NEWPERSPECTIVES

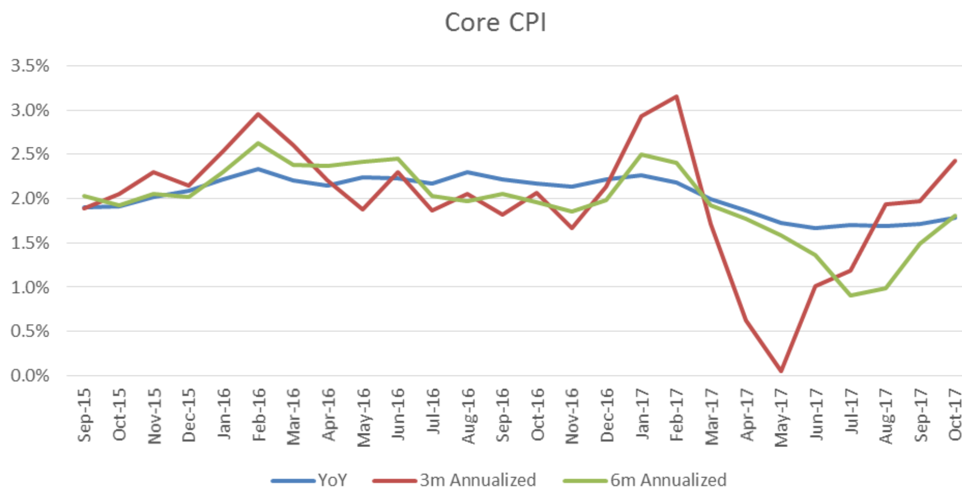
Commentary from New Century Advisors
November 2017

Flatter Curve Ahead

- **October CPI report bolsters the Fed's firmer expectations (and ours)**
- **Market still trails the Fed in 2018 rate hike expectations**
- **More rate hikes likely - keeps the flattening pressure on the curve**
- **Ellen Safir on fixed income investing in a rising rate environment**

Core CPI firms

The BLS published the October CPI report last week. As expected, a 5% drop in gasoline prices weighed on the headline print, a partial unwind of the hurricane-induced 15% spike in retail gasoline prices back in late August and September. Nevertheless, while Headline CPI fell from 2.2% to 2.0% YoY, Core CPI actually rose slightly faster than anticipated, gaining 0.23% MoM and 1.8% YoY, breaking a string of five consecutive 1.7% YoY prints. Core Goods, which remain a drag on overall prices (- 1% YoY), posted their second positive monthly print in a row. Meanwhile, Core Service prices remain robust, with Shelter rising 3.2% YoY and Core-Services Ex-Shelter rising 1.9% (and accelerating). Putting them all together, in the last three months, Core CPI has risen at an annualized pace of over 2.4% (chart). In short, we see evidence that the sharp drop in Core CPI this past spring was, to borrow the Fed's term, transitory.



Source: Bureau of Labor Statistics and New Century Advisors

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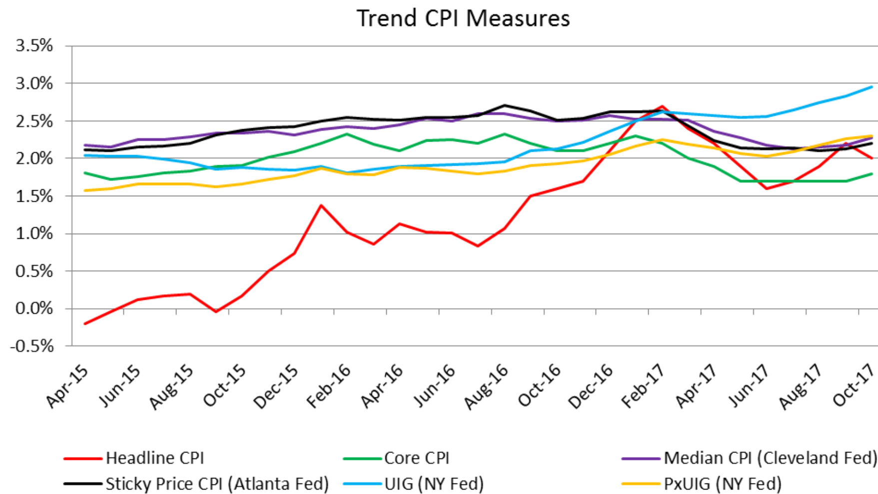
Similarly, the upward drift remains clearly apparent in the various Regional Fed models built to capture trend inflation. Most notably, the NY Fed's recently-published Underlying Inflation Gauge rose to 2.96% in October, the highest reading since August, '06.

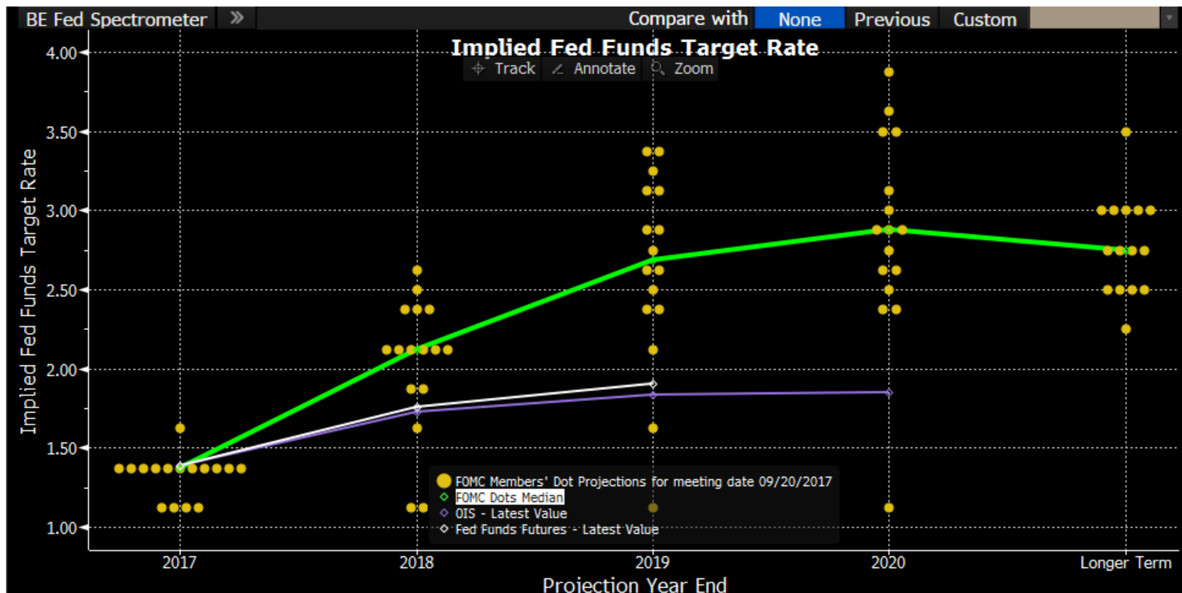


Source: Bureau of Labor Statistics and New Century Advisors

What does it mean?

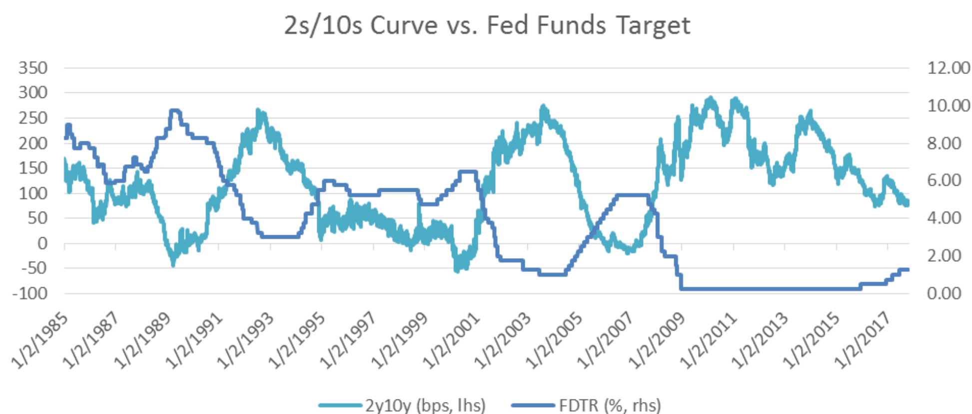
With rising inflation in mind, we turn our attention to the markets where we make three observations. First, TIPS appear mispriced to inflation expectations. While 2018-19 inflation forecasts see YoY CPI approaching 2.5%, TIPS breakeven spreads remain below 2% across the curve. Not only do they appear to represent good value at current levels, but we also feel that they are cheap insurance against an inflation-induced back-up in interest rates.

Second, we continue to believe the market is underpricing Fed rate hikes for next year. While a third 2017 rate hike in December is nearly fully priced in (92% odds according to Fed funds futures), the market prices in just 1.5 rate hikes next year. The Fed's own forecast, according to the median dot in their Summary of Economic Projections (last published at the September FOMC meeting, below) looks for 3 hikes in 2018. Given rising inflation, we think the market is underestimating the amount of tightening on the horizon.



Source: Bloomberg

Finally, more rate hikes are likely to put further flattening pressure on the curve. As can easily be seen in the chart below, the upward pressure on short rates from a rising fed funds target typically leads to a flatter yield curve. Much has been written about how the yield curve is the flattest it's been in a decade. Of course, it has also been more than a decade since the prior Fed hiking cycle concluded (June, '06.) Since the start of the current hiking cycle nearly two years ago (begun in December, '15), the Fed has thus far only hiked four times. If we're correct and they hike another four times over the next 13 months, the curve can flatten much further. More on this below.



Source: Bloomberg and New Century Advisors

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A rising rate environment

Last week our founder and Chief Investment Officer, Ellen Safir, CFA, spoke at a gathering of the Washington Association of Money Managers. Ellen spoke about a highly relevant topic: *managing fixed income in a rising rate environment*. Of course, the title begs the question, are rates in fact rising? To that we'd respond that it depends on where you look: Fed funds and short rates are certainly on the rise. The yield on 2yr Notes broke above 1.5% last month for the first time since 2008 and are at 1.76% as of this writing. 10yr yields are 30bps above their September lows and 100bps above their 2016 lows, but the 30 year bull trend (lower in yield) remains intact, at least for now (below.)

Source: Bloomberg

So yields are rising but in varying degrees depending on where you look, and the curve is flattening as discussed above, thanks to Fed rate hikes which we expect to continue. 10yr Notes have sold off (yields rising) by 100bps or more four times since the end of the last rate hike cycle in 2006, so rate hikes aren't a necessary condition for a selloff. And 10yr Notes have only sold off by 10bps since the Fed first hiked rates in this cycle nearly 2 years ago, so Fed rate hikes don't necessarily spell doom for bonds. All of which gets to the crux of Ellen's talk: all rising rate markets are not created equal. The chart below examines this further, listing the performance of various fixed income asset classes during five different periods of rising rates (with and without Fed rate hikes) over the past 20 years.

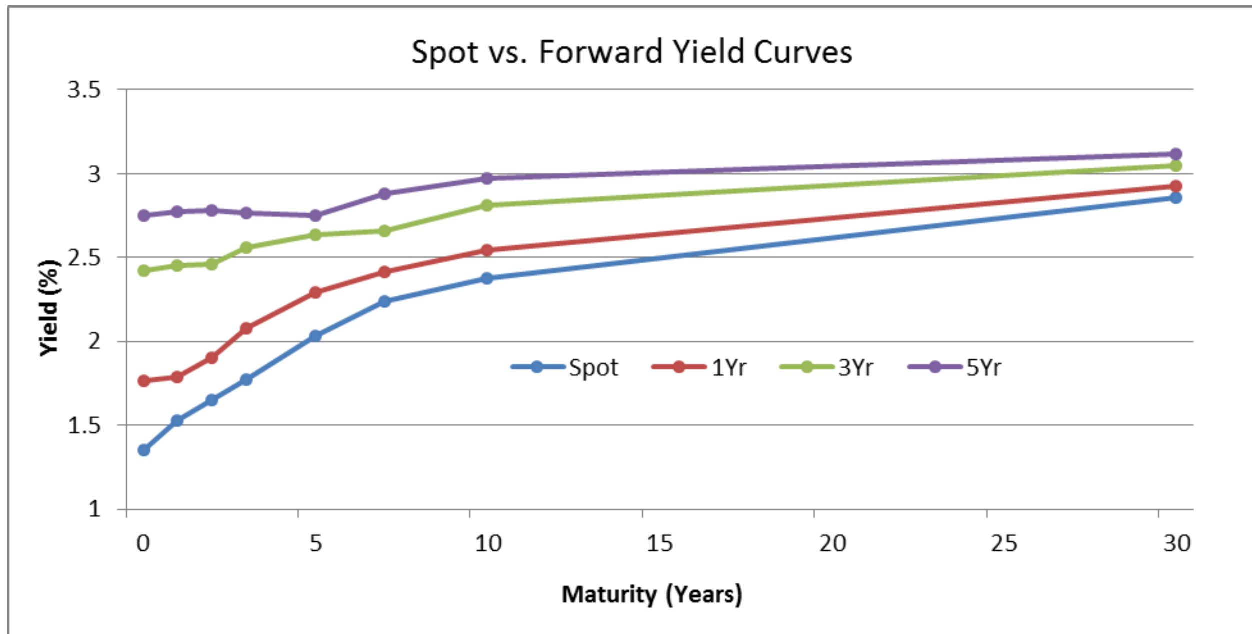
Period Start Period End	Oct-98 Jan-00	Jun-03 Jun-06	Jan-09 Dec-09	Aug-12 Dec-13	Jul-16 Dec-16
Initial 2yr Rate & Δ	4.2%, +232bps	1.2%, +383bps	0.8%, +37bps	0.2%, +17bps	0.6%, +61bps
Initial 10yr Rate & Δ	4.4%, +225bps	3.5%, +177bps	2.5%, +163bps	1.4%, +156bps	1.4%, +97bps
Notes	Post-Asia Crisis & LTCM. Pre-DotCom Bubble	"Measured Pace"	Initial Recovery Post-2008 Crash	Includes Taper Tantrum	Includes Trump Trade
High Yield Bonds	4.2%	28.1%	47.5%	13.1%	7.2%
Emerging Market Debt*	32.2%	30.5%	30.0%	2.1%	0.5%
Short Term Credit	2.9%	5.5%	12.8%	2.8%	-0.5%
MBS	1.8%	8.8%	5.8%	-1.3%	-1.4%
Core US Bonds	-0.8%	6.1%	5.8%	-1.6%	-2.5%
10 year US Treasury	-12.1%	-2.0%	-10.8%	-10.4%	-7.5%
TIPS	2.4%	10.7%	10.3%	-8.6%	-1.6%
Leveraged Loans	5.8%	18.2%	42.8%	8.8%	5.3%

Source: Bloomberg Barclays Indices: US Corporate High Yield; EM USD Aggregate; US Credit 1-5; US MBS; US Aggregate; 10-year Treasury; US TIPS; and Bloomberg SPBDAL. *The Bloomberg Barclays **EM USD Aggregate Index** is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

A few takeaways:

- Rising rates do not spell doom - or even negative returns - for all fixed income asset classes
- Fed rate hikes do not spell doom for all fixed income asset classes (See June ’03 – June ’06, during which the Fed hiked 16 times)
- 10 year Treasury Notes don’t just under-perform but deliver negative returns in all rising rate examples cited
- TIPS don’t just out-perform nominal Treasuries in all rising rate examples cited, they also deliver positive returns in some rising-rate markets, notably including the hiking ’04-’06 hiking cycle. As mentioned briefly above, we feel that TIPS are good insurance against a further back-up in rates – particularly one that is induced by rising inflation
- The starting point matters: more recent selloffs have begun from ever-lower levels of rates, thus decreasing returns. Likewise, spreads have trended tighter, limiting the ability for spread-product to further outperform in a selloff

Effectively managing the various types of bond risk in a rising rate environment requires understanding why rates are rising in the first place, analyzing current market pricing, and having a view. Where your view aligns with the market, there’s not likely to be much of a trade. For example, the current spot curve implies a forward curve that is higher and flatter than current yields (below.) As such, it’s not enough to simply expect rates to head higher. How much will they rise, and how fast, and how does that compare with what is already priced in? 10yr Treasury yields are already priced to rise 17bps in the next year, 44bps in the next three years, and 60bps in the next five years.



Source: Bloomberg and New Century Advisors

Implied Rate Increases			
	In 1 year	In 3 years	In 5 years
2yr Notes	25	81	113
5yr Notes	25	60	71
10yr Notes	17	44	60
2s/10s	-8	-37	-53

Source: Bloomberg and New Century Advisors

The same point can be made with respect to our curve view expressed earlier. We discussed reasons why we expect the Fed to hike faster than is currently priced into the market. Likewise, we expect the yield curve to flatten faster than what is currently priced into the market. From the above table, the 2s/10s curve is priced to flatten by 8bp over the course of the next year, 37bps over the next three years, and 53bps over the next five years. Based on our expectations for inflation and thus further rate hikes, we expect the 2s/10s curve could flatten as much as 40-50bps by the end of 2018.

If you are interested in the slide-deck from Ellen's presentation, please contact Leigh Talbot at ltalbot@ncallc.com.

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For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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