

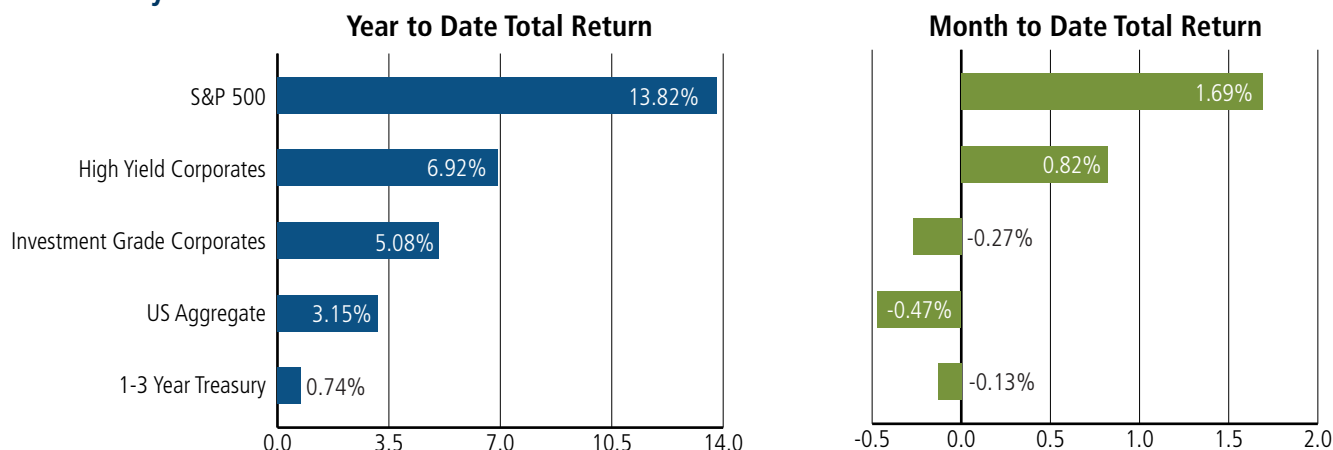
Week Ending September 29, 2017

Is Yellen Still Not Worried?

Economic Overview:

Chair Yellen took the stage this week and reiterated that policymakers continue “to anticipate that inflation is likely to stabilize around 2 percent over the next few years” and that the recent bout of “low inflation is probably temporary.” [Of course, her comments arrived before Friday morning’s release of the August core personal consumption expenditure \(PCE\) price index, which fell to 1.29% year-over-year.](#) Policymakers may have trapped themselves with the self-imposed “2% target”. Optically, it will prove difficult to hike in December unless monthly inflation numbers move back toward their target. What’s a better approach? Well, in the last 20 years, core PCE has averaged 1.7%—lower than the Fed’s target! It might have been better to adopt a band, say 1.5-2%, rather than an unrealistic point target. Kevin Warsh, former Fed Board Governor and betting market favorite for next Fed Chair recently said, “the idea that policy should be looser or tighter because we are at 1.71% instead of 2.0%, that is way beyond what the science of monetary policy really has...that sounds more like physics to me.” We agree!

Total Returns by Asset Class



Highlights of the Week:

- **Treasuries:** Treasuries bear steepened this week with Yellen reiterating her hawkish tone from the September FOMC meeting. However, core PCE came in a touch weaker. Trump’s unveiling of a personal and corporate tax cut outline along with a meeting with Kevin Warsh to discuss his nomination as Fed chair caused the long end to back up on larger deficits and possible stronger balance sheet unwind. North Korea headlines were tame and month/quarter end extensions were in line with the average allowed for long duration positioning to be cleaned up providing more of a tail wind for yields.
- **Corporates:** Corporate bond spreads tightened over the week, boosted mid-week after the tax proposal presented a 20% corporate tax versus the current 35% tax rate (albeit most companies pay less). The proposal also suggested a partial removal of interest deductibility, which would likely shift corporate structure incentives away from taking out additional debt.
- **Emerging Markets:** Several EM central banks met this week, and each left policy unchanged. Among them, Banco de Mexico kept its overnight rate at 7%, seeing inflation as having reached its ceiling and not expecting recent natural disasters to have an impact on longer term inflation outcomes. After hiking for the first time in eight years this August, the Czech National Bank opted to maintain its key rate at 0.25%. The bank has moved to a hawkish bias as growth and wages have moved higher.
- **Mortgages:** National home prices are almost 6% higher than last year according to the S&P CoreLogic Case-Shiller index. While strong home price increases have been a consistent trend for over five years, it may be surprising that 11 years since the peak in 2006, national home prices still haven’t fully recovered (2% below the peak.) The housing recovery is different depending on the market of course (Denver prices are 43% higher than 2006), but nationally, there are very few signs of weakness in the near term.
- **Currencies:** The Canadian dollar lost some ground this week after Bank of Canada’s Governor Stephen Poloz tempered the recent optimism about the Canadian economy during a speech on Wednesday. Mr Poloz dampened investors’ expectations of further rate hikes this year by highlighting the risks to the economy and suggesting that the central bank will remain cautious. Wednesday’s currency plunge, however, proved to be short-lived after some end of the month rebalancing helped the loonie recoup some of its earlier losses.
- **Municipal:** The unveiling of President Trump’s tax plan raises many questions going forward. While short on details, we believe the reduction in the top marginal tax rate to 35% will have minimal impact on the municipal bond market. However, the reduction of the corporate tax rate to 20% (which we believe will be difficult to actually pass) would likely be bearish for the long-end of the municipal curve, as it would reduce the incentive for banks and P&C insurers to buy munis due to the lower grossed-up returns.
- **High Yield:** Increasing levels of “covenant lite” issuance in the leveraged loan market has investors concerned about a market top. Less stringent covenant packages are a modest negative, but other indicators of loan quality, such as LBO, CCC-rated, and second-lien issuance volumes that are in line with or below historical averages, indicate a healthier market overall.
- **Equities:** The U.S. equity market surged to new record highs as the latest U.S. tax reform proposal provided a boost to investor sentiment. This week, we continued to see investors rotate into year-to-date laggards from year-to-date winners, such as small-caps over large-caps and energy over health care stocks, which has been the theme for the month of September.