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MONTHLY COMMENTARY

February Rates Update

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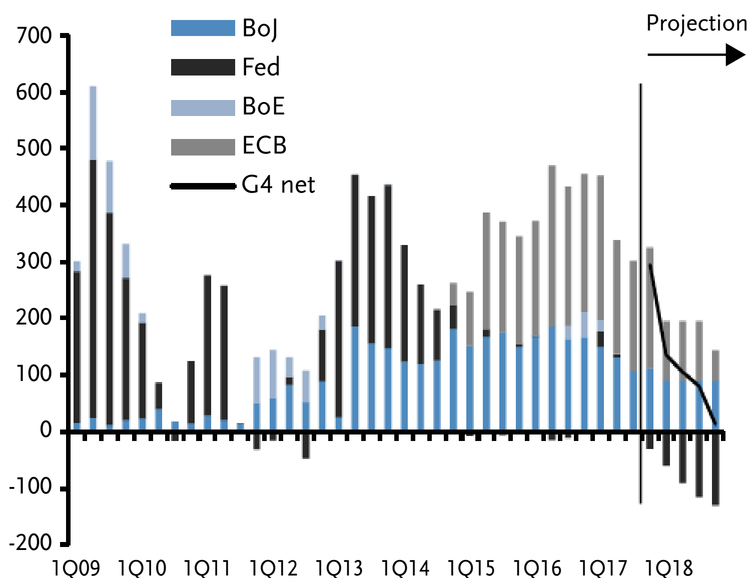
One of the most tranquil periods for equities in financial markets history was finally brought to an abrupt end in February as the grinding rally that had been characteristic of the past 15 months turned into a 12% plunge from all-time highs. Dip buyers were fairly undeterred and bought weakness pushing U.S. indices back higher but not with the same enthusiasm seen in late 2017. It may be hard to believe, but equity selloffs are normal in a functioning market and pullbacks can be seen even in the most bullish of years. Further supporting this notion, as equities unraveled credit markets were little changed with Treasury yields pushing higher. During a true risk off event, credit spreads would be expected to widen and Sovereign yields to press lower as money heads into safe haven assets. However, this was not the case in the most recent experience as 10y Treasury yields continued their surge higher to reach as high as 2.95%, the highest level seen since January 2014. Though it would be premature to call an end to the equity bull run based on one correction, it seems fair to expect elevated asset volatility moving forward.

It is fairly remarkable that long end Treasury yields have managed this sustained push higher despite a negative rate of change in inflation readings. Since reaching 2.7% YoY in February 2017, CPI has moved significantly lower, checking in at 2.1% YoY last, and yet the 10y breakeven rate is wider than when domestic CPI was running above 2.5%. Similarly, German bunds are nearly 25bp higher in yield from February 2017 when German CPI peaked despite a similar fading trajectory in inflation. If not fundamentally driven, maybe this backup in rates is simply a byproduct of the end of central bank accommodation and lenders will now have to issue debt at higher costs as the price-insensitive central buyer exits the market. Indeed, with ongoing Fed balance sheet reduction, slowing BoJ purchases, and ECB taper, G4 asset purchases will decline from $300 bln in Q417 to only $13bln by Q418.

Declining Central Bank Asset Purchases



Source: Fed, BoJ, ECB, BoE, Haver Analytics, JPM Global Research

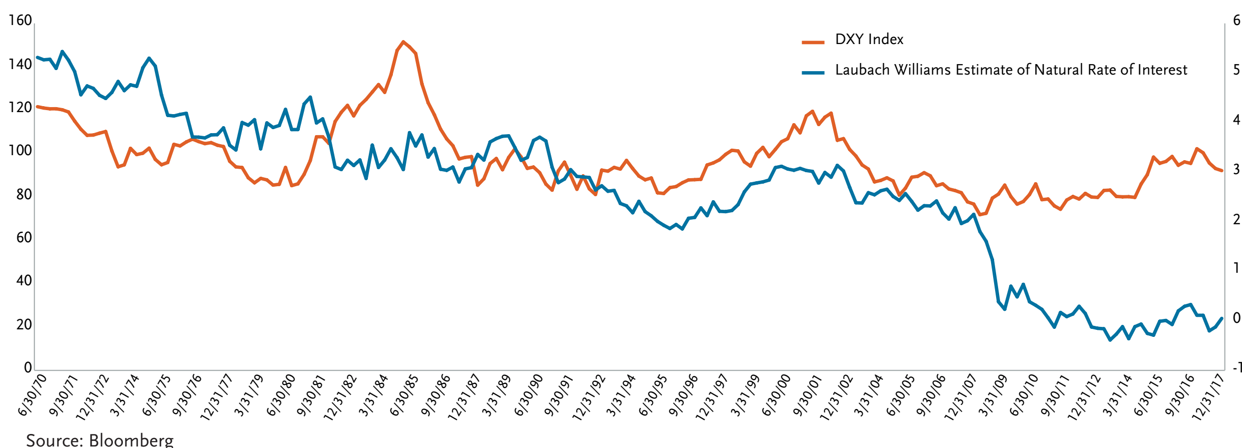
On the domestic monetary policy front, Jerome Powell made his first major appearance as the new chairman of the Federal Reserve to close the month. Testifying before the House Financial Services Committee, he noted that several factors that were once headwinds for the economy -- fiscal policy, foreign growth, and financial conditions – had become tailwinds. Powell said that he expects the next couple of years to look quite strong with continued improvement in the labor market, inflation moving up to 2%, and faster wage growth. He also downplayed some concerns raised by members of Congress, noting that he was not bothered by the flattening in the yield curve. Additionally, the chairman noted that his outlook has improved incrementally since the FOMC's December meeting, a comment that sparked a sell-off in the Treasury market and appeared to raise the odds of an upward move in the Fed's dot plot at the March meeting. There is little doubt the chairman's comments are sincere and he is indeed optimistic about the economy at the moment but the market may be interpreting a rookie mistake as increased hawkishness. Just as market participants had to adjust to the last two FOMC Chairs, we may have to undergo the same adjustment period with Chairman Powell as we recalibrate what he is saying to what he actually means.

While the chair has become incrementally more optimistic on the U.S. economy and inflation, it remains to be seen if his colleagues share his optimism and plan to upgrade their economic forecast submissions enough to move the median 2018 "dot" from three hikes to four. Based on the dispersion of the dots in December, the hurdle for the 2018 median dot moving up seems relatively high. As shown in the December dot plot, it appears at least three participants would need to upgrade their 2018 tightening forecast to four hikes in 2018 from three, to get the median dot to move. If we do see the median dot move higher next month, it will most likely mean Powell has indeed changed his view and has passed his first leadership test as other centrist members fall in line with him.

It is maybe not a coincidence then that February was the first month out of the last four that observed a higher close in the DXY dollar index on a month-over-month basis. If the FOMC's policy reaction function is undergoing a more hawkish transformation, then current market pricing of five hikes over the next two years is potentially too pessimistic. This would also suggest that the U.S. dollar is cheap to expectations during a time when the market is near positioning extremes in favor of a weaker dollar. What dollar shorts may be disappointed to learn is that every U.S. dollar bull market since 1970 has been marked by an increasing real neutral rate as modeled by Laubach and Williams.

The neutral rate of interest is the level of the federal funds rate where real GDP continues to grow at its current trend and inflation is stable. It is the approximate level where FOMC policy goes from expansionary to restrictive. While it is nearly impossible to track an exact level for the neutral rate of interest at any given moment, the idea of a terminal rate or a level where the FOMC will stop tightening policy is a key driver of interest rates and therefore currencies. In the early 1980s the dollar bull market occurred with the real neutral rate rising from about 3% to 4%. In late 1990, the dollar bull charge occurred with a rise from just over 2% to over 3%. The most recent dollar bull market occurred with the neutral rate rising from around -0.5% to about 0.3%, before rolling over. If the market estimates of the neutral rate begin to creep higher again, as new Fed leadership sets a more aggressive policy course, could we see the dollar rally to new cyclical highs, punishing a position that is very much market consensus? It seems entirely possible.

DXY Index vs. Laubach Williams Natural Rate of Interest



Source: Bloomberg

It is now fairly clear that 2018 will be an entirely different type of year than 2017. With volatility in rates and equities looking like they plan to linger, high Sharpe ratio return investments will likely be less plentiful this year. That would represent a pretty significant shift in the investing landscape as a simple buy and hold strategy on the S&P 500 would have generated a Sharpe ratio near 4 in 2017. That is not to say that there won't be outsized returns to be had this year, but it appears excess returns will be harder to come by.

	1/31/2018	2/28/2018	52 Week High	52 Week Low
2y Treasury Yields	2.14	2.25	2.28	1.16
5y Treasury Yields	2.51	2.64	2.69	1.60
10y Treasury Yields	2.71	2.86	2.95	2.01
30y Treasury Yields	2.93	3.12	3.23	2.63
Yield Curve Steepness 2s to 30s	79.03	87.02	183.62	77.02
Bloomberg Barclays U.S. Aggregate Bond Index	2022.80	2003.63		

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