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Corporate Cash Alert

Reasons to Remain Cautious

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Executive Summary

- 1-2 Year Treasury yields rose sharply on Sep. 20th after the Fed reaffirmed its rate hike forecast
- Market is pricing in 1 more rate hike in 2017 and 1 more during 2018-2019
- Fed projects 5 hikes in 2018-2019.
- Tax reform, wage growth may be catalysts for rising rates
- Biased toward maintaining cautious stance on reinvestment

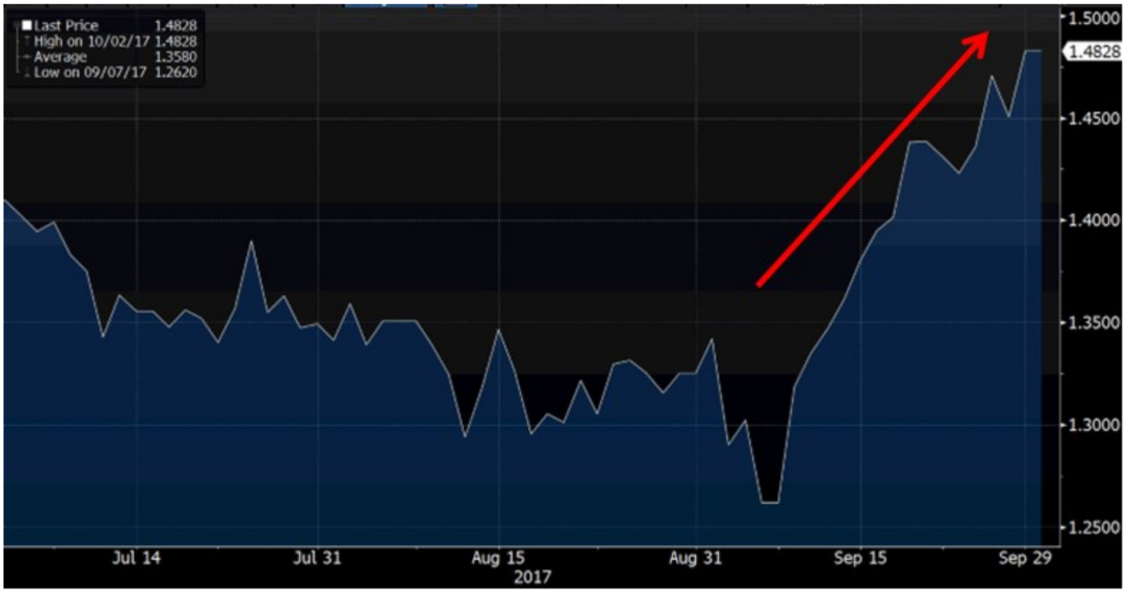
Last month, , we noted that short term rates were too low relative to our forecasts ("*Keeping a Close Eye on Federal Reserve Policy,*" 8/29/17). In this follow-up, we discuss market developments after the Fed's Sept. 20th meeting and reaffirm our cautious approach to extending maturities at current rates.

Market Still Discounting Fed Projections

Before their Sept. 20th meeting, the Fed expected 1 more hike in 2017 and 3 in both 2018 and 2019. At the time of our previous Alert, 2 and 3 year Treasuries were at 1.32% and 1.42%, respectively. We advised to maintain below average durations and not extend reinvestments as the market wasn't properly calibrating for this additional fed tightening.

The Fed has since largely reaffirmed this forecast, expecting 1 more hike in 2017, 3 in 2018, and 2 in 2019. Although 2 and 3 year Treasuries have since surged 0.16-0.18% as a result, the market still isn't adequately pricing in additional fed tightening. Despite that, the 1.48% yield on the 2 Year Treasury is now at its highest point since Q4 2008.

2 Year Treasury Yields



Source: Bloomberg

While the total Fed-market gap has now decreased from +6 to +4 rate hikes, this is still a substantive divergence. Current short-term Treasury yields build in cushion for only 1 more 2017 hike and 1 additional rate increase in total from 2018-2019:

- 2 Year Treasuries at 1.48% now are fair value only if you believe 1 Year Treasury rates in 1 year will not exceed 1.66%
    - 0.30% cushion from current 1 Year Treasuries
- 3 Year Treasuries at 1.60% now are fair value only if you believe 1 Year Treasury rates in 2 years will not exceed 1.84%
    - 0.54% cushion from current 1 Year Treasuries

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.

Risks Skewed Towards Rising Rates

Previously, we noted that short-term market rates were not accounting for an increasingly assertive Fed. Fed governors face compelling pressure to continue gradually raising rates, as they seek to stockpile monetary-easing "ammunition" ahead of the next inevitable downturn. When combined with the recent announcement that it will begin to reduce its balance sheet, FOMC members are clearly preoccupied with establishing a path back to rate normalization.

In addition, we believe there are several external factors pressuring rates higher:

- Washington lawmakers are pivoting towards tax cuts/reform. Substantive progress in this area may lead to economic acceleration.
- The European Central Bank will likely begin tapering its long-running quantitative easing program in the near future. Resulting increases in European rates may incentivize foreign holders of US government and corporate debt to refocus on their own domestic markets.
- Inflation and wage growth have been tepid. There may be signs of life here, though, and any acceleration will catch the Fed's attention and increase the odds they take further action.

Treasury Partners Outlook

Our outlook and strategy remain unchanged. Although the Fed-market gap has narrowed somewhat, current rates are still substantially lagging the Fed's projections. In particular, the 2-3 year portion of the curve is primed to see the largest upward shifts should the Fed hike more than once over the next couple of years.

We will continue to reinvest proceeds from natural maturities to avoid a buildup of excess liquidity. However, we will focus on shorter-term maturities and liquidity management instruments as opposed to longer bonds. We will consider extending maturities more forcefully only if the Fed lowers its projections or the market applies a lower discount to them.