

## Credit Markets: Is Inflation Finally Coming?

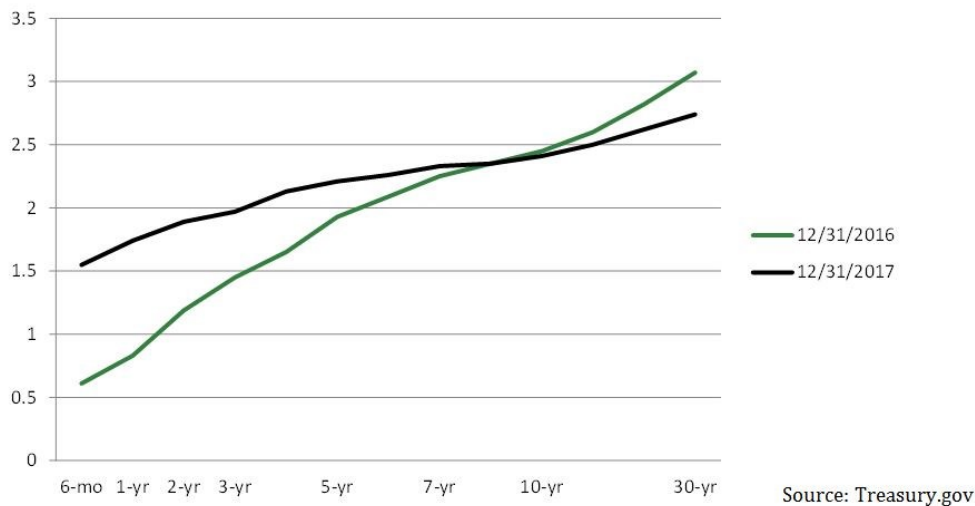
By: Charles J. Else

January 2018

The fourth quarter brought greater clarity to the future of interest rates as the Federal Reserve began to shrink its huge \$4.5 trillion balance sheet and followed through with a third interest rate hike for the year in December. The Fed also indicated they plan three more rate hikes in 2018 as economic growth improves and the potential for higher inflation seems to finally be materializing.

Much of the press in the past couple of quarters has centered on the “flattening” of the yield curve.

### U.S. Treasury Yield Curve



As you can see in the above graph, shorter-term interest rates rose substantially versus a year ago (due to the Fed tightening), while long-term rates actually fell, resulting in a flatter curve.

What is interesting to note is that intermediate term rates in the 3-7 year range have also begun to move up. This indicates credit markets are slowly buying into the fact that economic growth is improving and the prospect of inflation down the road is increasing, particularly due to a tightening labor market.

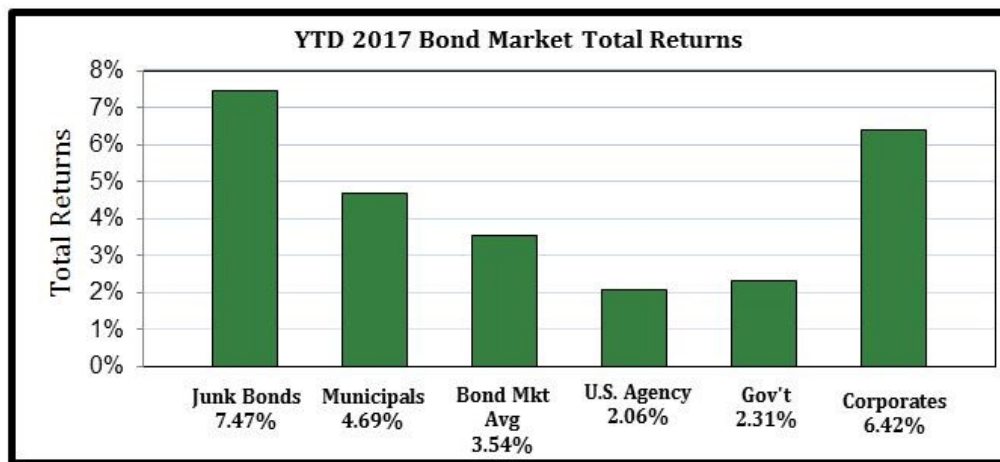
Historically, a flattening yield curve has been an ominous sign of a pending economic recession. However, we believe this time may be different. Coming off of unprecedented low rates and one of the slowest economic expansions in history, longer-dated maturities have been hesitant to price in any significant inflation down the road. But unlike prior flattening periods, for the first time in history the Fed actually has some ammunition to defend against further flattening in longer maturities as they can accelerate the sale of bonds currently held on their balance sheet. We would not be surprised to see the move up in rates begin to spread to long-term Treasuries.

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For the year, the best performing issues were junk bonds, corporate bonds and municipals (all of which we generally own). U.S. Treasuries and Agencies underperformed the bond market averages. As 2018 unfolds, we expect to see the overall yield curve continue to move up, with long-term rates joining the trend in anticipation of greater inflationary pressure in the future. As a result, we continue to favor bonds with maturities in the 3-8 year range.



Source: Wall Street Journal

Bond Market Yields 12/31/2017			
Average Money Market Fund	0.78%	10 Yr. AAA Muni Bond	2.01%
5 Yr. AAA Muni Bond	1.70%	10 Yr. AA Corporate Bond—Long Term	3.09%
5 Yr. AA Corporate Bond—Intermediate	2.54%	10 Yr. U.S. Treasury	2.41%
		30 Yr. Fixed Rate Mortgage (Conforming)	4.15%

Source: Bankrate.com

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