Market and Economic News

The March to June quarter was marked by sharp declines in market yields, primarily driven by flight-to-quality investment flows and expectations for lower domestic monetary policy rates. International trade tensions and the negative impact on the global economy are beginning to weigh on the investment and hiring outlook, particularly for manufacturing companies. The Fed has noted the negative implications of a protracted trade war, now suggesting that they could cut policy rates, possibly multiple times before the end of 2019. As domestic policy rates are the primary driver of short-term fixed income market returns, policy rate cuts will drive the LGIP yield lower by a similar magnitude. Although the Fed has not clearly signaled impending rate cuts, futures markets are suggesting that Fed Funds rates will be approximately 50 basis points lower by the end of this year.

The Fed maintained policy rates at the June meeting in a range of 2.25 percent to 2.50 percent although the committee dropped the word “patient” and instead highlighted “uncertainties” surrounding the
economic outlook in its prepared statement. In the ‘dot-plot,’ eight of seventeen participants see lower policy rates in 2019 and seven of those see two potential rate cuts by year end. However, the median dot continues to call for no change in rates in 2019 while in 2020 the median dot now sees policy rates falling to a range of 2.00 percent to 2.25 percent. A single FOMC participant dissented and preferred a 25 basis points cut to policy rates at the June meeting. During the press conference, Chair Powell made comments about low current and expected inflation rates which, in conjunction with a desire to maintain the economic expansion, were interpreted by market participants to be supportive of a cut to policy rates in a so-called “insurance cut” at the upcoming July 31 meeting. FOMC members speaking in the days after the press conference largely reiterated the case for rate cuts. Fed Funds futures contracts are currently pricing a 100 percent probability of a 25 basis points cut at the July meeting and an 80 percent probability of a second cut at the September meeting.

Another important component determining yields for LGIP Program participants is the excess return over risk free assets received by investing in high quality bank and corporate issuance. The following is a high-level review of financial highlights released for the calendar second quarter of 2019 among approved LGIP investment names.

Domestic bank credit quality continued to remain high. Many banks have reached their capital retention goals and are returning a majority of earnings to shareholders. Earnings growth is slowing as net interest margins compress and the prospect of higher rates fades away. Non-performing loans are lower than in the prior year period. Foreign financial institutions are continuing the slow process of building capital. European lenders are reporting improving loan losses but continue to operate in a low return environment.

Corporate earnings remained favorable, allowing leverage improvements on the balance sheets of many issuers. The technology sector in particular benefited from continued high levels of cash flow and a reduction in outstanding debt. Bristol-Myers Squibb and International Business Machines were removed from purchase consideration as both firms increased leverage in advance of acquisitions. The approved list expanded with the additions of truck manufacturer PACCAR and Chilean state-owned bank Banco Estado.