Quarterly Commentary Q1 2016: Two Negatives Don't Make a Positive

According to all the mathematical textbooks we've ever read the multiplication of two negatives make a positive. In finance, the same rules don't necessarily apply. With the potential for negative interest rates, along with continued downward revisions of global growth, the outlook seems to be trending away from the positive. Integer mayhem be dammed!

Janet Yellen, the Fed chair, hinted at the possibility of utilizing a negative interest rate policy, or NIRP, as part of her arsenal. This level of accommodative policy would be a first for the US. Negative interest rates, if they do materialize in the US, would first be seen at the Federal Reserve Bank, wherein financial institutions would be charged to hold their excess capital. This initial step would happen prior to being passed down to any commercial or consumer depositors. It is difficult to ascertain how financial institutions would respond to NIRP, as it could vary from a flurry of transactions to a limited scope of activity. What should be stressed is that given a NIRP scenario, relative value becomes a larger component of the discussion. In other words, if other countries choose to invoke NIRP as well it would become a race to the bottom as each country would be looking to devalue their currency in order to increase the value of their exports and drive investment. If all the major players enact similar strategies, NIRP's effectiveness will become more muted.

Fiscal stimulus aside, the global economic anchor may serve to keep the US economic ship tethered to the dock. The International Monetary Fund has cut its global growth forecast for the fourth time in less than a year. Chronic weakness, cites the IMF, leaves the global economy vulnerable to shocks, such as sharp currency devaluations and worsening geopolitical conflicts. A NIRP policy has the potential to be a ripe environment for such a currency war. Part of the IMF revision has been credited to a spillover from China's economic slowdown and the impact of low oil prices on emerging market economies- look no further than Brazil. Going forward, the Brexit referendum (UK's vote in June to remain a member of the European Union) as well as the US presidential elections, and the potential impacts on foreign trade relations loom as clouds over the IMF's warning of possible "secular stagnation".

At home, the modest improvement in wages and job growth has continued their positive trend over the last six months. In contrast, both the unemployment rate, which includes discouraged workers, and the labor force participation rate have edged higher once again. Overall the sentiment remains cautiously optimistic even though the global slowdown has the potential to slow continued domestic growth. Commodity prices have rebounded from their lows with oil leading the way. Tempered expectations for oil should be expected due to the fact that supply has not tapered off as much as OPEC had hoped. Previously, the overproduction was supported in hopes of forcing out US domestic producers. Domestic producers, having used technology and reduced pricing from suppliers, have countered OPEC's punches leading to only a minimal five percent reduction in production on a year over year basis. A recent summit amongst some large oil producing countries did not lead to an output freeze, which will foster a continued environment where supply outpaces demand. This could lead to another more sustained drop in price. Renewed price deterioration could cause issues for states whose oil production represents a disproportionate amount of revenue when compared to other sources- North Dakota, Alaska, Oklahoma, New Mexico, and Wyoming to name a few.

Puerto Rico continues to garner many headlines, and for good reason. The Governor recently signed into law the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act, which allows the Governor to declare a payment moratorium on debt service through January 31st of 2017 across all of Puerto Rico's credits. Additionally, the bill also stays any legal actions with respect to the obligations of the Commonwealth or its public corporations. Lastly, it amends the Government Development Bank's Enabling Act by creating a new bridge bank, which creates a good bank/bad bank scenario- similar to

what happens when the FDIC takes control of a domestic bank that is in receivership. As anticipated, the opponents to the bill have been outspoken which will probably lead to legal challenges in the future.

Because of concerns over global turmoil and an economic slowdown, including the possibility of negative interest rates, investors sought refuge in US Treasury securities. As a result, US government backed instruments outperformed municipals during the quarter. The most significant movements were in bonds maturing in three to twenty years. Municipals also performed well during the quarter taking advantage of the January effect, where limited supply helped boost returns, before a slight underperformance in March. Overall for the quarter, AAA municipals showed yield compression in bonds maturing three years or more. Municipal investors weren't necessarily rewarded for investments in lower rated credits as single A rated bonds only outperformed in five to ten year maturities. With US Treasuries outperforming municipals, yield ratios reversed course and are now trending back above historical norms, thus once again providing relative value in municipals.

US Treasury Yields			
	12/31/2015	3/31/2016	Change
1 Year	0.72	0.56	-16 bps
3 Year	1.40	0.94	-46 bps
5 Year	1.80	1.25	-55 bps
10 Year	2.34	1.83	-51 bps
20 Year	2.76	2.31	-45 bps
AAA Municipal Yields			
	12/31/2015	3/31/2016	Change
1 Year	0.50	0.59	9 bps
3 Year	0.97	0.86	-11 bps
5 Year	1.33	1.14	-19 bps
10 Year	2.00	1.76	-24 bps
20 Year	2.68	2.38	-30 bps

While the multiplication of two negatives doesn't always equate to a positive, we know that the addition of positives are exactly that- positive. With the stock market's continued bull-run, consistent positive bond returns, states benefitting from revenue growth, climbing wage and spending growth as well as upticks in job growth, the domestic outlook has plenty of plus ticks on the ledger. While the US doesn't live in a bubble, and may very well feel the effects of global uncertainties, we aren't ready to throw out our math textbooks just yet.

All the best,

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