

# VANDERBILT *Ave.*

## ASSET MANAGEMENT

### 2<sup>nd</sup> Quarter 2018

As the Federal Reserve moves to normalize its policy stance, rates have been on the rise and its balance sheet has been shrinking. In keeping with its previously established normalization principals, the Fed has embarked on its predetermined program to reduce its bond holdings and raise its policy rate. From its peak in 2015, the Fed's holdings of U.S. Treasury and agency MBS (mortgage backed securities) has only fallen by about 4% or approximately \$173 billion. The initiation of the balance sheet reduction program came in September of 2017. Since then, the Fed has trimmed its assets by a little over \$100 billion. As expected, the Fed has allowed its maturing securities to roll-off, rather than pursue outright sales of its assets. There could be unknown ramifications in this unwinding since the Fed has not undertaken a program of this magnitude in the past.

The scale and magnitude of this process has followed a measured approach. The Fed has established predetermined caps on the amount it is willing to allow to roll-off monthly. Once these caps are reached, the excess is reinvested or rolled-over into other securities. According to its announced schedule, the reduction will take the following form:

\$30 billion a month in Q2 2018  
\$40 billion a month in Q3 2018  
\$50 billion a month in Q4 2018

For periods beyond Q4 2018, the Fed expects the pace to be maintained at \$50 billion per month. It is important to note that, given the maturity schedule of the Fed's holdings, they are expected to continue purchasing bonds as the caps are breached.

In addition to the process of balance sheet unwinding, the Fed has been on a rate hiking path. That is, it has been normalizing its policy rate, the Fed Funds rate. Recent changes to the Federal Open Market Committee's membership suggest that the composition of the policy setting group has tilted away from the dovish stance that was predominant during its last incarnation. Nonetheless, the Fed has been clear in outlining its intentions for the path of interest rates, going as far as announcing it would hold press conferences after every meeting in contrast to the previous schedule of every other meeting. This persistent communication with market participants has helped to maintain central bank credibility. In its most recent meeting, the Fed announced a second rate hike for the year, bringing the rate to a range of 1.75-2%. In addition, it altered its projections for the year, signaling an additional two hikes for 2018. This cleared up some ambiguity among investors, who were pricing in between one and two additional hikes. Currently, futures markets are pricing in a hike in September with a subsequent one in December.

In discussing the stance of monetary policy, it is important to understand what we mean by stipulating that policy is accommodative, restrictive or neutral. In central banker jargon, this usually means whether the policy rate is below, above or at its long run natural rate. This comparator is often termed "R\*" or "R-Star". In short, R\* is the long run real interest rate that is consistent with full employment and price stability. It can be thought of as an analog to the natural rate of unemployment. The biggest issue, however, is that this rate is a theoretical construct and can't be observed empirically. It can be estimated using fundamental data on the economy such as productivity and labor force growth. It is important to note that both the level and the trend of the rate are relevant for determining the stance of policy. That

is, the path of future interest rates matters for policy setting purposes. One major implication of evaluating policy using  $R^*$ , or some variation of it, is that if the natural real interest rate is negative, the efficacy of monetary policy becomes impaired. This is part of the explanation for why monetary policy wasn't more stimulative in the aftermath of the great recession in the presence of very low nominal rates. That is, the natural real rate was negative and while nominal rates were at zero, in real terms they were higher due to an episode of deflation. Accordingly, policy was likely tighter than would be suggested by the level of nominal interest rates.

Finally, a common theme among FOMC members, as gleaned from the meeting minutes, has been the concern of a flattening yield curve. Since the beginning of the year, the curve, as measured by the spread between 10 year and 2-year Treasury notes, has been flattening. The spread currently stands at around 32 basis points, or about 20 basis points tighter than at year end 2017. A negative spread, with long rates yielding lower than short rates, tends to precede cyclical downturns. Given the indicator's nearly perfect record of predicting recessions 6-12 months ahead, it has received considerable attention lately both among policy makers and market practitioners. Indeed, since 1970, a yield curve inversion has signaled nearly every recession with about 6-12 months of lead time. However, if we look at a longer history of the indicator it becomes clear that recessions do occur in the absence of an inversion. Of note are the four post Great Depression recessions, which were not preceded by a negative term spread. Additionally, these periods roughly coincide with the last time interest rates were near zero or exiting the zero-lower bound.

Global growth is likely to continue with U.S. economic momentum picking up. Risks would include trade policies and fiscal stimulus that over or under shoots its target. U.S. economic growth contrasts with that of Europe and Asia, where there has been slowing momentum. U.S. consumption spending (70% of GDP) has been aided by a continuing strong labor market and tax cuts. For example, May retail sales were up 0.8% which was the biggest jump in six months. In addition, profits have been a stimulant to the economy with both first quarter and full year estimates up 26%. With a reduction in the corporate tax rate from 35% to 21%, capital spending is beginning to pick up. An immediate tax write off across a range of capital spending projects and a tax holiday to repatriate overseas profits should be a stimulant for infrastructure projects and other business investments.

The labor market has continued its very strong growth with hiring (plus 213,000) up more than was forecast in June. Wages ticked up to a 2.7% increase year-over-year. The unemployment rate rose from 3.8% to 4.0% due to a large increase of workers seeking employment. This 3.8% unemployment rate was the lowest in almost five decades. Jobs have been added for 93 straight months, far and away the longest streak on record. There has been a recent uptick in job hiring momentum. Although wage growth has increased to 2.7%, there has been lackluster real wage growth. Why haven't wages risen? Some attribute it to slack in the labor market, although it appears other factors are at work. Workers might be content with modest wage increases because fringe benefits are valued more than in the past. Companies have become more resourceful in reducing wage costs (for example, noncompete-clauses and the use of independent contractors) and consolidations have made it more difficult to move to a competitor. Finally, continuing disappointing productivity growth is also a major reason.

Although subdued, a gradual rise in inflation is anticipated. Rising inflation is likely to surpass the Fed's target of 2%. The most recent measure of the Fed's preferred inflation gauge (core PCE) rose 2.0% on a year-over-year basis. Risks include the continuing increase in services inflation and uncertainty over the future of the ACA. For the five years through 2016, healthcare inflation averaged just 1% per year. This trend has reversed. The elimination of the individual mandate and defunding of the ACA's cost sharing

reductions will mean fewer Americans with health care and an increased burden on hospitals due to uncompensated care provided. This is a cost that will be inflationary. Health care inflation is estimated to run closer to 2.6% by late 2019.

Trade policy uncertainty is another risk that has recently intensified. While we think ultimately there will be agreements amongst trade partners to avert major trade wars, it is unclear at this time when or what the details of the agreements will be. Tariff implementation is just getting started and the full extent of retaliation and damage is uncertain. Trade tariffs are viewed as inflationary, whereby price increases tend to extend beyond import prices to domestic prices. Tariffs not only increase the cost of imported goods but also may raise world prices, thereby increasing the cost of domestic prices as well. These price increases pass-through to other goods, putting upward pressure on the broader economy. A trade war may not be beneficial to the U.S. considering that the U.S. accounts for 9% of world exports and 14% of world imports.

Trade wars have the potential to result in slower growth and lower productivity. Economic damage can result even before the tariffs go into effect. For example, futures prices for grain products have declined approximately 15%-20% since early June in anticipation of China placing retaliatory tariffs on U.S. exports of agricultural products to China, a major market for our farm sector. General Motors recently warned that Trump's proposed auto tariffs would lead to less investment, fewer jobs and lower wages for its employees. It said demand would suffer and production would slow which could lead to a smaller G.M. Consumer and business confidence could be adversely affected with negative impacts upon spending and capital investment

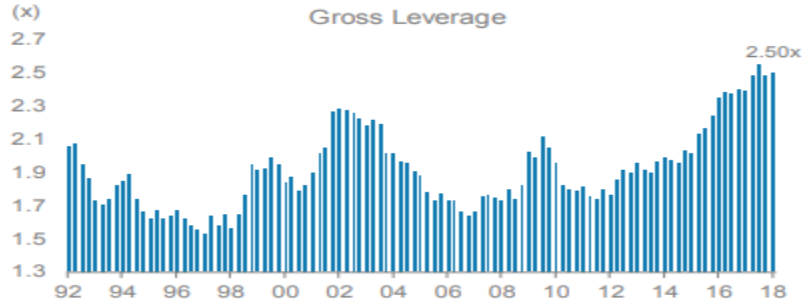
Tariffs benefit a handful of companies but will harm many more. There is a case to be made that free trade is the best policy and that the U.S. should drop all tariffs. Studies show that countries that have frequent trade with one another have both higher per capita income and faster rates of productivity growth. At the recent G7 meeting, Trump threw out a proposal of making all trade within G7 tariff free, i.e. a free trade zone. This would do away with any criticism of unfair tariffs and guarantee complete reciprocity. We would no longer have a situation where a small minority, those helped by protective tariffs, benefits at the expense of a large majority of the populace.

### **Corporate Securities**

An impressive earnings season, strength in CAPEX, the corporate tax cut, and a strong U.S. economy should have provided a positive foundation for the corporate bond market. For instance, S&P 500 earnings rose by an impressive 26% during the quarter, and by quarter end earnings were projected to rise an additional 20% for the next quarter with sales up 8.7% as reported by FACTSET. 82% of companies reported earnings that met or exceeded analyst expectations. These results, however, did not flow through to key corporate credit financial fundamentals.

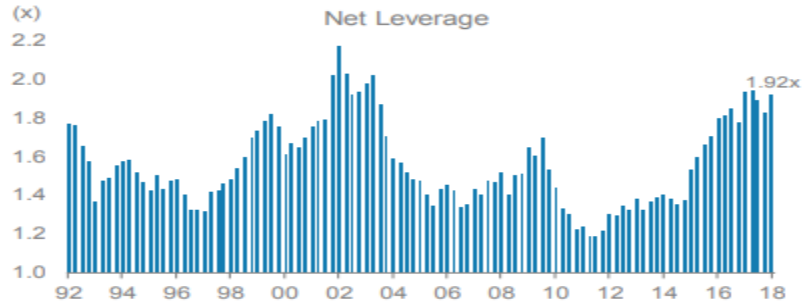
As shown in the three graphs below, Investment Grade Gross Leverage (Debt/EBITDA) exceeds prior economic cycles while Net Leverage (Debt-Minus/EBITDA) is also elevated as compared with prior cycles.

**Median Investment Grade Gross Leverage Roughly Flat on the Quarter, Near Record High**



Source: Morgan Stanley Research, Bloomberg

**IG Net Leverage Jumps Notably, Just Shy of Post-Crisis Highs**



Source: Morgan Stanley Research, Bloomberg

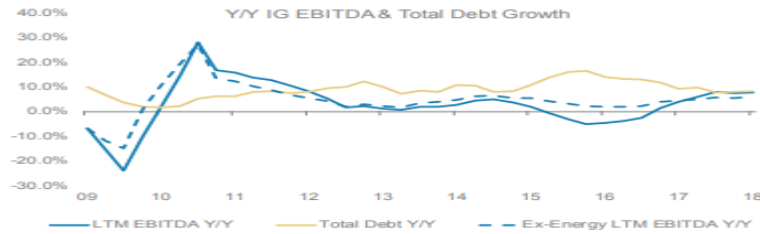
**Even on the Broadest Measures, Non-fin Corporate Leverage Remains High**



Source: Morgan Stanley Research, Federal Reserve

EBITDA growth has not been sufficient to fully offset the increase in debt during the past quarter, with only energy, basic industry and healthcare companies de-leveraging.

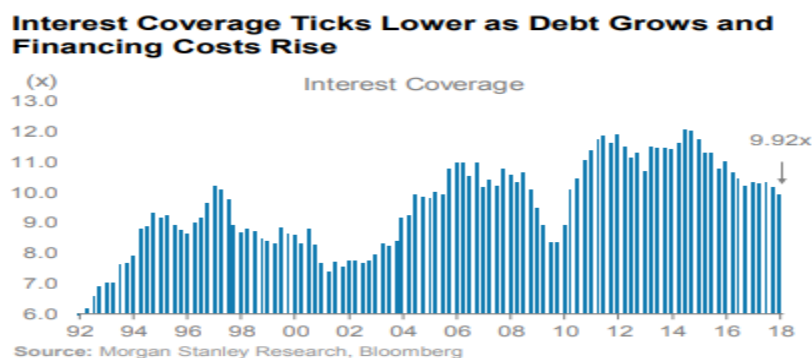
**Solid EBITDA Growth Has Driven the Stabilization in IG Gross Leverage**



Source: Morgan Stanley Research, Bloomberg

Note: Constant universe

The combination of modestly higher leverage and an increase in the coupon rate on new debt issuance is continuing to drive the interest coverage of the investment grade corporate universe lower.



The investment grade universe has changed meaningfully since the last recession. "BBB" rated corporate bonds (the lowest investment grade rating classification) comprise 48% of the ICE BofAML 1-10 Year Corporate Index ("Intermediate Index") as of June 30, versus just 32% of the Index on 12/31/2007. The higher percentage of marginal investment grade corporate bonds increases the risk of bonds within the Intermediate Index being downgraded to high yield during the next downturn. CAPEX remained strong during the past quarter, but the most significant increases in the use of repatriation of overseas cash, debt issuance, and operating cash flow was for stock buybacks, clearly not a credit positive.

The Intermediate Index ended the quarter with a spread of 1.08% over comparable U.S. Treasury securities, which is 0.08% wider from 3/31/2018. The corporate spread is now 0.29% wider from the beginning of the year with the sector underperforming the U.S. Treasury by 0.79% for the six months and 0.18% during the second quarter. The shorter ICE BofAML 1-3 Year Corporate Index benefited from solid earnings and demand for shorter duration corporate bonds from market participants during the second quarter. Their spread over comparable U.S. Treasury securities tightened by 0.03% to 0.73% at the end of the quarter. Combined with the higher income of the sector, the Index's excess return is now positive for the year by a modest 0.03%. Corporate spreads remain tighter than historical averages of 1.25% for the Intermediate Index and 0.91% for the shorter Index.

During the past quarter, investments continued to focus on Issuers with relatively strong credit fundamentals and stable cash flow. Procter & Gamble manufactures and markets a wide range of consumer products. It had EBITDA/Interest Coverage of over 30 times and Net Debt to EBITDA of just 1.2 times. The issue is Aa3/AA-. They had a positive earnings surprise in the last quarter. An additional purchase was the reinvestment of a maturity of Stryker Corp., a medical device manufacturer. Their credit rating is Baa1/A, they had Interest Coverage of over 12 times and a Net Leverage ratio of 1.8 times at prior quarter end. Earnings were a significant positive earnings surprise. Though the sector is not undervalued at this time, our overweight is being maintained. Our portfolios' are focused on issuers with relatively strong credit fundamentals, stable cash flow and a duration shorter than the relevant corporate index. These are expected to provide modest excess returns over alternative investments.

### **Asset Backed and Mortgage Backed Securities**

After a weak first quarter, ABS and MBS spreads tightened in the second quarter. Short ABS posted 0.49% on a total return basis, and 0.18% on an excess return basis versus similar duration U.S. Treasury issues. MBS had a 0.31% total return, which equated to 0.24% excess return. In light of the continued backup in

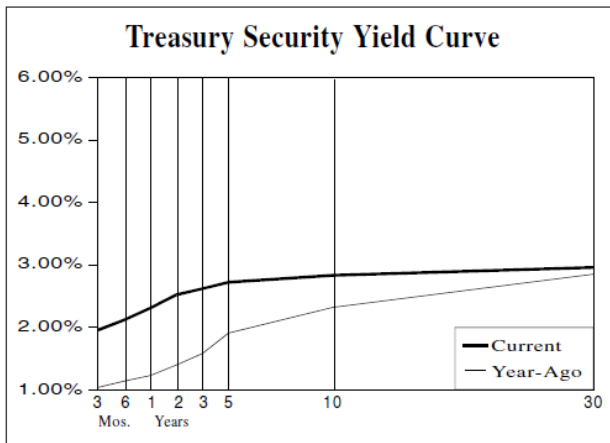
short term interest rates, short duration, high quality ABS and MBS offer investors yield pickup without taking on credit risk.

With the strong consumer sector, credit card and auto loans are performing well. Credit card charge offs are low and automobile loss rates are in line with expectations for continued strong performance on a fundamental basis. The credit quality of ABS in our portfolios' remains high. The securities we hold are all AAA-rated and high in the securitization structure, paying off principal in less than three years. As securities mature, we have been adding to our ABS, specifically within the floating rate sector. We added a two-year Barclays ABS credit card security: DROCK 2017-1 A. This bond has an average life of two years and pays a floating rate coupon of one-month Libor plus 0.33%. This security is locked out from prepayments and is expected to pay off in May 2020, while earning a coupon that increases with rising rates. We also added a floating rate ABS backed by auto loans: HART 2018-A A2B. This is a one-year security that pays a floating rate of one month plus 0.12%. This auto loan is experiencing low delinquencies and is gradually paying down principal, while earning a coupon that increases with rising rates. As the short end of the yield curve continues to rise, our portfolios' benefits from holding floating rate securities such as these, whose coupon increases accordingly.

The MBS portion our portfolios' continue to be invested in short super seasoned Agency MBS, which offer default and prepayment protection. The Agency rating insulates these securities from defaults. Due to the seasoning of the collateral backing these securities, they experience stable prepayment levels that do not fluctuate greatly with moves in interest rates. The loans backing these securities are "burnt out", meaning the balances are lower and the borrower has less incentive to refinance. Therefore, prepayments are more consistent from month to month based on seasonality rather than interest rate movements.

## Selected Yields

	Recent (7/3/18)	3 Months Ago (4/4/18)	Year Ago (7/5/17)		Recent (7/3/18)	3 Months Ago (4/4/18)	Year Ago (7/5/17)
<b>TAXABLE</b>							
<b>Market Rates</b>				<b>Mortgage-Backed Securities</b>			
Discount Rate	2.25	2.25	1.75	GNMA 5.5%	3.50	3.44	2.43
Federal Funds	1.75-2.00	1.50-1.75	1.00-1.25	FHLMC 5.5% (Gold)	3.66	3.36	2.69
Prime Rate	5.00	4.75	4.25	FHLMC 5.5%	3.51	3.32	2.49
30-day CP (A1/P1)	2.06	1.85	1.21	FHLMC ARM	2.04	1.97	1.81
3-month Libor	2.34	2.32	1.30	<b>Corporate Bonds</b>			
<b>U.S. Treasury Securities</b>				Financial (10-year) A	4.00	3.86	3.41
3-month	1.96	1.70	1.04	Industrial (25/30-year) A	4.24	4.11	3.91
6-month	2.12	1.90	1.14	Utility (25/30-year) A	4.21	4.11	4.01
1-year	2.31	2.06	1.23	Utility (25/30-year) Baa/BBB	4.56	4.43	4.34
5-year	2.72	2.62	1.91	<b>Foreign Bonds</b>			
10-year	2.83	2.80	2.32	Canada	2.16	2.18	1.79
10-year (inflation-protected)	0.72	0.72	0.56	Germany	0.31	0.50	0.47
30-year	2.96	3.04	2.85	Japan	0.03	0.03	0.09
30-year Zero	2.97	3.07	2.94	United Kingdom	1.28	1.37	1.26
				<b>Preferred Stocks</b>			
				Utility A	5.81	5.96	5.79
				Financial A	5.47	5.92	5.73
				Financial Adjustable A	#REF!	5.47	5.47



Source: Value Line, Inc.

# Federal Reserve Data

## BANK RESERVES

(Two-Week Period; in Millions, Not Seasonally Adjusted)

	Recent Levels			Average Levels Over the Last...		
	06/20/18	06/08/18	Change	12 Wks.	26 Wks.	52 W
Excess Reserves	1894884	1896246	-1362	1931964	2017621	2083
Borrowed Reserves	129	104	25	74	56	
Net Free/Borrowed Reserves	1894755	1896142	-1387	1931891	2017565	2083

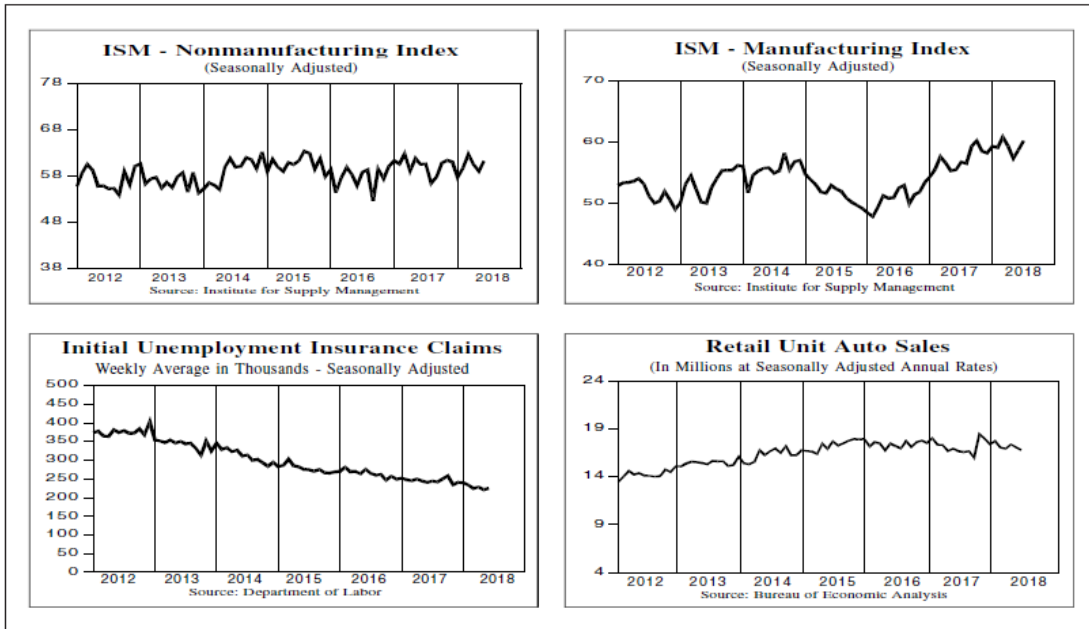
## MONEY SUPPLY

(One-Week Period; in Billions, Not Seasonally Adjusted)

	Recent Levels			Ann'l Growth Rates Over the Last		
	06/18/18	06/11/18	Change	3 Mos.	6 Mos.	12 Mo
M1 (Currency+demand deposits)	3671.5	3676.3	-4.8	1.7%	2.8%	5.2%
M2 (M1+savings+small time deposits)	14117.6	14097.8	19.8	6.1%	3.2%	4.3%

Source: United States Federal Reserve Bank

# Tracking the Economy



Source: Value Line, Inc.