Stonebridge Market Wrap

October 13, 2017

For the week ending October 13, 2017

After weeks of hurricane talk and large damage estimates, we now have three hurricanes in a row with estimates ranging in the $60– 100 Billion...each. This week we have wildfires in California with damages estimates in the $65 billion area...and counting. This is starting to get expensive. There is going to be a ton of replacement activity in this country from all of this destruction. From cars/trucks to furniture, building components, electronics, just to name a few. This will likely give the economy some extra juice going forward. Not all of the fallout is on the positive side of the equation however. On the minus side is all of the disruption caused by the people that now have uninhabitable homes, wrecked businesses, flooded or burned cars and wrecked infrastructure. Those factors will hinder the local economies for months, if not years. There will probably be some migratory effects as Puerto Ricans move to Florida or New York and some Houstonians move because they were uninsured for floods. There will be housing problems in all of the areas mentioned as there will be little available housing stock sitting around for the displaced to be able to utilize. More disruption. Add to that many lives were lost and many people were injured. Very sad.

Earnings season kicked off this week and the markets liked what little the have seen so far. The earnings reports will be coming in hot and heavy for the next few weeks and it will be interesting to see how things went in the third quarter. We certainly have effects from the September hurricanes in there but if you look at the September retail sales number that came out this week you'd have to say that things are pretty good on that front so far. Auto sales, higher gasoline prices and home improvement stores were all factors in this report. Surprise.

David A. Eckenrode
Director of Equity Management

Key Economic Releases for the coming week:

Tuesday, October 17th:
- Industrial Production.; .2% expected
- Capacity Utilization; 76.2% expected

Wednesday, October 18th:
- Housing Starts; 1.18MM expected

Index & Price Changes for week ending 10/13/17	
DJIA– 22,871.72	Rose 98.05 points
NASDAQ– 6590.18	Rose 15.62 points
S&P 500– 2553.17	Rose 3.84 points
S&P Small Cap 600– 908.37	Fell 6.73 points
90 Day T Bill– 1.07%	Yield Rose .01%
2 yr TSY– 1.49%	Yield Fell .02%
5 yr TSY– 1.90%	Yield Fell .07%
10 yr TSY– 2.27%	Yield Fell .10%
30 yr TSY– 2.81%	Yield Fell .10%
Oil- $ 49.41*	Rose $1.99 per barrel
Gold- $ 1304.00*	Rose $28.50 per oz.
Unleaded Gasoline*-$1.62	Rose $.06 per gallon
Euro- $ 1.1734	Rose $.0085 against the $

** Wholesale price for NY Mercantile Exchange traded cont*

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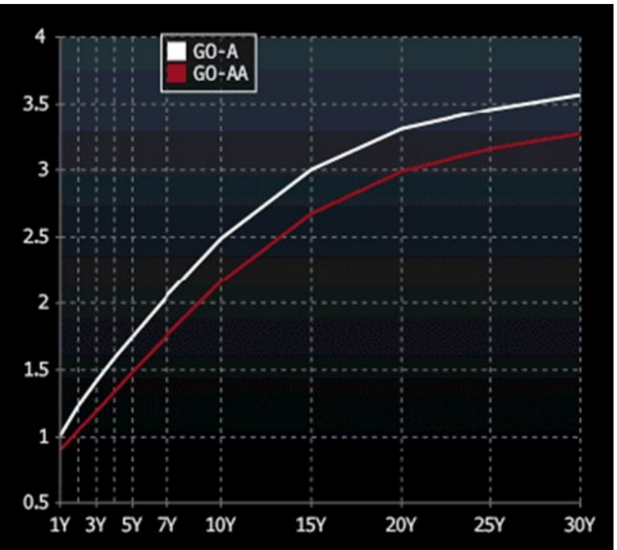
Callable Bonds: What are They and Why Does Stonebridge Use Them?

When a corporation or municipality decides to issue debt, they have several options on how they want to structure it. One caveat that they can do is make the bonds callable. The call allows the issuer to redeem the bonds prior to its ultimate maturity. Why would the issuer do this? The advantage for this issuer is if rates go down, they are able to call the bonds and issue new bonds at a lower rate, thus making it cheaper for them to borrow money. This works well for the issuer in an interest rate environment that is decreasing, like we have generally had over the past 35 years.

That being said, why would Stonebridge buy a callable bond? Generally speaking, you get better pricing on callable bonds and thus a better yield. In order to accept the callable aspect of the bond, a purchaser of the bond will expect to get a better yield compared to a non-callable bond. An example of this would be a bond that we purchased this week. We bought some North Carolina State Medical Care Commission bonds. They are A rated, have a 5% coupon and mature on 6/1/24. However, the issuer of these bonds is able to call them on 6/1/22. We bought them with a yield to the call (YTC) of 1.65%. As you can see from the chart below, this is in line with the yields of A rated debt that is between 4 and 5 years to maturity. So, if the bonds do get called you would be getting a rate that you would expect to receive in that maturity range. Where you gain value is if the bonds don't get called. In the example we used earlier, if the bonds go to maturity (YTM) they will yield 2.55% in June of 2024. Referring to the below chart again, you should expect to get around 2.06% for a similar bond maturing in 7 years. If the bond goes to maturity, you are gaining around 0.5% by purchasing a callable bond. That is a significant difference, especially in our current interest rate environment.

Term	A GO-A 10/12/17	B GO-AA 10/12/17	Spread (+/- BPs)	Spread (%)
1 Yr	1.012	0.903	11	112.1
2 Yr	1.234	1.051	18	117.4
3 Yr	1.415	1.190	23	119.0
4 Yr	1.588	1.338	25	118.7
5 Yr	1.745	1.483	26	117.6
7 Yr	2.058	1.761	30	116.8
10 Yr	2.489	2.163	33	115.1
15 Yr	3.002	2.675	33	112.2
20 Yr	3.305	2.988	32	110.6
25 Yr	3.457	3.156	30	109.5
30 Yr	3.569	3.271	30	109.1



Source: Bloomberg

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As is the case with the North Carolina bond we purchased, we like to buy callable bonds that have higher coupons. The closer to par that the coupons are, the less of an increase in yield you get if they go to maturity. The higher the coupon the more yield it will produce, but it also increases the likelihood of the bonds being called. However, as we showed earlier, you will still get an interest rate that is in line with bonds maturing at the same time as the bonds would be called.

It is good to buy a variety of bonds in client accounts. This can include sectors, maturities and also structure. It isn't always wise to buy only callable bonds, but it might be beneficial to allow room for them in a portion of your portfolio.

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Fixed Income Trader & Portfolio Manager

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