Staring at the barrel: Energy taking over this week’s central bank discussion?

Aftermarket yesterday the Trump Administration announced a trade agreement with Japan, which might provide some relief from the various geopolitical uncertainties. The biggest move likely will be felt in Japan, as the US has other issues at hand. The aftermath of the attack on the Saudi oilfield this weekend remains top of mind. West Texas Intermediate (US benchmark) followed Brent (international benchmark) crude higher in the largest one-day percentage change in over 10 years for West Texas (14.7% to almost $63/barrel at close from under $55/barrel at Friday’s close) and the biggest percentage bump up for Brent in its over 30-year history (14.6% to $69/barrel from $60/barrel). The 5-, 10-, and 30-year treasury each showed a reversal from the selloff on Friday, with each rate coming down 5bps from last week’s close, while the 2-year yield rallied only 4bps during the day. Should higher energy prices linger, the average consumer is likely to feel the effects in the wallet just in time for peak retail season, thereby dampening the main source of support in the US economy currently. Consumers are already worried about tariff effects, so any additional pressure may alter spending habits.

**Taxable Fixed Income**

Energy-related debt represents about 8% of non-governmental debt outstanding in the US. The addition of debt from companies in the materials space brings the total to about 11% of the roughly $6.7T outstanding. For these issuers, the uptick in energy prices, should they stay, will help bolster margins that have been depressed since the drop in energy prices starting in mid-2014. The $60/barrel psychological barrier may cause investors to look more seriously at the sector, while rotating out of industries that may be negatively affected by elevated input costs, including industrials (about 7% of total US debt). For the high yield space, in which cyclical firms are more commonplace, the severity of this most recent headwind will be more noticeable. Perceived credit risk for both investment grade and high yield corporates improved yesterday, while average yields for the asset classes, along with most other taxable risk assets, followed treasuries lower and produced positive total returns for the day, with investment grade and high yield both nearing 12% year-to-date total returns.

**Municipal Fixed Income**

After 8 days of weakness, Treasury markets rebounded on Monday in reaction to the flight-to-safety sentiment spurred by drone attacks on Saudi oil facilities. Despite Treasury market strength, tax free yields continued to move up, ending yesterday’s session about 2.5 bps higher in most maturities. Monday’s soft muni markets are continuing last week’s trend which generated the largest weekly loss (~1.77% per MMA) for tax free bonds since the November 2016 post-election period. This muni underperformance pushed relative value indicators higher, with municipal-to-Treasury ratios improving to 84.7% and 97.3% for 10-year and 30-year maturities, higher in both cases than 2019 averages (79.1% and 96.1%). Fund inflows in the muni space have been the unrelentingly positive metric for tax free investors in 2019.

**Puerto Rico**

8% of 2035 printed block size trades yesterday at 57.84, the highest level of 2019. The PR Oversight Board attorney told Judge Swain, who is overseeing Puerto Rico’s bankruptcy process, that a Plan of Adjustment for Puerto Rico’s debt and other liabilities would be released by month-end. Concerns about the viability of such a plan were heightened after US Treasury Secretary Mnuchin told Puerto Rico’s new governor that the US will take steps to end a tax credit that supports the Commonwealth’s 4% excise tax on foreign corporations, which includes US companies. The Act 154 tax is paid primarily by US corporations who can claim a credit on federal returns for Act 154 taxes paid. If this tax credit ends, it could spur some corporations operating in Puerto Rico to move operations from Puerto Rico. Income from the tax provided about 18% of Puerto Rico’s revenues in FY 2019.