

The Short-term Investment Landscape

New Mexico LGIP Stakeholders Meeting

Wells Fargo Securities – Fixed Income Market & Portfolio Strategy
August 2017

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Director

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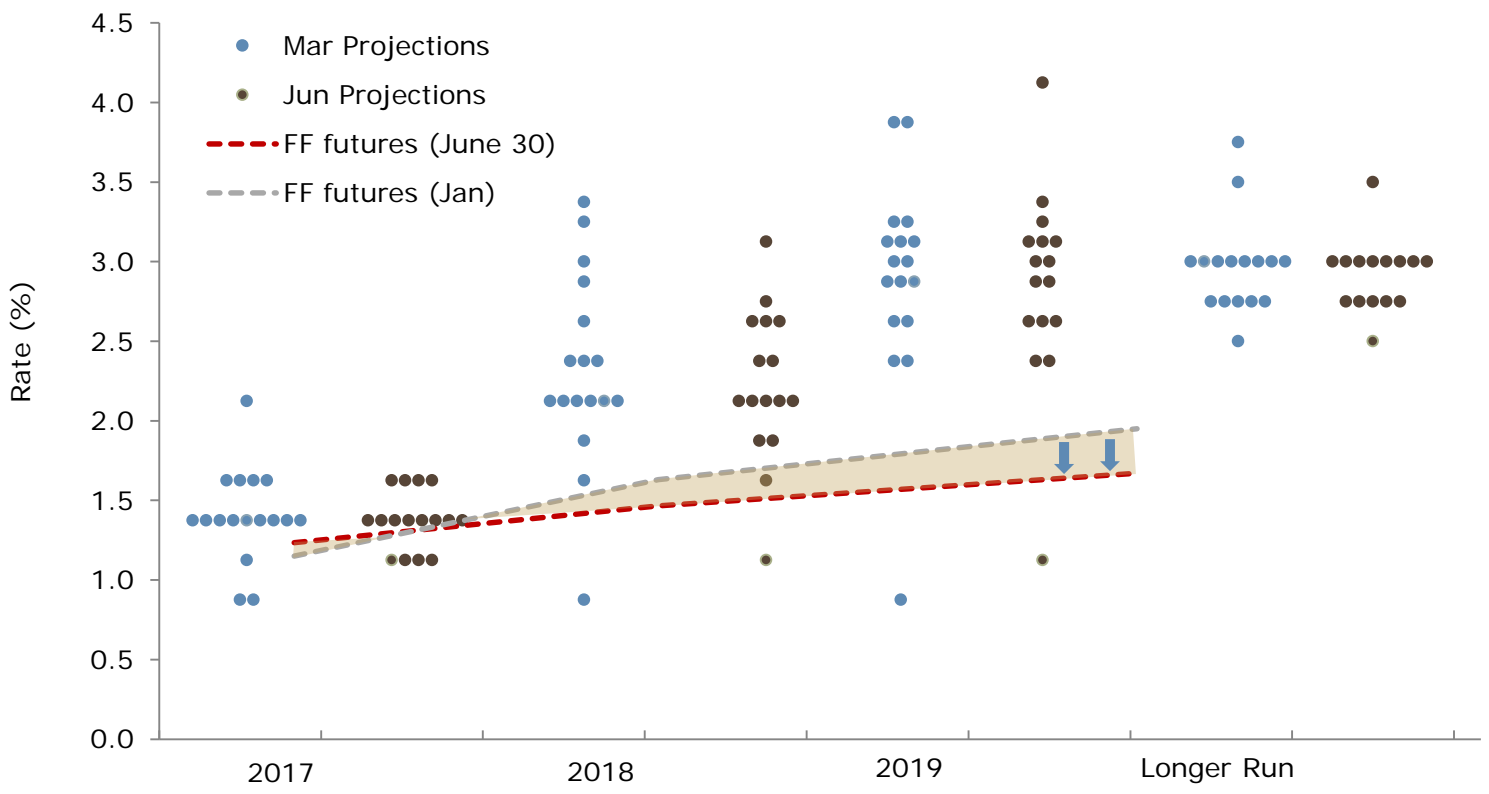


How much will Rates Rise? According to Policymakers...

The 2017 median *appropriate* Fed funds rate remained unchanged at 1.38 percent and the 2018 median appropriate rate also remained unchanged at 2.13 percent.

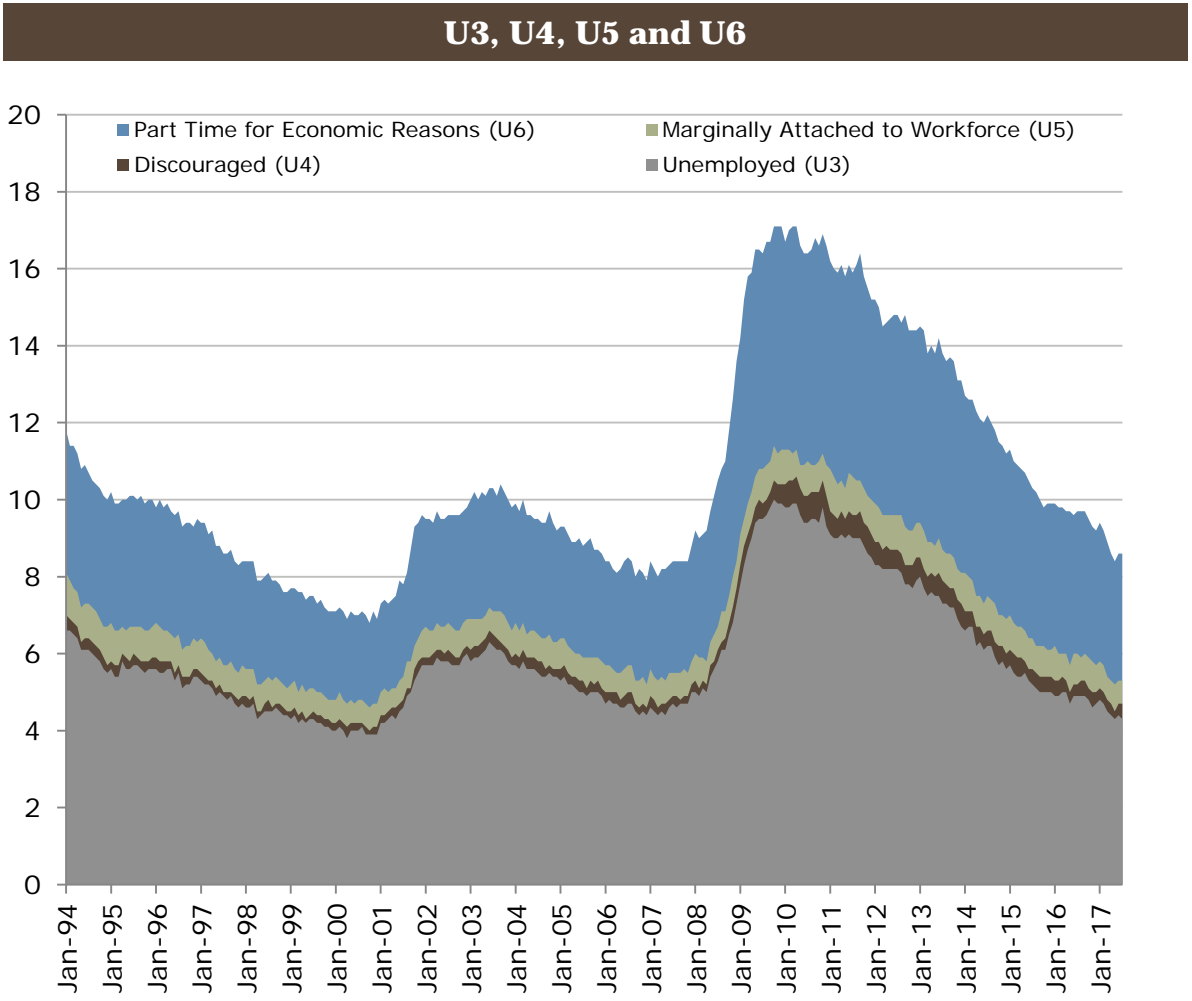
Fed Fund futures are pricing at the lower end of the 2018 and 2019 forecasts.

March – June Dot Plot Comparison



Source: Federal Reserve Board and Wells Fargo Securities, LLC

U-3 and U-6 Unemployment

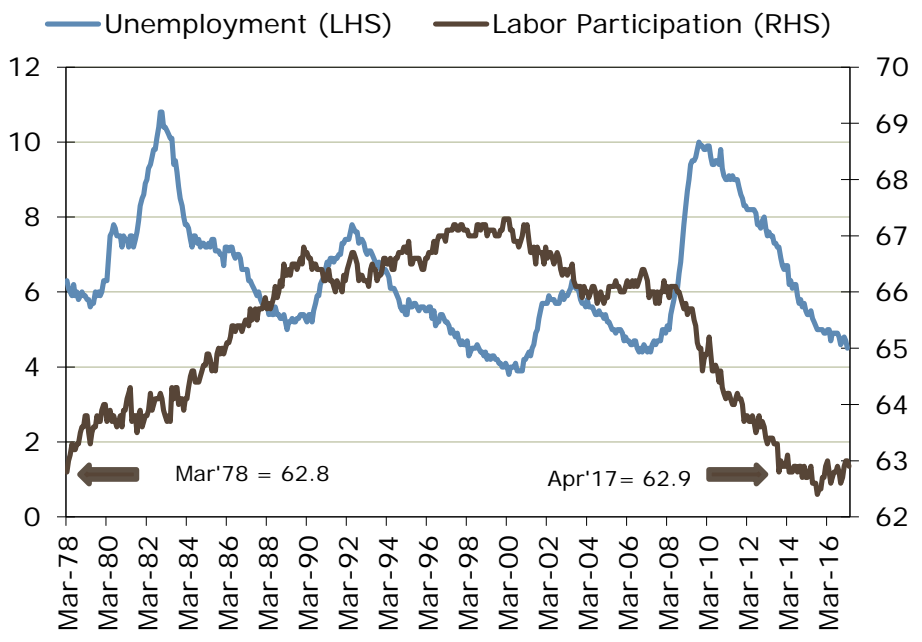


Source: BLS, Wells Fargo Securities, LLC

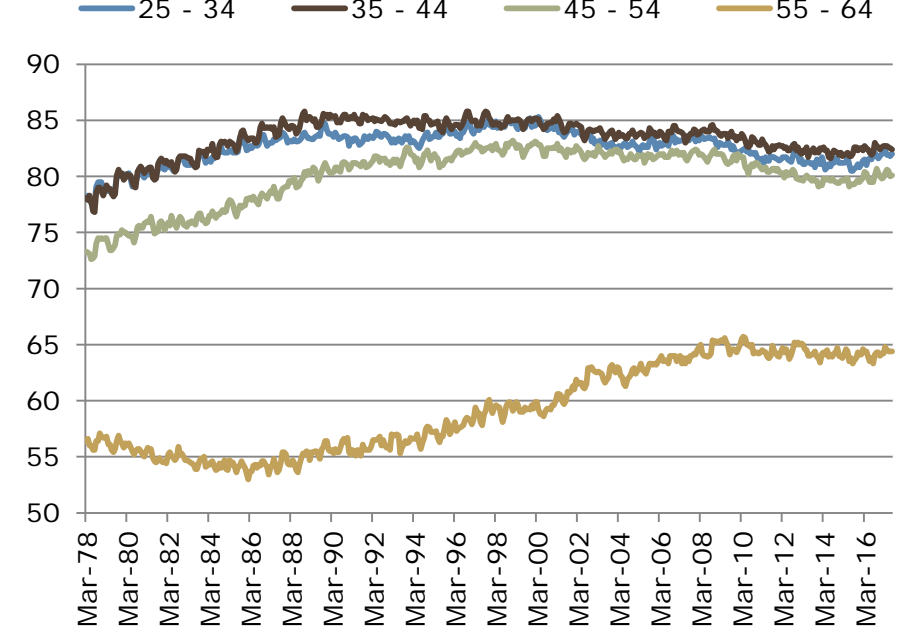
Labor Force Participation Rate and Unemployment

The participation rate has followed the decline in the unemployment rate, suggesting some of the decline in unemployment is not due to job creation.

Labor Force Participation and Unemployment



Prime Age Participation Rate

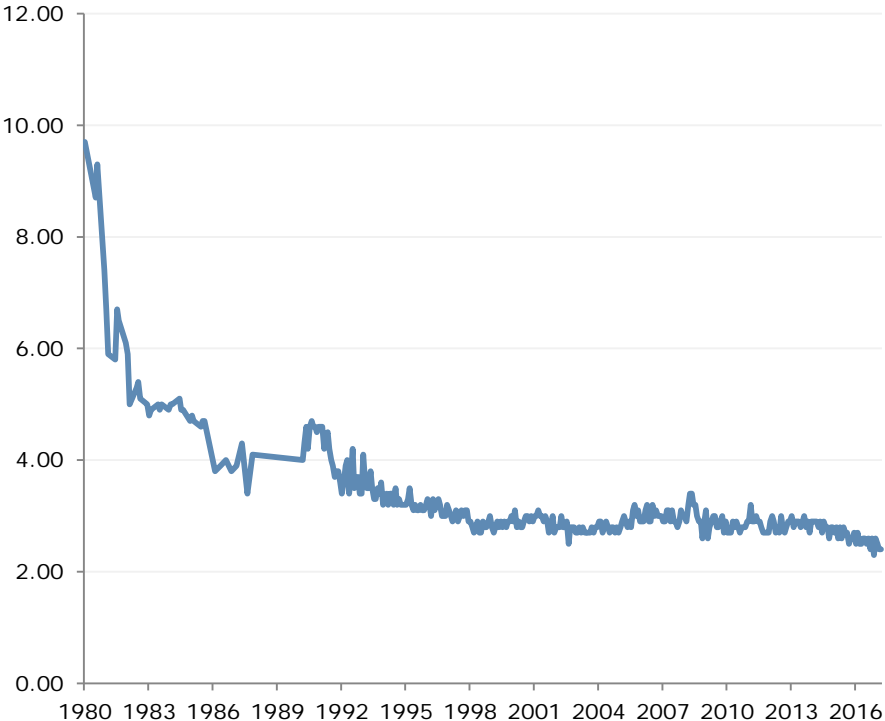


Source: BLS, Wells Fargo Securities, LLC

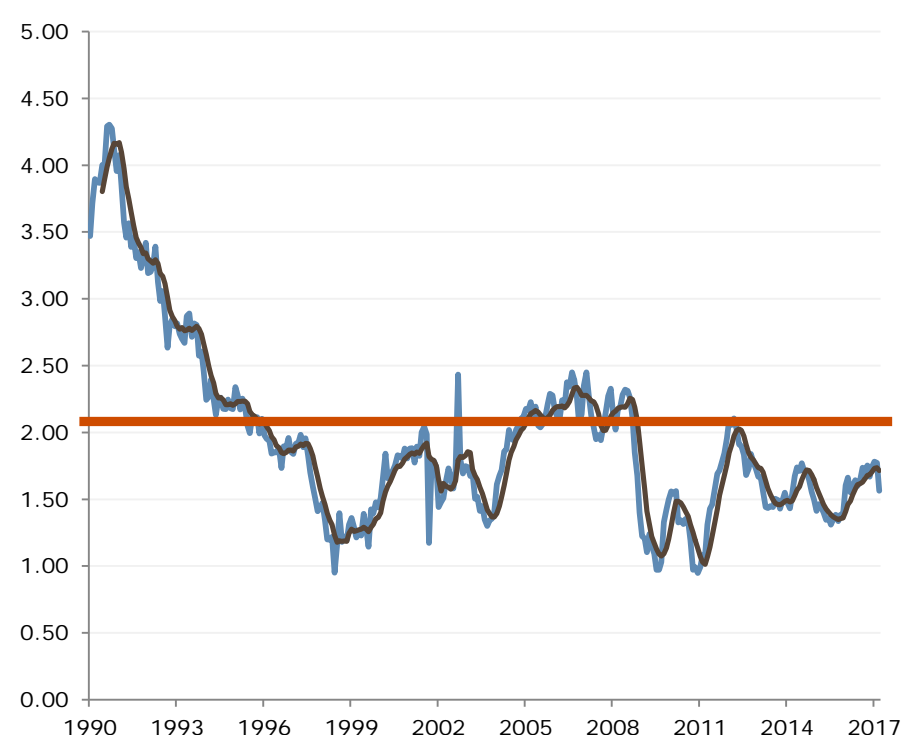
The argument to keep rates low has been focused on inflation, with international weakness and low oil prices putting downward pressure on inflation expectations.

“There is...uncertainty about when -- and how much -- inflation will respond to tightening resource utilization.”
Fed Chair Janet Yellen

5-Year Inflation Expectations in 5 Years

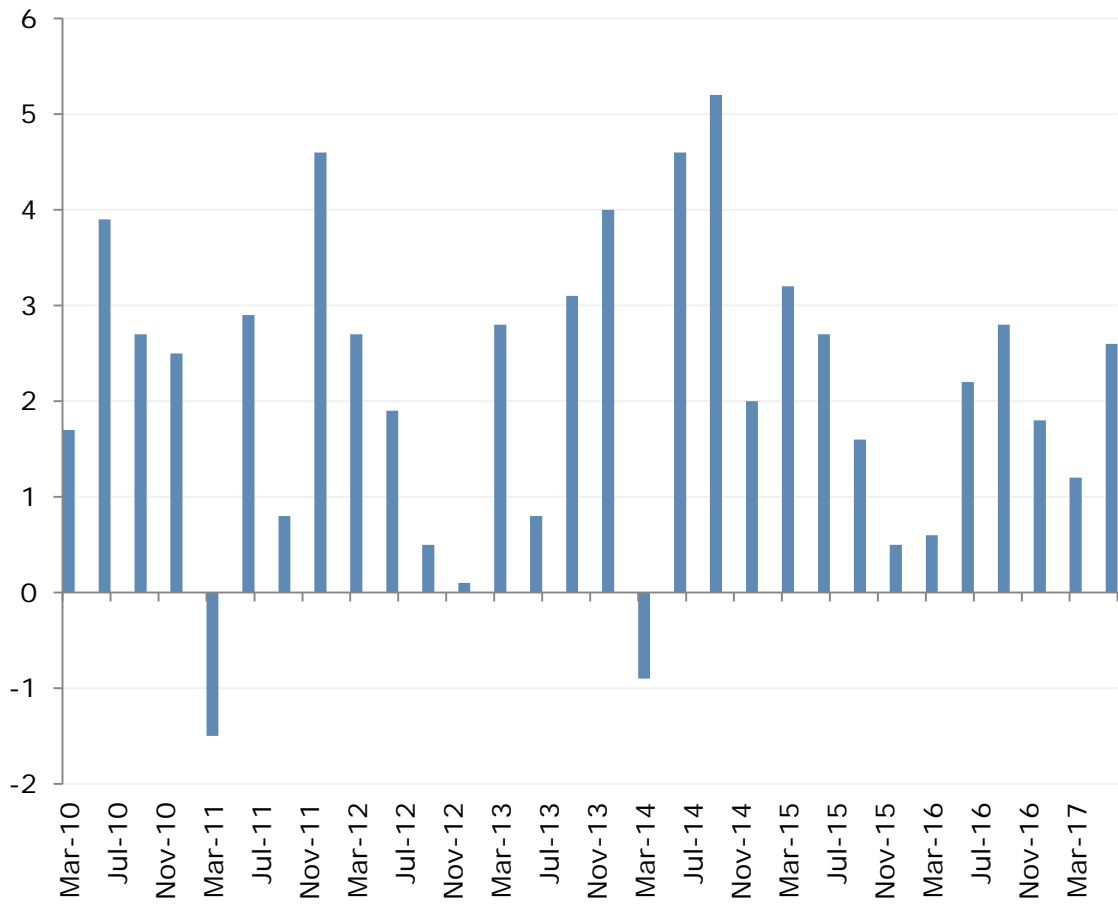


PCE Core Deflator Remains Below Forecast



Source: BLS, University of Michigan and Wells Fargo Securities, LLC

U.S. Quarterly GDP

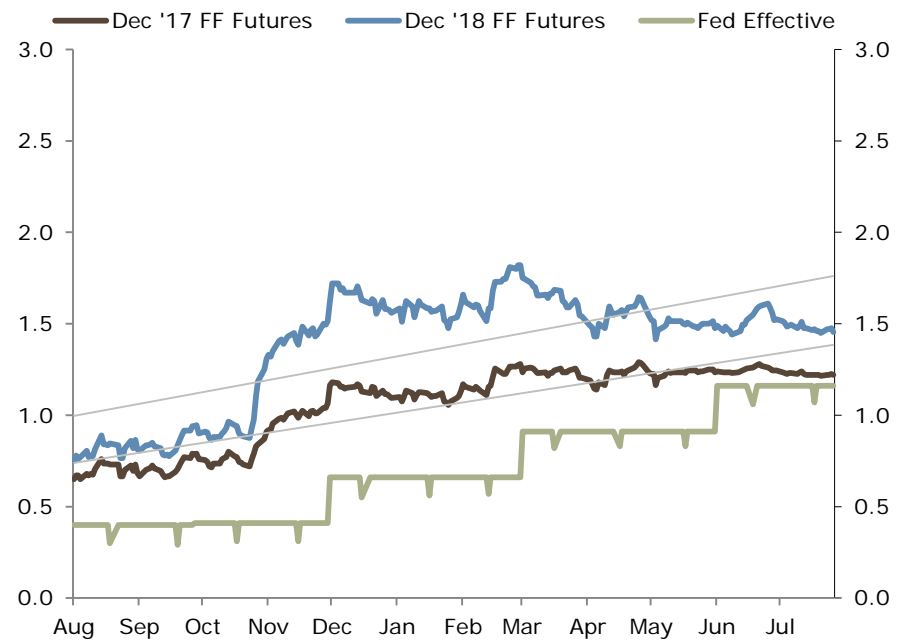
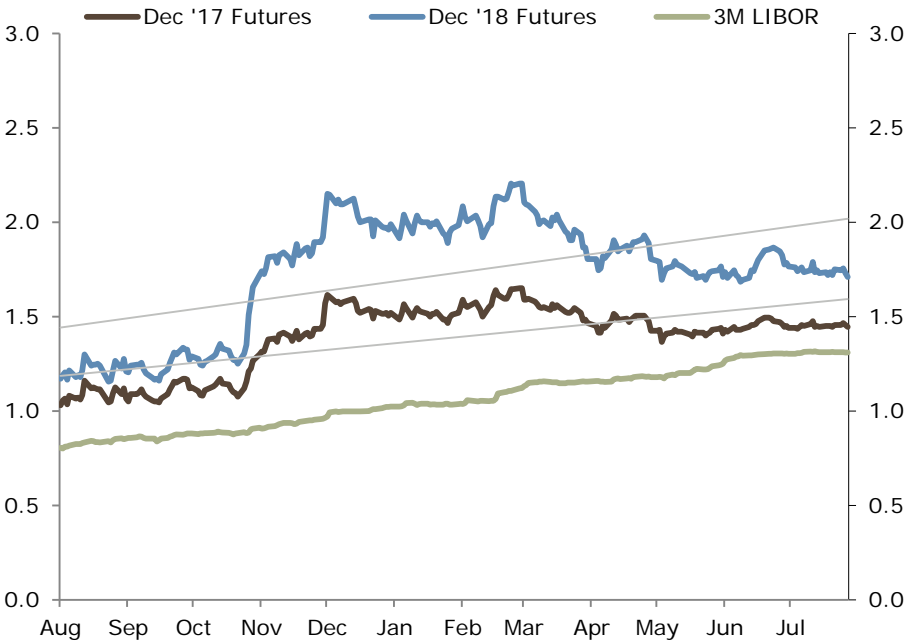


Source: BEA, Wells Fargo Securities, LLC

Market Expectations for Short-Term Rates

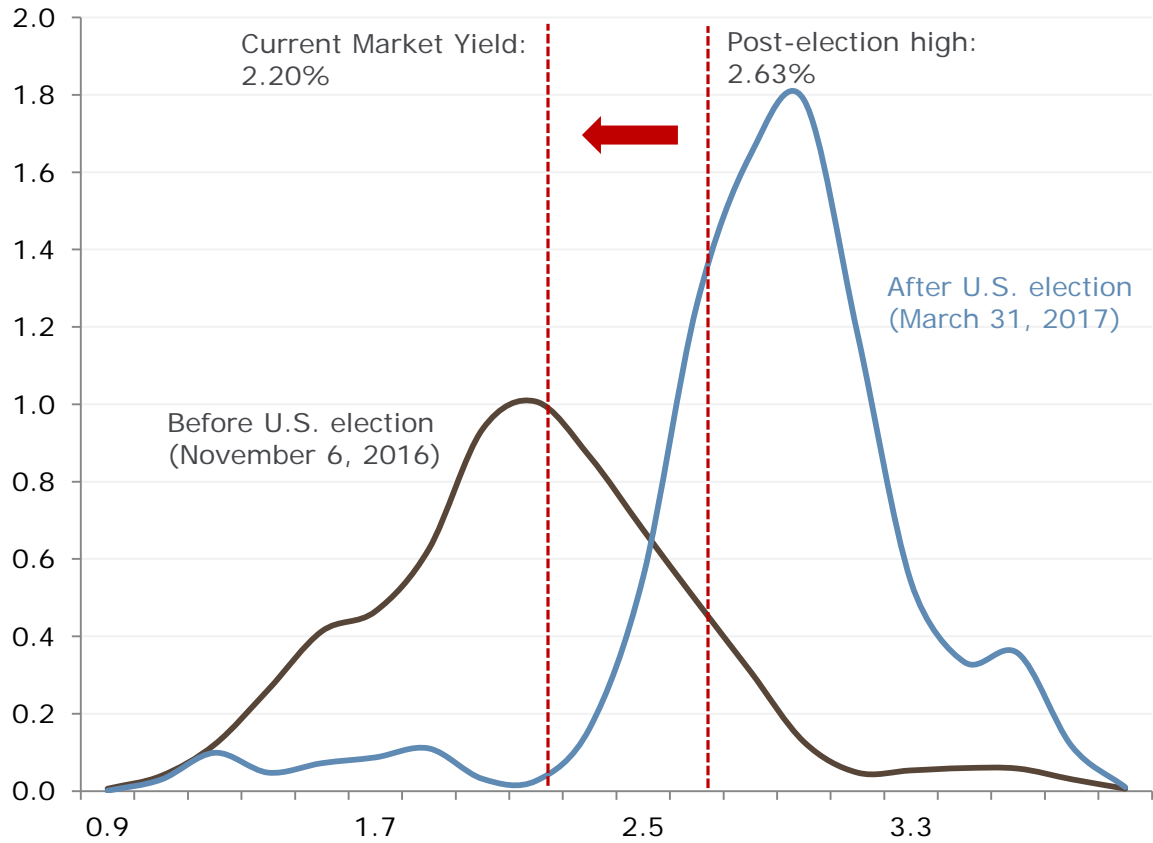
Cash and Futures-Implied Yields

Eurodollar and Fed funds futures contracts have slightly subsided after rising sharply in anticipation of rate hikes in early 2017.



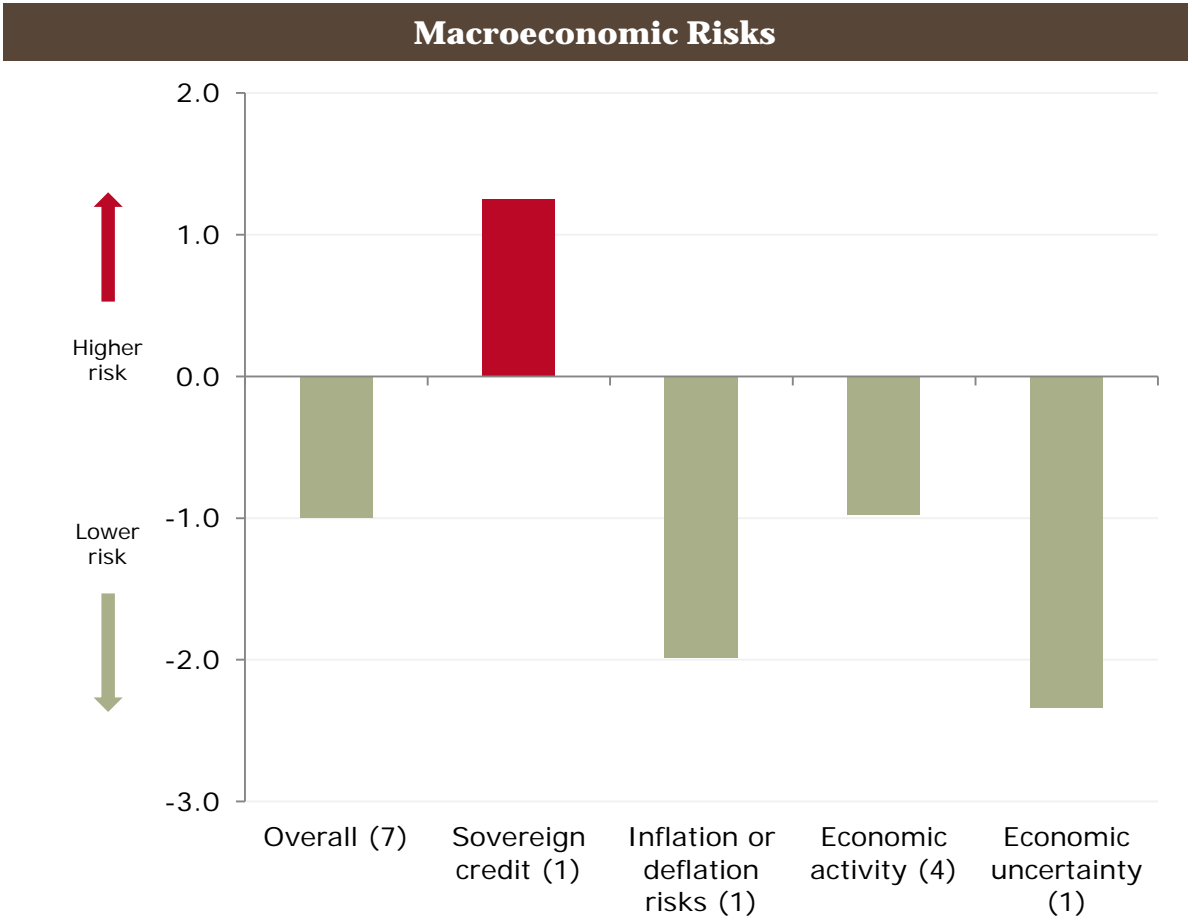
Source: CBOT, ICE, Bloomberg and Wells Fargo Securities, LLC

Consensus Forecasts for End-2017 U.S. 10-Year Treasury Yield

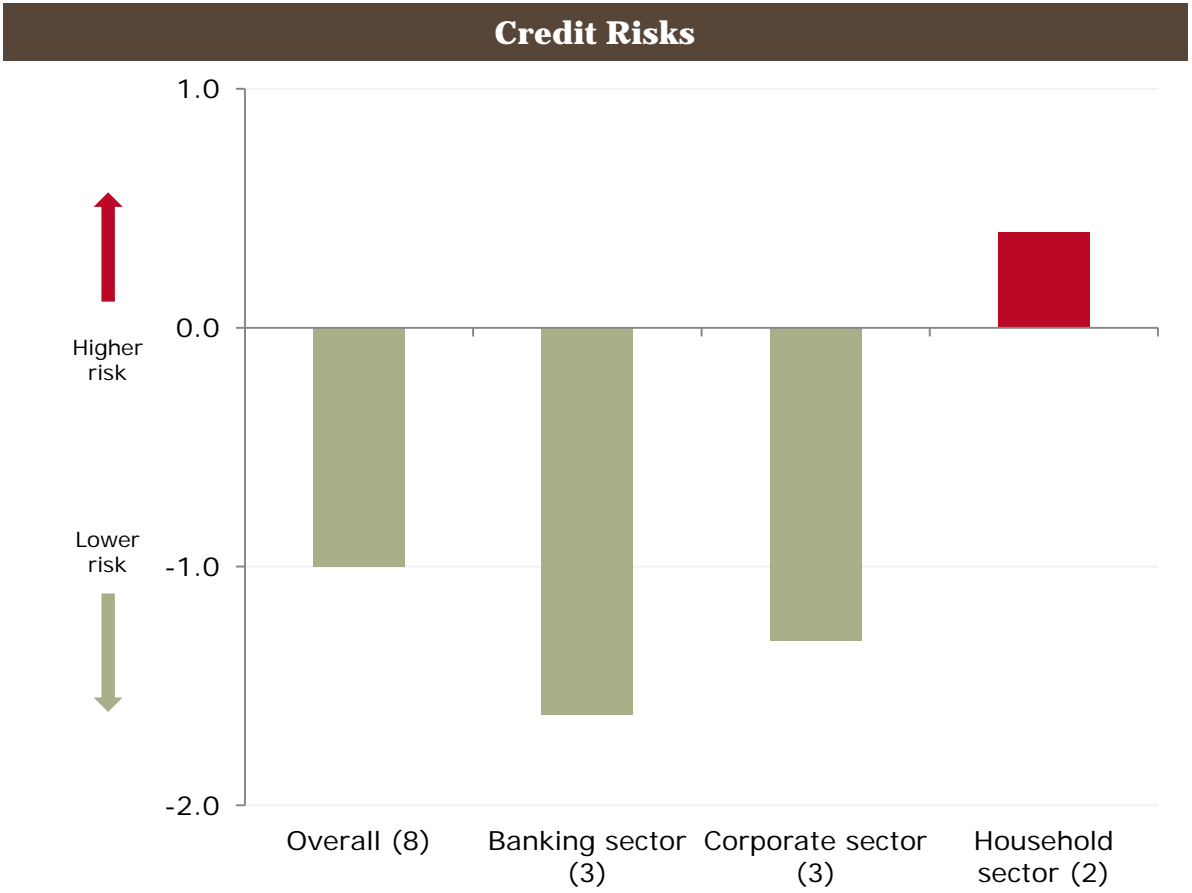


Source: IMF, Wells Fargo Securities, LLC

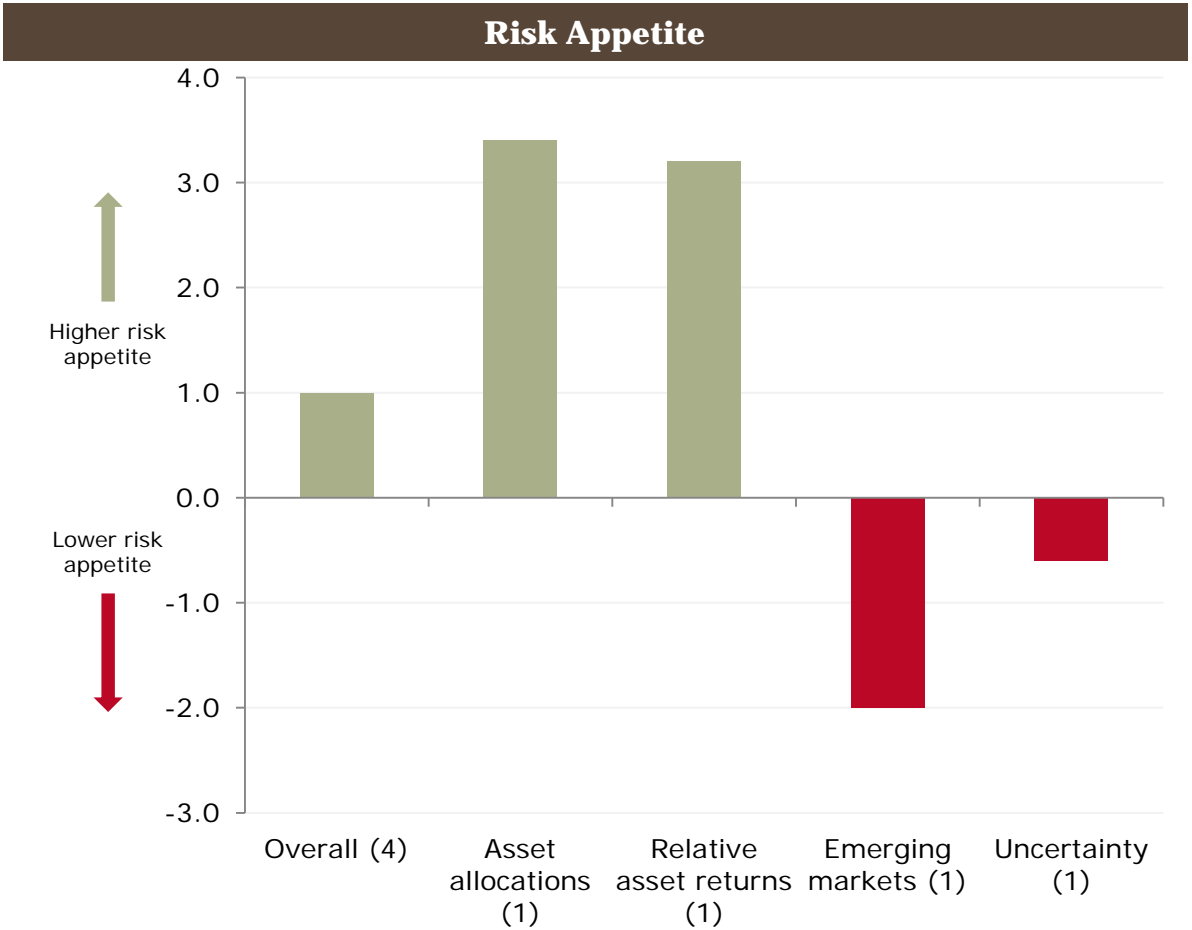
Financial Conditions and Short-Term Rates



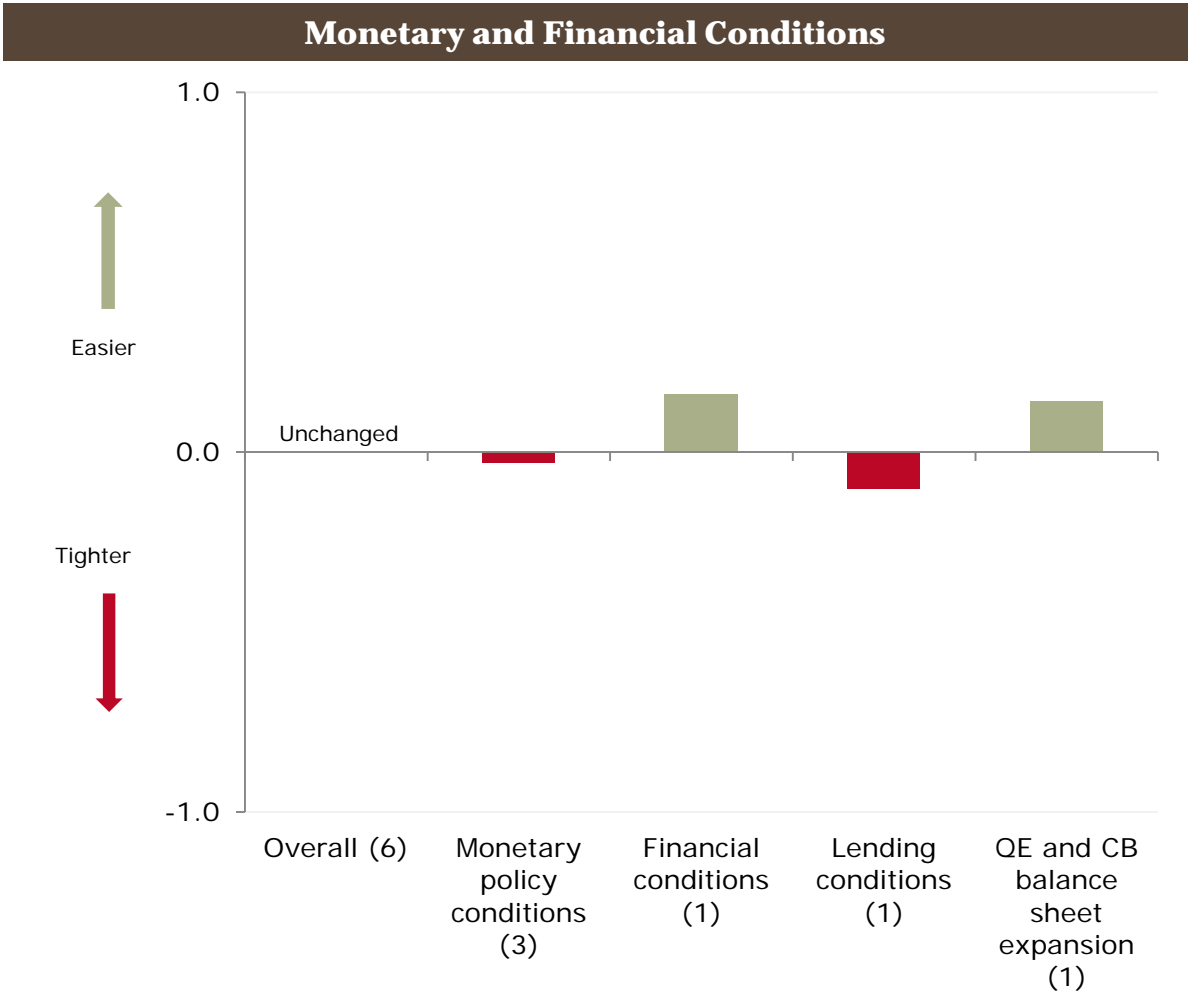
Source: IMF, Wells Fargo Securities, LLC



Source: IMF, Wells Fargo Securities, LLC

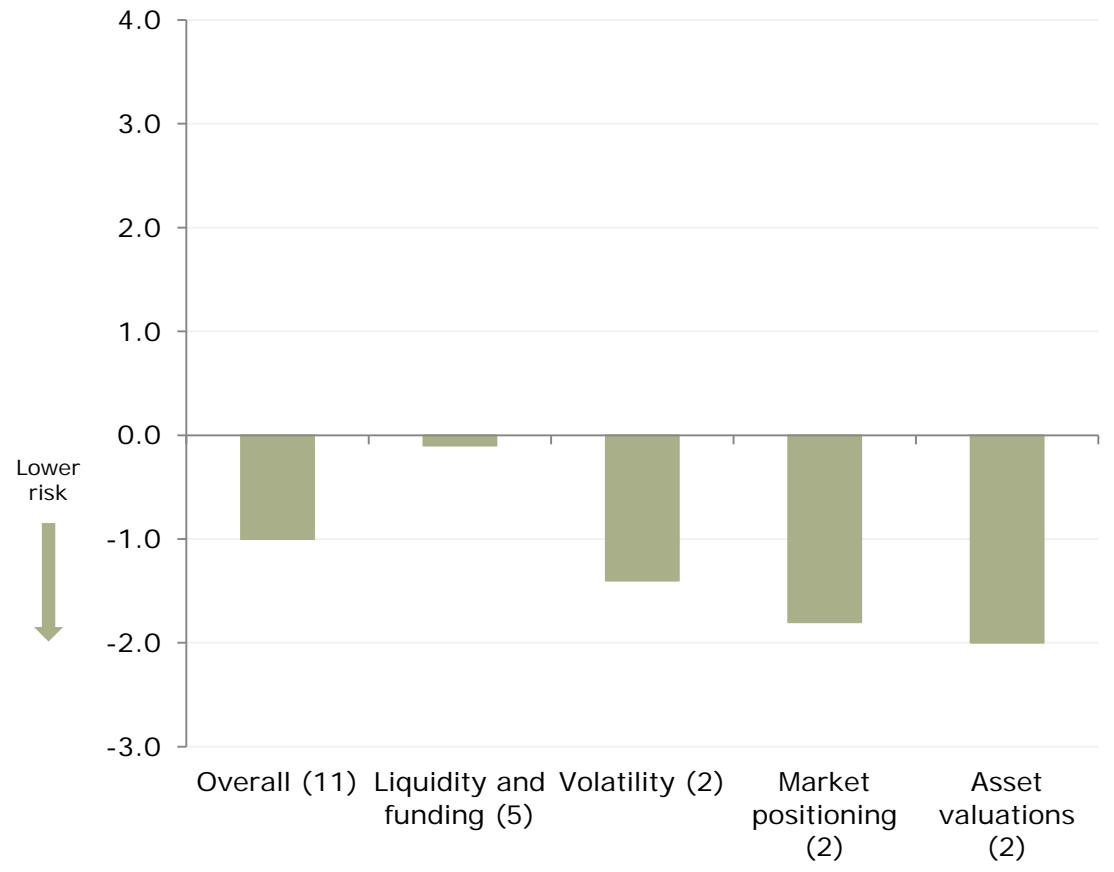


Source: IMF, Wells Fargo Securities, LLC



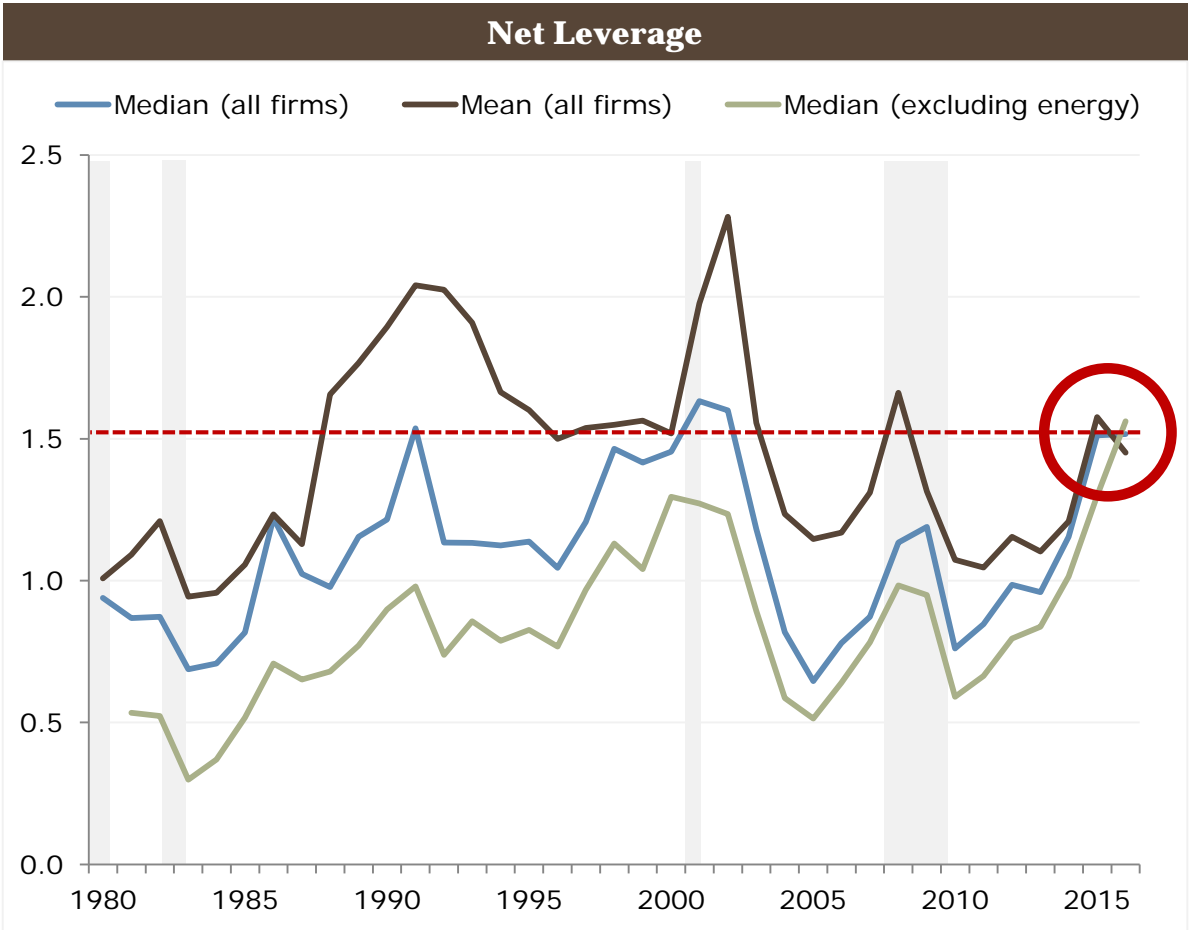
Source: IMF, Wells Fargo Securities, LLC

Market and Liquidity Risks



Source: IMF, Wells Fargo Securities, LLC

Net Leverage of S&P 500 Companies



Source: IMF, Wells Fargo Securities, LLC

Stages of a Stylized Credit Cycle

August 2007 – March 2009

- Falling credit growth
- Falling profits, rising leverage, weakened cash flow
- Credit undervaluation

March 2009 – December 2009

- Companies try to shore up balance sheets
- Weak credit growth
- Falling profits and leverage
- Credit undervaluation



July 2004 – August 2007

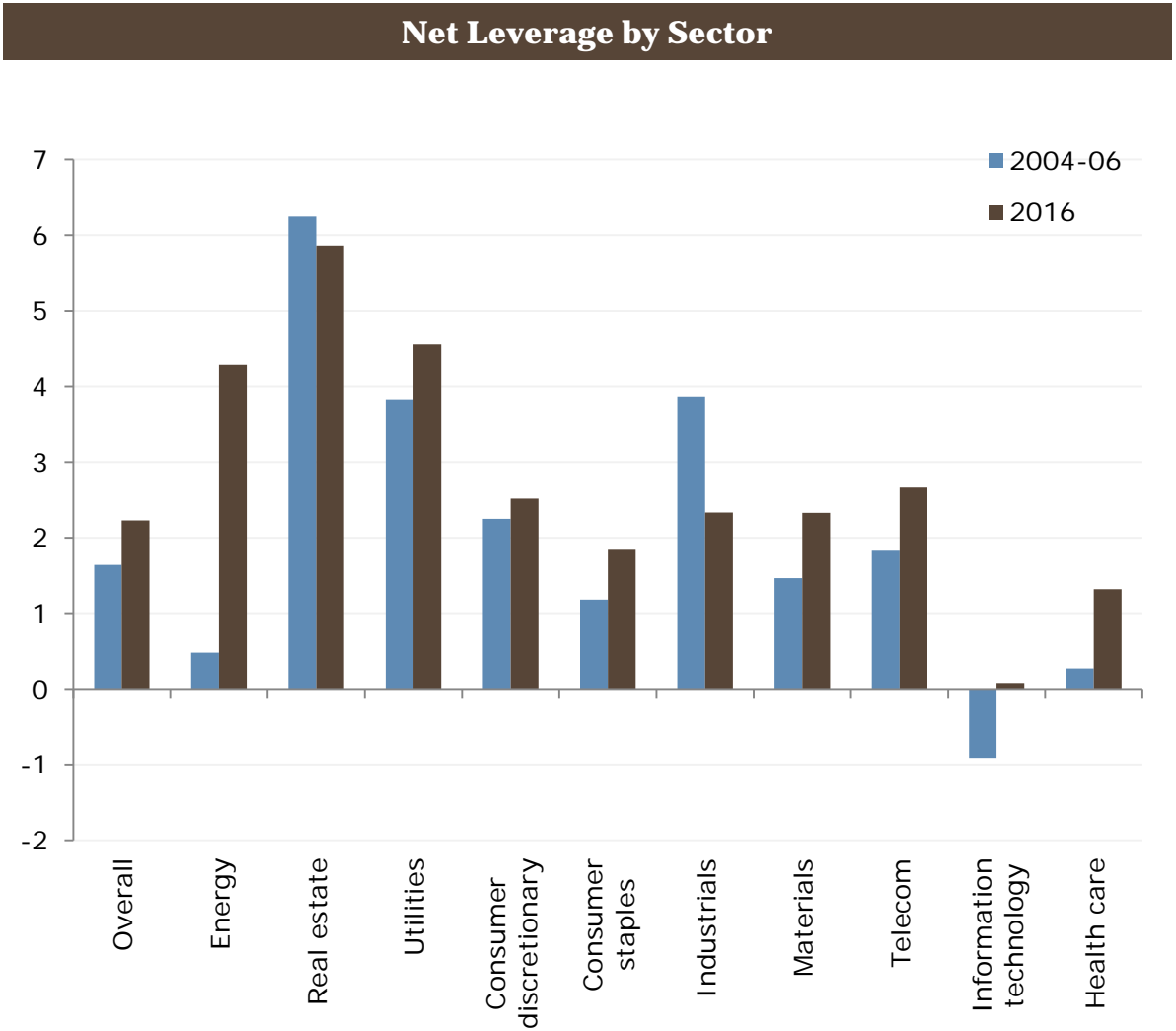
- Excessive risk taking
- Rapid credit growth
- Rising profits, rising leverage, large-scale M&A and capex
- Credit overvaluation

July 2004 – August 2007

- Improving momentum
- Accelerating credit
- Rising profits, falling leverage
- Valuations close to fair value and rising

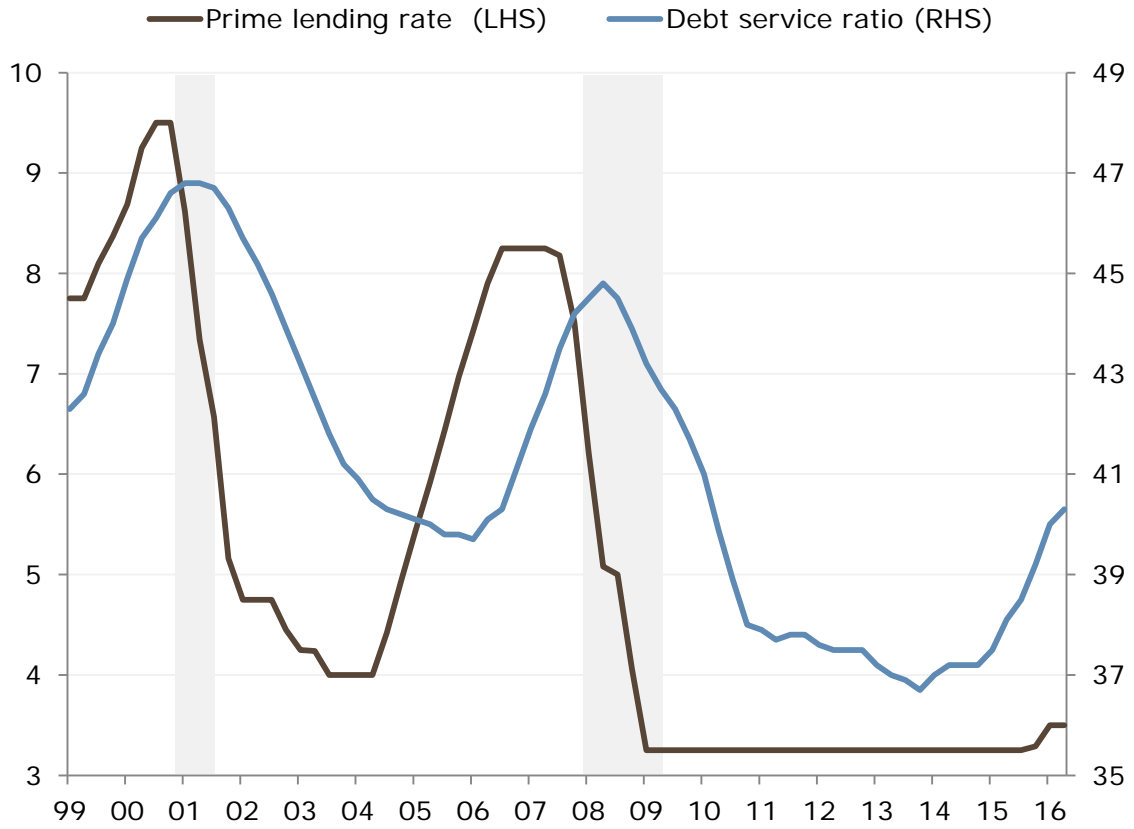
Source: IMF, Wells Fargo Securities, LLC

Net Leverage of S&P 500 Companies by Sector



Source: IMF, Wells Fargo Securities, LLC

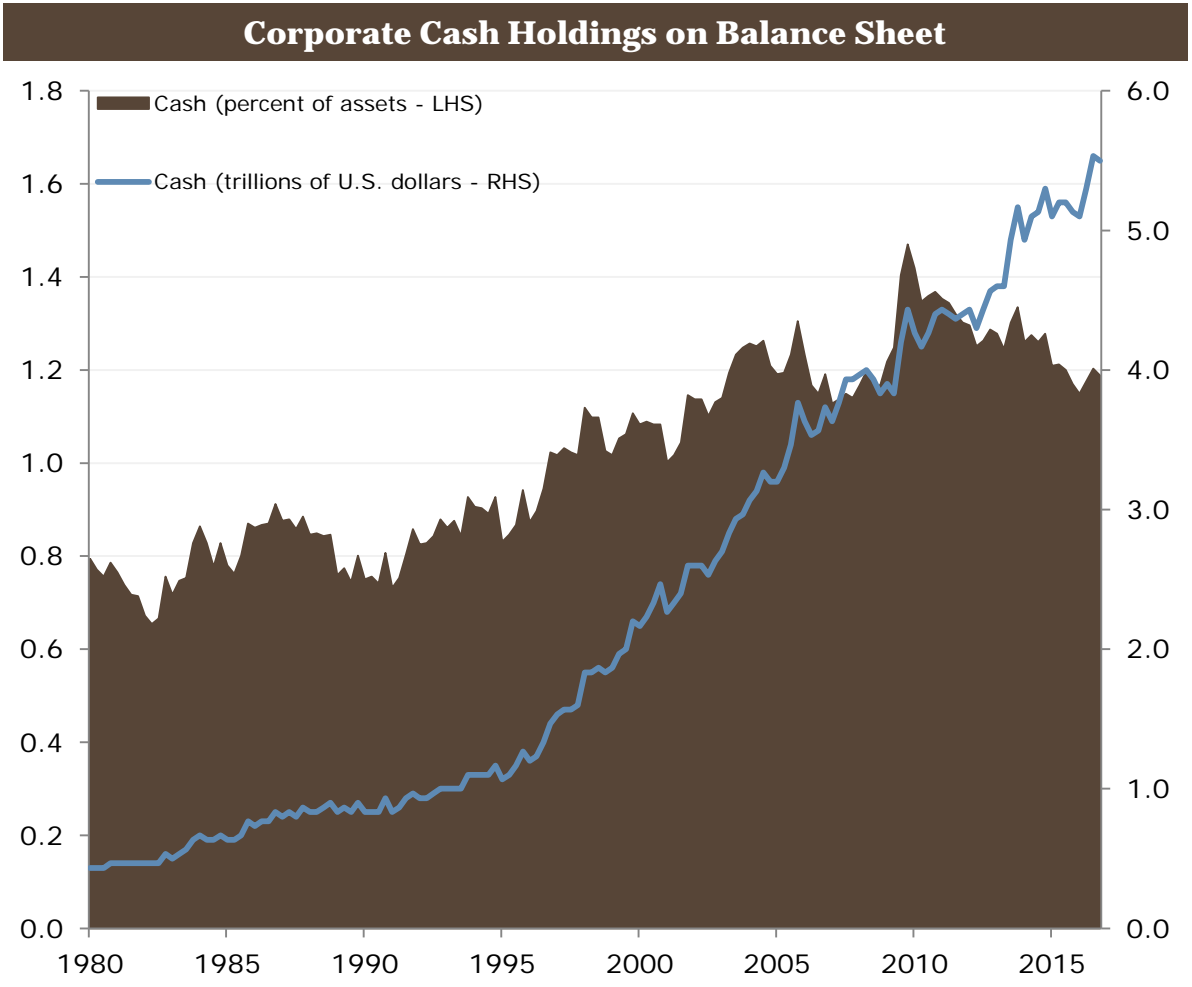
Corporate Debt Service and Interest Rates



Source: IMF, Wells Fargo Securities, LLC

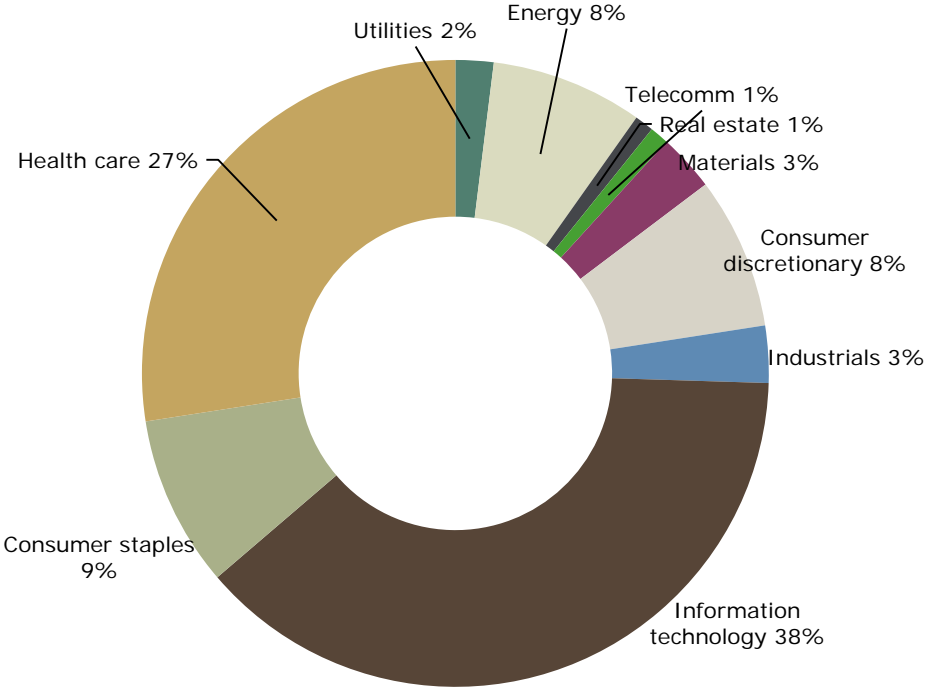
Macro Considerations for Short-Term Markets

Corporate Cash Holdings on Balance Sheet



Source: IMF, Wells Fargo Securities, LLC

Unrepatriated Income, by Sector



Source: IMF, Wells Fargo Securities, LLC

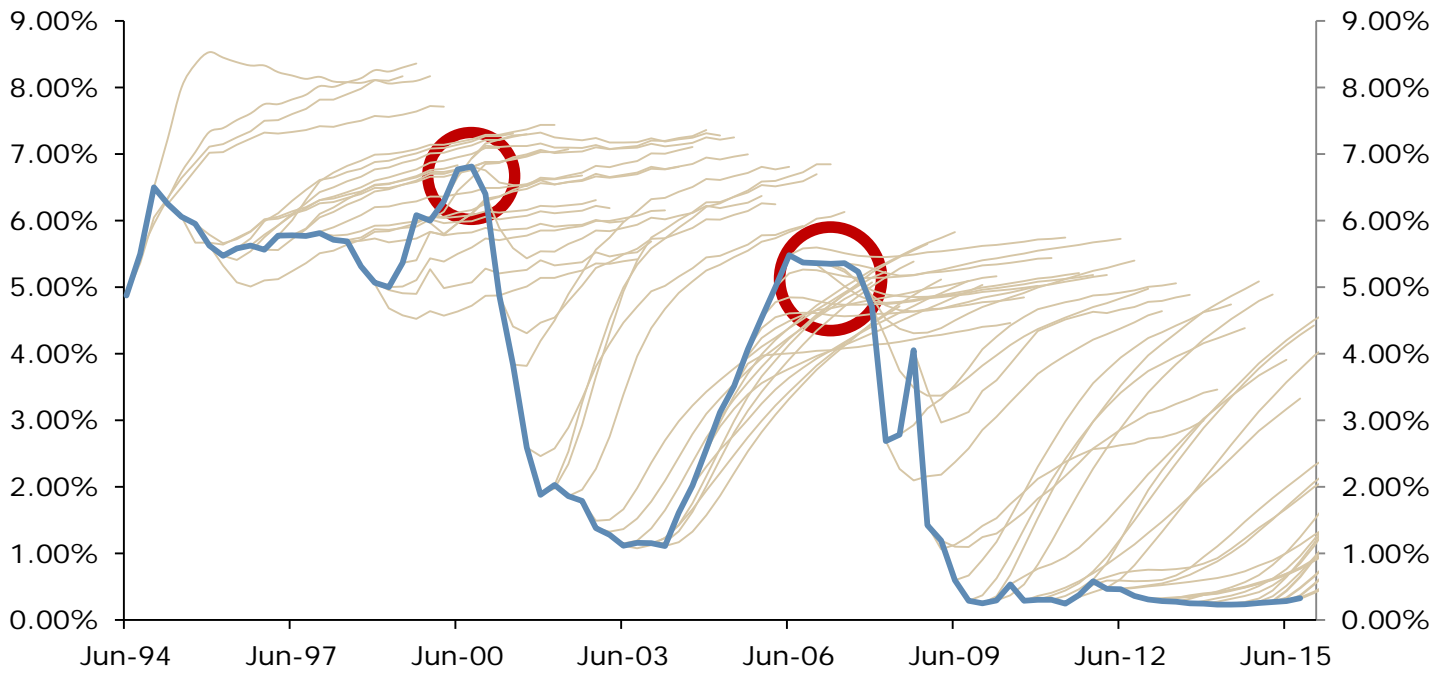
Sector Performance in a Rising Rate Environment

Does it make sense to move to floaters in a rising rate environment? *It depends...*

History shows that forward rates frequently overshoot actual movements in short-term rates, making a case for not being heavily underweight duration just because rates are rising.

If investors move from fixed to floating and actual floating rates stay lower than forward rates, the floating rate position underperforms the fixed-rate alternative

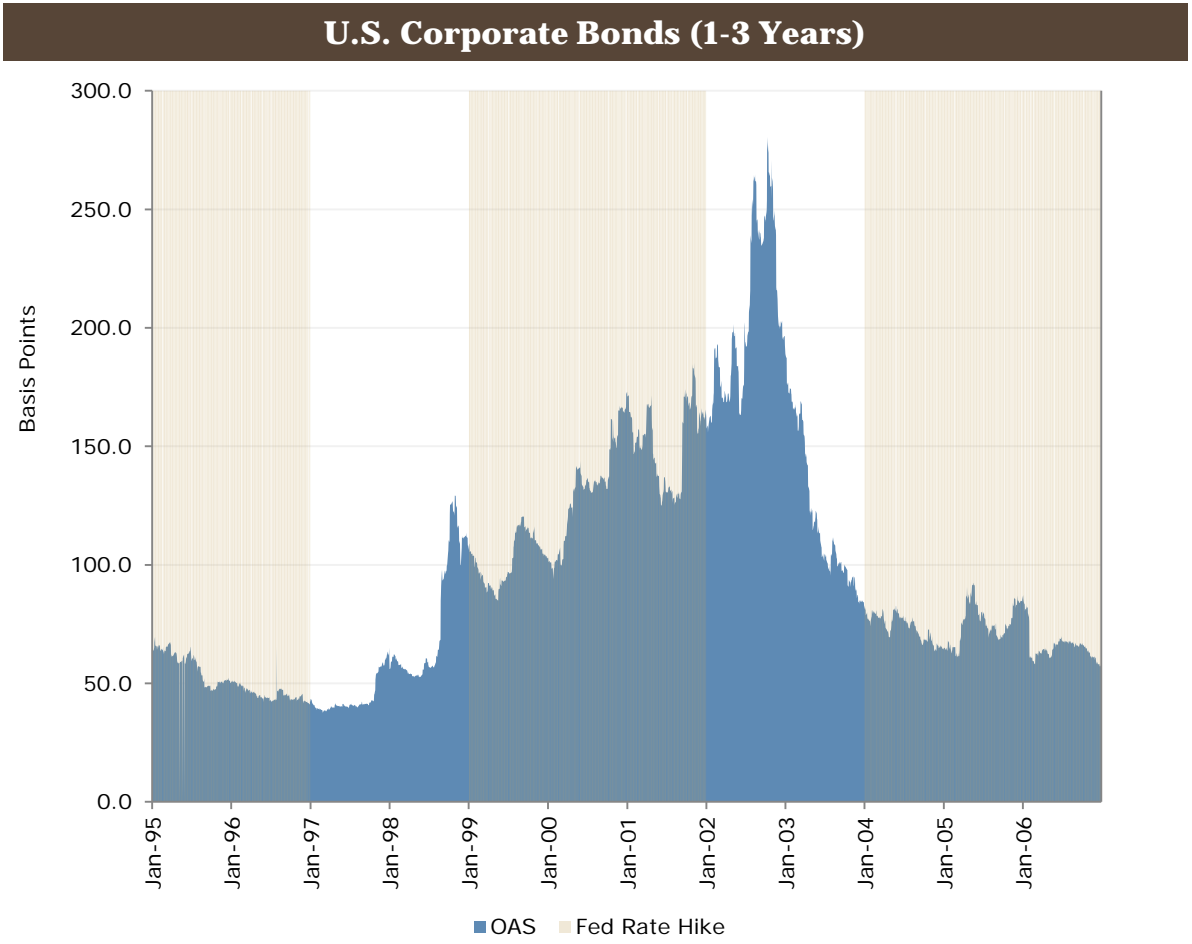
3-month LIBOR vs. 5-year forward rates



○ Approximated points where 3-month LIBOR exceeded forward rate expectations

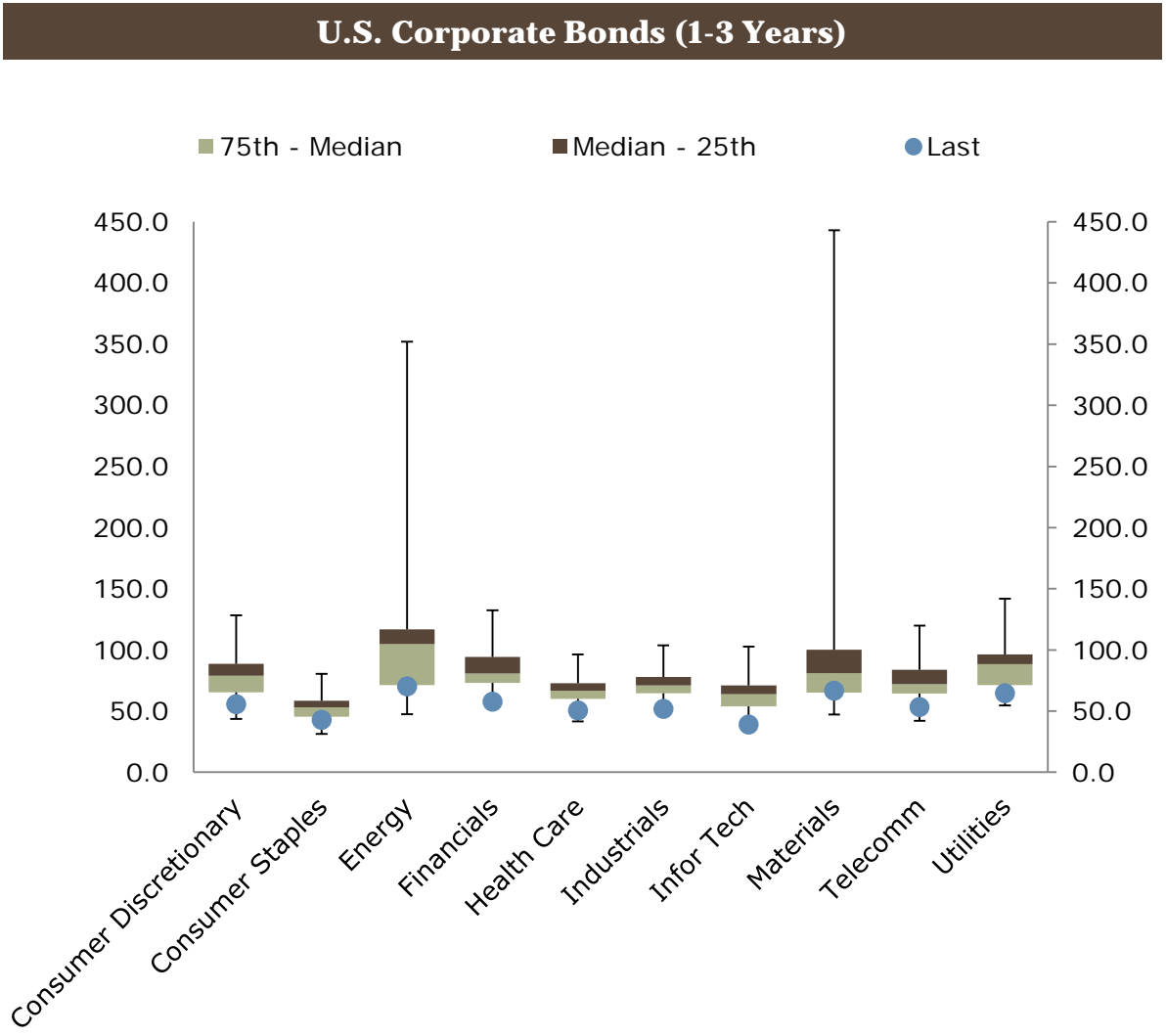
Source: ICE, Bloomberg, and Wells Fargo Securities, LLC

Investment Landscape: U.S. Corporate Bonds (1-3 Years)



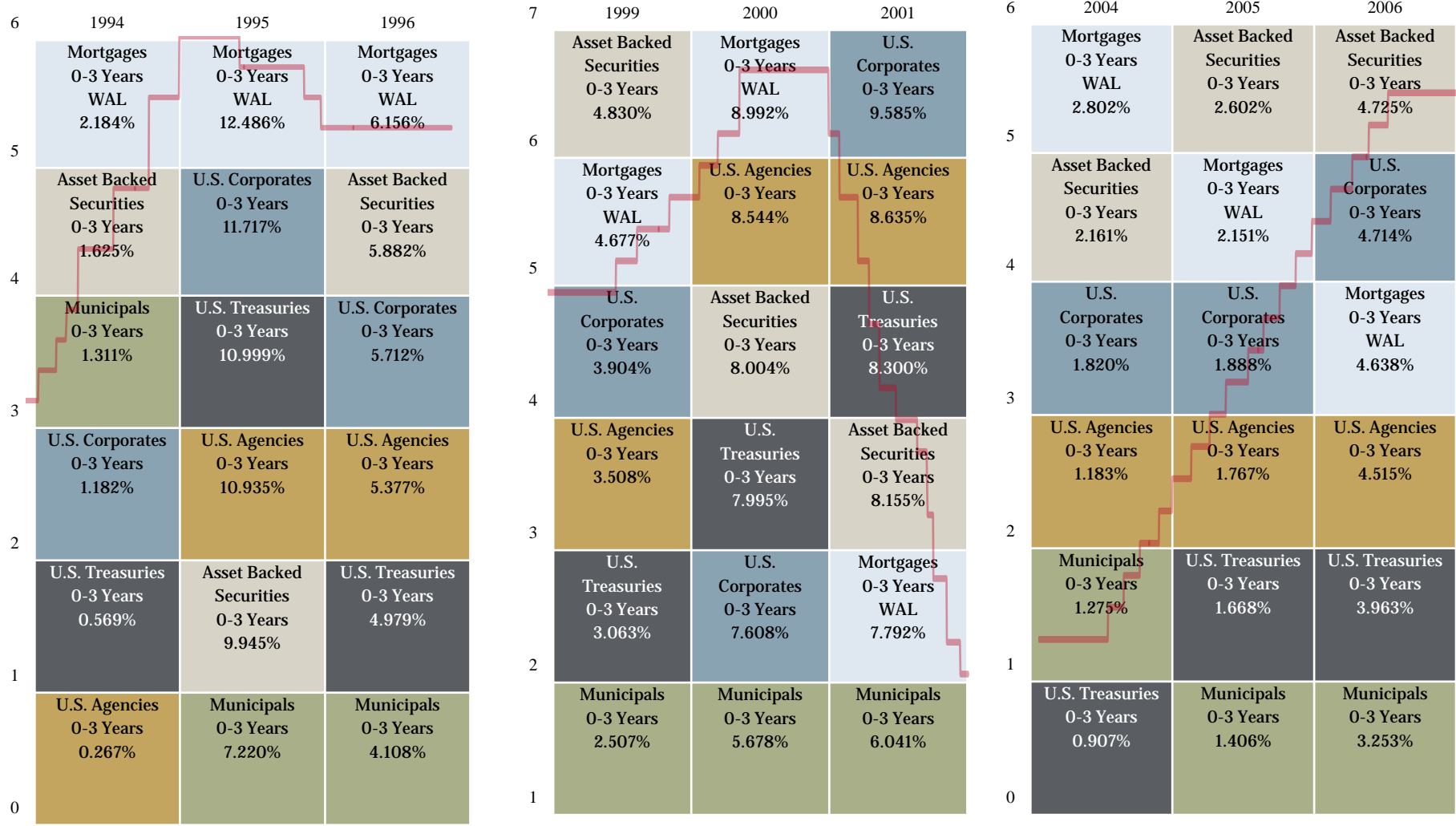
Source: Bloomberg, Yield Book, Wells Fargo Securities, LLC

Investment Landscape: U.S. Corporate Bonds (1-3 Years)



Source: Bloomberg, Wells Fargo Securities, LLC

Investment Landscape: Annual Returns for Short Duration Sectors



Source: Bloomberg, Federal Reserve, Wells Fargo Securities, LLC

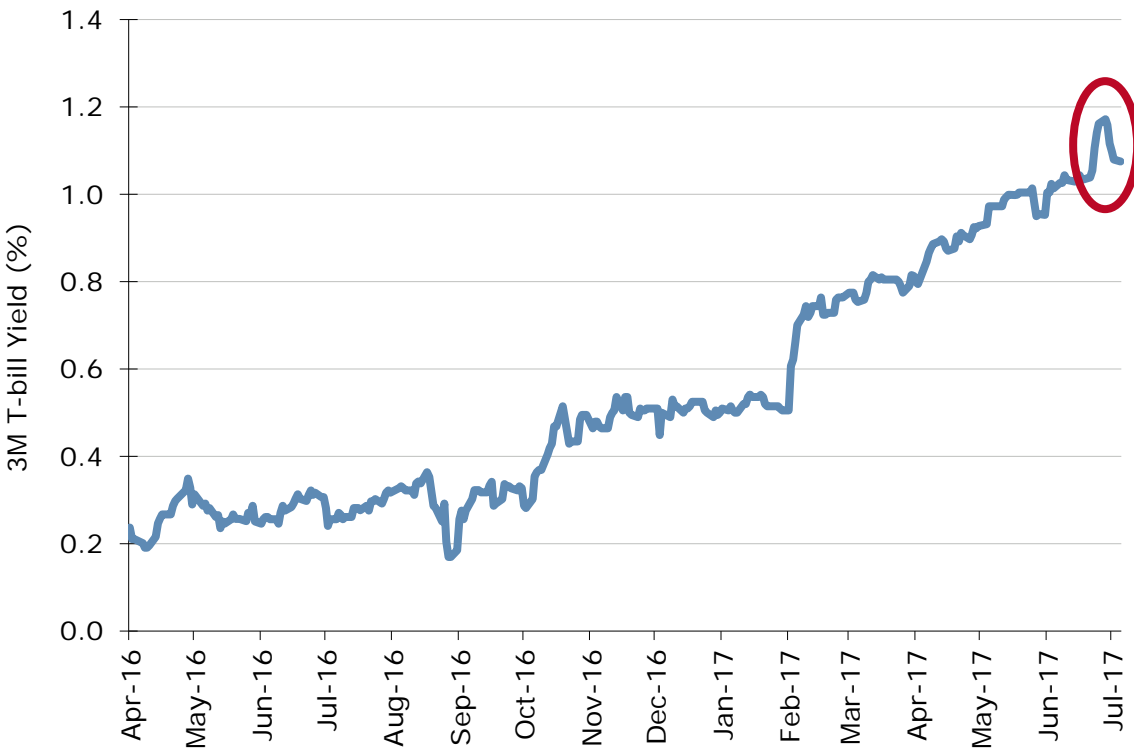
Returns shown are the annual total returns of select Bank of America Merrill Lynch indices. This Table of Short Duration Returns is a comprehensive representation of relative sector performance for a 12-year period through 12/31/2006.

Debt Ceiling – *This Time It's Different...*

All aboard the Debt Ceiling Train...

Sentiment about the likelihood of technical default is shifting day-to-day.

Short-term Market Psychology is Oscillating



Source: Wells Fargo Securities, LLC, Bloomberg

Comments from the Administration suggest a willingness to prioritize payments...

Thoughts on the Debt Ceiling

Timing

Late Q3 – early Q4 remains best estimate for the exhaustion of “extraordinary measures

Politics

Administration may be willing to allow a government shutdown

“Our country needs a good ‘shutdown’ in September to fix mess.”
— *President Trump*
May 2, 2017

Supply

1. TSY cash position is likely to be squeezed
2. Could constrain bill supply
3. FOMC run-off caps could help

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