Corporate Cash Alert

January 31, 2018

Don't Look in the Rear-View Mirror: The Road Ahead is Different

Executive Summary

- Over the last 5 months, two and three Year Treasury yields surged from 1.26% to 2.14% and 1.37% to 2.28%, respectively
- Steady Fed tightening, continued economic growth, US tax reform have been catalysts
- Yield environment has fundamentally changed, expect further yield increases
- Maintain defensive bond portfolio structures - keep maturities short and be patient

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Last August we sounded the alarm that short-term rates were primed to rise (*Corporate Cash Alert: Keeping a Close Eye on Federal Reserve Policy*, 8/29/17). At the time, the Federal Reserve's dual mandate of full employment and 2% inflation was not achieved, yet they nonetheless believed the economy had progressed enough to allow for tighter monetary policy. The market disagreed, setting short-term Treasury yields much lower than our forecasts. We believed the market was mispriced and not adequately compensating bondholders for the strong possibility of rising rates.

> *"If the Fed's projections prove to be the more accurate projection of future hikes, rates in the 2-3 year portion of the curve are likely to see significant increases."*
>
> ***Corporate Cash Alert: Reasons to Remain Cautious, 9/29/17***

Beginning in September, rates began ratcheting up. After the Fed hiked 0.25% on September 20, 2017, 2 and 3 year Treasury yields spiked sharply and ended the month 0.16% and 0.18% higher, respectively. These increases reduced some, but not nearly all, of the Fed-market gap, and we reaffirmed our outlook to stay short and defensive (*Corporate Cash Alert: Reasons to Remain Cautious*, 9/29/17).

The rising rate trend accelerated into year-end and continued in January, as strengthening economic growth and the passage of tax reform triggered a more optimistic market narrative. Since September, the rise in yields has been impressive and relentless.

Recent 2-3 Year Treasury Yield Changes

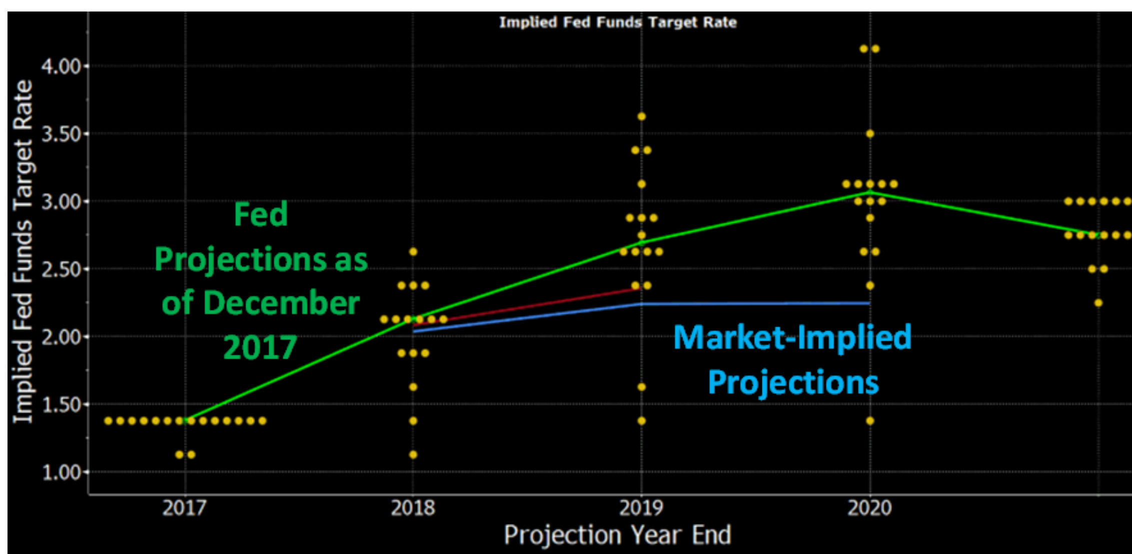
Source: Bloomberg, as of 1/31/18

Current Outlook

The balance of risks are skewed towards higher rates and our outlook remains unchanged:

- New Fed Chair Jerome Powell, a member of the Fed Board since 2012, will likely continue the mildly-hawkish course set by departing Fed Chair Janet Yellen. This points to further Fed Funds hikes and balance sheet runoff over the next few years. Current market rates are once again 'underpricing' our expectations for Fed tightening.

Fed Projections vs. Market-Implied Fed Funds Target Rate

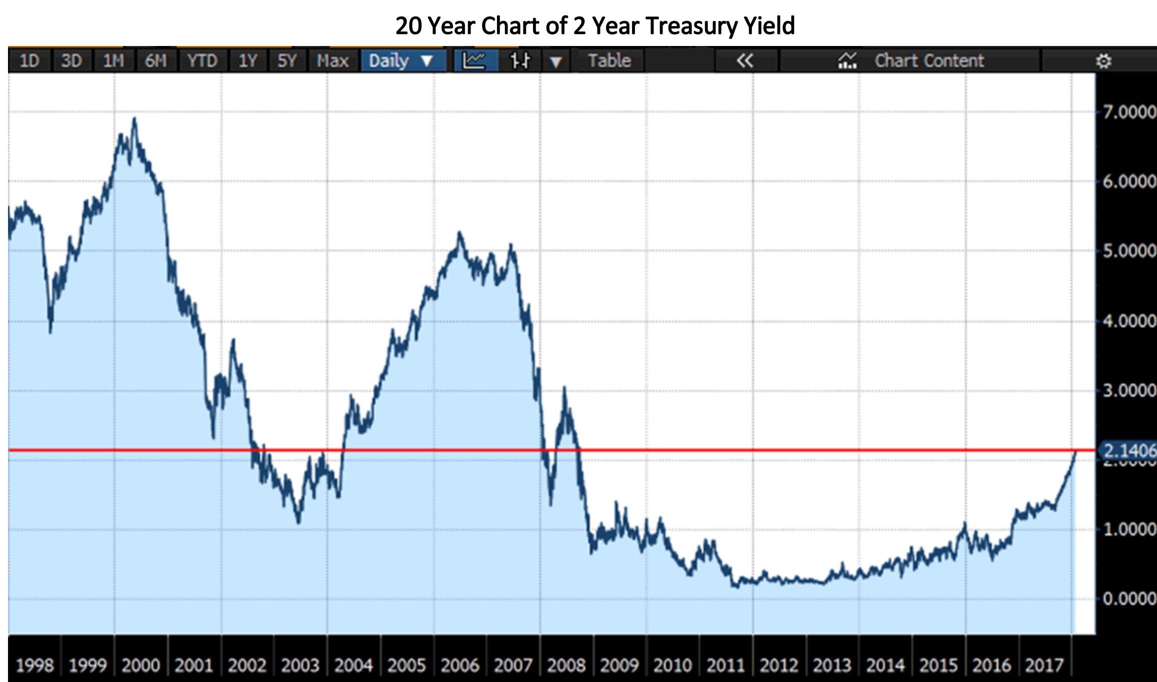


Source: Bloomberg, as of 1/31/18

- For the first time in decades we’re experiencing global "synchronized" economic growth which is putting pressure on yields worldwide. Expect radical changes in Eurozone rates which will impact Treasury yields
- The recent US tax reform legislation included powerful short-term stimulus measures that could further accelerate economic growth while increasing the Federal budget deficit. This would require issuing more Treasuries, increasing the supply and fueling more rate pressure.

For these reasons, we strongly repeat our recommendation to maintain defensive portfolio positions. The market outlook has clearly improved, and as a result corporate investors shouldn’t manage portfolios as if we’re stuck in the post-crisis era of ultra-low rates and minimal volatility. Investors are looking in the rear-view mirror of the last 8 years for guidance on upcoming Fed policy and rates, *but the road ahead is vastly different*. It’s crucial to remember that the short-term rates we’ve grown accustomed to are historical anomalies, and can spike higher in a hurry – as witnessed over the past 5 months.

20 Year Chart of 2 Year Treasury Yield



Source: Bloomberg, as of 1/31/18

Portfolio Strategy

Given our outlook, maintain short-term maturity ladders and/or prudent allocations to floating-rate securities. Fully taxed investors may find opportunity in tax-free Variable-Rate Demand Notes. Defensive tactics such as these are poised to reap attractive rewards by providing liquidity to extend maturities at a future point in time.

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