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Corporate Cash Alert

Reassessing the Outlook

October 2, 2018

Executive Summary

- Fed highly motivated to keep normalizing monetary policy while economic expansion continues
- Expect another hike in December and two more in 2019, with timing and execution subject to four factors highlighted below
- Continue to maintain below-average portfolio durations

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Since December 2015, the Federal Reserve has:

- Tightened eight times
- Raised the Fed Funds rate by 2%, and
- Shrunk the balance sheet by 6%

It's time to reassess the outlook for corporate cash investors.

Current Environment

Last week's 0.25% Fed Funds rate hike was the third this year and the 8th since December 2015's liftoff from the zero bound. Markets are currently pricing in a roughly 75% chance of another hike in December, but there's much more disagreement on what's to come in 2019.

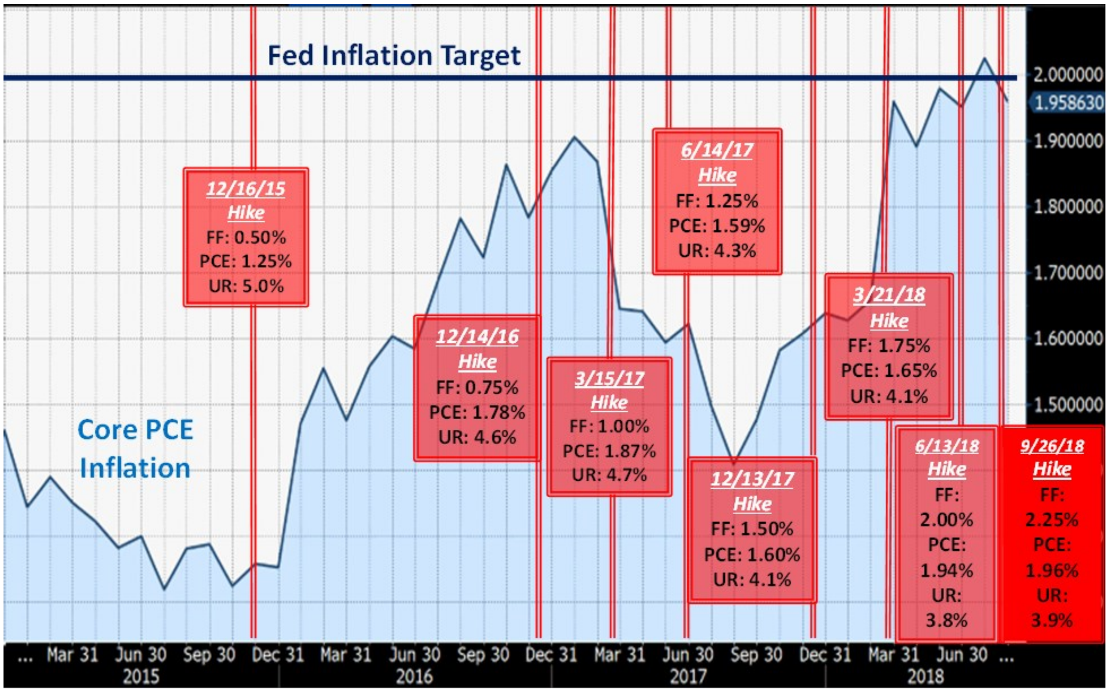
Quite A Move

Since summer 2016, the 1 and 2 year Treasury yields have risen from 0.50% to 2.60%, and 0.60% to 2.80%, respectively. Longtime readers of our Alerts know that we've advised staying short since September 2016. Corporate cash investors can now earn a positive inflation-adjusted return and for the first time in 10 years, the 1 year Treasury yields more than the S&P 500 dividend rate.

What Comes Next?

We've spent much of the past two years highlighting the market's consistent underpricing of the likelihood of rate hikes that ultimately materialized. In our view, investors should focus on the Fed and not market expectations *as the Fed has and continues to be highly motivated to normalize monetary policy during the "safe harbor" window provided by the long-running economic expansion.* This was first evidenced when the Fed first started to tighten in December 2015 despite not yet achieving their dual mandate of "full employment and price stability," as inflation was still well below their stated 2% target.

Fed Hikes vs. Concurrent Economic Data

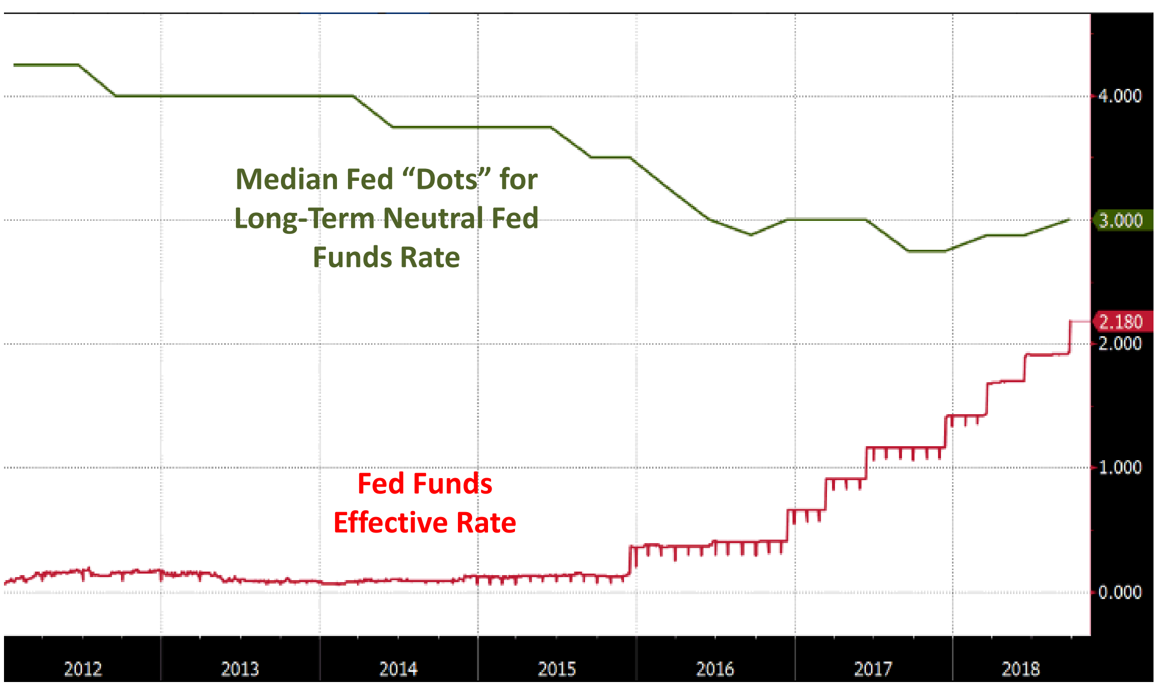


Source: Bloomberg, Treasury Partners (FF = Upper-Bound Fed Funds Rate, UR = Unemployment Rate)

We see no change in economic and financial market conditions that will cause the Fed to shift gears. Now, however, we've identified four key factors to monitor to gauge Fed behavior into 2019

- **Neutral Rate** - The Fed will likely tighten up until they reach their projected "neutral rate" of 3.00-3.25%. We're currently at 2.00-2.25%, so it's possible that they will slow the pace of tightening as they close this gap.

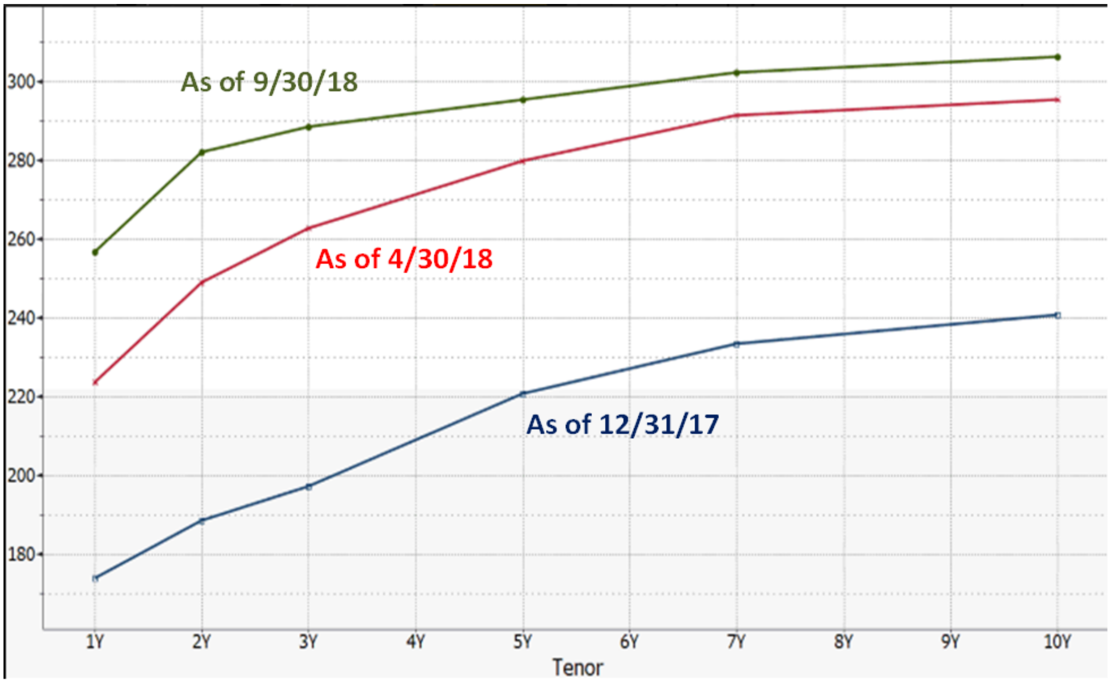
Fed Terminal Rate Projections vs. Effective Fed Funds



Source: Bloomberg

- **Yield Curve Flattening** - Increases in 10 year Treasury yields have failed to keep pace with the steady pace of Fed hikes filtering through to short-end rates, causing the curve to flatten.

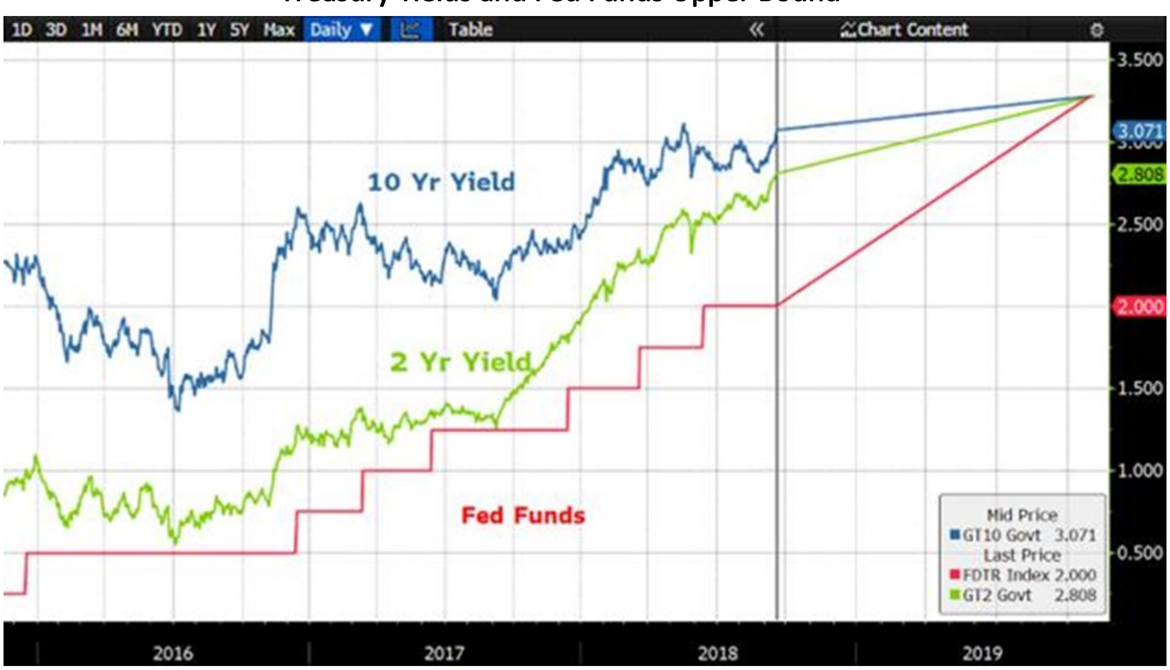
Treasury Yield Curves Over Time



Source: Bloomberg,

If current trends hold, we're moving closer towards a flat curve as the Fed Funds rate, 2 year, and 10 year Treasury yields converge in the roughly 3.00-3.25% area. While an inverted curve isn't our base case, the Fed will potentially seek to prevent this scenario by slowing the pace of tightening in 2019.

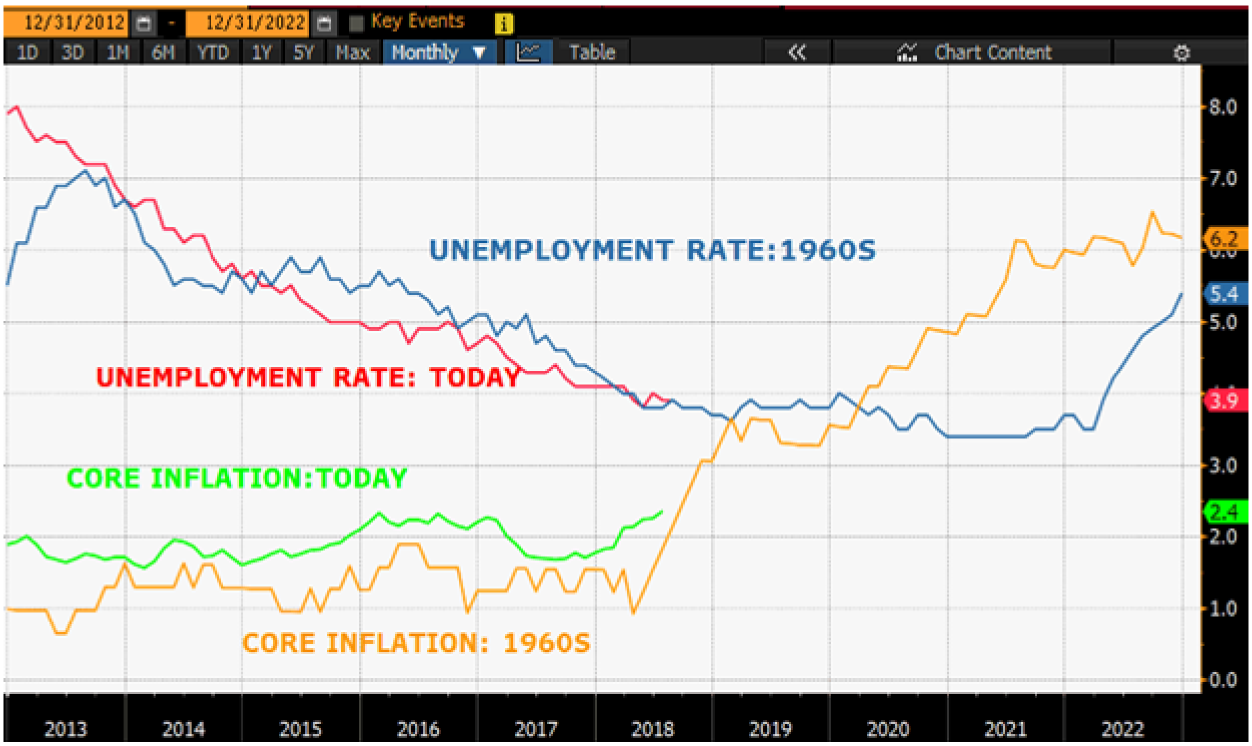
Treasury Yields and Fed Funds Upper Bound



Source: Bloomberg, Treasury Partners

- **Excessive Speculation** - We believe the lingering shadow of the 2008 Financial Crisis has left an awareness within the Fed that the long-running expansion and low-rate regime has fueled potentially "invisible" excessive speculation and imbalances in financial markets. The Fed will likely continue tightening to address this. As a former Fed Governor (Jeremy Stein) once stated, *"While monetary policy may not be quite the right tool for the job, it has one important advantage relative to supervision and regulation; namely that it gets in all of the cracks."*
- **Inflation** - Clearly inflation has remained tame throughout the expansion and provided the Fed with cover to normalize monetary policy. If the rate of inflation turns higher it could steepen the curve and force the Fed into a more aggressive pace of hikes. We note the historical precedent from the 1960s (the last time we experienced similar labor conditions), when several years of low/declining US unemployment sparked inflation higher.

Unemployment Rate vs. Core Inflation: 1960s and Current



Source: Bloomberg, Treasury Partners

What Are We Doing With Client Portfolios?

We expect another rate hike in December and 2 more hikes in 2019, but with the timing and execution subject to how the 4 previously mentioned conditions unfold.

We continue to be patient and are maintaining below-average portfolio durations. For clients with overwhelming liquidity or strong positive cash inflows, we're extending out to 12-24 month maturities. With the current flatness of the curve, corporate cash investors can capture over 90% of the current 10 Year Treasury yield (3.09%) by buying the 2-year Treasury (2.82%). Even better, for those clients who can purchase A-rated corporate debt, 6-12 month A-rated corporate bonds now offer yields ranging from 2.50-2.75%, while 3.00% yields are available in select 18-24 month names and maturities. Credit spreads remain tight with pockets of opportunity.

Although we haven't quite reached the point where it makes sense to extend aggressively, we're getting closer. If this were a baseball game, first pitch is still in the offing, but they're about to start singing the national anthem. Now's the time to finish warming up.