ARX
MANAGEMENT, LLC

MARKET COMMENTARY – MAY 2018

U.S. Treasury rates decreased in May, pulling back from 2018 highs late in the month on concerns of political uncertainty in Italy spreading to the Eurozone, and a potential U.S. initiated trade war. The yield curve flattened, as the rally was led by longer-dated bonds while very short maturities continued to price in more Fed tightening. The reshaping of the curve reflects the market's view that: 1) the Federal Reserve will continue to raise interest rates at a measured pace, 2) the removal of monetary policy accommodation will keep a lid on inflation and inhibit future economic growth, and 3) there are dangers lurking after a 10-year bull market. ARX is still looking for two more 25 basis point rate hikes in 2018, most likely in June and September, taking the Fed Funds range to 2.00-2.25% by year end.

Stocks and risk assets generally rallied, with the S&P 500 gaining 3.7% on the month, despite the aforementioned concerns around Italy and trade. Volatility, as measured by the VIX Index, was somehow unchanged over the period after a spike late in the month. Something to keep an eye on are ominous signs coming from the European bank sector[1], as Deutsche Bank looks like a problem child that could morph into a systemic risk. Where there's smoke there is often fire, and it's hard to get a handle on the risks that reside under the surface of these mega-banks because they are so big, opaque, and hard to manage.

Outlook:

We expect the Fed to continue to remove accommodation at a measured pace through 2019, ultimately achieving a "neutral" Fed Funds rate around 2.75-3.25%. This bodes well for investors with conservative mandates and short time horizons, such as Qualified Settlement Funds, as the front end of the yield curve will continue to offer more attractive yields with very low principal risk.

Equity markets should continue to climb the late cycle "wall of worry", making new highs as strong earnings and the tax cut drive growth. Caution is warranted, however, as the aforementioned risk factors will become more magnified as the Fed continues to remove unprecedented levels of monetary accommodation. In our view, the Fed needs to get to "neutral" as soon as possible in order to have room to respond to the next recession or crisis. This challenge is exacerbated by the Fed's efforts to concurrently shed over $4 trillion from its balance sheet, which ballooned during its Quantitative Easing program implemented during the Financial Crisis. To put this in perspective, Total U.S. public debt and U.S. Annual GDP are both currently running about $20 trillion. Yes, a trillion has twelve zeroes.

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[1] Deutsche Bank's credit rating cut, the Fed states it's US operations are in a "troubled condition", and the FDIC labels it a "problem" bank.

https://www.google.com/amp/s/www.bloomberg.com/amp/news/articles/2018-06-01/deutsche-bank-cut-by-s-p-in-latest-blow-for-sewing-s-revamp

Market Snapshot:

	4/30/18	5/31/18	Change
Fed Funds Target Rate	1.50-1.75%	1.50-1.75%	UNCH
3-month US Treasury	1.82%	1.92%	+10
2-year US Treasury	2.49%	2.41%	-8
10-year US Treasury	2.96%	2.85%	-11
30-year US Treasury	3.12%	3.01%	-11
S&P 500	2,648	2,746	+3.7%
Stock Mkt Volatility (VIX)	15.49	15.43	UNCH
US Dollar (DXY)	91.84	94.07	+2.4%
Oil	$68.57	$67.04	-2.2%
Gold	$1,319	$1,305	-1.1%
Bitcoin	$9,244	$7,487	-19.0%

This month's featured song is "Sunday Roast" by Courtney Barnett. Enjoy!

https://open.spotify.com/track/0Qvple74ZC8ZVx5d9Ov0v3?si=9NWO6ZfqQmm4PSpJDLUc1A

About ARX Management:

Founded by professionals with direct experience in complex litigation and institutional investment management, ARX offers an unmatched mix of expertise relevant to managing 1.468b Qualified Settlement Funds. Prior to establishing ARX in 2011, our partners actively managed $8 billion in fixed income assets together for a large institutional asset manager. Our expertise investing conservative capital preservation products, such as money market and enhanced cash strategies, is directly applicable to the management of institutional QSFs.

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