Taplin, Canida & Habacht

September 1, 2017

Fixed income market update

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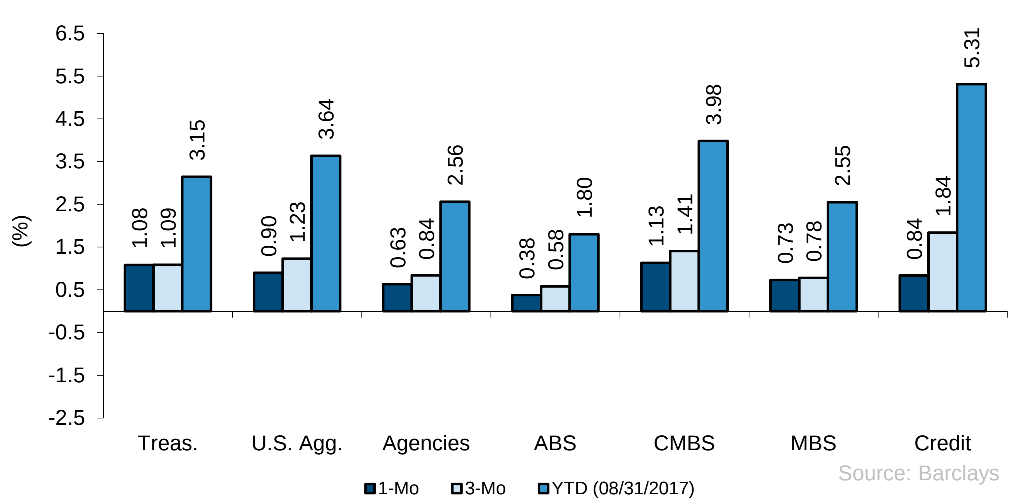
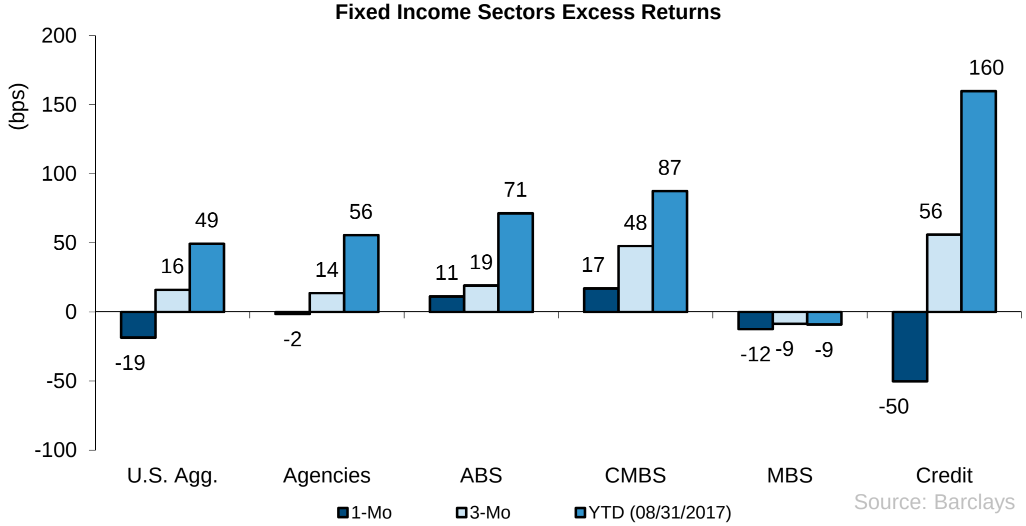
Fixed income market update

- For the month ended August 31, 2017, the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.90%. Year to date, the index has returned 3.64%.
- U.S. Treasuries returned 1.08% during the month as the yield on the 10-year U.S. Treasury declined to 2.12% from 2.29% at the end of July. For the month, long Treasuries (+3.43%) outperformed intermediate Treasuries (+0.62%).
- Mortgage-backed securities (MBS) returned 0.73% during the month, underperforming duration-matched Treasuries by 12 basis points. The option adjusted spread (OAS) of the Bloomberg Barclays U.S. Mortgage Index widened 2 basis points to end the month at 30 basis points.



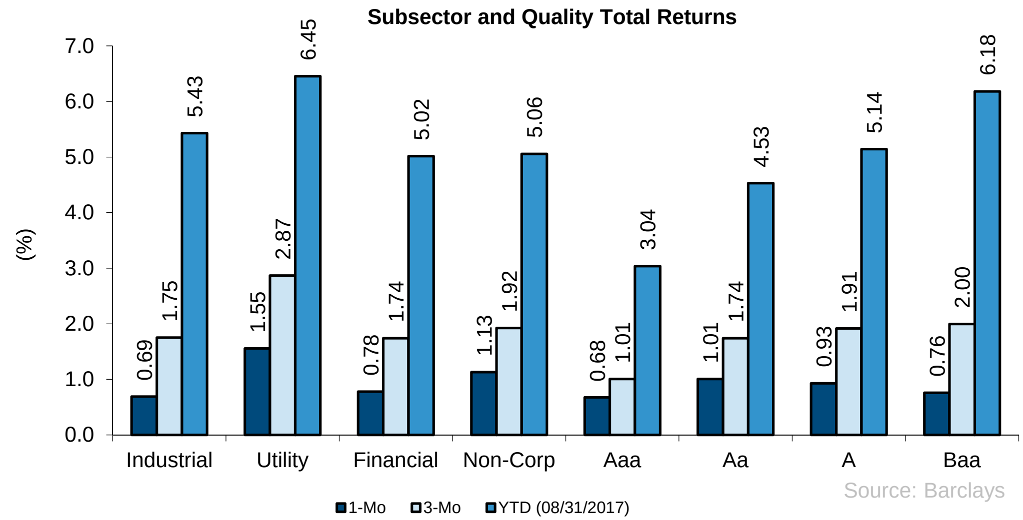


Fixed income market update (continued)

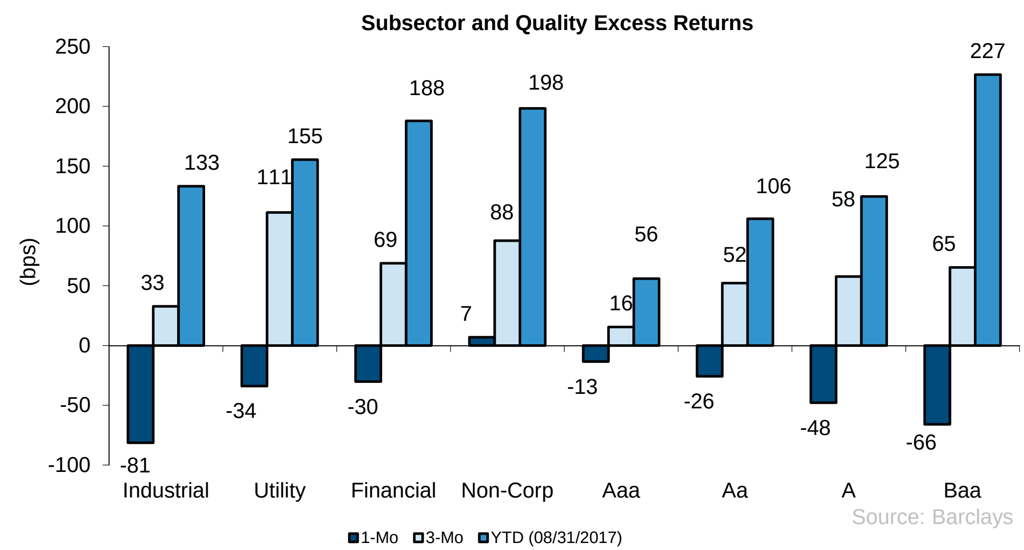
- Credit securities returned 0.84% for the month, underperforming Treasuries by 50 basis points on a duration-adjusted basis. The OAS of the Bloomberg Barclays U.S. Credit Index ended the period at 104 bps, 6 basis points wider than at the end of July. For the month, long credit (+1.46%) underperformed intermediate credit (+0.57%) by 117 basis points on a duration-adjusted basis.

- For the month, on a duration-adjusted basis, non-corporates delivered 7 basis points of excess returns, outperforming financials, utilities and industrials by 37, 41 and 88 basis points, respectively.

- AAA rated securities delivered -13 basis points of excess return for the month, outperforming AA, A and BBB rated securities by 13, 35 and 53 basis points of excess return, respectively. High yield delivered -67 basis points of excess return for the month.



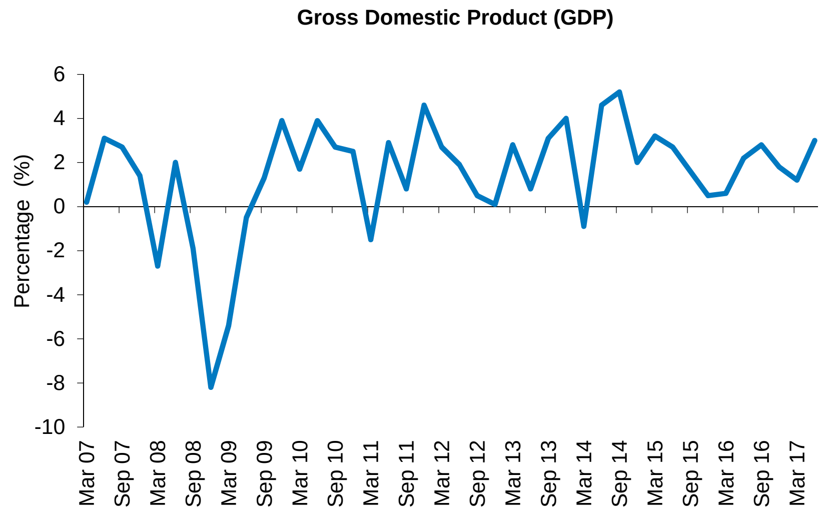
Source: Barclays



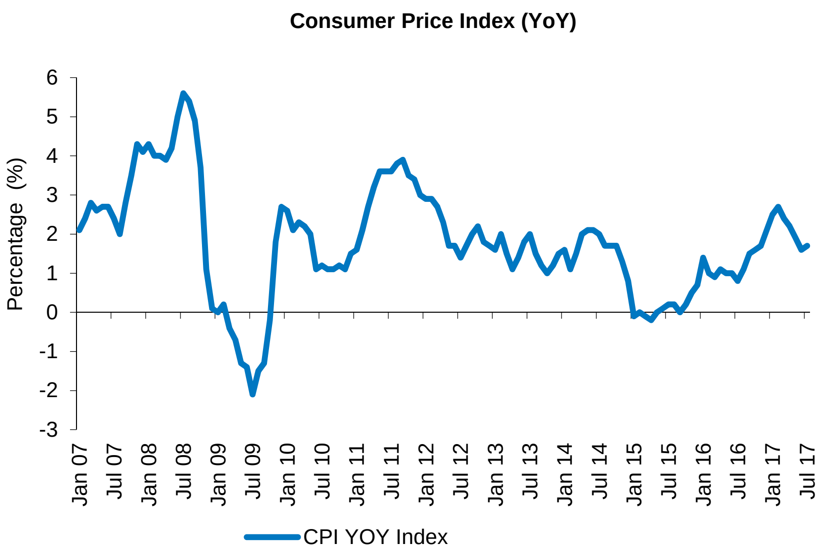
Source: Barclays

Economic update

U.S. gross domestic product (GDP) growth was revised higher from 2.6% to a 3.0% annualized rate for the second quarter. The quarterly growth rate was the highest in over two years and was driven by strong consumer spending (+3.3%) and the largest increase in business investment in two years (+8.8%.) Corporate pre-tax earnings rose 7% year over year, while homebuilding investment slowed 6.5%. The Atlanta Fed's GDPNow third quarter growth estimate of 3.3% (as of August 31), suggests further improvement in the economic landscape.



Source: Bureau of Economic Analysis

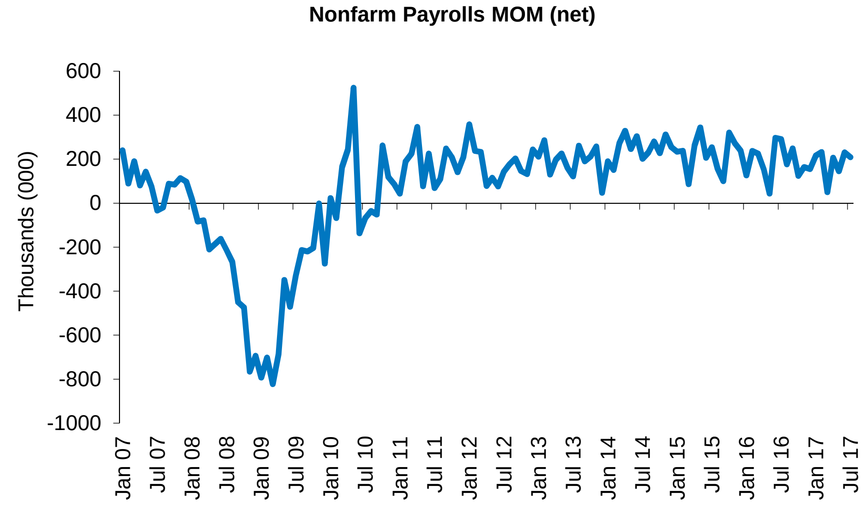


Source: Bureau of Labor Statistics

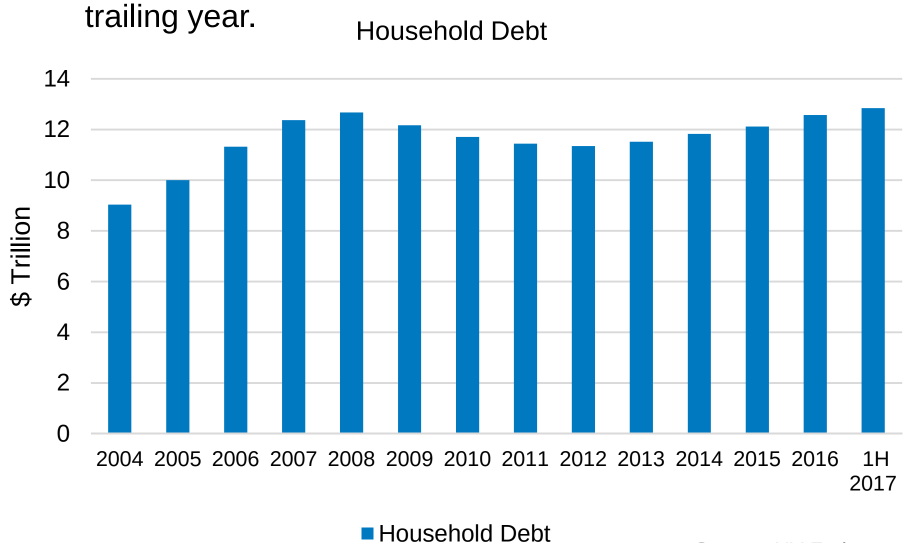
The Consumer Price Index (CPI) rose 0.1% in July and 1.7% for the past year, both were 0.1% less than consensus estimates. Core CPI rose by the same 0.1% for the month and 1.7% for the trailing year. Low inflation figures have led to speculation the Fed would be more hesitant to raise rates again near term. Chair Yellen has noted that 'special factors', notably cell phone plan pricing and prescription drugs have been deflationary, impacting the overall inflation readings.

Economic update (continued)

Following a strong July jobs report, the non-farm payrolls for August disappointed. Announced on September 1, 156,000 jobs were added, below the estimate of 180,000 and revisions to the prior two months reduced payrolls by approximately 40,000 jobs. Manufacturing jobs rose by 36,000 jobs, the biggest increase in five years. The unemployment rose 0.1% to 4.4%, while the underemployment rate remained unchanged at 8.6%. Labor force participation also remained unchanged at 62.9%. Average hourly earnings rose 0.1% for the month and 2.5% for the trailing year.



Source: Bureau of Labor Statistics



Source: NY Fed

U.S. household debt hit a new all-time high in the second quarter at $12.8 trillion. However, household debt level is currently 67% of GDP versus 87% in 2009, reflecting the growth of the economy. Mortgage debt accounts for over 70% of household debt, though the current $9.1 trillion of mortgage debt remains below the $10 trillion peak in 2008. Since then, student loan debt has more than doubled, auto debt has grown approximately 50% and credit card debt is roughly the same. The second quarter marked the twelfth consecutive quarter of increases in household debt.

Economic and market perspective

- Hurricane Harvey resulted in devastating flooding in Houston, the fourth largest city in the United States, and throughout southeast Texas and Louisiana. Half a million people are believed to be impacted by the flooding, either needing temporary shelter or having experienced property damage. Estimates of the damage are as high as $100 billion and a prolonged rebuild will be required. The current expected impact to third quarter GDP is a decrease of 0.2%, though the impact of rebuilding is expected to add an equivalent amount of growth to fourth quarter GDP.
- In addition to the direct damage to the region, the Texas gulf coast contains significant oil refining capabilities. With approximately 25% of oil refining capacity forced offline, including the nation's largest refinery, only 8 million barrels of gasoline are being refined a day versus average daily consumption of 9.7 million barrels. Gasoline futures rose 25% for the month, despite the price of oil falling 6% during August.
- The federal debt-ceiling was expected to be reached at the end of September. In anticipation, lawmakers had begun debating the conditions under which they would approve an increase to the maximum amount the country can borrow, including threats of a government shut-down. Hurricane Harvey has shifted that debate as billions of dollars in emergency funding are expected to be needed. This expense would pull forward the date of hitting the debt limit and politicians are likely to find it unpalatable to oppose raising the debt ceiling to aid the disaster stricken areas.
- In response to continued missile tests by North Korea, the United Nations Security Council imposed additional economic sanctions on the country. China, viewed as North Korea's closest ally, agreed to implement the U.N. sanctions. In response to continued threats from Kim Jong Un, President Trump warned the dictator of "fire and fury like the world has never seen" if North Korea were to attack. In response, the North Korean leader threatened to strike the U.S. territory of Guam with a nuclear warhead, before backing down. While tensions seemed to abate during the month, North Korea launched a missile over Japan at the end of August, reigniting regional concerns.

Outlook and conclusions

- Minutes from the Federal Open Market Committee's July 25-26th meeting were released in August. Of note, there appeared to be a difference of opinion regarding whether the recent decline in inflation should push back the timing of the next rate hike or whether unemployment had declined sufficiently that risks to inaction were increasing. The Fed's next meeting is September 19-20. There is almost no expectation of an additional rate hike at that meeting, though many expect the Fed will announce the beginning of the gradual wind-down of the $4.2 trillion balance sheet. Fed Fund Futures imply about a one-third chance of an additional hike in December.
- At the annual Jackson Hole Economic Policy Symposium, Fed Chair Janet Yellen spoke out in favor of financial regulation put in place since the crisis. Her view contrasts with President Trump's push for deregulation, which has increased speculation that President Trump will nominate a different candidate when Chair Yellen's term expires next year. Mario Draghi, President of the European Central Bank (ECB), delivered a more optimistic speech about European and global growth giving credit to global central banks for their significant level of accommodation. At the same time, he acknowledged that inflation has failed to meet ECB targets.
- In our view, improving economic growth data and corporate profits are encouraging, however, data is not uniformly positive with weaker inflation data and still middling wage growth data. Treasuries appear to have priced in more of the negative data and have been impacted by August's exogenous events (North Korean tensions, debt-ceiling debate and Hurricane Harvey.) In this environment, non-governmental sectors underperformed Treasuries, yet the fundamentals for those non-governmental sectors remain robust. The Fed is expected to provide further clarity on their balance sheet wind-down timing in September, but the accommodative nature of the plan has alleviated some market concerns and the Fed minutes show meaningful deliberation around the costs and benefits of future hikes. In aggregate, these positions suggest reasonably supportive central bank policy, even in normalization, and a benign landscape for U.S. fixed income.

Fixed income returns as of August 31, 2017

Index Returns as of August 31, 2017				
	Total Return (%)		Excess Return (%)	
	Month-to-Date	Year-to- Date	Month-to-Date	Year-to- Date
U.S. Aggregate	0.90	3.64	-0.19	0.49
U.S. Treasury	1.08	3.15	-	-
Intermediate	0.62	2.16	-	-
Long	3.43	8.36	-	-
TIPS	1.06	2.38	-	-
Agencies	0.63	2.56	-0.02	0.56
U.S. MBS	0.73	2.55	-0.12	-0.09
U.S. Credit	0.84	5.31	-0.50	1.60
Intermediate	0.57	3.82	-0.15	1.45
Long	1.46	8.91	-1.32	1.99
Industrial	0.69	5.43	-0.81	1.33
Utility	1.55	6.45	-0.34	1.55
Financial	0.78	5.02	-0.30	1.88
Non-Corporate	1.13	5.06	0.07	1.98
Aaa	0.68	3.04	-0.13	0.56
Aa	1.01	4.53	-0.26	1.06
A	0.93	5.14	-0.48	1.25
Baa	0.76	6.18	-0.66	2.27
High Yield	-0.04	6.05	-0.67	3.86
Floating Rate Notes	0.13	1.55	0.03	1.06

Source: Bloomberg Barclays

Disclosures

All investments involve risk, including the possible loss of principal.

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