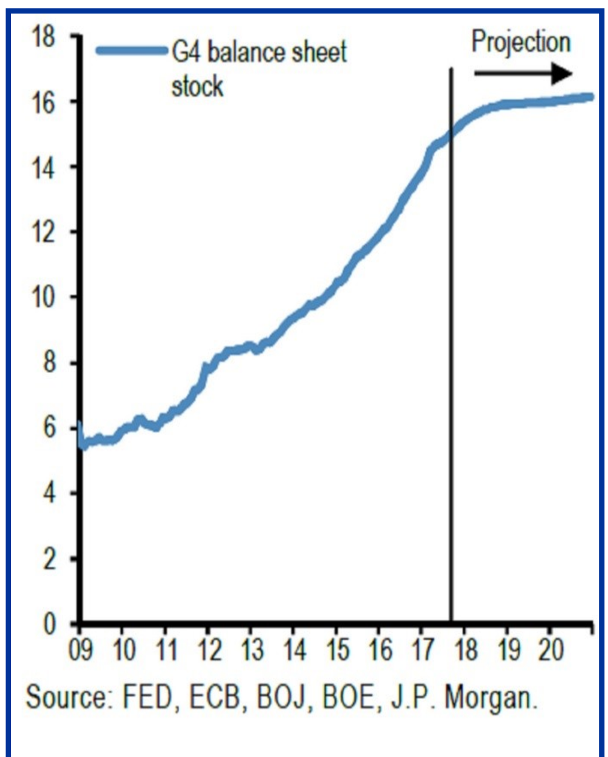
Redstone Advisors

Economic and Market Review

Third Quarter 2017

The third quarter of 2017 was marked by speculation regarding monetary policy by central banks and fiscal policy by Congress, and what shifts in policy could possibly mean for financial markets. The overarching story in the markets for the past few years has been the unprecedented central bank intervention that has left the United States and much of the global economy with low rates, low inflation, and a weak growth environment. Our opinion remains that fundamentally nothing has changed regarding the long-term trajectory of the economy. The forces of secular stagnation are still conspiring with the headwinds of a massive overhang of debt, deteriorating demographics, and the financialization and globalization of the economy to restrain economic growth. These deeper, long-lasting and secular (non-cyclical) forces are helping to hold down long-term interest rates. As the structural issues around subpar growth remain unaddressed, the markets are very likely to be mired in a low-rate environment. The staggering growth in the cumulative size of the four major central bank balance sheets (Federal Reserve, European Central Bank, Bank of Japan, Bank of England) since 2009 can be seen in **Figure 1**.

Figure 1



Central-bank balance sheets in trillions, dollars JPMorgan Chase & Co.

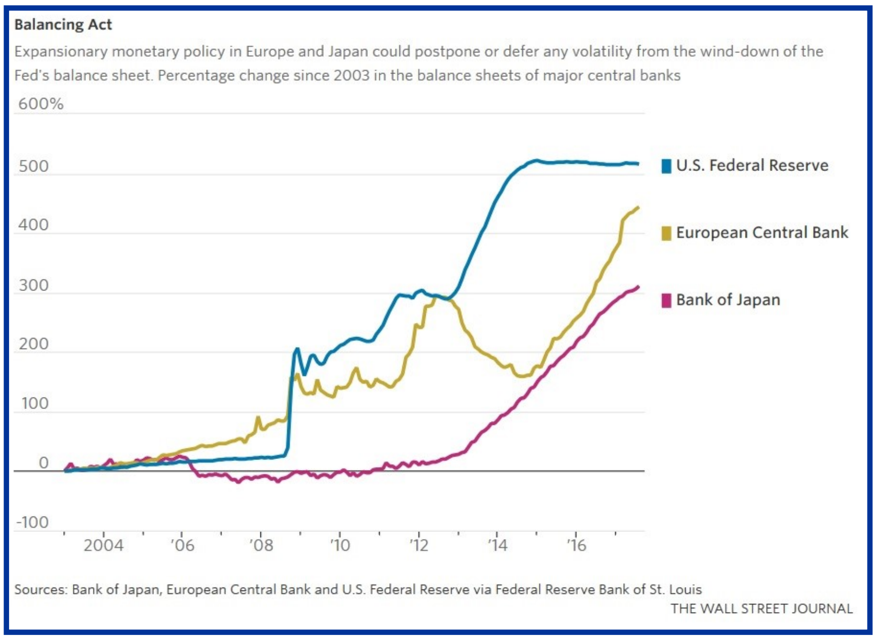
Treasury bond yields ended the quarter essentially flat. Yields largely declined for the first two months of the quarter before rising in September. The closely watched benchmark 10-year Treasury bond started the quarter with a yield of 2.33% and finished it at 2.34%. 10-year Treasury yields have fluctuated in a narrow trading range this year, between 2.01% and 2.63%, the tightest range going all the way back to 1965. A variety of factors explain the narrow range, one reason given is that the market is waiting for clear signs of legislative progress on the proposed tax policies of the Trump administration. Another reason given for the low volatility is the consistent economic data showing sluggish growth and tepid inflation. This past quarter there was a slight flattening of the yield curve, as the spread between the 2-year and 10-year Treasury narrowed from 92 basis points to 83 basis points by quarter end. The largest move of the quarter was the 2-year Treasury, which rose 10 basis points to finish at 1.51 percent, its highest level in more than 9 years. The 2-year Treasury yield, seen as the most sensitive to moves by the Fed, rose as the Fed signaled that one more rate increase this year was on the table.

While short-term rates are influenced by the Fed's monetary policy, longer-term bond yields are driven partly by inflation expectations and are more sensitive to fiscal policy and economic growth. The Fed's preferred inflation index, excluding volatile food and energy categories, came in at 1.4% in July, below the Fed's desired 2 percent target. In past recent years, factors including weaker commodities and energy prices, a stronger dollar and labor-market slack helped economists understand why inflation hung below the Fed's target, but those influences have receded lately and yet inflation hasn't rebounded noticeably. Fed Chair Janet Yellen acknowledged that the Fed's understanding of inflation is "imperfect", calling the shortfall in inflation "a mystery". *"We recognize that something more persistent may be responsible for the current undershooting",* she said in a speech at an economics conference in late September.

The Federal Reserve, at its September meeting, decided to leave rates unchanged as expected and confirmed its plan to start very slowly shrinking its massive $4.5 trillion portfolio of mortgage and Treasury bonds purchased during and after the financial crisis. The decision to lighten their bond portfolio has been telegraphed for months by the Fed as it attempts to gradually normalize policy after an unprecedented and controversial quantitative easing (QE) experiment. While leaving the benchmark federal funds rate in the target range of 1.00 percent to 1.25 percent, the Fed indicated the possibility of one more rate hike this year if the economy performs in accordance with their expectations. The Fed has increased rates by a quarter-point four times since December 2015, after keeping them near zero for seven years as part of their zero-interest rate policy (ZIRP).

The markets have taken this balance sheet reduction plan largely in stride because other central banks are still purchasing large quantities of government bonds and other assets. *"Investors want to believe yields will go up as there are signs that the QE policy has had its day,"* wrote Steven Major, global head of fixed-income research at HSBC. *"But we think the stabilizing ballast of central bank balance sheets will contain yields with the normalization of Fed policy likely to be very gradual."* Central bank balance sheets in the U.S., Eurozone, Japan and the United Kingdom combined will remain at very elevated levels for the next three to four years. The percentage change since 2003 in the balance sheets of the Fed, European Central Bank (ECB) and Bank of Japan (BOJ) can been in **Figure 2**. While the Fed could reduce its balance sheet to a still sizeable $3 trillion by 2021, the ECB

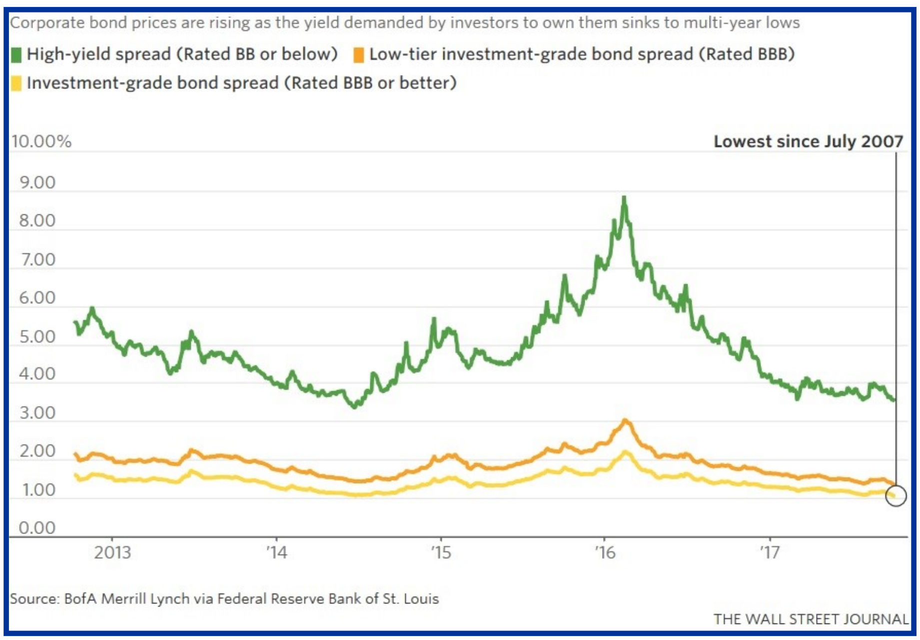
Figure 2



is set to continue purchasing roughly 40 billion euros a month in the early part of 2018 and continue at about 20 billion euros a month in the latter half of next year. Meanwhile, the BOJ is expected to continue on its current pace of 60 trillion yen ($538 billion) per year in QE. If the Fed ceases its reduction plan when its balance sheet is roughly $3 trillion as some analysts project, that would mean the balance-sheet shrinkage will return only about $1.5 trillion of bonds, while the multiple QE programs absorbed a much higher $3.6 trillion. It should be noted that the asymmetry of the entry and exit portfolio flows further contradicts the narrative that bond yields must rise considerably due to the Fed's balance sheet normalization plan.

As we mentioned last quarter, the Fed is in a tight spot. It is attempting to normalize monetary policy during a time of weak growth, while its fellow central bankers in Europe and Asia are maintaining accommodative monetary policies, pushing global investors hunting for yield into less-creditworthy bonds and other risky assets. For example, the spread between investment-grade corporate bond yields and Treasuries fell to just 104 basis points in early October, the lowest level since July 2007, as seen in **Figure 3**. Many are concerned that this 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

Figure 3



central banks will intervene if danger pops up in the market, i.e., moral hazard. The Fed reduction plan is very gradual, starting with allowing $10 billion in holdings to roll off without reinvestment every month. The amounts will then increase by $10 billion each quarter to a maximum monthly roll off totaling $50 billion. For perspective, $50 billion of a $4.5 trillion portfolio amounts to just 1.1 percent. Richard Clarida, an economist at PIMCO, compared the start of the plan to losing weight by eating only two desserts a day instead of three. The Fed currently owns $1.7 trillion in mortgage bonds issued by government-related agencies, or roughly 29% of the market, and about $2.4 trillion in Treasuries, which is approximately 17% of that market.

GOP leaders released an updated tentative framework of their tax reform plan in September. The highlights include reducing the current seven individual tax brackets to three new ones of 12%, 25% and 35%, with the open option of a fourth higher rate on the highest-income households. Still unknown is the income break points for the new tax brackets. The corporate tax rate would be reduced to 20%, down from the current 35% rate. One part of the tax plan already facing blowback from several GOP members of the House is the ending of the state and local tax (SALT) deduction for individuals. GOP House members from high-tax states including New York, New Jersey, and California among others are making their objection to the elimination of SALT loud and clear. Many difficult decisions about the potential winners and losers of this plan were left to be sorted out by the House and Senate in their respective committees in the months ahead. Tax reform is a complicated and thorny issue, where the devil is in the details. Powerful and deep-pocketed interests are pitted against one another. The tax code is filled with special-interest provisions and deductions enacted over decades. There’s a reason that Congress hasn’t overhauled the tax system in over 30 years. If the tax reform push gets mired in political gridlock and intraparty divisions, there is a chance we could see a pivot to just tax cuts, which historically have been much easier to achieve in Washington.