

The First Tee...

Betting on the Odds...as the yield-curve approaches inversion (short dated bond rates higher than longer maturing issues), **recession talk ramps-up** (an inverted curve has occurred prior to the past seven recessions):

- The yield-curve historically reflects the market's sense of the economy and inflation:
 - Investors who believe inflation will increase typically demand higher yields to offset the effect:
 - Inflation typically results from strong economic growth...a steeper yield-curve implies investors are bullish on the economy;
 - CPI and PCE (lead and core readings) are trending at or above the Fed's 2% inflation target for the first time in six years.
- There are additional factors impacting the yield-curve in the current environment:
 - The Fed's methodical tightening of monetary policy has increased short rates, but there has been conflicting issues effecting longer-dated securities, primarily keeping a cap on bond yields:
 - **Some of the aspects influencing longer-term interest rates higher and lower include:**
 - **Higher...**CPI and PCE inflation meeting Fed target rate, Central Bank ending quantitative easing bond purchases, the Treasury Dept. doubling supply of new bond issuance to over \$1 trillion this year, stock market rally drawing liquidity out credit curve:
 - Typically, with GDP growth approaching 3% and inflation at 2%, the rate on a 10-year T-Note would be 4.5% to 5% (versus current 2.88% rate).
 - It is anticipated, the Fed's intent is to get to a "neutral" Fed Funds rate, this would place the benchmark target rate at close to 3%.
 - **Lower...**concerns over the fall-out from the trade disputes, weakening trend in emerging market economies, geopolitical issues, pension and insurance funds voracious demand for long-term high-grade bonds, the economic expansion being late in the cycle, low international interest rates and bond purchases by European and Japanese central banks:
 - There is a perceived confidence among traders (due to the Fed's establishment as an inflation fighter during the past three decades) that longer-term bond rates should be expected to trade in a lower range than compared to the historical average (*maybe the confidence is misplaced?*).
 - The Treasury Department has announced it is focused on increasing the amount of T-Bills and shorter-dated coupon maturities, this is creating a scarcity of longer-term issues while creating rate pressures on the short-end of the curve to absorb the extra supply.
- **Self-fulfilling prophecy...an inverted curve has historically led commercial banks to tighten credit:**
 - Upside-down yields depress net interest margins, curtailing lending and slowing business activity:
 - The U.S. has a highly leveraged economy with large amounts of debt...a flattening trend in the yield curve can slow economic activity:
 - Corporate debt stands at 45.4% of GDP (a record high)...corporate debt was near 45% of GDP prior to the last two recessions.
 - A negative business confidence indicator has been corporations using excess cash for share buy-backs instead of organic investment.
 - Treasury Secretary Mnuchin claims having a flat yield-curve is a positive thing...at a time when the government is increasing the amount of debt sales to fund the widening budget deficits...Mnuchin had claimed in the past tax-cuts would not increase deficits due to gains in GDP.
- **Gray anatomy...the Fed is expected to pause hiking the benchmark target rate when it hits monetary policy nirvana of "neutral"...**this would be a departure from Central Bank strategy during the last two economic cycles:
 - A neutral rate is one that promotes trend-line real GDP growth while maintaining stable inflation:
 - During the past 30 years, Treasury yields have typically traded at a positive spread to the level of inflation:
 - Historical real interest rates (returns minus the rate of inflation) have been strongly positive, especially at the end of economic cycles:
 - High real interest rates have promoted the Fed's credibility for keeping inflation low...helping sustain a higher value for the dollar:
 - The elevated value of the dollar made U.S. companies less competitive in global markets, but maintained the currency's purchasing power internationally.
 - When the job market is at full employment, the Fed typically continues to raise rates above the neutral level:
 - Fed Chairman Jerome Powell, recently pointed to Alan Greenspan's pausing of monetary tightening in 1996 when the target rate hit neutral, despite a majority of economists calling for higher rates...Greenspan had surmised the U.S. was on the cusp of a change in the economy where an increase in productivity could support faster GDP growth without an increase in inflation:
 - It is anticipated Powell could view the recent acceleration in inflation at transitory, and stopping at neutral is the correct policy action:
 - If inflation remains controlled, a less hawkish Fed policy shift would be warranted but could lead to different economic and financial market dynamics.
 - Currently, a majority of the Federal Open Market Committee is projecting the neutral rate to be close to 3.00%.
 - **Holding real interest rates at neutral could result in a weaker dollar and higher commodity costs:**
 - Future economic cycles could be more volatile as companies may be forced to deal with erratic supply-chain issues:
 - Inventory management would be challenging with periods of surpluses and deficits aligned with unstable raw material prices.
 - Unemployment trends could be restrained but worker wages will have reduced leverage in their buying power.

At the turn...

The Back Nine...

Trading Places...the U.S. tariff blitz is designed to convert the American economy from a buyer to a builder...placing emphasis on manufacturing instead of consuming:

- The tariffs will have an inflationary impact as consumers will face higher prices on housing and transportation, as well as discretionary and non-discretionary goods:
 - Companies will hope for pricing flexibility to off-load tariff related costs...without negatively impacting sales.
- President Trump also wants monetary policy to assist in plans for economic reorientation
 - As noted on Page 1, the Fed has established inflation fighting credibility over the past few decades by implementing a policy strategy of keeping real interest rates high (sometimes much higher than the rate of inflation):
 - The emphasis on high rates focused the economy around financial activities, consumption and imports, rather than labor, production and exports...consumers benefited at the expense of manufacturing workers as production jobs were moved over-seas:
 - If the Fed does stop increasing the benchmark rate target at the neutral rate, then the high real interest rates experienced in past economic cycles will not be realized in the current cycle...placing downward pressure on the dollar, but making exports more competitive.
 - When investors can earn high real interest rates on U.S. Treasury bonds, they are dis-incentivized to invest in new production or consumer goods and services...items that would put upward pressure on inflation:
 - From a global perspective, foreign investors will purchase U.S. assets when they can earn a high real interest rate:
 - This investing will push the value of the dollar higher in foreign exchange markets, making U.S. exports less competitive.
- If changes in trade and monetary policies result in the economy being less consumption oriented, the global adjustment will be cumbersome and slow to implement:
 - Countries and businesses have allocated resources and made investment decisions based on assumptions regarding trade arrangements and value of currencies...change will be a costly undertaking.

Valuation Values...price gap for new homes versus used is at smallest spread in 8 years

- The new to used home price differential has contracted from 37% to 27% since 2015:
 - Used home prices are rising faster than new homes...about 2% to 3% annually over the past couple of years:
 - New home builders continue to struggle with high land, labor and material costs...there has been a recent trend of some new home construction shifting to smaller homes with less amenities farther from job centers to attract budget conscious buyers:
 - As used home prices have appreciated, it has increased the homeowners' wealth...this should benefit home builders as a majority of new construction is purchased by existing buyers...a positive impact from housing inflation.
 - There are some concerns that another housing bubble is starting to form...a negative impact from housing inflation.

19th Hole...

“Impossible” only describes the degree of difficulty.

David Phillips

Ross Elford, First Vice President

Direct: 314.746.3679 | Mobile: 314.223.9739 | Fax: 314.746.8737



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