Strategy

January 18, 2018

Central Bank Tightening, Tax Reform and Event Risk

Three Trends to Watch in 2018

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Abstract

At the start of each year, we typically name three broad market trends or events that could potentially have the greatest impact on the short-term debt market. For 2018, we think central bank tightening, tax reform and event risk will have the most impact on short-term debt markets. We are generally sanguine about the interest rate and credit spread outlook. What is less clear is how investors will manage a market reversal. We think the demand for institutional cash portfolios to "self-insure" against liquidity events has increased. Treasury professionals should focus on risk diversification and liquidity stratification.

Introduction

2017 turned out to be an unexpectedly blissful year by some standards. A political novice occupying the White House did not lead to the financial market volatility many had predicted, in spite of his unconventional communication style. Britain will leave the European Union, but no other country followed suit. The debt ceiling came and went… and came again, but Treasury issuances were well received. Headline news was dotted with reports of partisan politics, slowing growth in China, terrorism, asset bubbles and rising corporate leverage. Nevertheless, risk assets, interest rates and market liquidity all seem to have held up well.

In 2018, we expect the cumulative effect of monetary policy normalization from the Federal Reserve and other central banks to guide the yield curve higher. Market responses to the tax reform legislation passed in December will also shape the cash investment landscape. As in 2017, we think unknown event risk occupies a very important corner of an increasingly uncertain world.

1. Market Implications from the New Tax Legislation

The hotly contested, highly partisan Tax Cuts and Jobs Act is finally here. The estimated $1.5 trillion tax package that permanently lowers corporate income tax while providing temporary relief to individual taxpayers will touch many corners of the economy and financial markets beyond 2018. In the context of institutional liquidity management and short-term debt markets, we have the following initial reflections.

Moderate impact on Near-term Growth and Policy Rates: Despite Republican leadership's high hopes and promises of the bill's jolt to economic growth, economists seem to agree that the uplift will be modest. While bringing corporate profits home and giving households more cash to spend are expected to stimulate the economy, previous tax cuts between the 1960s and 2000s produced mixed long-term results. A December Wall Street Journal survey of economists showed that most forecasters thought growth pickup over the next two years from the tax bill would be moderate[1]. In her last press conference as Fed Chair, Janet Yellen said the legislation would provide "a modest lift" to the economy and that it would not lead to an acceleration of the Fed's pace of rate hikes in 2018[2].

Higher Deficits and Treasury Issuance: The Joint Committee on Taxation (JCT) estimates that the tax law will increase the deficit by $1.5 trillion over 10 years, most of which is front-loaded, with a projected increase of $135.7 billion in 2018. Larger deficits mean correspondingly higher Treasury security issuance. Based on recent Treasury auctions and comments from government officials, nearly half of the new debt supply is expected in Treasury bills. This means that, even without the Fed ratcheting up interest rate hikes, short-term Treasury yields will be under pressure to rise more for the market to absorb higher supply.

Deemed Repatriation Changes Funding and Investment Behaviors: The closely-watched repatriation tax law will subject foreign profits accumulated from 1986 to 2017 to a one-time tax of 15.5% for cash and liquid assets and 8.0% for illiquid assets, higher than the initial Senate plan of 10% and 5%, respectively. Companies can either make payments immediately or defer them over a multi-year period. On the tax front, the estimated $2.6 trillion total offshore profits[3] may translate into tax bills of $208-390 billion. How companies pay these bills will influence their liquidity management and financing decisions, and by extension, debt supply and demand dynamics across global markets. While the full impact of cash reshuffling on a grand scale will take years to materialize, we have already observed some cash investors putting their investment decisions on hold pending strategic review.

Uneven Impact Across Industries: As we wrote previously, there will be winners and losers due to tax reform. Businesses in general will benefit from a permanently lower corporate tax rate. Banks will emerge as major beneficiaries due to their high effective tax rates. The boost to long-term revenue should more than offset one-time write-downs of tax shelters. Technology and life science companies, with stockpiles of offshore cash, will have more flexibility and rely less on capital market funding. Other sectors such as retail, telecommunications, oil & gas, auto and agriculture also will benefit. On the flip side, businesses related to the housing market may be hurt by reduced mortgage interest and local tax deductions. Healthcare providers will feel the pinch from the repealed individual mandate in the Affordable Care Act. We expect differentiation among industries in credit strength, funding and market liquidity.

2. Central Bank Tightening and Rising Interests Rates

Along with the tax reform, we expect the reversal of central banks' quantitative easing to show further effect on the yield curve in 2018.

In 2017, the Federal Reserve delivered three rate hikes for a total of 0.75%, matching consensus forecasts by Fed officials at its December 2016 policy meeting. The Fed's current projections call for three more rate hikes in 2018, pushing short-term rates up to 2.00-2.25% by the end of the year. Financial market consensus, as measured by Fed funds futures, were initially reluctant to match the Fed's projected pace of increases but have since moved closer to the Fed and now price in two rate hikes in 2018. Jerome Powell, President Donald Trump's nominee as the next Federal Reserve Chairman, is expected to follow the gradual path of rate increases set in motion by current Fed Chair Janet Yellen.

[1] David Harrison, Economists see three Fed rate rises next year, lower unemployment, The Wall Street Journal, Economy Section, December 12, 2017. https://www.wsj.com/articles/economists-see-three-fed-rate-rises-next-year-lower-unemployment-1513106667
[2] Binyamin Appelbaum, Fed predicts modest economic growth from tax cut, the New York Times, December 13, 20017. https://www.nytimes.com/2017/12/13/business/economy/fed-interest-rates.html?mtrref=www.google.com
[3] Many press reports quote the $2.6 trillion figure based on a March 2017 report by Institute on Taxation and Economic Policy that combed through annual report filings of Fortune 500 corporations. https://itep.org/fortune-500-companies-hold-a-record-26-trillion-offshore/

The Fed started reducing its $4.5 trillion balance sheet last October on a pre-determined schedule. The pace of the reduction starts small, at $10 billion per month, and gradually increases by $10 billon per month each quarter until it reaches $50 billion per month. Fed Chairman nominee Jerome Powell alluded to a Fed balance sheet of $2.5-3 trillion in size over five years[4]. This implies that overall bank reserves will be reduced by $1.5-2 trillion accordingly.

The Federal Reserve was not alone in ending accommodative monetary policies. The other major central banks, including the Bank of England, the European Central Bank, and the Bank of Japan have already revealed, or are expected to reveal, intentions to raise interest rates or scale back asset purchases. The reversal of the so-call "quantitative easing" by these central banks should also put upwards pressure on short-term interest rates and drain liquidity from the financial system.

In recent months, the market was faced with a conundrum of rising short-term rates but relatively range-bound long-term rates, resulting in a phenomenon known as yield curve flattening. In the past, a flatter, sometimes inverted, yield curve has foretold rising probability of an impending recession. This time around, economists, including some Fed researchers, have attributed the flat curve to stubbornly low inflation, a lower premium for holding bonds longer, and permanently lower real interest rates.

While these postulations may have elements of truth, the cumulative effect of central banks reversing or lessening their accommodative stances, in addition to larger federal deficits, should put greater upwards pressure on long-term rates, leading to losses further up on the yield curve. We think investors should be mindful of too much complacency in the bond market, especially since bond scarcity is quickly becoming a thing of the past.

3. The Many Known and Unknown Risks

Keeping an eye on the many known and unknown external threats to debt market stability has become a perennial challenge in this age of uncertainty. It is paradoxical despite many simmering risks in 2017, that equity markets had another stellar year. The moving averages of the VIX, a broad market index of volatility, trended downward throughout the year, dipping below 10 near the end of the year.

[4] Steve Matthews, Matthew Boesler and Jeanna Smialek, Jerome Powell's views on monetary policy in his own words, Bloomberg.com, November 1, 2017. https://www.bloomberg.com/news/articles/2017-11-01/jerome-powell-s-views-on-u-s-monetary-policy-in-his-own-words

VIX Index

Source: Bloomberg, Chicago Board Options Exchange (Cboe). As of December 21, 2017.

But in terms of headline news, we expect 2018 will be no less volatile than 2017. We should hear more on the Trump Administration's "America First" immigration and trade policies, its diplomatic or military responses to the nuclear conflict on the Korean Peninsula, and presumed major personnel changes in the President's Cabinet. The 2018 mid-term elections loom large, while Congress tackles the federal budget and, wait for it, the unresolved debt ceiling. China continues to face monumental challenges in managing its credit bubbles both in and outside of its banking system, while at the same time maintaining stable growth and social cohesion. Brexit is a year closer to reality, while countries in the European Union continue to face nationalist and/or separatist pressures. Lofty valuation in stocks, high yield bonds, and real estate in many parts of the world remain a threat to capital market stability.

Adding to these relative known risks are the unknowns such as cyber security and cyber terrorism, the former leaving financial institutions (see Equifax) particularly vulnerable. Ransomware, a tactic of exacting financial gains by hijacking corporate computer systems, may get more frequent and potent, affecting companies everywhere. The meteoric rise and proliferation of cryptocurrencies, the emergence of crypto exchanges and the introduction of derivative trading of this unregulated or thinly regulated market may induce unwelcome shocks to liquidity in the broader financial market.

When combined with risk yields and higher debt issuance, event risk may pop up where least expected, leading to compounding challenges at inopportune times. The lingering known and unknown risk factors suggest the permanency of a liquidity premium in cash investment portfolios.

Portfolio Implications – As Good as It Gets

As we reflect on the major trends and events that will impact investment decisions by institutional liquidity managers, we are generally sanguine about interest rate and credit spread outlook. With the return of yield to these portfolios and the Federal Reserve's commitment to a gradual path of higher interest rates, we are tasked with a traditional duty of managing portfolios in a rising rate environment. Fed balance sheet reduction and the reversal of foreign central bank QE are still at an early stage; thus, we do not expect rapidly rising interest rates. As well, we think higher Treasury issuances will be met by strong demand, especially with government money market funds extending beyond overnight reverse repurchase agreements with the Fed.

We also view general credit quality to be stable. The low yield environment and moderate economic growth should still support benign credit quality, although some deterioration on lower rated, more leveraged, credits is to be expected.

What is less clear is how investors will manage the potential reversal of asset valuation and market liquidity agitated by the risk factors highlighted above. While one can never pinpoint the timing of such events, we expect demands on institutional cash portfolios to hold more liquidity to "self-insure" against these contingencies to increase. In addition to duration (interest rate) risk management, treasury professionals should continue to focus on risk diversification and liquidity stratification with a tiered approach that separates overall liquidity portfolios into separate liquidity vehicles.

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