TCW

INSIGHT

MONTHLY COMMENTARY

April Rates Update

TYLER TUCCI | MAY 11, 2018

While 3% 10y Treasury yields may have seemed like a pipe dream in 2016, in the depths of market angst, they were seen in April. Not only did 10y yields reach as high as 3.03%, good for a 5y high, front end yields (6-months to 3-years) saw their highest levels in nearly a decade: 6-mo Treasury, 2.02%; 1-yr, 2.16%; 2-yr, 2.41%; 3-yr, 2.52%. All told, the front end led weakness in Treasury yields saw the spread between 2y and 30y close at a cycle low of 63bps. If history is any guide, further flattening should be expected as 2s30s has bottomed in close proximity to the end of the monetary policy tightening cycle. Also notable in April, higher yields pushed the U.S. dollar higher and emerging market assets, gold, and equities lower.

Fed Funds Peaks	**2s30s Bottom Out**	
Month	Month	Level
Oct-84	Sep-84	0
Apr-89	Apr-89	-64
Apr-95	Dec-94	11
May-00	May-00	*-75
Jun-06	Feb-06	-21

* Treasury Had Just Canceled 30y Issuance

Supporting the idea that the expansion hasn't come to an end just yet, real GDP rose 2.3% in the first quarter, a relatively solid pace given weak Q1 showings in recent years. (Q1 growth has averaged 1.7% since 2015). The composition of growth wasn't very impressive, as consumption growth slowed sharply, falling from 4.0% in Q4 to 1.1%, and inventories contributed 0.4pp to headline growth. The employment compensation index details were also encouraging with wages and salaries advancing 0.9% QoQ. Total compensation, which includes wages and benefits, climbed 2.7% over the past 12 months, while private-sector wages and salaries advanced 2.9%YoY - both the strongest prints since Q3 2008.

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.

While wages creep higher and U.S. data continue to show stability for the time being, core inflation remains stuck near but squarely under the Fed's target of 2%. In April, CPI printed 2.3% with the more important core CPI (excluding food and energy) growing 1.9% YoY. Similarly, The Fed's preferred measure, personal consumption expenditures total and core PCE were 1.8% and 1.6% YoY, respectively, last month. February 2017 is the only month that registered a PCE reading over 2% since the Q2 2012. Conversely, the six-month annualized percent change of the U.S. core PCE price index is already close to 2011 highs, the last inflation peak in this cycle. The comparison between the current 6m annualized inflation and the same measure in 2011 seems apt, as both periods were preceded by a significant depreciation in the dollar and large commodity price increases. However, the current inflation picture is cloudy due to base effects left by a sharp drop in telecomm prices last year. This will bias upcoming fixings higher.

On the other side of the inflation equation, the dollar index was able to arrest persistent weakness to close the month nearly 2% higher. This move higher on a month over month basis is only the fifth since the start of 2015 but any renewed strength could serve to throw a wet blanket over the current inflation narrative. In order for this dollar strength to persist we will have to see another potential source of dollar strength manifest itself. This catalyst may be via monetary policy driven weakness in other currencies abroad. Indeed, the market priced likelihood of incrementally hawkish policy action in the UK, Canada and the Eurozone has diminished significantly in some cases. This may not come to much of a shock to observers of the Citi Economic Surprise Index series, which has turned significantly negative for most G-10 countries, indicating that the trajectory of economic data is slowing. If this slowdown relative to expectations continues on a broad scale, expected forward interest rate spreads should continue to favor the USD as other central banks get priced out.

After significant moves in equities, Treasuries and the dollar, views on the direction of the next 5% move in each asset class remain divergent. There are some who view recent developments as indicative that recessionary conditions may be on the horizon, while others prefer the view that recent price movement was just corrective and expect higher prices in the future. A third possible outcome may be that instead of seeing the direction of the next move play out immediately we could enter a consolidation phase and see price movement sideways with the summer months looming. Regardless of which direction risk assets move, it appears more uncertainty should be expected in the second half of the year. ■

	3/30/2018	4/30/18	52 Week High	52 Week Low
2y Treasury Yields	2.27	2.49	2.54	1.22
5y Treasury Yields	2.56	2.80	2.85	1.60
10y Treasury Yields	2.74	2.95	3.03	2.01
30y Treasury Yields	2.97	3.12	3.23	2.63
Yield Curve Steepness 2s to 30s	70.36	63.18	171.64	55.55
Bloomberg Barclays U.S. Aggregate Index	2016.48	2001.48		

Source: Bloomberg Barclays

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