TEMPLETON
FINANCIAL SERVICES

Credit Comments
October 2018

Return Summary

Interest rates have been rising since the first of the year. The Fed has raised the Fed Funds rate from 1.50% to 2.25%, which has caused the 10-year UST yield to increase from 2.45% to 3.20%. The table below shows the returns year to date for various fixed income indices. The 10-year UST index has been the worst performing index this year.

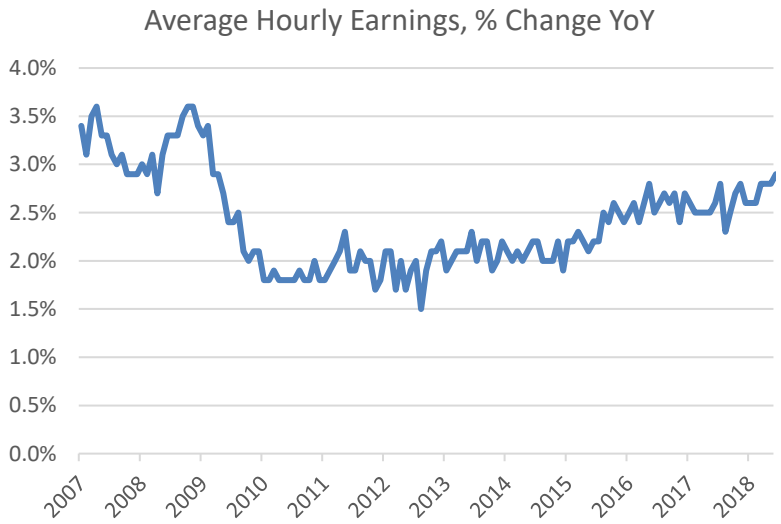
Municipal Index	Effective Duration	3Q 2018 Return	YTD Return
ML Municipal 3-7 Year Index	3.99	-0.073%	0.195%
ML Municipal 12-22 Year Index	8.09	-0.276%	-0.735%
Taxable Index	**Effective Duration**	**3Q 2018 Return**	**YTD Return**
ML US Corp & Gov 5-7 Year A Rated & Above	5.43	-0.114%	-1.581%
ML US Treasury/Agency 7-10 Year	7.47	-0.774%	-2.727%
ML US High Yield BB Rated	4.47	2.357%	0.546%

Views from TFS Economic Dashboard

We use an Economic Dashboard to aggregate market data and monitor trends in the economy. Our Economic Dashboard is divided into 4 different categories, and each category has 3 different key indicators. The categories are Inflation, Labor, Growth, and Market. These categories are all suggesting continued economic strength and an increase in inflationary pressures.

Inflation

Signs are pointing to higher rates of wage inflation. Average Hourly Earnings (AHE) is currently increasing at a 2.80% year-over-year rate. This is the fastest rate since the Great Recession. AHE has averaged 2.40% during the last 50 years. The chart below shows AHE year-over-year since 2007. We expect the shortage of workers in the economy to continue to put upward pressure on wages and inflation.



The 10-year breakeven rate for UST is now at 2.2%. The 10-year breakeven rate is the difference between the 10-year UST and the 10-year TIPS and is an indicator of the market's expectations for inflation. The current breakeven rate of 2.2% is higher than the 20-year average breakeven rate of 2.0%. This suggests slightly higher levels of inflation in the future. The core personal consumption expenditure index (Core PCE) is also starting to rise. This measure of inflation excludes the volatile food and energy industries and has been the Fed's preferred inflation measure. Core PCE has been below the Fed's target of 2.0% for several years and has just recently risen to 2.0%. This is higher than the 20-year average rate of 1.7%. Since the U.S. economy is late in the business cycle and inflation is a late-cycle occurrence, we would not be overly concerned if inflation rises above the Fed's 2% target.

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Labor

The unemployment rate is currently at 3.7%. This is significantly lower than the 50-year average unemployment rate of 6.2%. There is currently an acute shortage of workers in the construction industry, and there are frequent reports of firms being unable to hire qualified workers for unfilled positions. Labor shortages incentivize firms to raise wages to attract workers. For example, there are many instances where companies have raised wages to $15 per hour for unskilled workers, which is higher than the minimum wage. A continued supply shortage in the labor market will likely lead to wage push inflation.

Growth

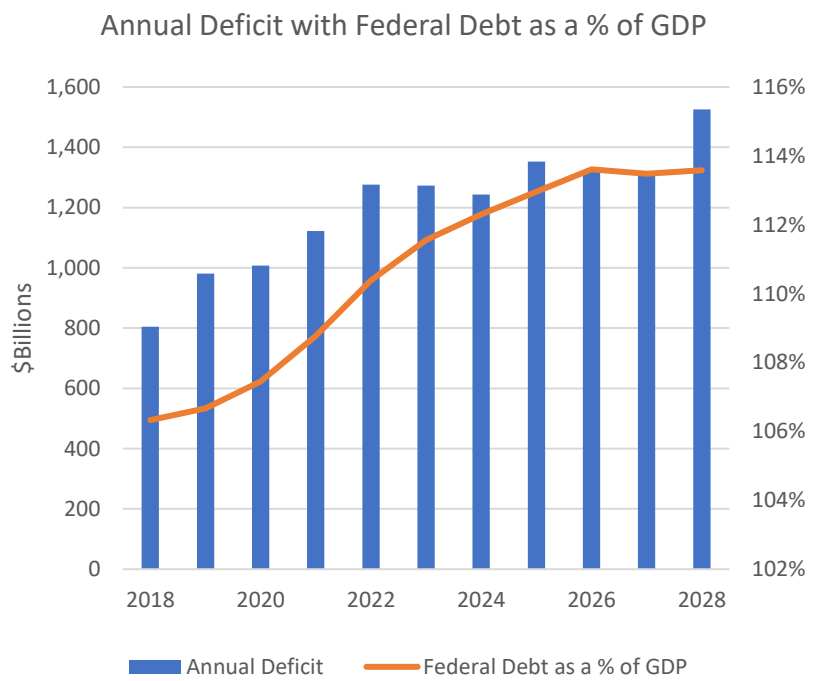
The GDP year-over-year growth rate is 2.9%. This is higher than the 20-year average GDP growth rate of 2.2%, and even higher than the 50-year average, which is 2.8%. The economy has been doing well and is finally emerging from the depressed levels of growth associated with the financial crisis 10 years ago.

Market

Market indicators have also been increasing. The 10-year UST is now at 3.2% which is higher than the 10-year average of 2.5%. The Fed Funds rate is at 2.25% and rising, compared to the 20-year average Fed Funds rate of 2.0%. The Home Price Index is also relatively high, standing at 213.8 compared to the 10-year average of 165.6.

Possible Economic Headwind

The Congressional Budget Office forecasts a trend of increasing federal budget deficits resulting from the recent tax cuts. The federal government ran a budget deficit of about $800 billion this year. The annual deficit is projected to rise to nearly $1 trillion next year and stay above that threshold for each of the next 10 years. By 2028, the United States is projected to run a deficit of over $1.5 trillion. The following chart shows both the size of the projected deficits and the associated projected percentage of Federal Debt to GDP. Studies have shown when debt to GDP increases to over 90% the deficits become a drag on economic activity. Deficits of this size caused by fiscal stimulus during the late stages of an economic recovery are unprecedented in the U.S. We expect these deficits to put upward pressure on rates as the government is forced to borrow increased sums of money from the bond markets. However, these deficits may turn into a headwind for economic activity in the future.



Source: CBO and author's calculations.

The Fed: Quantitative Tightening

The Fed increased its balance sheet to about $4.5 trillion by purchasing U.S. Treasury securities as it implemented a policy called Quantitative Easing (QE) in the aftermath of the financial crisis to stimulate the economy by lowering interest rates. The Fed is now in the process of undoing QE by reducing its balance sheet by letting some of these UST purchases run off. This reduction may be referred to as Quantitative Tightening (QT). The table below shows the changes in the Fed's balance sheet since the first of the year. This is the amount of UST that have "run off" without being reinvested in other UST securities. The total is $271.8 billion.

2018 YTD Fed Balance Sheet Monthly Net Change	
Month	**Change in Balance Sheet ($Millions)**
Starting Value	**$4,443,718.00**
January	-$29,455.00
February	-$25,824.00
March	-$1,203.00
April	-$19,312.00
May	-$45,367.00
June	-$22,028.00
July	-$27,810.00
August	-$58,767.00
September	-$26,005.00
October	-$16,003.00
YTD Change	**-$271,774.00**
Ending Value	**$4,176,906.00**

Source: Board of Governors of the Federal Reserve

This reduction in the Fed's holdings is putting some upward pressure on interest rates. We expect the Fed to continue letting their balance sheet run down until there is some evidence they are causing the economy to slow down. At the same time the Fed has been increasing the Fed Funds rate. This rate has gone from 0.0% to 2.25%. Unfortunately, there are lags before the impact of Fed policies start showing results. The Fed has a history of continuing to tighten until something "breaks." There is no reason to believe this time will be different.

Conclusion

We believe we are nearing the neutral rate of interest for Fed Funds. Our studies show it is somewhere between 2.25%-2.75%. The combination of budget deficit financing and Fed policies will likely continue to put upward pressure on interest rates with the 10- year UST reaching 3.25%-3.50% this year. We believe, however, that further increases in rates will have a negative impact on the economy and will likely lead to declines in rates in the future.