Redstone Advisors

Economic and Market Review

Fourth Quarter 2017

"Tax law is like the world's biggest game of chess with all sorts of weird conundrums about ethics and civics and consent of the governed built in."
David Foster Wallace

Financial markets in the fourth quarter of 2017 were again focused on fiscal policy by Congress and speculation regarding future monetary policy by central banks. On the fiscal policy front, the tax bill was ultimately signed into law in late December. Regarding monetary policy, the global bond market is still flooded with central bank purchases, most notably from the Bank of Japan (BOJ) and the European Central Bank (ECB). Unprecedented, massive bond buying by central banks and other major players in the global fixed-income market have shrunken the availability of higher yielding debt, according to a report by Bank of America Merrill Lynch. In 2008, there were $28 trillion of bonds yielding 4 percent or more. As of December, that number had shrunk to just $3 trillion, as the hunt for yield has intensified.

This past quarter saw the Treasury yield curve flatten considerably, with rates at the short end steadily rising and rates at the long end modestly declining. Rates at the short end have risen as they adjust to the Fed's projected tightening path while longer rates have stubbornly tracked sideways and fallen on diminished views on long-term growth and inflation. The spread between the 2-year and 10-year Treasury narrowed from 83 basis points (bps) at the end of September to just 50 bps at year end. Meanwhile, the 2-year/30-year spread narrowed from 136 bps to 82 bps over the course of the 4th quarter. 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. Some analysts, however, believe that 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. In addition, global quantitative easing (QE) or bond-buying by the ECB and the BOJ

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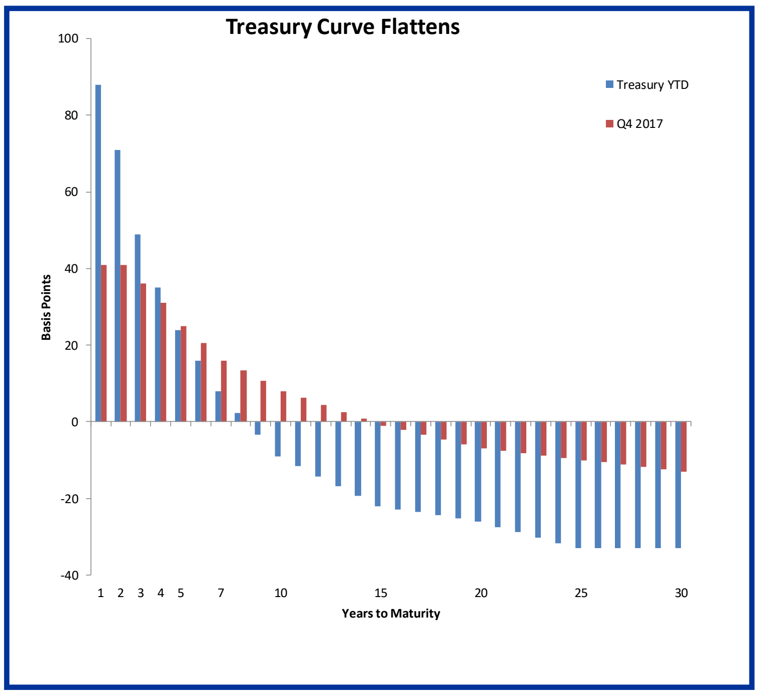
has effectively put pressure on long-term interest rates, including those in the United States. Another factor to consider when looking at historically low long-term yields is that asset-liability managers like insurance companies and pension funds are always seeking duration, and long-term Treasuries are among the surest ways to get it. Demographics must be considered as well. According to the Census Bureau, the population of U.S. residents age 65 or older has grown more than 40% since 2000 to 49.2 million in 2016. Investors typically increase bond holdings as they approach retirement, so an aging population could signal a steady future demand for fixed income securities.

The flattening of the yield curve has been the trend for 2017, as one can see in **Figure 1**, which shows the change in Treasury yields for the fourth quarter and year to date 2017. The largest move of the year came at the short end, where the 1-year shot up 88 bps and the 2-year jumped 71 bps, both reaching multi-year highs. Our view is that the flattening yield curve at this point isn't signaling a recession is imminent, however it does suggest that the economy is likely to remain bogged down in a low rate environment for quite some time. In December, Fed Chairwoman Janet Yellen said, *"There is a strong correlation historically between yield curve inversions and recessions. But let me emphasize that correlation is not causation, and I think that there are good reasons to think that the relationship between the slope of the yield curve and the business cycle may have changed."* Federal Reserve Bank of San Francisco economist John Fernald recently warned that the sluggish recovery from the 2007-09 Great Recession reflected broad trends that were under way before the downturn, and may not dissipate. *"The headwinds to a substantial pickup in growth are fierce,"* he argued.

Figure 1

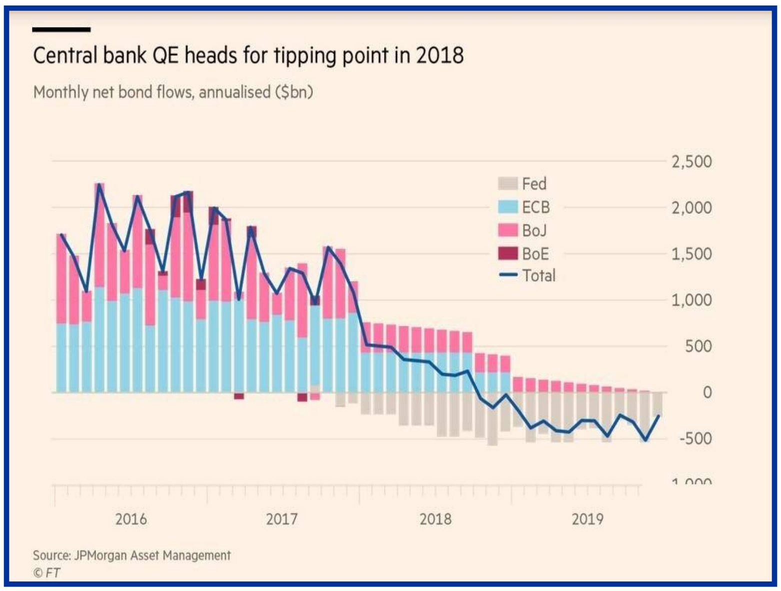


The "Tax Cuts and Jobs" bill was signed into law in late December by President Trump. Major features of the new law include permanently reducing the corporate tax rate from 35% to 21%. For individuals, tax rates across the seven brackets were lowered and are set to expire at the end of 2025, unless a future Congress and President extends them. The top rate of 39.6% was lowered to 37%. The new 37% top rate would apply to taxable income over $500,000 for single filers and $600,000 for joint filers. The bill ended up consisting more of tax cuts then being a true "tax reform" effort. The Tax Policy Center noted that of the ten most costly tax breaks in the old tax code, nine remain in place today. Only the state and local tax deduction (SALT) is significantly diminished, with a new $10,000 cap on deducting state and local property taxes, and income or sales taxes. Many distortionary business tax breaks such as the "carried interest" loophole for hedge fund profits survived, thanks to well-heeled lobbying efforts. Meanwhile, some brand-new tax breaks were created, most notably for pass-through entities. The tax burden by owners, partners and shareholders of S-corporations, LLCs and partnerships (those who pay their share of the business' taxes through their individual tax returns) has been lowered by a 20% deduction. Of course, the impact on individuals and businesses of this new law will widely vary depending on how your income is earned, what state you live in, and a variety of other factors. High income residents of certain states with a high state tax (New York, New Jersey, California, etc.) or high property taxes are widely seen as paying more in taxes, due to the capping of SALT.

The Joint Committee on Taxation (JCT), official scorekeeper of Congress, estimated that this tax law will increase deficits by about $1.4 trillion over the next decade. The Penn Wharton Budget Model, making some different assumptions, came up with a number that is closer to $2 trillion. The JCT calculated that gross domestic product (GDP) would be only 0.1% to 0.2% larger by 2027 due to the tax overhaul. The growth effect would be bigger if the provisions that expire are instead extended, as many of the law's backers hope. On average, the JCT analysis said the economy would be 0.7% larger over the next decade due to the law's lower personal and business tax rates. The JCT said higher growth would defray the total cost of the tax cuts but not by enough for the cuts to pay for themselves. Without taking into account growth effects, the law leads to a $1.5 trillion revenue loss over a decade. The 0.7% average growth boost brings up $451 billion in new revenue, but higher interest rates add $66 billion in cost, for a net deficit impact of about $1.1 trillion. Meanwhile, the Committee for a Responsible Federal Budget estimated that the national debt, instead of rising to 91% of GDP in 2027 from 77% now, jumps to 100% if certain cost-cutting gimmicks of this new tax law are ignored. Accounting for some positive effect on growth and revenue, the Committee still sees a debt/GDP level reaching 98%.

In mid-December, in a widely-expected move, the Federal Reserve raised their benchmark federal funds rate by a quarter point to a new target range of 1.25 percent to 1.50 percent. This was the third rate hike of 2017 and the fifth such increase in the past two years. Fed officials forecast three more quarter-point rate increases for 2018. Some analysts see 2018 as possibly being an inflection point for central banks. The Fed's very gradual shrinking of its massive $4.5 trillion portfolio is set to continue as it slowly attempts to normalize policy. There's still a tremendous amount of liquidity in the US financial system, and it will take time for the Fed to drain it. The European Central Bank started to taper its quantitative easing (QE) program in 2017 and is expected to end it altogether in 2018. And the Bank of Japan is expected to raise its bond yield target slightly this year. Monthly net bond flows by central banks can be seen in **Figure 2**, with future projections for 2018 and early 2019. Reports estimate that central banks have globally increased the size of their balance sheets by an astounding $15 trillion since 2008. Rather than a punchbowl, central banks have over the past decade served up something closer to an Olympic-sized swimming pool and removing a few buckets

Figure 2



might not make much of a difference, reckon some analysts.

On a final note, we've talked about how central bank intervention has driven yields to historical lows. As a result, some investors hunting for yield have been drawn to less-creditworthy bonds and other riskier assets. As seen in **Figure 3**, at the end of 2017, the junk bond spread had fallen to its lowest level since 2007, as junk or "high yield" bond prices have risen and their yields have fallen. Noel Hebert of Bloomberg warns that valuations are divorced from balance-sheet reality. *"It's very difficult to tell where things are going to go. This isn't a world where fundamentals matter in any shape or form*."

Figure 3