Market Update

"What do you have in investment-grade reds?"

Are There Threats to the Reflation Trade?

By Bruce VonCannon

March 31, 2017

The Voice for Reason

Comments and Views for the Individual Investor

(March 31, 2017)- First quarter 2017 has quietly slipped past us. Despite the violent upheaval in Syria and its rippling effect across the developed world and the irascible behavior of the North Korean regime last month, the global economy still enjoys a cyclical upturn. Leading economic indicators have reached new highs. The US economy still remains in a long recovery since the Global Financial Crisis in 2008.

It remains to be seen if it can continue under the new Trump administration. Markets have discounted the administration's plans to lower taxes. However, the inexplicable inability to pass reform of the Affordable Care Act (ACA) despite Republicans holding a majority on both houses of Congress is a true setback. It threatens the momentum of the so-called "Trump reflation trade," a late 2016 view that Trump could achieve tax reform, dismantle Obamacare, launch initiatives into infrastructure re-building, and close down illegal immigration all in the first 100 days in office.

Meanwhile stability in Europe (in fact, the future of the European Union) hangs in the balance on the outcome of the upcoming French election in April. Japan continues to enjoy many plus factors as its economy continues to benefit from close trade ties with both China and the U.S. China's economy, while slowing to the 6% annual GDP growth range, is still a key engine for the global economy.

The First Quarter 2017 scoreboard....

Take note of these 1st quarter (Year to date) 2017 global economic statistics:

S&P 500	up 5.36%
Nasdaq	up 9.50%
Dow Jones	up 4.49
Euro Stoxx 50	up 5.54%
FTSE 100	up 1.96%

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DAX	up 6.76%
Hang Seng	up 10.28%
CSI 300	up 4.41%

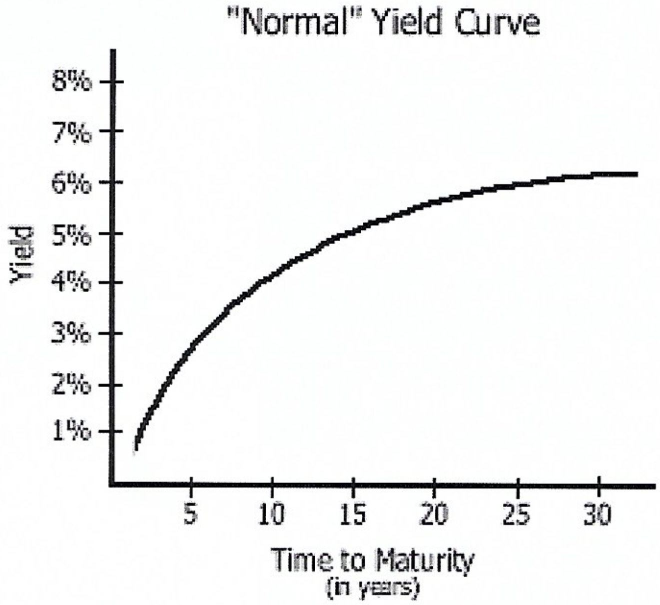
US 3 mo LIBOR	1.14% p.a.
US 10 Yr Treas	2.35% p.a.
US 30 Yr Treas	2.98% p.a.

VIX (the US equity volatility index)	still in the moderate 10-15% range!
Brent Oil	down 6.48%
Natural Gas	down 11.21%
Gold	up 8.99%
Silver	up 15.03%

What is the Yield Curve telling us about current economic vitality?
A common and sometimes mistaken assumption about interest rate and bond yields is that the longer the maturity of the debt instrument, the higher the rate of interest will be. This is only partially true. It will serve you well to understand the importance of the "yield curve" in relation to the bond markets. The yield curve is also referred to as the "term structure of interest rates." It essentially charts the interest rate paid or yield on bonds of various maturities across different contract maturities whether it be 1 month, three months, five years, ten years, or even up to 30 years. One might assume that the rate for investing or borrowing for 3 months will be lower than the rate for 30 years. Under what is called a "normal yield curve" that is correct. However, there are moments in financial history where the yield curve may become a "flat yield curve," meaning that rates are almost identical regardless the tenor of the investment or borrowing. There are also more extreme oddities in the history of the yield curve when the phenomenon of an "inverted yield curve" occurs. An inverted yield curve is normally associated with a severe slowdown in the economy and actually occurred in 2008 on the eve of the Great Financial Crisis. Kindly see attached Illustrations A through C .

Illustration A

The Normal Yield Curve



A "normal yield curve" is typically associated with a healthy economy. The yield on long-term bonds is slightly higher than on short-term bills. A much steeper yield curve than what appears in the illustration would be expected if long-term rates are much higher than short-term rates and would suggest that investors are anticipating rapid economic growth. Such yield curve scenario existed in mid-2005 about three and half years after the 9/11 terrorist attacks when the U.S. economy was starting to expand again.

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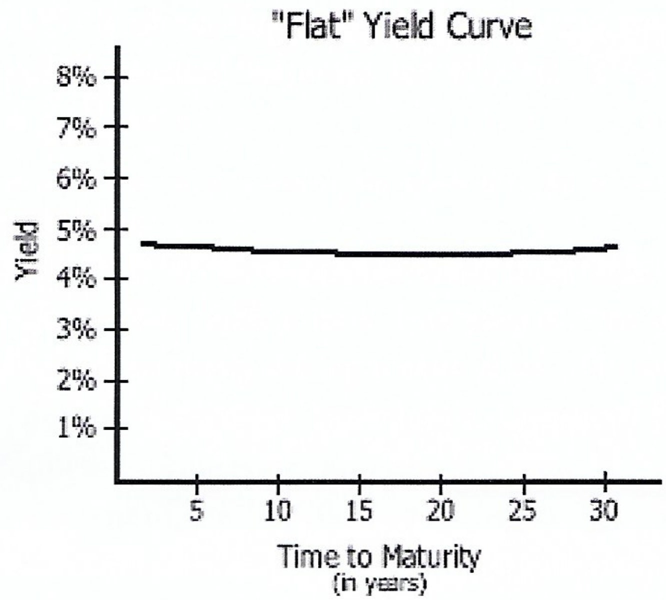
Illustration B

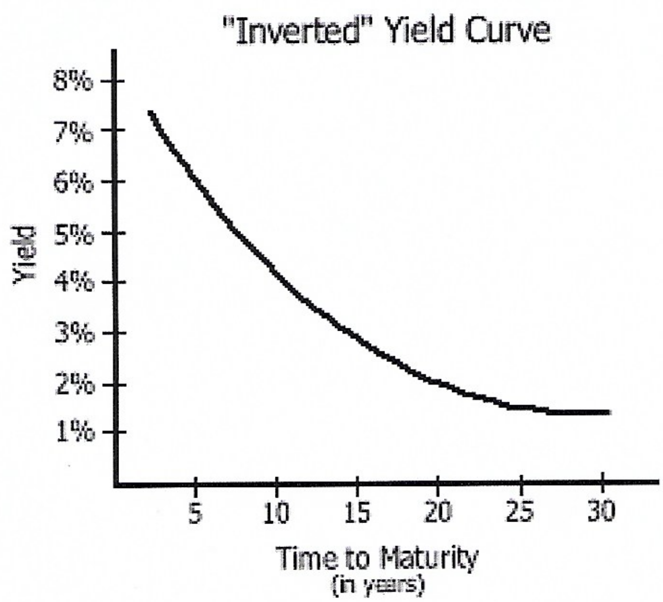
The Flat Yield Curve



A "flat yield curve" normally occurs when short term rates edge higher and longer term rates fall. An example of this occurred in late 2015 when the U.S. Fed raised short-term rates by 0.25%. It pushed up the short term yields on the graph above. However, long-term rates which are determined by the market, actually fell and and implied that rates might remain low in the future.

Illustration C

The Inverted Yield Curve



When short-term rates actually rise above long-term rates, investors would label it an "inverted yield curve" environment. Such scenario usually is a sign of imminent recession as long-term rates are an estimation of the outlook for shorter-term instruments. Falling long-term rates imply that there will be a future decline in short-term rates. It suggests a weakening of the economic environment. Inversion occurred in 2000 and 2006-07 and in both instances were followed by economic recession. In fact, 48% of global yield curves were inverted at the time time of the Global Financial Crisis (GFC) in 2008.

In summary, at the time these lines are being written we are not fully in a "normal yield curve" environment, but we are clearly not in an "invert yield curve" either. The current yield curve is slightly rising. Short term US Dollar interest rates (although on the rise) are historically very low. In the mid-term range just in the past month the bell weather US Dollar 10 year yields for US Treasuries dropped from 2.55% p.a. down into the 2.30% range.

We are currently somewhere in between a "normal yield curve" and a "flat yield curve." Watch for the shifts in he US Dollar yield curve in the coming months as US Congress attempts to make a second pass at healthcare reform and tackles the all-important corporate tax reforms. These actions will have an impact on the yield curve.

Footnotes:

i)The cover cartoon appeared in a 1999 edition of New Yorker Magazine (a Conte Nast publication). Investing in wine has become a popular investment activity during recent years. The industry benchmark, Liv-ex, stands for the London International Vintners Exchange, a global trading platform for fine wines and its Fine Wine 100 Index that tracks the price movement of the 100 most sought-after fine wines.

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