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# Corporate Cash Alert

## Surveying the Landscape at Midyear

June 21, 2018

### Executive Summary

- US economy continues to grow, expect steady additional rate hikes by the Fed
- With both rising rates and a relatively flat curve, it still doesn't make sense to extend maturities
- Most attractive opportunities in LIBOR-based floaters and fixed coupon bonds with maturities out to 1 year


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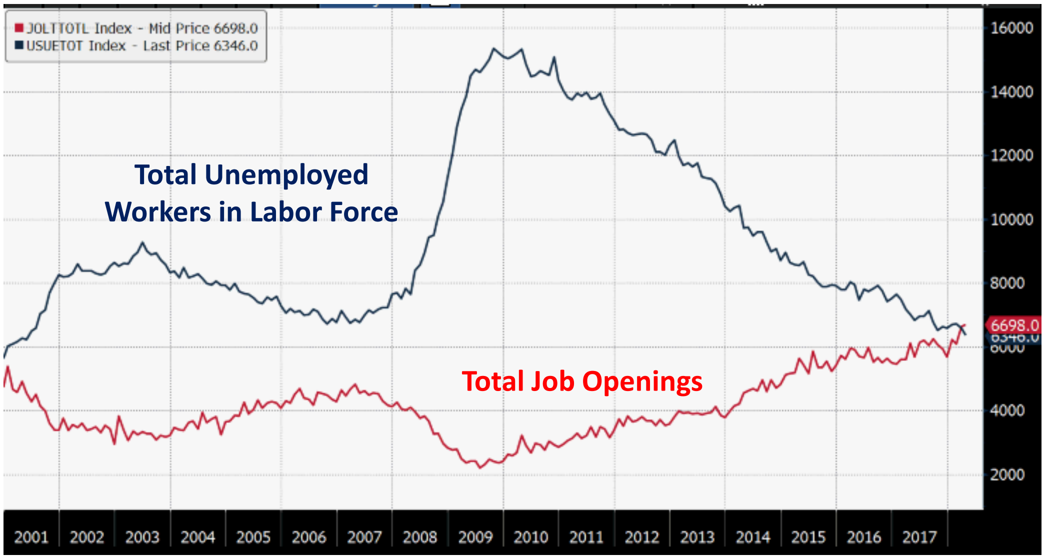
Our market outlook has only been reinforced since our last Alert (***Corporate Cash Alert: Meet the New Boss…Same as the Old Boss***, 4/6/18).

The US economic growth story continues to press forward, recently posting a remarkably low 3.8% headline unemployment rate. In fact, for the first time since 2001, the number of job openings exceeds the number of job seekers!

**Job Seekers vs. Job Openings**




*Source: Bloomberg*

Manufacturing and service sector surveys forecast more near-term expansion. Evidence of unspectacular but rising wage growth, along with (for now) benign inflation readings, bodes well for the financial health of American consumers. At the corporate level, earnings remain robust following last year's tax cuts, and tax reform's powerful pro-capex incentives have yet to really kick in. In short, there are many reasons to expect continued growth. However, the prospect of a prolonged trade war can certainly derail our outcome. Specifically, the Fed could potentially soften its stance on tightening, which will dampen our expected rise in short term rates.

The Fed continued its tightening cycle by raising the Fed Funds rate by 0.25% on June 13th. Moreover, it's now projecting two additional rate hikes in 2018, reflecting its judgment of an improved economic outlook. Treasury rates have kept steadily rising, quickly reflecting the full brunt of the hike while generally preserving the curve's shallow slope.

| Maturity | Treasury Yield as of 4/3/18 | Treasury Yield as of 6/13/18 | Change |
|---|---|---|---|
| **3 Months** | 1.68% | 1.93% | 0.25% |
| **6 Months** | 1.86% | 2.09% | 0.23% |
| **1 Year** | 2.08% | 2.32% | 0.24% |
| **2 Year** | 2.27% | 2.58% | 0.31% |
| **3 Year** | 2.40% | 2.71% | 0.31% |

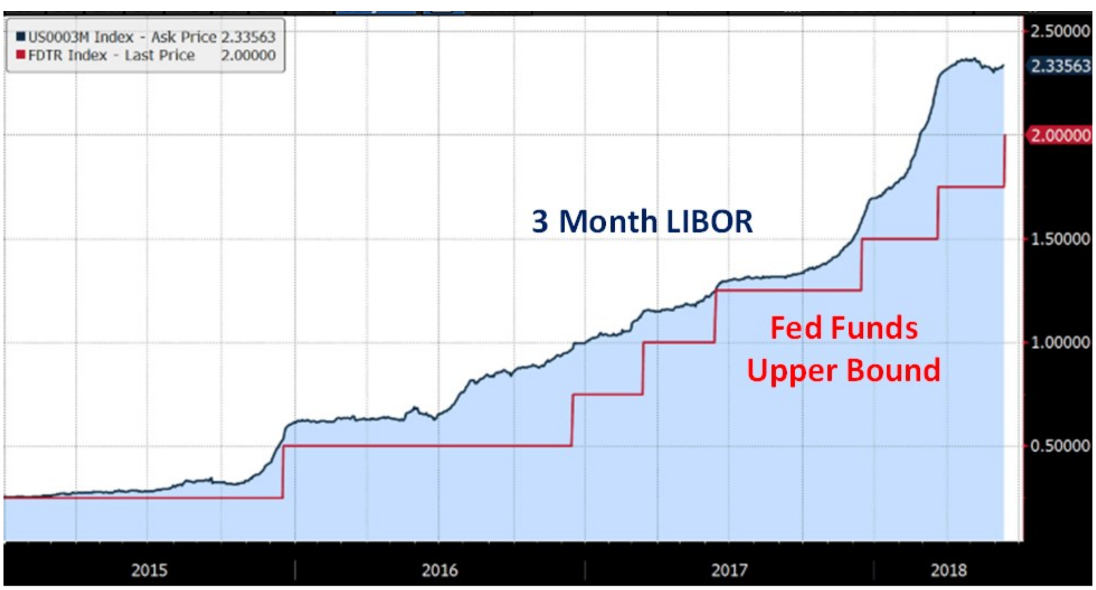
*Source: Bloomberg*

These yield increases were slowly priced in by the market long before the 6/13 Fed decision. In fact, to get to this point the market first successfully shook off a brief but sharp Treasury rally following a global flight-to-quality bid in response to Italy's recent troubles (for more background, please see our June 18, 2018 blog post, ***Mamma Mia! Italy's Bad Week = A Lesson for Investors***, on TreasuryPartners.com). This speaks to the resiliency and momentum behind the current rising rate environment.

**Why Libor?**

At the same time, 3 Month LIBOR remains in a plateau, bouncing around within a narrow 2.30-2.37% trading range since the end of March. The gap between LIBOR and Fed Funds remains unusually high, however, even when taking the latest Fed hike into account. The gap is largely attributable to a spike in credit spreads precipitated by repatriation flows in the wake of last year's US tax reform. Accordingly, LIBOR-based floaters continue to offer attractive relative value for accounts authorized to add variable-rate debt.

**3 Month LIBOR vs. Fed Funds Rate**




*Source: Bloomberg*

**Outlook**

Looking ahead, we believe both fundamentals and technical factors are pointing to higher rates. The Fed is clearly signaling more hikes that will naturally push up the short-end of the curve. Importantly, we believe the balance of risk is skewed towards the upside – that is, the rolling economy could potentially result in more cost and wage pressures, causing core inflation to press above the Fed's 2% target. If inflation really begins to accelerate, the Fed will almost certainly take an even more hawkish stance.

There are also several technical factors that are likely to further bias yields upward:

- To finance expanding federal deficits, Washington expects to issue a whopping $1.8 trillion in net new Treasuries through 2019 ($650 billion more in 2018, $1.2 trillion in 2019)
- On top of this, the Fed is slowly unwinding its massive balance sheet, incrementally removing the support provided by the vestiges of Quantitative Easing
- Similarly, the European Central Bank projects ending its own massive Quantitative Easing program in December 2018, incrementally tightening monetary policy in a major overseas market

Given these realities, we continue to view 6-12 month corporate debt as the most attractive maturity sector. With current yields at 2.60-2.70%, investors realize approximately 1.00% and 0.70% over Government and Prime money market funds, respectively. *Moreover, corporate cash investors capture the brunt of the spike in credit spreads without having to extend maturities beyond 1 year*.

As always, we continue to monitor the market and developing risks to this outlook, and will communicate any recommended changes as necessary.