What Caught Our Eye This Week
Longer London Interbank Offered Rate (LIBOR) is the reference interest rate for tens of millions of financial instruments worth hundreds of trillions of dollars. It is derived from a daily survey from several large banks that estimate the rate to borrow from each other without putting up collateral. Today, very few banks make unsecured loans thus making LIBOR more theoretical than real. The first step in transitioning from LIBOR begins next week when the Federal Reserve Bank of NY will publish SOFR (Secured Overnight Financing Rate), a rate based on repurchase agreements which are transactions for overnight loans collateralized by treasury securities. Transitioning to SOFR will not be easy. Currently, SOFR is only an overnight rate while LIBOR is published in several tenors or term maturities. A plan to add terms for SOFR is in place. Liquidity for SOFR products is important and the development of a derivatives market will be critical. The original language in financial instrument contracts in which LIBOR is referenced will also be a challenge. Some legacy contracts do not mention an alternative base rate in the event LIBOR ceases to be published. To deal with these issues, the Alternative Reference Rate Committee (part of the NY Federal Reserve) has issued a transition plan which concludes in 2021.

Economy
The economic headlines this week was Wednesday’s report on fourth quarter real GDP. This was the final look at Q4 GDP, and the figures came in better than consensus rising at a 2.9% annual rate. The previous reading was 2.5%, but upward revisions to consumer spending and inventories increased the overall estimate. Q4 corporate profits were highlighted in this report and were down 0.1% compared to the third quarter. Over the past 12 months, corporate profits are now up 2.7%. The first look at first quarter real GDP will be presented on April 27th. In other news this week consumer confidence figures showed a modest decline, decreasing from 130 to 127.7 in March. The labor market differential increased from 24 to 25, which is a new high for the expansion. On Thursday, personal income/consumption data was released for February and personal income increased by 0.4% and personal consumption increased by 0.2%. Personal income is now up 3.7% year-over-year and personal consumption has advanced by 4.6%. Finally, weekly jobless claims dropped by 12,000 during the week ending March 24th. This is a new best for the expansion, and the four-week moving average is now at 225,000.

Fixed Income/Credit Market
The first quarter of 2018 saw interest rates across the U.S. Treasury curve increase anywhere from 23 basis points (bps) at the 30-year tenor to 41.2 bps at the 3-year tenor. Yields on the benchmark 2-year and 10-year Treasuries increased 38.4 bps and 33.3 bps, respectively. The 2-year and 10-year U.S. Treasury spread decreased 5.1 bps in the first quarter to close at approximately 47 bps, its flattest spread over the last 5 years. We have iterated in the past that the flatter yield curve is not currently pointing toward a U.S. recession, rather, it is reflecting that longer-dated yields may make it difficult for the FOMC to increase interest rates to historic levels. Since the Fed increased the Fed funds rate 25 bps on March 21st, the 10-year U.S. Treasury yield has decreased 15.7 bps to close the quarter at 2.74%. One month ago, the one-year forward curve forecasted the 10-year Treasury to be 3.00%, however, that has since decreased 15 bps to 2.85.

Equities
The first quarter ended the holiday shortened week with the major themes being elevated volatility and divergence of investment styles, despite the broad market index finishing only slightly down for the quarter. To illustrate the increased volatility, the S&P 500 experienced at least a 1% up or down movement during 23 days this past quarter, which compares to only 8 days in the whole year of 2017. Furthermore, the divergence of growth over value continued during the quarter with the Russell 1000 Growth index total return of +1.4% versus the Russell 1000 Value total return of -2.8%. Most of the positive returns for the quarter came from technology and consumer discretionary, while the other sectors were in negative territory. Dissecting each of the sectors displayed significant return variance among the largest sector constituents, with no broad growth leadership and several declines. General dollar weakness provided some lift to emerging markets, yet even the larger developed international markets witnessed softness during the quarter.

Our View
It is incredible the difference a year can make. Risk assets, which performed extremely well in 2017, have hit a bit of turbulence through the first quarter of 2018. The 20-day realized volatility of the S&P 500 Index in 2017 averaged an incredibly low 6.75% according to Bloomberg, with the highest level reaching 10.78% in early September. Through the first quarter of 2018, the 20-day realized volatility of the S&P 500 Index has averaged 16.15%, which is more than double 2017’s figure. However, when 2018’s 20-day realized volatility is viewed from a longer-term perspective, it is in line with the average of 15.32% dating back to March of 1928. The previously mentioned data leads us to conclude that risk assets are behaving as expected year-to-date in terms of volatility and that 2017 was truly an abnormal year. The two main drivers of increased volatility this year have been the elevated uncertainty of the future path of interest rates and the potential for a global trade war. With respect to the future path of interest rates, market participants are concerned over increased fiscal easing in the U.S. in an economy that is at or near full employment. This could cause inflation to increase faster than current expectations and push the Fed to shift from a position of gradually removing monetary policy accommodation to proactive tightening. The FOMC released their updated monetary policy projections last week and even though the median Fed funds rate projections increased by 20 to 30 basis points in 2019 and 2020, the median projection for 2018 stayed the same at 2.125%. At this point it appears that the Fed will be able to continue on its path of gradually removing accommodative monetary policy, but we will be keeping a close eye on inflation measures moving forward.