Third Quarter 2017

The Strategist's Corner

Trouble with the Curve(s)

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"The financial markets have had a quality at-bat for the third quarter."

It is Major League Baseball (MLB) World Series time! I hope that my favorite team, the Washington Nationals, is still playing in the post-season as you read this piece. *Trouble with the Curve* is the title of a forgettable baseball movie that stars Clint Eastwood, Amy Adams and Justin Timberlake (it has been nearly ten years since I wrote a parody of Justin Timberlake's hit song, SexyBack in a Strategy piece by stating bonds were bringing sexy back after the recession).

Trouble with the Curve is about an old pro scout scouting a top high school baseball prospect. Unlike a curveball, one can predict what is coming next in this weak grounder of a movie. As you probably suspected, in the end, the hotshot player can't hit a curveball. This baseball movie is no *Moneyball or Bull Durham*.

According to MLB statistics, the most common pitch in baseball is the four-seam fastball which makes up about 35% of all major league pitches thrown. The second most popular pitch is the two-seam fastball which accounts for 21% of all pitches. The slider makes up a little over 14% of all big-league pitches at number three, while the curveball accounts for 9.9% of all pitches at number four. The remaining types of pitches are off speed and various "junk" pitches.

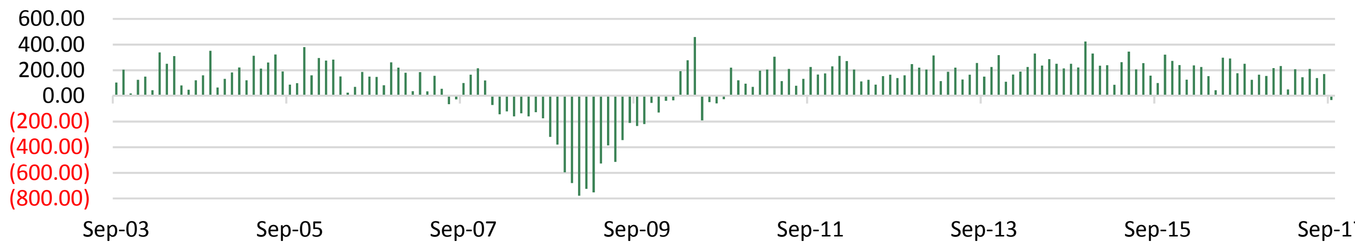
I normally don't buy into the whole baseball as a metaphor comparison, but we will go down this path together to discuss America's two pastimes: baseball and money! The third quarter of the year contained a fair number of curves, but the financial markets had little trouble reading them and fouled them off. The markets fouled off volatility catalysts from North Korea, tax reform, Federal Reserve Chairperson replacement, Fed balance sheet reduction, European Central Bank tapering and multiple hurricanes that packed plenty of velocity. The financial markets have had a quality at-bat for the third quarter.

U.S. Treasury yield curve tracks the relationship between interest rates and the maturity of Treasury securities at a point in time. The slope, shape, and level of yield curves change over time with fluctuations in interest rates. Investment professionals often look at yield curves because they may provide suggestions to financial market conditions and future interest rates.

The most frequent shape of the yield curve has been upward sloping. Yields usually increase as the maturity of the security lengthens. An upward sloping yield curve suggests that financial markets expect short-term interest rates to rise in the future. Investment professionals are having some trouble with the current yield curve.

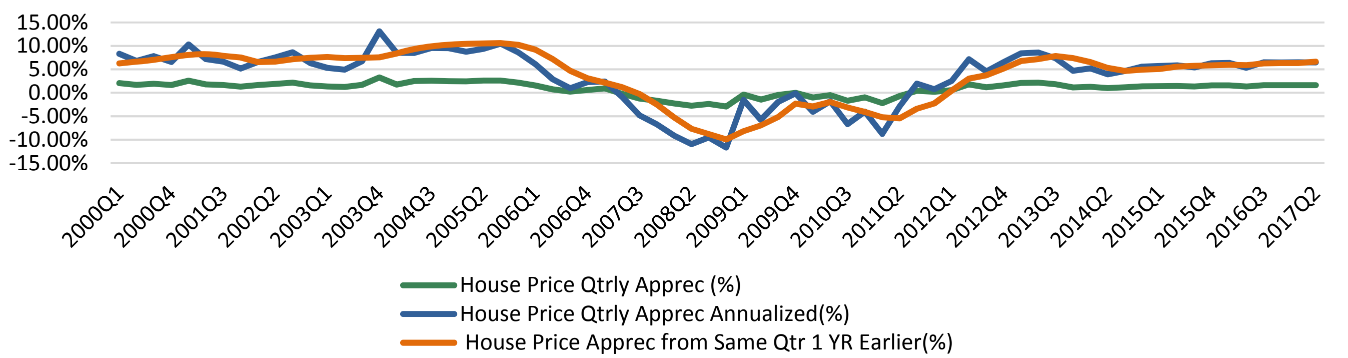
Please see "Curve" on page 4

U.S. Non-Farm Payroll
(Month over Month Net Change)
(in thousands)



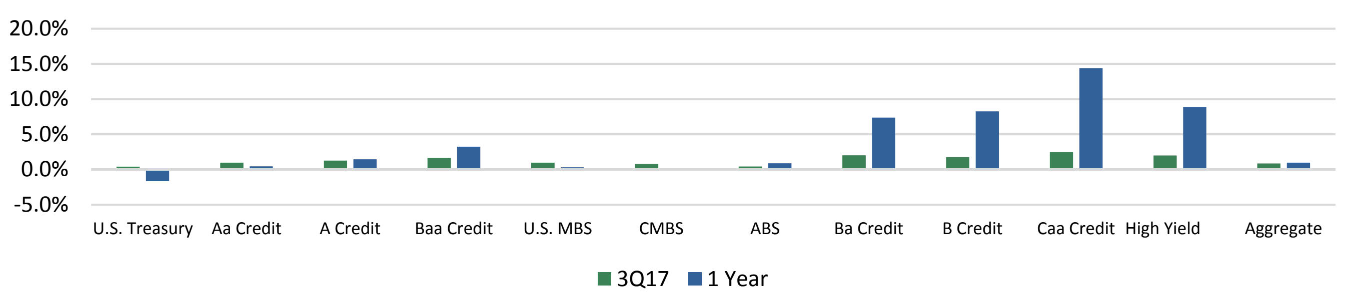
Source: Bureau of Labor Statistics

House Price Index History for the USA

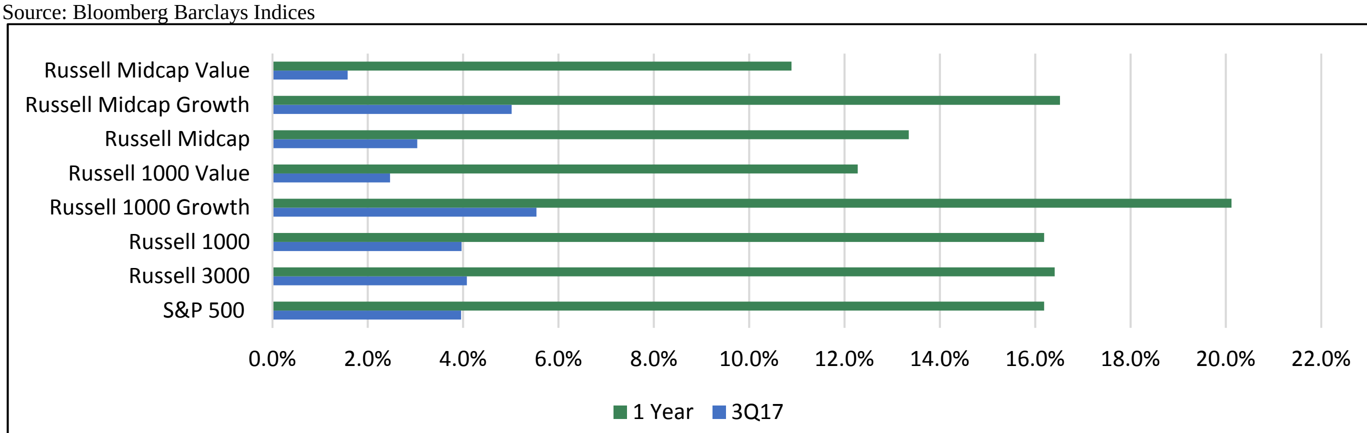


Source: FHFA

US Bond Sector Performance
(for the period ending September 30, 2017)



Source: Bloomberg Barclays Indices



Source: Bloomberg

Review and Outlook

The U.S. stock market continued to go up a bit higher during September. The S&P was up nearly 4% in the quarter, achieving its 8th quarterly advance. Investors did not seem overly concerned about a series of hurricanes and rising political tensions with North Korea. Many on Wall Street may still be hoping the Trump Administration will be able to advance its tax reform initiatives after health care reform fell short again.

"The big question is whether wages and inflation pose any threat to overheating the economy."

The Federal Reserve is expected to hike U.S. interest rates in December. Three more interest rate increases are expected in 2018. Some Fed officials suggest that the labor market feels tight and they are seeing signs of building pressure on wages. The big question is whether wages and inflation pose any threat to overheating the economy.

The major domestic fixed income indices etched out positive return numbers for 3Q2017, given the 3-basis point increase in yield on the 10-year Treasury. The U.S. Aggregate index improved 0.85% during the quarter. High yield bonds posted positive returns while investment-grade debt also gained during the third quarter, according to Barclays Capital indices. The total returns from corporate high yield were 1.98% for the quarter, while returns from investment-grade corporate debt produced total returns of 1.34%. High yield debt is rated below Baa3 by Moody's Investors Service and lower than BBB- by S&P.

The 2-year Treasury yield climbed 10 basis points while the 10-year Treasury yield increased 3 basis points during the quarter to yield 1.48% and 2.33% for the period, respectively. Utilities and Industrial were the best performing sectors within the U.S. Aggregate index. The two sectors returned 1.57% and 1.33%, respectively, for the quarter. U.S. Treasury bonds produced total returns of 0.38%. Baa bonds were the best-performing investment-grade credit quality during the third quarter, posting a 1.63% gain. Refining, Oil Field Services, Independent Energy, and Transportation Services were the best performing industries within the high yield corporate sector.

The Bloomberg News monthly survey of bond yields – which includes input from more than 60 economists – forecasts that U.S. Treasury 10-year yields will increase to 2.95% in 3Q2018 and then rise to 3.00% in 4Q2018. All the yields are less than the forecasted yields of the August survey. After another soft start to the year, U.S. economic growth is now benefitting from an upturn in global activity and a loosening of financial conditions. The weaker dollar should boost export growth, while domestic demand should benefit from low long-term interest rates and modest fiscal stimulus at the start of next year. Key to watch will be whether traditional measures of wage inflation start to take hold as some businesses try to lure away valuable employees with higher pay packages.

It remains to be seen whether equities will resume their advance as third quarter earnings season approaches and talk of tax cuts heats up. Regardless, we will continue to seek high-quality companies in a diversified portfolio that have favorable growth profiles. We will continue to manage portfolios that tend to exhibit less volatility than their relative index and strive to deliver attractive risk-adjusted returns. Our portfolios are designed to perform over a full market cycle with a focus on downside risk, a style we believe will succeed over the long term.

"Curve from page 1

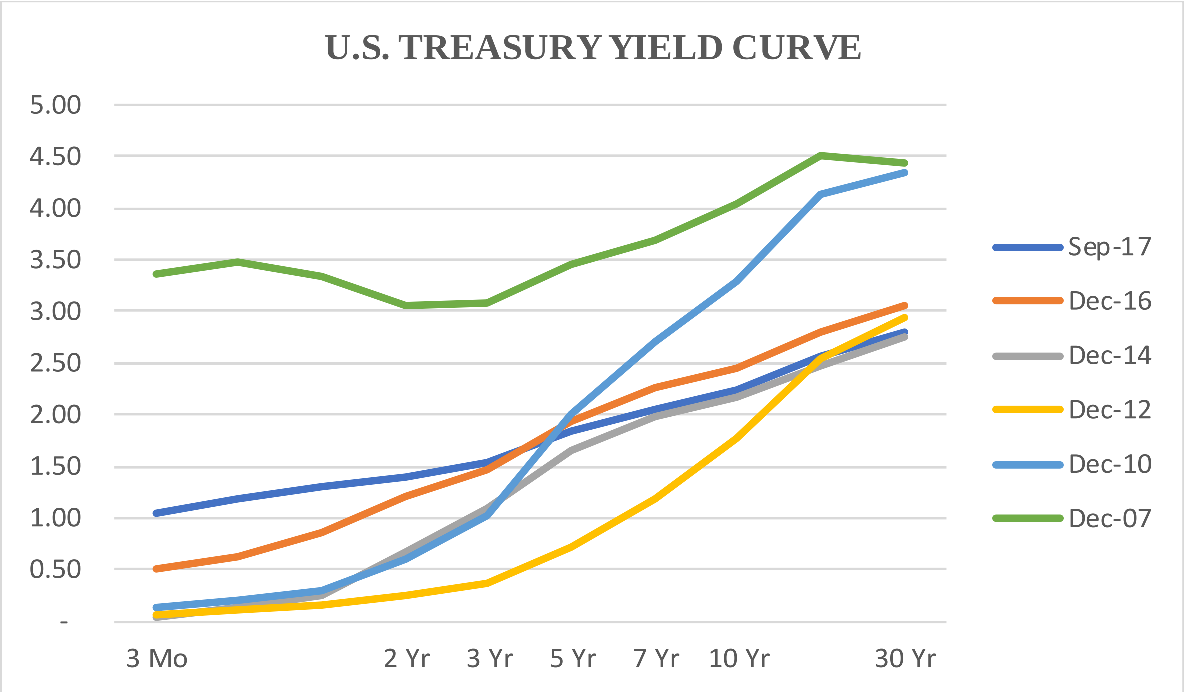
We are in an artificial market environment where central banks around the world are at near-zero rates. Chart 1 shows that the yield curve has flattened in 2017 and has been flattening for most of the last ten years.

When the yield curve flattens, the spread between shorter-term treasury bonds and bonds of longer maturities dwindles. This is often measured as the spread or difference between the yield on the 10-year Treasury and the 2-year Treasury. At the end of 2016, the spread was 1.25%, and at the end of the third quarter it was 0.85%. Similar curve movement was experienced by the yield on the 30-year Treasury and the 2-year Treasury spread.

"The flattening of the yield curve could be deemed a market bet against inflation.

The curve has flattened over the last 1, 3, 5 and 7-year periods. The flattening of the yield curve could be deemed a market bet against inflation. The rotation of a curveball pitch angle and the current yield curve are similar with the former being humped and the latter becoming more parallel. We must be mindful of the message from the Fed and the pitcher when it comes to the curve. A flattening curve is different than an inverted curve, just like curveballs have a variety of trajectories and breaks depending on the pitcher.

Chart 1



Source: Federal Reserve Bank of St. Louis and PIA

The Fed has three monetary policy mandates: full employment, stable prices and moderate long-term interest rates. While we can argue about whether we're really at full employment, the measures they use say they have met that goal. With full employment inflation normally follows. If the market is wrong about inflation expectations and we see inflation, it could make achieving the Fed's mandates more challenging. It is much easier to stop inflation before it starts. The same goes for developing a good swing for a batter or good mechanics for a pitcher. One must nip bad habits early before major adjustments are needed.

Two of the three Fed's primary concerns are inflation (interest rates) and unemployment. The Phillips curve explains the relationship between the rate of wage inflation and the rate of unemployment. The two variables are inversely related. Wage inflation is one of the key indicators that I follow to provide insight on the direction of interest rates and the U.S. economy. Wages tend to lead the direction of real yields and inflation.

We see in Chart 2 that the labor force statistics for the August 2017 unemployment rate came in at 4.4%. Chart 3 shows that compensation costs for civilian workers increased 2.4% for the 12-month period ending in June 2017. Inflation and unemployment no longer seem to be correlated. This is inconsistent with the shape of the Phillips curve.

"The Fed has been very effective pitching 'down the middle of the plate' since the Great Recession."

Chart 2 U.S. Unemployment Rate in Total Labor Force Seasonally Adjusted

Source: Bloomberg and PIA

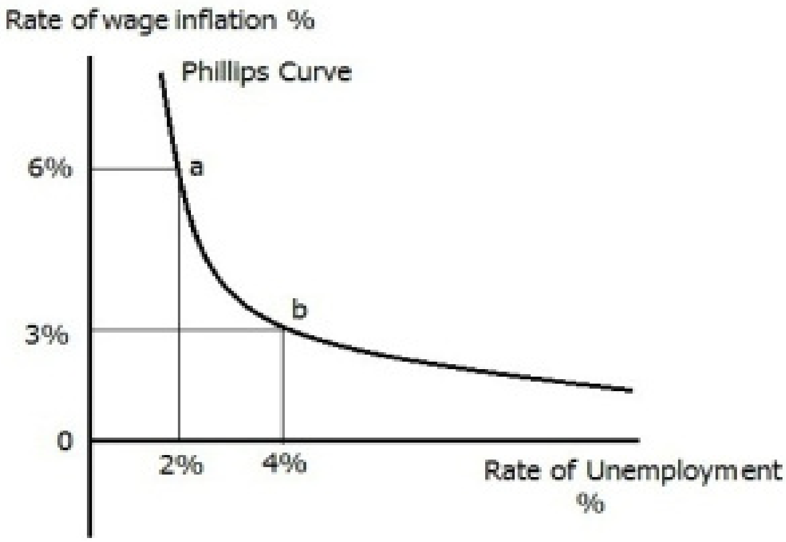
Chart 3 Employment Cost Civilian Workers YoY

Source: Bloomberg and PIA

With the very low unemployment rate, salary expectations and wage inflation should be higher. Wage inflation is a risk to shrink operating margins. Does the Fed think that the U.S. economy is at full employment, especially after having the rate come down from 10% during the height of the recession? Are Americans fully employed but fully unhappy because their salary growth is too slow and below equilibrium?

Let's talk more about the Phillips curve. Chart 4 illustrates that the rate of unemployment will fall when the rate of wage inflation increases. More workers with jobs will increase demand in a stronger economy and that should elevate prices, wages and inflation.

Chart 4 Phillips Curve



Source: https://husainomics.wordpress.com

"It has been relatively easy to hit line drives because of an accommodating policy of asset purchasing and near zero Fed funds."

The Fed has been very effective pitching "down the middle of the plate" since the Great Recession. It has been relatively easy to hit line drives because of an accommodating policy of asset purchases and near zero Fed funds. The economy is now in a 3-2 count and investment professionals are at the plate attempting to watch the Fed's grip on Fed funds. We are focused on the balls trajectory while letting the market come to us and waiting on it. If we don't approach the market with that discipline then we will be thrown a timeless knee-buckling curveball that has made countless investors look foolish over the years.

Investors need to have good plate discipline to know when to swing and when to "take" a pitch. To take a pitch means the batter should not swing at the next pitch. Janet Yellen, Ben Bernanke and Alan Greenspan have been very helpful over the years to assist the decision-making process. But the U.S. economy is giving off mixed signals with the economic data, treasury yields and the Phillips curves.

Clayton Kershaw, Sandy Koufax and Satchel Paige are/were three of the best at throwing the curveball. This market is different visually. Inflation projections are probably more of a contributing factor for inflation outcomes than unemployment. We must wait for our pitch. We must not swing at the nasty curveballs and instead wait for the one left hanging over the middle of the plate (if you hang it, we'll bang it). The Fed is having trouble commanding the pitch. Uncertainty over inflation is a risk both ways, but continuing inflation weakness will have more implications for 2018 Fed course of action than this year.

"Some people are born on third base and go through life thinking they hit a triple."
Barry Switzer - former football player, college and pro coach

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