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INSIGHT

MONTHLY COMMENTARY

January Rates Update

TYLER TUCCI | FEBRUARY 5, 2018

After 2017 saw the smallest trading ranges on record in U.S., German, British and Japanese 10y debt, the start of 2018 was a welcome change as 10y global benchmark yields surged higher to levels not seen in quite some time. The composition of the selloff varied by domicile, with the selloffs seen in the U.S. and the UK led by increases in expected inflation, pushing breakevens wider. In Germany and Japan the push higher in yield was driven by real rates as realized inflation remains low in both countries. Also notable in January was the explosive move to the upside in equities with the S&P 500 closing 5% higher for the month. Interestingly, in the other 12 instances of the S&P 500 ending up 5% or greater in January, the year-over-year return for the index has never been negative. That doesn't mean any potential path higher won't be full of potholes though, as the average intra-year pullback for the previous 12 instances is -10.7%.

Global 10 Year Benchmark Yields

Source: Barclays Live

U.S. Treasury Market Overview

	12/29/2017	1/31/2018	52 Week High	52 Week Low
2 Year Treasury Yields	1.88	2.14	2.18	1.14
5 Year Treasury Yields	2.21	2.51	2.62	1.60
10 Year Treasury Yields	2.41	2.71	2.85	2.01
30 Year Treasury Yields	2.74	2.93	3.21	2.63
Yield Curve Steepness 2s to 30s	85.29	79.03	191.66	77.02
Bloomberg Barclays Aggregate Index	2,046.37	2,022.80		

Source: Bloomberg Barclays

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Though eurozone inflation has fallen significantly from its 2.0% YoY peak in early 2017, that has done very little to arrest the aggressive appreciation in the euro seen since late 2016. With peak QE for Europe firmly in the rearview, the ECB has significantly less scope to fight unwanted tightening in financial conditions, something market participants are well aware of. This lack of available policy tools to fight unwanted tighter financial conditions left ECB President Draghi no other real option than to try to pushing the currency lower verbally at his press conference following the January ECB meeting. Not only did Mr. Draghi go so far as ruling out any rate hikes in 2018, he also made several frank comments regarding communication on exchange rates by other parties (likely a thinly veiled reference to U.S. Treasury Secretary Mnuchin's recent comments on the USD), which he viewed as having deviated from standard practices. Despite President Draghi's best efforts, German yields and the euro continued their push higher into the end of the month. Maybe more important than this price action, was the fact Mr. Draghi was not able to jawbone the market in his preferred direction despite numerous attempts. In the past, his words have carried significant weight in terms of price movement but it appears the market is a less than enthusiastic audience so far in 2018.

As President Draghi continued guiding the ECB toward the end of QE, FOMC Chair Janet Yellen was putting the finishing touches on her term as FOMC leader, which concluded following the January FOMC meeting. As widely expected, the FOMC left the target fed funds range unchanged at 1.25%-1.50% with a few changes to the statement, but nothing to suggest the committee's thinking has changed. The characterization of current conditions was upbeat, with the Fed noting the labor market has continued to strengthen and economic activity has remained "solid." Gains in employment, household spending and business investment were also described as "solid." On inflation, the committee continued to note that core has "continued to run below 2%" but did remove mention of the decline seen in 2017. Committee members also upgraded their reading of market-based measure of inflation compensation, mentioning the increase seen in recent months. In isolation, none of these upgrades to inflation or economic conditions are news but the totality of the statement suggests the FOMC is ready to carry on tightening policy gradually. With the futures market now implying almost a 100% probability of a tightening in March, new FOMC Chair Powell has had most of the initial legwork already done for him.

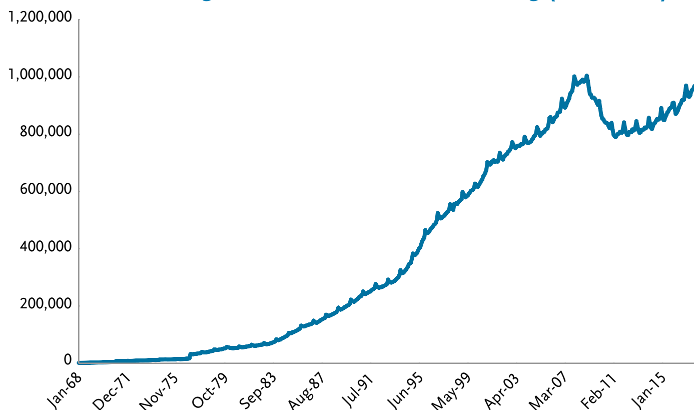
Further advancing the case for March policy action, U.S. GDP for the fourth quarter rang in at 2.6% this month. While it is not the 3% figure seen in the previous two quarters, the print would have been significantly stronger had it not been for a combined 1.8% drag from net exports and inventories. More encouraging, were the final sales to private purchasers, which rose 4.6% and were supported by personal consumption that rose by 3.8%. Nonresidential business fixed investment was also quite healthy, climbing by 6.8% at an annual rate, led by another double-digit rise in capex spending on equipment. On net, the prospects for the U.S. economy on a go-forward basis look to be quite strong. Consumers had their best quarter since 2016, and cap-ex spending continued to trend in the right direction. However, the November 2017 Federal Reserve Consumer Credit Report released in early January argues that these strong consumption numbers may be on leverage and less indicative of the economy being on strong footing. In November, consumer credit increased at a seasonally adjusted annual rate of 8.75%. Revolving credit increased at an annual rate of 13.25%, while nonrevolving credit increased at an annual rate of 7.25%. Additionally, as of November the $1 trillion outstanding in revolving credit is the highest level since December 2008. Compounding this potential issue further, the savings rate in the U.S. has fallen to 2.6% of disposable income, the lowest level seen since 2008. That is not to say the consumer won't be willing to take on further leverage, but historically we are near levels of debt and savings that have choked consumption in the past.

Real Gross Domestic Product, Advance Release

Annualized Quarterly, % Chg.	4Q16	1Q17	2Q17	3Q17	4Q17
Real GDP	+1.8	+1.2	+3.1	+3.2	+2.6
Consumer Spending	+2.9	+1.9	+3.3	+2.2	+3.8
Nonresidential Investment	+0.2	+7.2	+6.7	+4.7	+6.8
Structures	-2.2	+14.8	+7.0	-7.0	+1.4
Equipment	+1.8	+4.4	+8.8	+10.8	+11.4
Intellectual Property Products	-0.4	+5.7	+3.7	+5.2	+4.5
Residential Investment	+7.1	+11.1	-7.3	-4.7	+11.6
Change in Private Inventories ($ bil)	$63.1	$1.2	$5.5	$38.5	$9.2
Net Exports ($ bil)	-$631.1	-$622.2	-$613.6	-$597.5	-$652.6
Government Spending	+0.2	-0.6	-0.2	+0.7	+3.0
Real Final Sales (of Domestic Product)	+0.7	+2.7	+2.9	+2.4	+3.2
Real Final Sales to Domestic Purchasers	+2.3	+2.4	+2.7	+1.9	+4.3
Real Final Sales to Private Domestic Purchasers	+2.7	+3.1	+3.3	+2.2	+4.6
GDP Price Index	+2.0	+2.0	+1.0	+2.1	+2.4
Core PCE Deflator	+1.3	+1.8	+0.9	+1.3	+1.9

Source: NatWest Markets

Revolving Consumer Credit Outstanding (USD, Mln)



Source: The Federal Reserve

Savings Rate as % of Disposable Income

Source: Bloomberg

While both equities and yields continued their surge higher this month, market participants with memories of 2008 still freshly ingrained, have started to become concerned about the impact of higher interest rate on equity prices. Previously there had been some concern voiced about excessive equity valuation on an outright basis, but it would seem the larger source of market participant consternation has shifted to the relative valuation between equity and fixed income as fixed income yields rise. Eventually, rising rates could indeed bring the rally in risky assets to a halt; after all quantitative easing was designed to push investors out the risk curve, so it is plausible we could experience a push back toward less risky investments as yields normalize. However, it is interesting to note that in five of the six most dramatic 'melt-ups' (defined as a >15% run in <6-months), rates coincidently rose. In chronological order:

- 1999 saw 10y rates move 4.5% to 6.75%,
- 2003 10s went from 3.00% to 4.52%,
- 2009 rates bottomed preemptively at 2.00% before doubling by midyear,
- 2010 10s added 100bps in five months time,
- 2013's 30% SPX rally, 10s went from 1.75% to 3.00%.

Of course, each of these scenarios had a unique macroeconomic backdrop attached to it but it seems reasonable to believe that it may take more than the 45bp selloff seen in 10y notes over the last six months to warrant serious concern about rates moving too far too fast. ■

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