I. Equity Markets

A. Sweeping Overhaul of the Nation’s Tax Code Signed into Law.

- With the solid 3Q 2017 earnings reporting season largely concluded, the forward momentum in the economy continuing, the December rate hike by the Federal Reserve fully discounted, and still no signs of building inflation pressures, the markets spent December focused on the likelihood of comprehensive tax reform. Over the past two weeks the focus honed in on the details of the most significant changes to the U.S. tax code in more than three decades. Stock prices rose during December as most investors expect the tax overhaul to add to the already good stock market fundamentals of an expanding economy, solid earnings growth, low inflation and bond yields, and a gradualist Federal Reserve.

- We cautioned in the last couple ISS’s that the main concern regarding the tax proposal was the actual composition of the package. We pointed out that investors were looking for corporate tax reform with a lower statutory tax rate on earnings which would improve the attractiveness of the United States as a locale to do business on the global stage and allow U.S. multinationals to be more competitive with their global competitors. Additionally, a move to a territorial tax system which taxes earnings only where they are earned -- including a one-time, low repatriation tax rate on earnings currently trapped overseas which should bring some of the capital back to the U.S. where it can be spend on jobs, business capital spending projects, dividends, and share repurchases -- would be well received.
• We also stated that the primary risk in the tax proposal would be a major stimulus package which included a large tax cut for high income taxpayers, resulting in much larger budget deficits. An unwieldy increase in the national debt would likely place further upward pressure on Treasury yields at a time when the Federal Reserve is shrinking the size of its investment portfolio of Treasury securities and agency and mortgage-back securities.

• Additionally, a major stimulus package could also pull growth forward, boost wages, flame inflationary pressures, and move the Federal Reserve to leave the term “gradual” behind and more aggressively raise interest rates, beginning the tightening phase which will eventually lead to the next recession. The bottom line was that the larger the tax cuts turned out to be and the larger the resulting budget deficits turned out to be, the more likely it was that the tax proposal would hasten the end of the current business expansion.

• Well, what is our take on the tax package that was just passed into law? We are very encouraged by the permanent corporate tax reform and believe the temporary changes to the individual tax code will provide a moderate boost to the economy’s growth rate this year and next, but has the potential to either sharply boost the national debt if they are extended past 2025, or result in a significant tax boost in 2026 if the tax cuts are not extended. It seems that 2025 is far enough in the future that we should not worry about it today.

• The U.S. economy definitely needed two things for healthier growth in the long run. First, was a lower, more globally competitive corporate tax rate. Got it, with the drop in the top U.S. corporate tax rate of 35% -- the highest in the developed world -- to 21%! The second was a territorial tax system which would free up the movement of capital to the U.S. Got it, along with a onetime 15.5% repatriation tax rate on cash currently held overseas! On these two points alone, the tax package is a huge win for the U.S. economy and U.S. businesses, particularly on a longer term basis.

• In the near term, the immediate expensing of capital spending outlays for the next five years, rather than depreciating major purchases over time, is an underappreciated reform which allows companies to write off capital investments in the year in which they are made. We believe that in the near term this is the most economically interesting part of the tax package as it will stimulate business capital spending on equipment, providing a near term boost to aggregate demand while increasing the economy’s productive capacity.

• The total package of corporate tax reform reduces the cost of capital to U.S. companies, which should raise business investment and spur a capital inflow to the United States. More investment means more hiring and more productive workers, which are the ingredients for real wage increases over time. This part of the tax package is a return to the economics of growth rather than an attempt to redistribute income through higher taxes on higher incomes and more subsidies which lower the incentive to work.

• The individual portion of the tax package is a mixed bag of lower personal tax rates which expire after 2025, a cap on deductions for property, state and local income and sales taxes, a lower cap on the mortgage interest deduction, and a sizeable, yet complicated tax rate cut for business owners who declare income on personal returns, known as pass-throughs. The one nod toward simplification is a near doubling of the standard deduction which could reduce the current number of 50 million tax filers who itemize their deductions by 25 million or more.
It appears the net economic impact from the tax package on households is marginally positive, with no significant windfalls for most taxpayers as the reduction in the tax rates are moderate and the caps on deductions offset a portion of the rate reductions, particularly for taxpayers in expensive real estate, high state and local tax states. Households that receive pass-through income will receive a significant reduction in their federal tax burden, however.

As we look at the corporate and individual sides of the tax package together, we look for a moderate amount of near term stimulus, but not an overwhelming push to faster growth. We expect the economy’s growth rate to rise to the 2.5% to 3% range over the next two years compared to the 2% to 2.5% pace of growth over the course of the current business expansion, and would not be surprised by the economy’s quarterly growth rate exceeding 3% for a quarter or two. This represents a moderate amount of growth being pulled forward, but not a significant amount.

There are no federal budget forecasts from the Congressional Budget Office that incorporate the tax package available as of now. However, it is safe to say that the budget deficits for FY 2018 and FY 2019 will exceed the $549 billion deficit recorded in FY 2017, with some preliminary estimates pointing to the annual budget deficit approaching $1 trillion again in FY 2019. In summary, the corporate side of the tax package is a major, long term positive for the economy and the individual side is likely to pull a moderate amount of growth forward and supports the position we took in the January 3, 2017 ISS that the era of ultra-low interest rates and bond yields is in the rear view mirror.

The most optimistic outcome of the new tax legislation in the near term is that the decline in the cost of capital for businesses through the cuts in the corporate and pass-through tax rates and the immediate expensing of capital spending outlays could provide this expansion with a second wind. While demographics have played a major role in the slow pace of the current business expansion, sluggish capital investment over the past eight and a half years has also played a role and has held back productivity advances.

A lower cost of capital and the ongoing efforts of the Trump administration to roll back onerous regulations are supply side incentives meant to increase the economy’s productive capacity. These incentives could foster an environment where a slightly faster pace of growth is not necessarily inflationary despite the nation’s low unemployment rate. This type of boost to the economy at a time that the Federal Reserve is raising interest rates could help prolong the economic expansion, allowing it to challenge the record 120 month expansion under President Clinton.

For the full month of December, large company stocks led the way with the S&P 500 and the DJIA gaining 1.0% and 1.8%, respectively. The technology-heavy NASDAQ Composite added 0.4% last month, while the Russell 2000 Index of small company stocks declined -0.6%, lowering its gain on the year to 13.1%. The NASDAQ Composite was the winner on the year, soaring 28.2%, with the S&P 500 and the DJIA posting large gains of 19.4% and 25.1%, respectively. Since the presidential election on November 8 2016, the major market measures are higher by a remarkable 25% to 34.8%, with the DJIA leading the way.
B. **Optimistic Federal Reserve Raised Rates in December.**

- As widely expected, the Federal Reserve raised the target range for the federal funds rate another quarter point to 1.25% to 1.5% at the December 12-13 FOMC meeting. In what was likely her last scheduled press conference as the central bank chief, Chair Janet Yellen summed up the reason for the increase in the news conference following the policy meeting by stating, “At the moment the U.S. economy is performing well.” That marked the third rate hike this year and the central bank signaled it would stay on a similar path in 2018 amid a leadership transition.

- With investors expecting the rate hike last month, the big issue was the guidance the Federal Reserve would provide on future rate hikes, in light of the modest wage gains and low inflation, but with a firming in the economy’s growth rate, solid job growth, and the growing likelihood of congressional Republicans reaching agreement on tax reform/cuts. The FOMC committee members indicated three quarter point rate hikes this year, as they had in back in June, and two additional rate hikes in both 2019 and 2020.

- The committee members did nudge their forecasts for economic growth higher for this year to 2.5% from 2.1% and to 2.3% from 2.1% over the 2017 to 2020 timeframe, largely due to the fiscal stimulus expected from Washington. The Federal Reserve maintained its outlook for a very gradual rise in inflation to its 2% target by 2019, the same as it had expected in September.

- It looks to us that with the roughly 2.5% forward momentum in the economy, the near term repair, rebuild, and restock stimulus the economy is receiving from the hurricanes with another round of natural disaster stimulus coming this year from the California wildfires, and the moderate amount of stimulus from the recently passed GOP tax proposal, the Federal Reserve is likely to hike rates three times this year and the current business expansion should be able to “tolerate” it.

- It seems that both the economy and the Federal Reserve are becoming more comfortable with the central bank raising interest rates. Consider that the Federal Reserve expected to raise rates four times in both 2015 and 2016, but eventually raised rates only once each year, both times at the December FOMC meeting. 2017 was the first year the Federal Reserve was able to raise rates as expected since it started to plan for interest rate increases in 2015.

- The economic conditions last year were somewhat different than the Federal Reserve expected, as the FOMC committee members thought that the unemployment rate would fall less than it did and that economic growth would be a touch weaker than it turned out to be. They also expected the inflation rate to make more progress on moving toward the central bank’s 2% target. In other words, the Federal Reserve expected to raise rates because inflationary pressures were building, but it turned out rates were raised because a healthier economy was able to “tolerate” the rate hikes, keeping the economic expansion moving forward.
C. More on the Rate Hiking Cycle.

- With the Federal Reserve looking to raise rates three times in 2018, the federal funds rate would hit a target range of 2% to 2.25% by year end. We continue to believe that a 2% federal funds rate is very important, as that was the level of the federal funds rate prior to the Federal Reserve moving to an emergency level of interest rates -- ultimately zero -- between October and December 2008.

- A 2% federal funds rate would also put in place a roughly zero real, or inflation-adjusted, short-term interest rate if the Federal Reserve’s 2% inflation target were met, compared to the negative real federal funds rate that has been in place since the late fall/early winter of 2008. This is an important notion as Janet Yellen and other Federal Reserve officials have stated that the “neutral” federal funds rate at which monetary policy is neither stimulating nor restraining the economy is currently estimated to be near zero.

- The real federal funds rate is close to zero today with the 1.25% to 1.5% target range for the federal funds rate and the most recent reading on core inflation for consumer expenditures at 1.5%. Should core inflation remain low over the next twelve months, a 2% federal funds rate would put in place a positive real federal funds rate for the first time in over a decade.

- As stated in our review of the tax package which was signed into law late last month, the economy’s growth rate should accelerate to the 2.5% to 3% range over the next two years compared to the 2% to 2.5% pace which has been in place since the start of the current business expansion. The key for Federal Reserve policy will be if the economy’s inflation rate moves higher with the expected moderate acceleration in the economy’s growth rate.

- With the business expansion now 102 months old and the unemployment rate at 4.1%, a pickup in wage growth and inflationary pressures could result in a shift in monetary policy from removing accommodation to a tightening of policy. Watching the average hourly earnings data in the employment report and the core personal consumption expenditures measure of inflation will be the key indicators to monitor in order to get a read on the pace at which the Federal Reserve will continue on their path to higher interest rates and the pace at which its investment portfolio will be allowed to run off.

- Guiding rate hike decisions over the next couple years will be a dynamic process requiring a great deal of judgement by the Federal Reserve as to what level of short-term interest rates the economic expansion can tolerate and whether policy needs to shift from becoming less accommodative to an outright tightening posture. The economy’s inflation rate will determine how high the federal funds rate can rise without stalling the economy, unless that becomes the goal of the Federal Reserve to contain building inflationary pressures. As always, stay tuned!
D. An Update on “Too Quickly or Too Slowly.”

- Given the largely unprecedented turnover among the Federal Reserve’s top monetary policy and regulatory decision makers currently taking place, the unchartered waters the central bank has recently begun to navigate in reducing the size of its $4.3 trillion securities portfolio, and the growing likelihood of three rate hikes this year following the passage of the GOP tax package late last month, we feel it is crucially important to monitor the Treasury market’s assessment of whether the Federal Reserve is moving too quickly and aggressively to remove monetary accommodation -- possibly tipping to a tightening mode -- or too slowly which could lead to a build in inflationary pressures.

- We feel the answer to these questions will be unveiled in the Treasury bond market, specifically in the yield spread between two-year Treasury notes and ten-year Treasury notes. Recall that the primary determinant of the yield on longer dated Treasury securities is investor expectations for inflation, with the outlook for growth a secondary consideration.

- If the bond market believes the Federal Reserve is raising interest rates prematurely and/or at too rapid a pace, the yield curve will flatten, i.e., the yield spread between two-year Treasury notes and ten-year Treasury notes will shrink. Likewise, if investors believe the Federal Reserve is proceeding at a pace which is too slow or deliberate, the yield curve will steepen, widening the yield spread between two-year Treasury notes and ten-year Treasury notes.

- The yield spread ended 2015 at 122 basis points and ended 2016 at 125 basis points, compared to a reading of 75 basis points on July 8, 2016 at the peak of investor concerns over the vote in Great Britain to leave the European Union. Following the June 13-14 FOMC meeting where the Federal Reserve stepped up its proposed moves to reduce monetary accommodation, the yield spread fell to 78 basis points, nearly reaching its level on July 8, 2016.

- The yield spread ranged between 79 and 94 basis points over the late June to September period as the market anticipated that the Federal Reserve would start the gradual runoff of a portion of its bond portfolio during October. As the market began to focus on a likely rate hike at the December 12-13 FOMC meeting, the yield spread fell to 51 basis points, its narrowest level since late 2007. Following the passage of the GOP tax proposal, the yield spread widened slightly to 62 basis points, but finished 2017 at 53 basis points.

- In our view, the Treasury market has been, and continues to send a fairly clear message to the Federal Reserve that it needs to be careful in its ongoing effort to reduce the degree of monetary accommodation in the U.S. financial system. It appears to us that the economy’s growth rate will ramp a touch to 2.5% to 3% over the next two years following the passage of the GOP tax package. The key to the longevity of the current business expansion will be how inflation responds over the next couple years.
• If inflationary pressures rise and move above the Federal Reserve’s 2% target, the central bank will be forced to tighten monetary policy. The yield curve would eventually invert with yields at the short end of the yield curve rising and yields at the long end falling. For now we look for the economy to continue growing, but the Treasury market is growing fearful that a policy mistake could occur. Higher short-term interest rates and an inversion of the yield curve will be the signal that the end of the economic expansion is approaching. For now, the Treasury market is telling us it is on alert, as should we be.

E. Earnings and Inflation are the Keys to the Economy and Stocks in 2018-19.

• The backdrop for further gains in stock prices this year remains positive. The economy looks to have grown at a pace close to 2.5% over the four quarters of 2017 and is currently benefitting from a synchronized worldwide expansion that is carrying over into 2018. As mentioned earlier in this ISS, the recently passed tax legislation is expected to ramp the economy’s growth rate to 2.5% to 3% over the next two years compared to the 2% to 2.5% growth rate over the course of this business expansion.

• The long business expansion, which has now lasted 102 months, has translated into a long and relatively steady period of earnings growth, save for a seven quarter long pause in earnings growth from 4Q 2014 to 2Q 2016 largely due to the collapse in oil prices from mid-2014 to early 2016. With the rebound in oil prices and continued growth in the economy, earnings have now rebounded for five consecutive quarters, and with the release of 4Q 2017 operating earnings for the S&P 500 companies over the next couple months, the earnings recovery will reach six quarters.

• The rebound in earnings allowed stock prices to advance sharply last year without materially stretching the stock market’s trailing price-to-operating earnings ratio. Despite the 19.4% advance in the S&P 500 last year, the market’s P/E ratio has only risen from 22.1x at year end 2016 to 22.5x at year end 2017, but that P/E ratio will drop to approximately 21.4x once we flip to using operating earnings which include 4Q 2017 earnings. The very healthy rise in earnings since 3Q 2016 has moderated the rise in stock valuations despite the strong advance in stock prices since the presidential election.
The analysts at Standard & Poor’s look for operating earnings to grow another 15% to 18% this year on the back of another solid year of growth and the cut in the corporate tax rate to 21% from 35% as of January 1. Earnings should continue to carry the day for common stocks as the transition from a low interest rate driven bull market to an earnings driven bull market over the past 18 months or so continues.

The other factors which have supported the economy and common stocks since mid-2016 are a gradualist Federal Reserve and low inflation and bond yields. While these supports currently remain in place, we will need to watch closely during 2018 to see if these supporting factors remain in place. The key to these supports remaining in place this year is very simply, do inflationary pressures build during 2018?

While we assess that the tax package provides only a moderate amount of near term stimulus to the economy, it will to some extent pull growth forward into 2018 and 2019. We need to keep in mind that the tax package is arriving with an economic expansion that is eight and a half years removed from the Great Recession and is now the third longest expansion on record. The economy is posting consistent gains in the jobs market and consumer spending, while housing construction has accelerated over the year with housing starts rising 12.9% year-on-year. An improving global economy is boosting U.S. exports, industrial production, and capacity utilization rates.

Add in that the nation’s unemployment rate is at a 16 year low at 4.1%, down from 4.7% at the start of 2017. Wage and pricing pressures were surprisingly muted in 2017, actually easing over the course of the year as the unemployment rate fell, rather than showing any signs of rising. While we are not looking for a material build in inflationary pressures this year, it would not surprise us if some firming for both wages and prices took place during 2018.

The key will be the extent to which inflationary pressures rise this year and into 2019. Our view is that the tax package only provides a moderate amount of near term stimulus, with the majority of the benefits in the tax package embodied in the corporate tax reform which will benefit the U.S. economy and U.S. businesses on a longer term basis.

This should lower the likelihood of inflation moving significantly higher this year, postponing the day that the Federal Reserve needs to leave the term “gradual” behind and more aggressively raise interest rates, which would begin the tightening phase which will eventually lead to the next recession. It should also moderate the rise in bond yields this year, although we do expect a confluence of events to push bond yields a touch higher during 2018.

We caution our readers to acknowledge that the stock market has not experienced a double digit decline since the S&P 500 fell -14.5% from May 21, 2015 to the low on February 11, 2016. In fact, the market has not experienced even a -5% decline since February 2016. Some investors have delayed taking gains to push their long term capital gains into 2018 and the commensurate tax bill to April 15, 2019.

Do not be alarmed by some tax related selling pressure early this year. Watch that the earnings rebound continues, that wage gains remain at 3% or below on a year-on-year basis, and that core inflation does not move materially above 2%. As long as these conditions remain in place, we advise clients to buy any pullbacks which approach -5%.
II. Treasury Market

A. Treasury Yields Rise for Fourth Straight Month.

- In the January 3, 2017 ISS, we stated that in the aftermath of Donald Trump winning the presidential election and with his stated goal of bringing a pro-growth tax agenda to Washington focused on reforming the corporate tax code -- spurring business capital spending and hiring -- and a simplification of the personal tax code, that the era of ultra-low interest rates and bond yields was over. We also expected that once President Trump’s complete economic agenda was negotiated and set into policy, it would not surprise us if the yield on the ten-year Treasury note took a run at 3%, a level we have not seen since late December 2013.

- Well as it turned out, yields on longer dated Treasury securities fell over the first eight months of 2017 as there was no movement in Washington on advancing a pro-growth economic agenda. The effort to repeal and replace Obamacare suffered repeated failures and the erratic behavior of the Trump White House and the inability of the various strands of the Republican coalition to reach consensus among themselves on proposals which could move through Congress called into question the ability of the GOP to advance the Trump economic agenda.

- The yield on the ten-year Treasury fell from 2.44% at year-end 2016 to a low of 2.06% on September 5. The low in longer dated yields did contain a flight-to-safety element as the markets were alarmed by North Korea’s largest ever nuclear test and the potential economic devastation from Hurricanes Harvey and Irma.

![Basis Point Change in Yield](image-url)
Over the past four months, however, yields at the longer end of the yield curve reversed course and began to rise, while yields at the shorter end of the yield curve consistently moved higher over the course of the year as the Federal Reserve raised rates three times last year. Yields on three-month to two-year Treasury securities rose 10 to 50 basis points from the end of 2016 to September 5 and another 38 to 59 basis points to the end of 2017. In particular, the yield on the two-year Treasury note rose from 1.19% at the end to 2016 to 1.88% at last Friday’s close.

At the longer end of the yield curve, yields on five-year to thirty-year Treasury securities fell -29 to -39 basis points from the end of 2016 to September 5, but rose 6 to 57 basis points to the end of 2017. In particular, the yield on the ten-year Treasury note rose from the 2.06% low on September 5 to 2.41% at last Friday’s close.

Yields at the longer end of the Treasury yield curve are being impacted by two things. First is the Federal Reserve beginning to shrink the size of its investment portfolio during October. The central bank did not reinvest $10 billion of maturing securities in each of the past three months and will raise the monthly runoff amount to $20 billion this month. The Federal Reserve will continue to raise the monthly runoff amount by $10 billion each quarter until the monthly runoff reaches $50 billion per month in October 2018.

Investors are also responding to the passage of the tax package which is expected to pull a moderate amount of growth forward into 2018 and 2019 and increase the federal budget deficit. We expect some modest upward pressure on wages and prices, lending support to continued gradual rate hikes by the Federal Reserve and some additional upward pressure on longer term bond yields.

Yields on Treasury securities with maturities between three months and ten years were unchanged to rising 12 basis points last month while the yield on the thirty-year Treasury bond fell -9 basis points. Despite trading as high as 2.50% during December, the yield on the ten-year Treasury note finished December at 2.41%, slightly below the 2.44% yield at the end of 2016 which reflected investor anticipation of Donald Trump’s economic agenda being enacted during 2017.

With the Federal Reserve raising rates three times last year and the actual passage of the tax legislation, it is not surprising Treasury yields out to seven years are higher on the year, with the yield on the ten-year Treasury largely unchanged, falling a modest -3 basis points. However, the demand for longer dated Treasury securities has some unique elements, as evidenced by the -33 basis point decline in the yield on the thirty-year Treasury bond last year.

First, the decline in yield on longer maturity Treasury securities continues to reflect the growing demand for fixed income from the aging baby boomer generation. The leading edge of the baby boomers turned 60 in 2008 and the push into retirement will continue for the next two decades. Additionally, the persistent demand for higher yielding Treasury securities from foreign investors remains very strong. Consider that the ten-year Japanese bond yield remains close to 5 basis points, while the ten-year German bund yields about 45 basis points. In comparison, the 2.74% yield on the thirty-year Treasury bond last Friday looks very attractive.
B. Most Likely, Treasury Yields Will Rise Modestly over the Next Two Years.

- As the yield on the ten-year Treasury note rose from the low recorded on September 5, both the real, or TIP, yield and the implied inflation expectation embodied in the nominal ten-year Treasury yield have risen, as shown in the table below. While the Federal Reserve kicking off its effort to shrink its investment portfolio likely had some impact on the ten-year Treasury yield, we think the majority of the rise in the real yield and the inflation premium has been caused by the resilient nature of the economy’s forward moment and the anticipation -- now the actual passage -- of the tax reform/cut package ushered through Congress by the GOP.

<table>
<thead>
<tr>
<th>Date</th>
<th>Nominal Ten-Year Treasury Yield</th>
<th>Inflation-Index Ten-Year Treasury Yield (minus)</th>
<th>Implied Inflation Expectation</th>
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<tbody>
<tr>
<td>12/31/2014</td>
<td>2.17%</td>
<td>0.47%</td>
<td>1.70%</td>
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<tr>
<td>12/31/2015</td>
<td>2.27%</td>
<td>0.71%</td>
<td>1.56%</td>
</tr>
<tr>
<td>7/8/2016</td>
<td>1.36%</td>
<td>-0.09%</td>
<td>1.45%</td>
</tr>
<tr>
<td>11/8/2016</td>
<td>1.86%</td>
<td>0.12%</td>
<td>1.74%</td>
</tr>
<tr>
<td>12/30/2016</td>
<td>2.44%</td>
<td>0.48%</td>
<td>1.96%</td>
</tr>
<tr>
<td>9/5/2017</td>
<td>2.06%</td>
<td>0.28%</td>
<td>1.78%</td>
</tr>
<tr>
<td>12/29/2017</td>
<td>2.41%</td>
<td>0.43%</td>
<td>1.98%</td>
</tr>
</tbody>
</table>

- Also notice that since the presidential election, the implied inflation expectation has moved fairly consistently toward 2%, the Federal Reserve’s inflation target. While some easing in the inflation outlook took place at the September 5 low ten-yield Treasury yield for 2017, the rise in the inflation outlook at the end of 2016 was fueled by the anticipation of a tax package and the actual passage of the tax package pushed inflation expectations back toward the 2% level as 2017 drew to a close.

- As stated previously in this ISS, the key to the outlook for the economy and the markets, in this case the bond market, will be the extent to which inflationary pressures rise this year and into 2019. While not looking for a significant move higher in inflation this year, we expect some modest upward pressure which should take the current 1.5% year-over-year rise in the core personal consumption expenditures index closer to 2% over the next 24 months.

- Other factors impacting yields at the long end of the Treasury yield curve this year will be the extent to which there is any pullback in the massive bond buying programs still in place at the Bank of Japan, the Bank of England, and the European Central Bank. With the rebound in global growth over the past 12 to 18 months, it is fairly easy to say that those policymakers are closer to ending rather than ramping up their bond buying programs.

- We expect global policymakers to follow the lead of the United States and begin the shift from expansionary monetary policies to fiscal policies to maintain the forward momentum in the global economy and continue the process of reflating their economies. For the next couple months we continue to look for a trading range of 2.25% to 2.75% for the ten-year Treasury note yield to remain in place.
• The extent to which the tax package accelerates the economy’s growth rate and inflationary pressures rise over the next two years, we expect the entire Treasury curve to shift even higher and the ten-year Treasury yield to take a run at 3%, a level we have not seen since late December 2013. The expected increase in the federal budget deficit at a time that the Federal Reserve is shrinking its holdings of government bonds and the increase in the cost of servicing the national debt with the rise in Treasury yields will also contribute to upward pressure on Treasury yields. As always, stay tuned!

Joseph T. Keating
Chief Investment Officer

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