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Corporate Cash Alert

April 6, 2018

Meet the New Boss…Same as the Old Boss

Executive Summary

- Treasury rates continue to rise, with yields on 3-12 month maturities outstripping the increase in greater than one year maturities
- Increase in Three Month LIBOR has been even greater: LIBOR-based floaters are an increasingly attractive investment
- Steady economic growth, unchanged Fed projections, increased Treasury issuance, and tax-reform effects all responsible
- Continue maintaining short maturity ladders of three-to-twelve months –yield pickup from extending doesn't compensate for additional risks

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Since our previous Alert (***Corporate Cash Alert: Don't Look in the Rear-View Mirror, the Road Ahead is Different***, 1/31/18), Treasury yields have continued to rise, with greater than one year maturities increasing the most:

Maturity	Yield as of 1/31/18	Yield as of 4/3/18	Change
3 Months	1.47%	1.68%	+0.21%
6 Months	1.66%	1.86%	+0.20%
1 Year	1.91%	2.08%	+0.17%
2 Year	2.14%	2.27%	+0.13%
3 Year	2.28%	2.40%	+0.12%

For regular readers, this development shouldn't be surprising and is consistent with our forecasts. The Federal Reserve continues to signal its faith in the economy's strength and resilience, recently hiking the Fed Funds rate and maintaining its forecast for steady additional increases. Additionally, the widening federal budget deficit has led to accelerating Treasury bill issuance, driving up supply and further boosting rates.

At the same time, Three Month LIBOR has surged from 1.78% to 2.31% (+0.53%). The gap between Fed Funds and LIBOR is now unusually wide – indicating an increasing cost of credit and an attractive investment opportunity in LIBOR-based floaters.

Three Month LIBOR vs. Fed Funds Rate

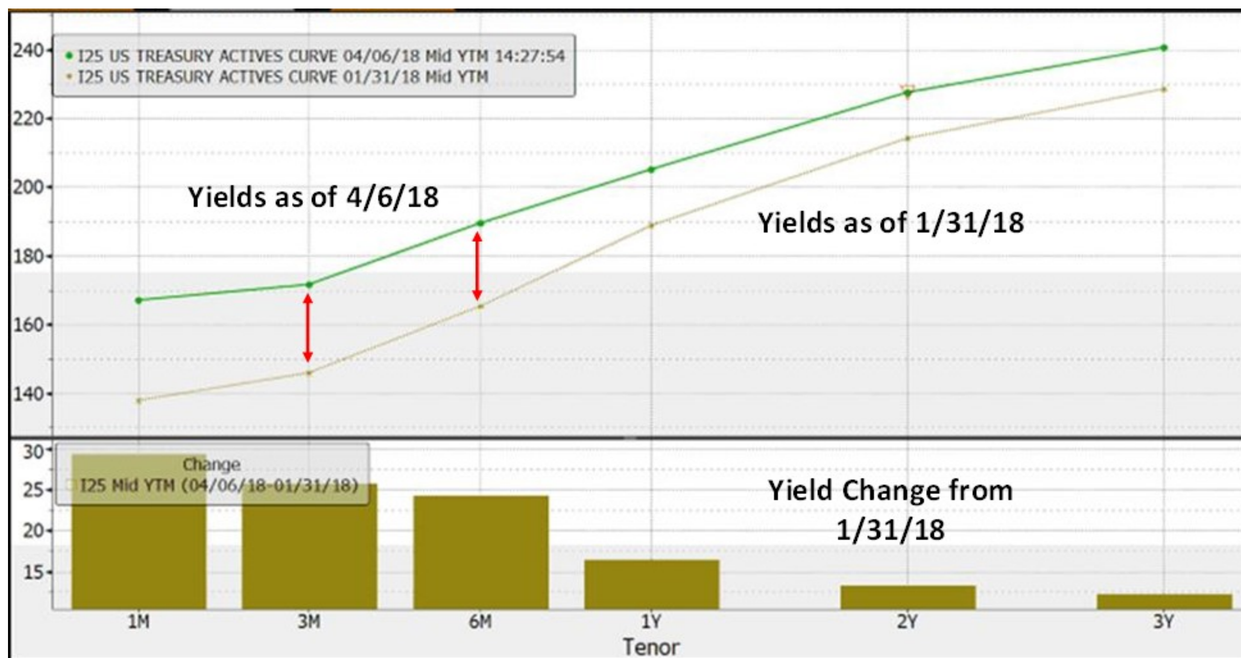
Source: Bloomberg

Although LIBOR spikes sometimes indicate trouble in the financial sector, the reasons behind this increase are more benign. We see two primary causes:

- Tax reform has incentivized American corporations with excess offshore cash to repatriate dollars. Now that repatriation is siphoning USD out of European banks, scarcer dollars are leading to a higher LIBOR.
- In addition, many repatriated dollars are being used to finance capex and other corporate purposes (e.g. dividends). This has reduced demand for commercial paper and short corporate debt, which has pushed yields and spreads higher.

What's the upshot? The combination of higher rates and wider credit spreads has created an opportunity to add six-to-twelve month corporate bonds. The current yields (approximately 2.50-2.70%), when compared with overnight rates, fully reflecting our expectations for continued Fed tightening.

One Month – Three Year Treasury Yields Over Time



Source: Bloomberg

Further, the LIBOR spike enables investors to enjoy attractive returns from LIBOR-based floaters with maturities greater than twelve months. Continuing economic growth, along with the expectation that the Powell-era Fed will continue to tighten the Fed Funds rate, should push short-term yields higher.

Of course, there are several risks to this benign outlook – the growing possibility of a US-China trade war, the ever-present threat of an inflation spike, etc. As always, we continue to monitor developments, and will recommend any prudent shifts in portfolio strategy as circumstances evolve.

Disclosure

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