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INSIGHT

MONTHLY COMMENTARY

March Rates Update

TYLER TUCCI | APRIL 10, 2018

The year of 2018 continues to be the polar opposite of 2017 as two-way price action has continued across asset classes after 2017 saw the smallest trading ranges in U.S., Germany, British and Japanese 10y debt on record. Indeed, March saw 10y Treasuries trace out a 15bp range and close March at 2.73%, a month-over-month decline of 13 pts. Similarly, the S&P 500 saw bulls and bears battle for control in a nearly 300-point range. The bears emerged victorious for the second month in a row as the S&P closed down 75pts to 2640. As is to be expected, the U.S. dollar index also finished the month slightly lower. The dollar has displayed more stability in recent months, albeit at lower price levels.

Remarkably, the volatility in equities has come with very little in the way of changes in the U.S. economic picture. U.S. economic data suggests that the economy is still on solid footing. Monthly employment gains remain strong, averaging 190,000 new jobs over the past year for an annual growth rate of 1.6%. Importantly, employment growth has been driven by full-time jobs, which rose to a new all-time high in February. Similarly, compensation growth is on an improving trend. Hourly wage growth was 2.6% YoY in February, while the 4Q17 employment cost index grew 2.8% YoY, the highest growth in the past nine years. On the demand side, real demand growth has been a respectable 2-3%. In January, real personal consumption growth was 2.7% while real retail sales (including gas) grew 1.5% YoY. The housing market has also remained strong as new home sales fell 1% YoY in January. During the January period, housing starts data also reached their second highest level of the past 10 years, rising 7% YoY. In the manufacturing sector, core durable goods rose 7.3% YoY in January, close to the best annual growth rate in four years. The manufacturing component of industrial production grew 2.0% YoY in January, near the highest rate of growth in over three years. Although the overall economic data picture is solid at the moment, macro assets respond to the rate of change of the data as well as to outright levels, so any deterioration in the data from current levels could spark concern.

Tyler T. Tucci
Assistant Vice President
Fixed Income

Tyler Tucci is an Assistant Vice President in the Fixed Income Rates group. Mr. Tucci trades foreign exchange products and is also responsible for assisting in the evaluation of interest rate derivatives and global monetary policy. Prior to joining TCW in 2015, Mr. Tucci was a Short Term Markets and Interest Rate Derivative Strategist at the Royal Bank of Scotland. Mr. Tucci holds a BA in Economics and Finance from Elon University. Mr. Tucci has completed level I of the CFA exam and Levels I and II of the CMT exam.

	2/28/2018	3/30/2018	52 Week High	52 Week Low
2y Treasury Yields	2.25	2.27	2.36	1.16
5y Treasury Yields	2.64	2.56	2.73	1.60
10y Treasury Yields	2.86	2.74	2.95	2.01
30y Treasury Yields	3.12	2.97	3.23	2.63
Yield Curve Steepness 2s to 30s	87.02	70.36	173.48	69.33
Bloomberg Barclays U.S. Aggregate Index	2003.63	2016.48		

Source: Bloomberg Barclays

While the economic data is holding for now, renewed rhetoric on reducing the trade deficit may be a risk to growth. In March, the administration announced a 25% tariff on $46bn of Chinese imports on top of the steel and aluminum tariffs announced previously. In addition to the perceived negative economic impact of the tariffs themselves, this lack of a cooperative stance between the U.S. and the rest of the world seems to have soured general sentiment around risky assets. It is important to keep in mind that, like many other of the initiatives undertaken by this administration, there is usually considerable negotiation between the initial proposal and the finished product. This matter appears to be no different as none of the proposed tariffs have been implemented yet. On the U.S. side, the public has until 22 May to provide feedback and the U.S. government will hold a public hearing on 15 May. Hopefully, the U.S. can reach a more favorable accord with its trading partners that will lead us away from a trade war narrative as any escalation in this arena could be messy.

Away from the fiscal side of things, Jerome Powell announced his presence as new FOMC chair in earnest at the March FOMC meeting by raising rates by 25 basis points without dissent. Changes made to the FOMC statement were not particularly meaningful, with most updates reflecting the reality of recent economic developments, including a somewhat slower pace of activity in Q1 but continued strong performance of the labor market. The improving growth prospects were acknowledged, with the FOMC noting that "the economic outlook has strengthened in recent months," along with expectations that inflation would likely move higher "in coming months." The latter comment reflects base effects as the low readings from March-May 2017 drop out of the 12-month change calculations.

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents Under Their Individual Assessments of Projected Appropriate Monetary Policy, March 2018

Percent

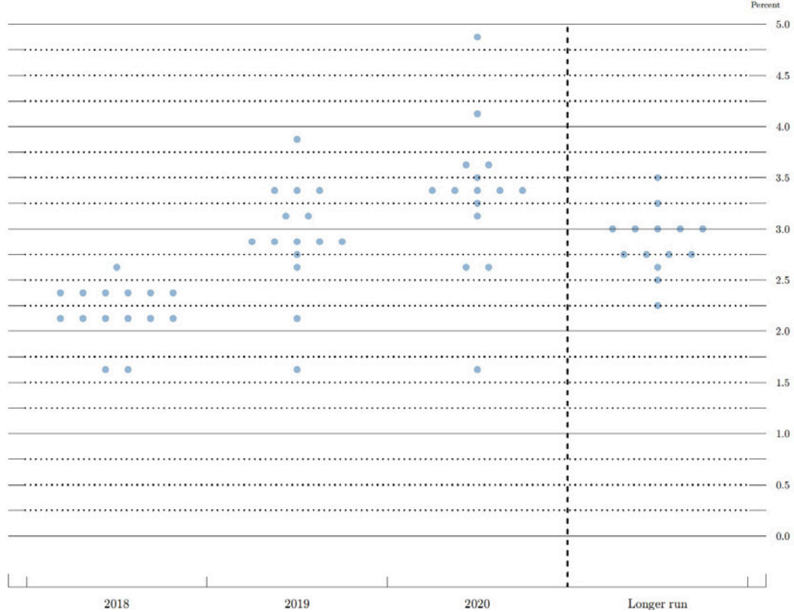
Variable	Median[1]				Central tendency[2]				Range[3]			
	2018	2019	2020	Longer run	2018	2019	2020	Longer run	2018	2019	2020	Longer run
Change in real GDP	2.7	2.4	2.0	1.8	2.6 – 3.0	2.2 – 2.6	1.8 – 2.1	1.8 – 2.0	2.5 – 3.0	2.0 – 2.8	1.5 – 2.3	1.7 – 2.2
December projection	2.5	2.1	2.0	1.8	2.2 – 2.6	1.9 – 2.3	1.7 – 2.0	1.8 – 1.9	2.2 – 2.8	1.7 – 2.4	1.1 – 2.2	1.7 – 2.2
Unemployment rate	3.8	3.6	3.6	4.5	3.6 – 3.8	3.4 – 3.7	3.5 – 3.8	4.3 – 4.7	3.6 – 4.0	3.3 – 4.2	3.3 – 4.4	4.2 – 4.8
December projection	3.9	3.9	4.0	4.6	3.7 – 4.0	3.6 – 4.0	3.6 – 4.2	4.4 – 4.7	3.6 – 4.0	3.5 – 4.2	3.5 – 4.5	4.3 – 5.0
PCE inflation	1.9	2.0	2.1	2.0	1.8 – 2.0	2.0 – 2.2	2.1 – 2.2	2.0	1.8 – 2.1	1.9 – 2.3	2.0 – 2.3	2.0
December projection	1.9	2.0	2.0	2.0	1.7 – 1.9	2.0	2.0 – 2.1	2.0	1.7 – 2.1	1.8 – 2.3	1.9 – 2.2	2.0
Core PCE inflation[4]	1.9	2.1	2.1		1.8 – 2.0	2.0 – 2.2	2.1 – 2.2		1.8 – 2.1	1.9 – 2.3	2.0 – 2.3	
December projection	1.9	2.0	2.0		1.7 – 1.9	2.0	2.0 – 2.1		1.7 – 2.0	1.8 – 2.3	1.9 – 2.3	
Memo: Projected appropriate policy path												
Federal funds rate	2.1	2.9	3.4	2.9	2.1 – 2.4	2.8 – 3.4	3.1 – 3.6	2.8 – 3.0	1.6 – 2.6	1.6 – 3.9	1.6 – 4.9	2.3 – 3.5
December projection	2.1	2.7	3.1	2.8	1.9 – 2.4	2.4 – 3.1	2.6 – 3.1	2.8 – 3.0	1.1 – 2.6	1.4 – 3.6	1.4 – 4.1	2.3 – 3.0

Source: FOMC

The much anticipated, March "dot plot" showed no change in the median year-end 2018 fed funds rate projection, however it was a very close call. Six participants favor three rate hikes in 2018 while six participants favor four rate hikes. Also as expected, the 2019 year-end estimate did move higher, pointing to three rate hikes next year as opposed to just two rate increases in the prior estimate. The 2020 median dot increased as well, now signaling two rate hikes in that year versus 1.5 rate hikes in the December forecast. The long-run median estimate edged up slightly as well (from 2.75% to 2.875%). Interestingly, the updated dot plot reveals a growing majority at the Fed that believe policy will eventually exceed the neutral rate and turn restrictive. In December, eight of 16 participants saw rates moving above 3% (highest estimate of neutral); now 12 of 15 participants see rates moving above 3%. Notably, Chair Powell downplayed this development in his press conference, noting that "It's [the forecast] highly uncertain. We don't have the ability to see that far into the future. I wouldn't put a lot in that. It could make sense, you could imagine narratives in which that would make sense, but I honestly wouldn't put too much on that."

While 2018 continues to diverge from 2017, there are still some apparent similarities. In both cases, the end of Q1 saw investors facing a lack of clear guidance from both the FOMC and the Trump administration. Just as in 2017, if the FOMC is to be believed, it would appear their modal outcome for 2018 is three policy tightenings with a risk of as many as four hikes. Similarly, it is not at all clear the market knows what to expect from the White House. In 2017 the market didn't regard these unknowns as much of an issue, as risky assets and Treasury yields were both able to climb the wall of worry higher. We will see if this time is different. ■

FOMC Federal Funds Rate Forecast



Source: FOMC

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865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup