

Market Update



Economic News

February 26, 2020

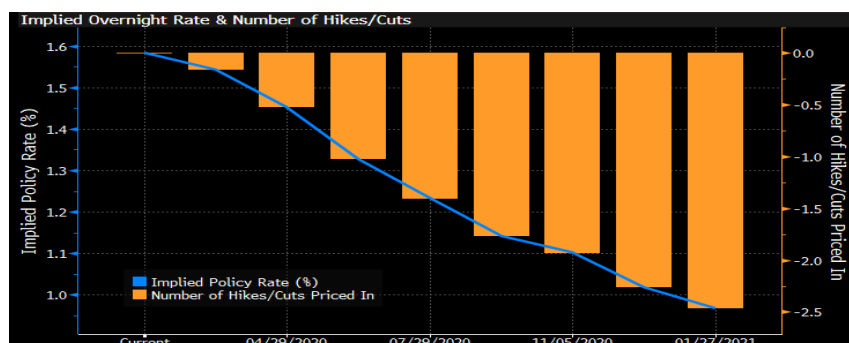
The coronavirus risk-off move continued yesterday and with new cases springing up the question is starting to be raised as to when to move from a containment strategy to one of mitigation? There's still a lot of unknowns about the virus and its lethality so the strategy switch will take more time, but if cases continue to spring up in locations far from its China origins maintaining a containment strategy, with all its heavy-handed costs, will start to look like folly. We are not there yet, but if it turns out that treatment options can prove effective, and cost-efficient, the shift to mitigation becomes a viable alternative. As long as containment, however, remains the preferred course of action the Fed will likely be forced to cut sooner as the economic impact climbs.



We wrote last Friday that the Treasury rally has some helpful forces from other quarters besides the flight-to-safety trade. Dollar strength and commodity price declines (especially oil), are factors that are furthering the rally, and likely will sustain much of the move when peak-virus concerns fade. Today, we want to list a couple more factors at play in helping Treasury bids. The first of these is the waning inflation expectations as expressed in the TIPs market. Treasury Inflation Protected securities (TIPs) are U.S. Treasury securities with a small nominal coupon but with additional payments tied to the CPI. By assessing the prices paid for these TIP securities one can deduce investor expectations for inflation over the life of the security. The graph below tracks both the 5- and 10-year inflation breakevens. As inflation projections go, so go yields.



Another factor is the increasing belief, no doubt virus-inspired, that the Fed will be forced to cut rates faster than expected going into 2020. The graph below tracks the most recent rate-cutting outlook. Projecting a 25bps rate cut by June and another 35bps by year-end are factors working to keep a bid in Treasuries as ultra-low short-end market yields start to force the Fed's hand. Frankly, we are starting to think the first rate cut could well happen next month if the virus remains uncontained.

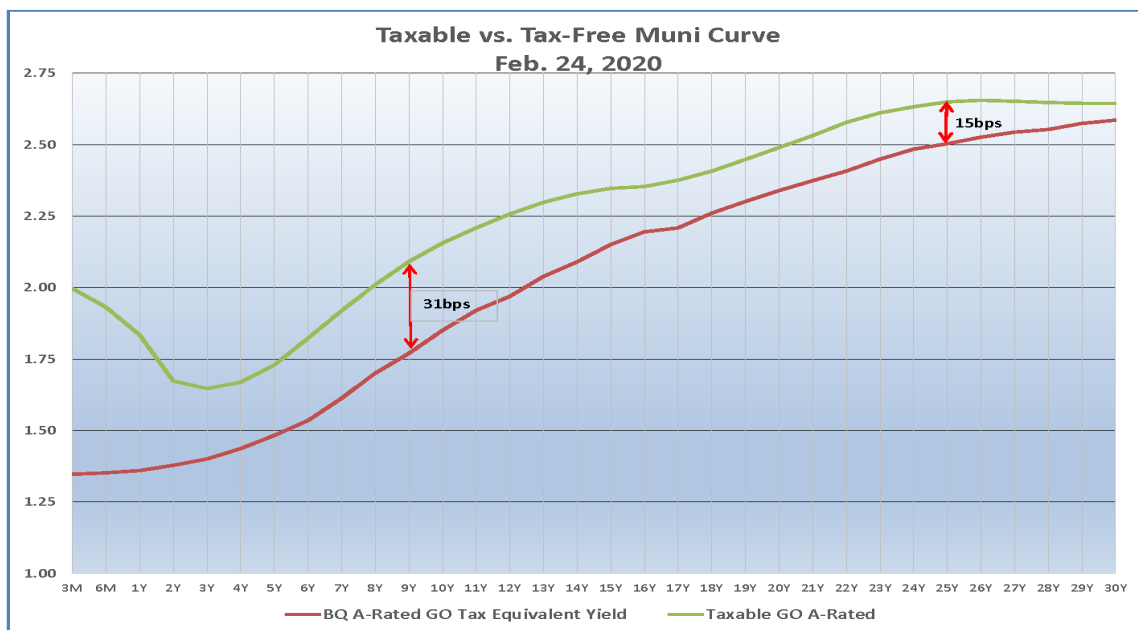


👍 Looking at the Taxable versus Tax-Free Muni Yield Curve

A couple weeks ago we discussed the relative richness in tax-free muni's as maturities roll inside of ten years. This price pattern is due to individual/retail buyers congregating in that part of the curve while also having tax rates upwards of 35% versus the corporate rate of 21%. Given the SALT cap from tax reform, individual investors in higher tax states have moved into muni's as one of the few remaining tax-advantaged investments and that has forced prices up.

The graph below looks at the situation from a slightly different angle: taxable muni versus tax-free. As shown, the taxable muni yields are higher across-the-curve but the real advantage is when maturities move inside of ten years. As shown, taxable muni's at nine-years have 31bps of yield advantage to a comparable tax-free maturity because of the aforementioned influence in that part of the tax-free curve from retail investors. A possible swap is to sell your tax-free muni bonds as they roll inside 10-years—with likely sizeable gains—and reinvest in taxable muni's to retain as much yield as possible, especially if extending duration on the reinvestment is a limiting constraint. If not, the yield advantage of the taxable muni further out the curve becomes less attractive versus a tax-free.

If your portfolio has tax-free municipals with maturities inside 8-10 years, a similar swap could be beneficial. Your Center-State representative can run an analysis and determine if a muni swap could enhance earnings while maintaining yields.



📊 Agency Indications— FNMA/FHLMC Callable

Maturity (yrs)	2 Year	3 Year	4 Year	5 Year	10 Year	15 Year
0.25	1.53	1.65	1.74	1.83	2.23	2.50
0.50	1.44	1.56	1.66	1.76	2.14	2.42
1.00	1.29	1.42	1.53	1.64	2.02	2.30
2.00	-	1.20	1.33	1.43	1.90	2.09
3.00	-	-	-	-	1.76	1.98
4.00	-	-	-	-	1.65	1.90
5.00	-	-	-	-	1.54	1.83
10.00	-	-	-	-	-	NA