CARRET
Asset Management

October 2018

Carret Credit Insight

How Does the FED Define Neutral?

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Firm AUM

$2.6 Billion

On December 15th of 2015, the day before the FED raised interest rates for the first time in this tightening cycle, inflation, as measured by the Core Personal Consumption Expenditures (or PCE, the FED's preferred inflation measure) stood at 1.3% and the effective Fed Funds Rate was 0.15%. Accordingly, the Real Fed Funds Rate (Fed Funds minus Core PCE) registered -1.15%, implying a negative real rate. A negative real rate simply means the FED was trying to "juice" the economy. Financial institutions (those with access to the FED window), were able to borrow below the rate of inflation. Imagine borrowing at 0% and investing at a rate above that! Market pundits would argue that a negative Real Fed Funds Rate pushes investors into risk-assets (we agree). That is exactly what the FED was encouraging and exactly how investors reacted, albeit slowly.

Fast forward to today. The effective Fed Funds Rate is 2.18% and inflation (Core PCE) is 2.0%, so the Real Fed Funds Rate is now +.18%. The real rate generally indicates whether the FED is being accommodative – helping to grow the economy, or being restrictive – trying to slow the economy. When the real rate is +/-0.25% of the inflation rate, the FED is in the neutral zone. As inflation rises, the FED increases rates to slow the economy. For the past 10 years, we have been in the "accommodative" zone. **When the FED is at a "neutral" monetary policy stance, this simply means the FED is not trying to grow or slow the economy.** We believe FED officials would define "neutral" the same way.

At the FED's September meeting, they removed the long established word "accommodative" from the policy statement – "monetary policy remains accommodative". The simple omission of a word implies that the FED recognizes that we have reached the neutral zone. In fact, New York Fed President Williams said, "the Federal Reserve has attained its dual mandate objectives of maximum employment and price stability about as well as it ever has". St. Louis Fed President Bullard noted "I don't think this is a situation where we need to get a lot higher with the policy rate in order to contain inflation," adding "We're good where we are, from here on, we'll react to the data." These statements indicate that going forward, the FED will be truly "data dependent" as they seek to guide the economy in for a soft landing.

Key Interest Rates	9.30.18	12.31.17	12.31.16
Prime Rate	5.25%	4.50%	3.75%
Fed Funds Rate	2.00% – 2.25%	1.25% – 1.50%	0.50% – 0.75%
3 Month U.S. T-Bill	2.19%	1.39%	0.50%
5 Yr U.S. Treasury Note	2.95%	2.21%	1.92%
10 Yr U.S. Treasury Bond	3.05%	2.41%	2.44%
10 Yr AAA Municipal Bond	2.60%	1.99%	2.33%
10 Yr A Corporate Bond	4.08%	3.25%	3.49%

Source: Bloomberg, Wall Street Journal, Reuters, Municipal Market Data (MMD), FactSet

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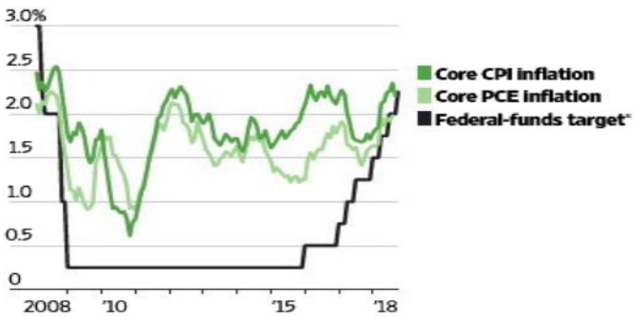
Rates Get Real

Note: Core inflation excludes food and energy.
** Top of federal-funds target range*



Source: The Wall Street Journal, Federal Reserve, Thomson Reuters

FED Actions: At the September FED meeting, the committee voted unanimously to hike the Fed Funds Rate to 2.00% - 2.25%, its eighth rate increase of the cycle. This is the first time the target has been above 2.00% since April of 2008 – 10+ years. The Committee also announced an increase in the balance sheet roll-off. As telegraphed, they will allow $50 billion per month to roll-off (mature) - $30 billion in U.S. Treasuries and $20 billion in Mortgage Backed Securities (MBS). According to the original plan, this is expected to be the maximum roll-off going forward.

Inflation / Economic Highlights: The August unemployment report registered 3.8% and the September reading hit 3.7%, the lowest rate since December of 1969. Average hourly earnings increased 2.9% in August and 2.8% in September. The August Personal Consumption Expenditures (PCE) inflation report headline rate fell from 2.3% YoY to 2.2% and core PCE held at 2.0% for a fourth straight month. Headline September Consumer Price Index (CPI) increased 2.3% YoY, slower that August's 2.7% YoY rise. September Core CPI increase 2.2% YoY. The December 19th FED meeting, being mid-month, will provide two more CPI/PCE reports for the FED to digest prior to making any policy announcements. We continue to focus on wage growth as the key to future inflation trends. The FED has now shrunk its balance sheet by 6% since it has switched from Quantitative Easing to Quantitative Tightening.

FED's Economic Outlook: In the Summary of Economic Projections (SEP), 12 of 16 participants expect to hike again in December to bring the range to 2.25% - 2.50%. Median projections for 2019 and 2020 remained unchanged at 3.00% - 3.25% and 3.25% - 3.50%, respectively, indicating the FED is expecting three hikes in 2019 and one in 2020. GDP growth is projected to be stronger in 2018 and 2019 than previously projected with growth of 3.1% in 2018 (up from 2.8%) and 2.5% in 2019 (up from 2.4%). The SEP also indicated a forecast of 2018 unemployment of 3.7% and left forecasts for near-term PCE unchanged at 2.0%.

Bottom Line: It took 10 years – after rescuing the economy/markets from the 2008 financial crisis, the FED has reached the "neutral" zone. The FED has removed the "accommodation" language from its policy statement. While we believe the FED would like to have rates higher when we inevitably enter the next recession, we believe the FED will continue to move slowly and truly be data dependent moving forward. As we enter the 4th quarter, we see continued economic growth, slowly rising inflation (wage driven), and in turn, interest rates that will creep higher (our 10 Yr U.S. Treasury forecast remains 3.00% - 3.25% for 2018). The one wild card… economists, the FED included, are struggling to determine (positively or negatively), how the trade and tariff negotiations will impact future data. At this point in the economic cycle, we see risk/reward favoring short duration and high quality fixed income securities.

Taxable Bond Strategy

The investment grade (IG) corporate bond market has been front and center in the media throughout the quarter. Headline after headline warns of the increasing amount of BBB rated bonds in the market and the "impending doom" that is coming. While it is true that BBB bonds now make up more than 40% of all U.S. corporate bonds versus 25% ten years ago, we believe that it is worth an extra look as to why this has occurred.

The primary driver is the record low interest rates that the FED manufactured for the past nine years that were intended to spur borrowing. The FED was successful – the size of the corporate bond market sits at record levels today. BBB rated companies especially, took advantage of the opportunity to pay record low rates on their debt – this has enabled corporate America to lower their cost of capital. This increased debt on corporate balance sheets leads to inflated debt coverage ratios (debt to EBITDA has risen over the past ten years for BBB rated companies). The weakening of these ratios could potentially lead to credit rating downgrades in an economic slowdown.

Lower-Quality Corporate Bonds

The lowest investment-grade rating category makes up more than 40% of all U.S. corporate bonds for the first time.

Source: ICE Data Services

Let's dig a little deeper past the headlines. Rating agencies seem to be reluctant to upgrade during this strong economic environment. This makes logical sense as they came under fire during the last recession – they are remaining cautious. Additionally, they may be waiting for the next downturn to see how businesses "weather the storm" before they issue upgraded ratings - they want to see how Corporate America performs through a full credit cycle. A potent example comes from Citigroup. Citigroup was AA rated when entering the crisis ten years ago. Today, it is rated BBB. While the equity market cap is still below where it was in 2007, we could make the argument that the bank poses less credit risk than before the crisis (thanks to the government regulations designed to shore up the financial system).

The measure of debt to EBITDA is a commonly quoted measure of leverage; however, as the economy continues to grow, a focus on trailing EBITDA may overstate credit risk. Other credit metrics include the interest coverage ratio. Based on this metric, the bond market is rather healthy – thanks to a combination of a decade of low rates and increasing earnings. Equity market capitalizations are at record levels – the equity markets are the first layer of defense for the bond market. Additionally, corporate cash is sitting at record levels – another positive sign for the bond market. While increasing amounts of BBB rated bonds can be a worry to some, further investigation demonstrations that value can be found and capitalized upon - it is as important as ever to have a focused credit research process and "know what you own".

As of September 30th, we remain over-weight corporate bonds with an emphasis on A and BBB credits. During the quarter, corporate yields rose across the curve, albeit rising less than comparable Treasuries. Relative to 5 Yr Treasuries, corporate spreads tightened during the quarter with A rated spreads decreasing from +81 bp to +65 bp and BBB rated spreads moving from +119 bp to +104 bp. The 3rd quarter saw additional flattening of the yield curve with the 2-10 Yr spread falling to +25bp at quarter end. Given our current market views, we are focused on keeping interest rate risk in the 3 - 4 Yr duration range and average portfolio credit quality above A-.

Our ***Taxable Bond Strategy*** is focused on high quality IG, intermediate maturity bonds. Portfolios are structured to generate an average yield to maturity (YTM) of 3.40% with a duration of 3.0, and an average credit rating of A-.

Opportunity & Leverage Opportunity Strategies

During the first nine months of 2018, high yield (HY) bonds have returned more than IG bonds as spreads have remained tight, a result of the accelerating economic and earnings growth. We have written previously that low yielding Treasuries were the higher risk segment of the bond market and 2018 is proving that point. With yields at record lows over the past few years, high quality bonds were not "paying" enough to offset the rise in interest rates experienced thus far in 2018. HY bonds entered 2018 yielding 5.88%, providing a meaningful enough cushion against the rate rise to provide positive returns thus far in 2018. We are fully participating with this benefit, generating positive total returns.

As we enter the 4th quarter, HY spreads, the yield differential between U.S. Treasuries and high yield bond yields, has fallen to a decade low. HY bond yields fell during the quarter from 6.49% to 6.24% at quarter end as measured by the Barclays U.S. HY Index. Spreads, as measured by the Barclays U.S. HY Index vs. the 5 Yr Treasury, tightened an additional +46 bp during the 3rd quarter, decreasing to +329 bp versus +375 at the start of the year. Spreads remain below the 20 year historical average of approximately +580bp. Once again, we like to get paid for taking risk and as spreads have collapsed, we have opted for higher quality bonds (even using some IG bonds in our Opportunity Strategies) coupled with shorter maturities. It is always difficult to identify the catalyst that creates volatility, but one thing is certain – volatility will arise again. When it does, spreads will widen and we will be ready.

At quarter end, our ***Opportunity Strategy***, on average, had a YTM of 5.17%, a duration of 3.2, and an average credit rating of BB. Our ***Leveraged Opportunity Strategy***, on average, had a YTM of 5.10%, a duration of 2.8, and an average credit rating of BB. We remain unleveraged at quarter end. In the current market environment, we remain defensively positioned as we wait for volatility to increase in the quarters ahead.

Enhanced Cash Strategy

While the 2 - 10 Yr spread of the U.S. Treasury curve remained frustratingly flat during the 3rd quarter, the steepest part of the curve is found inside of one year. We continued to take advantage of that trend, selectively reinvesting maturing and called bonds at compelling yields. Corporate bonds continued to add value in the short-end, providing a notable, attractive spread above Treasuries.

We also patiently upgraded portfolio quality, from an "A" to an "A+" average rating. While on the margin this is certainly not a dramatic move, it did serve to not only improve the quality of the portfolio, but also the liquidity, without giving up meaningful yield.

Our ***Enhanced Cash Strategy*** invests in a tactful mix of liquid, ultra-short duration Corporate, U.S. Agency, and U.S. Treasury bonds, adding tax-advantaged Municipal bonds to enhance overall returns when appropriate. At quarter's end, our portfolios averaged a 2.40% YTM and a 2.53%* Taxable Equivalent Yield (TEY), with an average credit rating of A+, and just a 4-month duration.

Municipal Bond Strategy

As the summer draws to a close, the tide is beginning to turn as broad interest rates have started to creep higher. Municipal bond yields have moved higher as well – although not in perfect lock-step fashion. The 10 year US Treasury Bond yield increased 20 basis points during the 3rd quarter while 10 year AAA Municipal Bond yield increased by 15 basis points. Municipal bond fundamentals along with supply and demand dynamics has provided some cushion against the rising interest rate push.

As we have outlined in the past few commentaries, market supply continues to be soft. According to a recent Reuters study, year-to-date volume stands at $293 billion, with 3rd quarter levels down roughly 9%. We do not expect to see a material pick up in supply levels for the balance of 2018 as many municipalities remain cautious about adding to debt levels. Austerity, at this point, is a good thing for the municipal landscape. The 30-day visible supply figures ended the 3rd quarter at $8 billion which is a bit lower than the 200 day moving average. During the quarter, visible supply posted two notable sub-$5 billion lows. These lows were the 3rd and 4th softest prints of the year.

The forward-looking redemption (demand) trend looks to be somewhat subdued for the remainder of 2018. Redemptions are only part of the demand-side of the equation. The other key driver was positive flows into municipal bond funds and Separately Managed Accounts (SMAs). Banks and insurance companies are still net-buyers even with lower corporate tax rates. Individual investors continue to fill the demand gap as interest rates reach compelling levels and tax reform 2018 takes hold.

AAA 5 Year Muni-to-Treasury Ratio

Holding lower than historic averages

Source: Bloomberg

The muni-to-treasury ratio (MOT) helps us determine "value" in the marketplace and impacts our yield curve decisions. A higher ratio points to good value as municipal yields approach parity with U.S. Treasury Bond yields on an absolute basis. A lower ratio, on the other hand, translates to potentially overvalued markets. The MOT ratio of 5 year municipal bonds to comparable U.S. Treasuries, dipped below 70% in late July, before reversing course in August and September. The ratio ended the quarter at 75%, moving from overvalued to fairly valued. The ratio has experienced wide swings throughout the year driven by tax reform, supply and demand, and yield volatility in US Treasuries. Interestingly, the ratio was only 1% higher at the beginning of the year (76%). The MOT ratio peaked at 81% in early April on an uptick in supply and declining US Treasury Bond yields.

During the quarter, market yields (5 Year AAA) trended higher as the yield curve flattened. 5 Year AAA yields rose by 23 basis points in the quarter while 10 Year AAA yields rose by only 15 basis points. Municipal bond yields remain compelling with credits in our preferred segments: 5 Year AAA yielding 2.20%, 5 Year AA yielding 2.27%, and 5 Year A yielding 2.58%. Crossover buyers, in mid-to-high tax brackets, can see tax-equivalent municipal spreads versus comparable corporate bonds at over 90 basis points. The municipal yield curve (2 year bonds vs. 10 year bonds) continues to flatten in sympathy with the US Treasury Bond curve. The 2-to-10 year spread closed the quarter at 64 basis points (down from 82 basis points on June 30th).

From the credit perspective, a recent Moodys report cited an improving trend in net pension liabilities at the state level. The report highlights the capacity to service pension liabilities due to improving tax revenues, economic expansion, and pension reform measures. In additional credit news, S&P commented on California's strong credit quality noting a "dynamic economy", strong budgetary performance, and revenue growth. In a confirmation of the quality of the municipal bond market, 81% of the 200 tax-secured credits that S&P follows carry a AA or AAA rating.

Our high-quality, intermediate-duration bias continues to add value from a risk reward perspective. We will continue to opportunistically add value through practical trading and reinvestment of redeemed bonds. Additionally, we continue to find value in diversification across sectors, ratings, and maturities. Our municipal bond portfolios are state-specific or state-focused where appropriate (General Market in approach otherwise). Essential service revenue bonds and high quality general obligation bonds are providing sound value in today's landscape.

Our ***Municipal Bond Strategy*** is focused on high quality IG, intermediate maturity bonds. Portfolios are structured to generate an average YTM of 2.48% and a TEY of 4.80%* with a duration to maturity of 3.9 years, and an average credit rating of AA.

** Assumes 48.3% Combined Effective Tax Bracket*

Separately Managed Account Strategies:

Municipal: Carret's Municipal Bond Strategy is designed to maximize tax efficiency through opportunistic portfolio management while preserving principal through practical portfolio structuring and fundamental credit analysis. We actively manage investment grade portfolios with a diversified blend of issuers, sectors, and maturities aimed at delivering consistent, risk-adjusted returns with an emphasis on tax-efficient cash flows.

Taxable: Carret's Taxable Bond Strategy is designed to achieve above average total returns with an emphasis on preservation of capital and consistent cash flow. We utilize investment-grade fixed income securities and shift across bond sectors based on changing market conditions. Our fundamental credit research and active portfolio management process has provided consistent and attractive risk-adjusted returns.

Opportunity: Carret's Fixed Income Opportunity Strategy is designed to generate a high level of current income with a secondary focus on long term capital appreciation. We utilize higher yielding fixed income securities and shift among various types of fixed income securities based on changing market conditions. We actively manage risk and reward and can respond quickly to market movements. We utilize interest rate hedges to limit duration risk.

Leveraged Opportunity: Carret's Fixed Income Leveraged Opportunity Strategy is designed to utilize low cost leverage and favorably negotiated release rates to potentially enhance our existing Opportunity Strategy returns. We actively manage leverage to augment opportunities within the high yield and investment-grade sectors of the fixed income market.

Enhanced Cash: Carret's Enhanced Cash Strategy is designed to provide excess returns above those offered by cash equivalents, while focusing on capital preservation and liquidity. The strategy invests in ultra-short duration investment grade bonds. Our custom approach opportunistically utilizes tax-advantaged municipal bonds to enhance overall after-tax returns when appropriate.

Mutual Fund Strategy:

Kansas Tax-Exempt: The American Independence Kansas Tax-Exempt Bond Fund's objective is to preserve capital while producing current income that is exempt from both Federal and Kansas state taxes. The Fund seeks to generate monthly income and principally invests in investment-grade bonds of intermediate maturity.