NEWPERSPECTIVES

Commentary from New Century Advisors
January 2019

NCA MARKET NOTES

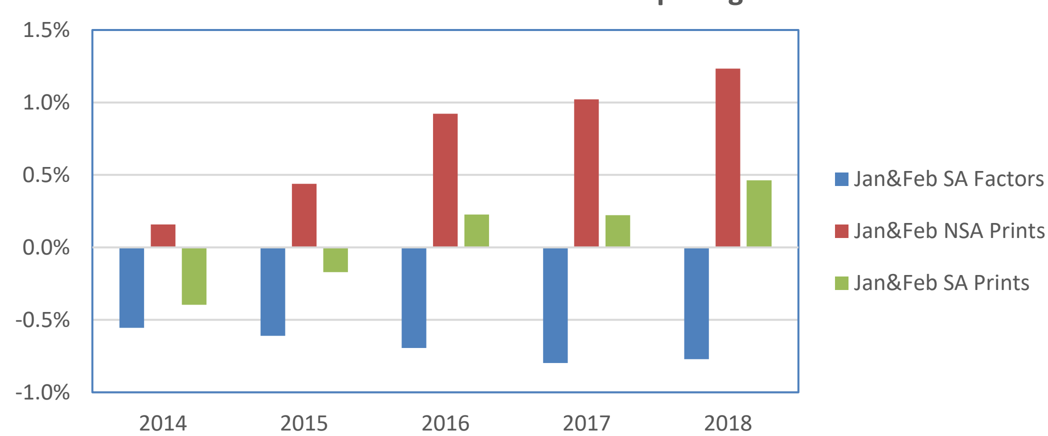
- **Residual Inflation Sensitivity**
- **Oil Services Not Participating in the Production Boom**
- **Looming Fed Pause and Key Investment Themes**

INFLATION CORNER: Residual Inflation Seasonality

While headline YoY CPI has fallen sharply due to the drop in oil prices, Core CPI has been more stable, currently sitting at 2.2%, the ninth consecutive YoY print between 2.1%-2.4%. That stability could be understating some recent strength, however - strength that could show through early in the new year.

In recent years, Core Goods prices have risen quickly at the start of the year, and at an even faster pace than recent trends. Seasonal adjustment factors have shifted higher to capture this trend, but they haven't kept up with the move, such that even the seasonally-adjusted prints have moved steadily higher.

Core Goods - Jan & Feb NSA Prints Outpacing Seasonals



Source: BLS and NCA

The trend has been particularly acute in apparel, where more aggressive holiday discounting has led prices lower in November and December, only to see them quickly rebound higher in the new year.

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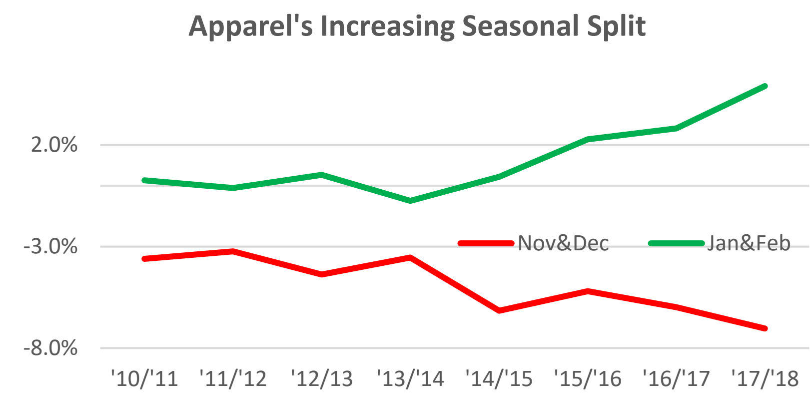


Source: BLS and NCA

As markets analyze the December CPI data later this week, they likely won't appreciate that inflation headwinds have suppressed the recent data – headwinds that have shifted to tailwinds with the turn in the calendar.

COMMODITIES & EQUITIES: Oil Services Not Participating in the Production Boom

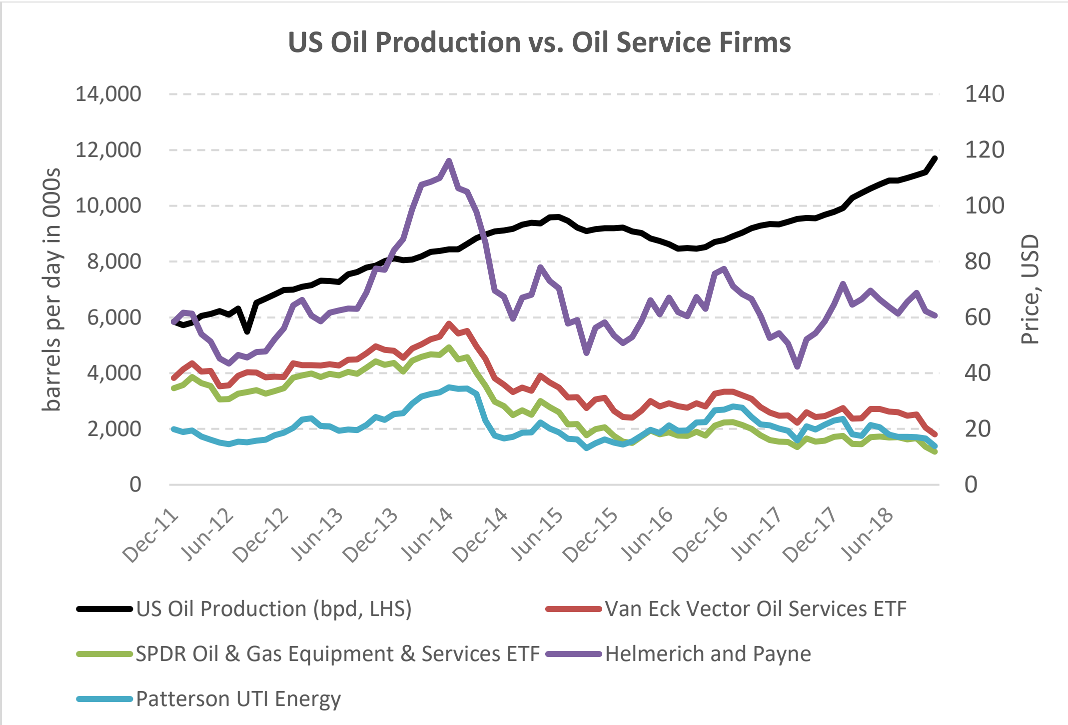
In 2018, the US officially became world's largest oil producer according to US government data (behind Russia and Saudi Arabia).

The story behind the country's growth in production is well known in the investment world: efficient oil fracking production techniques and a receptive high-yield bond market enabled US energy companies to boost production. This narrative should imply a vibrant North American oil services sector.

However, in the chart below, we show the stock graphs for:

- The largest two US publicly-trade North America focused oil services companies by market cap (Helmerich and Payne, and Patterson UTI Energy),
- The VanEck Vectors Oil Services ETF (Ticker: OIH),
- SPDR S&P Oil and Gas Equipment & Services ETF (Ticker: XES); and finally,
- The US Department of Energy US oil production data.

As one can see, despite the rise in production, the equity market has been pricing in an increasing dismal outlook for this sector since 2014. This perhaps reflects an *overcapacity* in oil service focused firms overall in the US.



Source: Bloomberg

Looking ahead, we expect oil production in the US to be sustained at the current production levels, but we think eventually we will witness industry consolidation and corporate restructuring within the US-focused energy services industry.

THEN & NOW: The Looming Fed Pause and Key Investment Themes

The Fed rate hike cycle that started in December 2015 is slowly coming to an end after eight 25bps hikes. A new era in US monetary policy is upon us. That's what the rates markets are telling us at least.

Since November 2018 short-term Fed expectations have been downgraded significantly. As can be seen in the chart on the left, the 1-mo forward OIS rate in 21-mo jumped 100bps between Jan-Nov but declined by almost 75 bps in the last two months. This translates, in Fed Funds Target Rate terms, from two more 25bps hikes in the next two years to the possibility of no move in 2019 (flat part of the red line) and a small cut in 2020, a major dovish shift in market sentiment.

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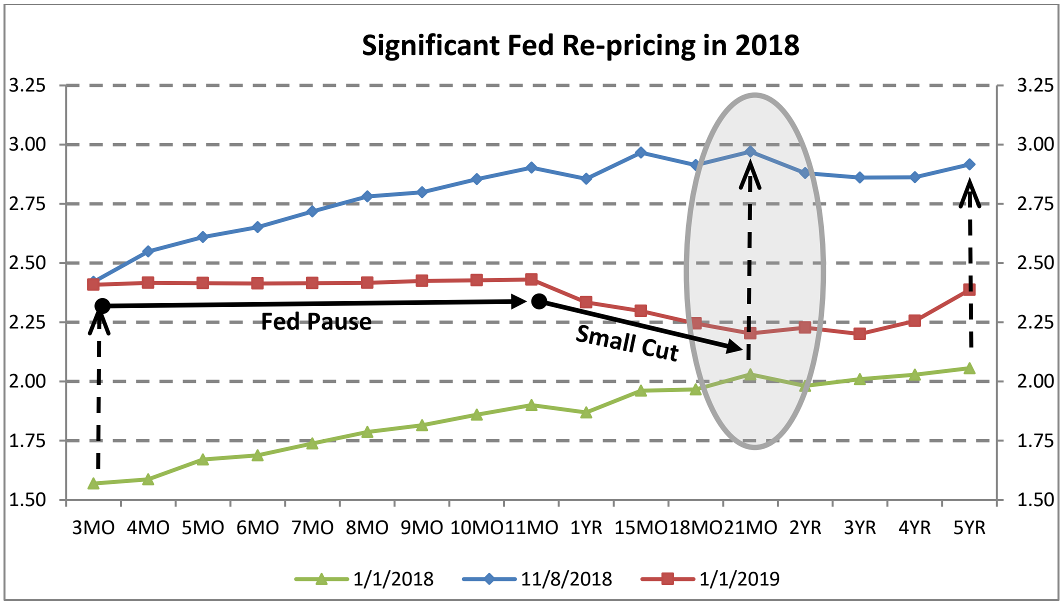

Source: Bloomberg

Without getting into what Fed should do in coming quarters we thought it would be instructive to show how major assets performed the last time Fed ended its rate hike cycle (June 06-June 07) and share our thoughts:

	Latest	1-Yr Before the Fed Pause	Fed Pause
From		6/30/2005	6/30/2006
To		6/30/2006	6/29/2007
WTI	52.2	30.8%	-4.4%
VIX	20.5	1.04	3.15
S&P	2,576	6.6%	18.4%
MSCI EM	5,458	26.6%	27.0%
MSCI EAFE	459	35.5%	45.0%
DXY	96	-4.4%	-3.8%
EMFX	83	-0.4%	3.3%
10-Year UST	2.73	+122	-11
10-30s	31	-23	5
2-10s	16	-31	19
10-yr BEI	1.81	33	-22
Barclays Agg TR	2,048	-0.8%	6.1%
Libor-OIS	39	+3	-1
US IG OAS	148	+1	+3
US HY OAS	445	-47	-28
EM Hard Ccy OAS	405	-79	-37
EM Local Ccy TR	201	3.7%	25%

Source: Bloomberg

- June 2006-June 2007 was generally a good period for global equities, continuation of the trend in 05-06 rally. However, the S&P underperformed the EM and DM ex-US equities large margin. General dollar weakness played a role in the S&P's significant underperformance.
- Spread sectors generally did well during the 06-07 pause with the exception of US investment grade bonds. EM local currency debt returned 25%, outperforming hard currency and US HY debt. Both yield compression and currency appreciation contributed.
- US Treasuries rallied, the yield curve steepened, and 10-Yr breakevens tightened during the pause, all opposite of what happened one year before the pause.

Investment themes we think could perform well, in case the Fed pauses in 2019, are long EM bonds & FX, general USD weakness, flatter US yield curve, long US duration vs. Europe, and long global equities vs. the US.

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

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