INSIGHT

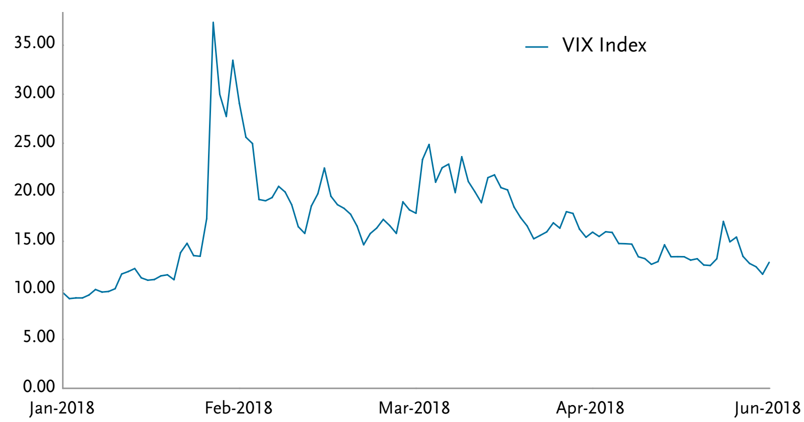
MONTHLY COMMENTARY

May Rates Update

TYLER TUCCI | JUNE 11, 2018

Five months into the year, the low equity volatility seen in 2017 already seems like a distant memory. So far in 2018, the VIX has moved 5+ pts in a single day on four separate occasions with the most recent coming on 5/29. Only 4 years have had more, it's still May. This higher equity volatility was finally joined by significantly higher rates volatility as concerns about the new Italian government's fiscal plans rocked the BTP market and sent shockwaves through global fixed income. Indeed, the end of May saw the Italian 2y move from -0.3% and touch as high as 2.85% in a single day. While this VaR shock did serve to drive 10y Treasury yields to the lows of the month near 2.75% temporarily, the rally was ultimately reversed somewhat to close the month at 2.85%.

VIX Index



Source: Bloomberg

Far and away the biggest global macro catalyst in May was the renewed anti-Euro rhetoric from Italian populist parties who went as far as to discuss a potential government debt write-down worth billions of euros. While these threats of redenomination will likely end up idle, it was more than enough to scare holders of Italian front-end paper out of positions and to the sideline, exacerbating what was already a once in a lifetime move. As has been the case recently, the days following this volatility spike saw the market revert back toward less stressed levels as leading parties watered down their anti-EU rhetoric and backed away from calls for fresh elections for now. Realistically, the threat of a new Italian election could hang over that market indefinitely while the coalition partners look for the most opportune time to go to the polls again. So this is not a problem that will somehow just go away. While relative calm has been restored for now, the spread between 10y German debt and 10y Italian debt remains at 2.42% after as being as wide as 2.88%.

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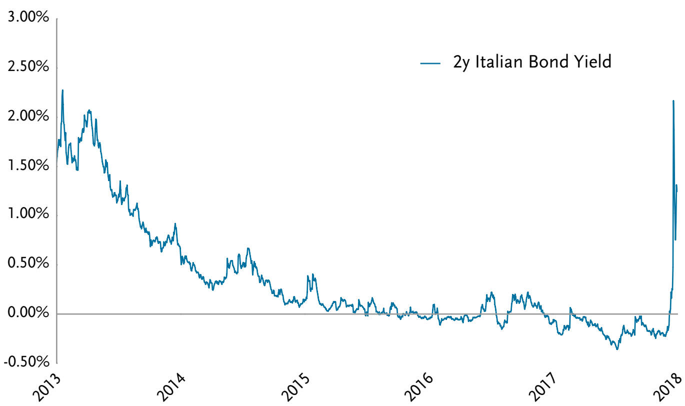
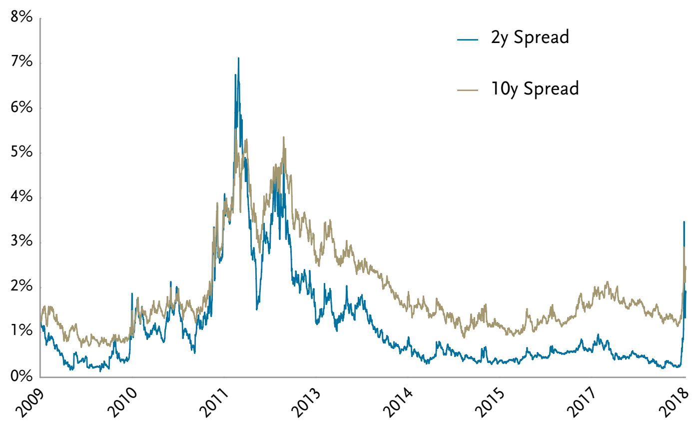
As recently as April, this spread sat at 1.11% but now asset allocators are demanding over twice that yield pickup in order to take on additional risk in form of Italian debt. With no clear, single path forward, this spread should continue to reflect the sum of the probabilities of a euro-positive solution.

2 Year Italian Bond Yield



Source: Citi Velocity

Spread Between Italian and German Bonds



Source: Bloomberg

This most recent Italian populist flare ups couldn't have come at a worse time for Mario Draghi and the ECB, which seemed primed to proceed with an exit from extraordinary easing measures later this year. Now, central bank officials will be forced to debate the merits of proceeding with a planned taper or waiting for more information on both incoming data and the Italian governmental proceedings at their next meeting in June. Some market observers expect to see Draghi split the difference by moving forward with the gradual taper as planned but being more explicit in forward guidance, reiterating that interest rate hikes will not emerge until "well past the horizon of the net asset purchases."

PSPP Country Breakdown

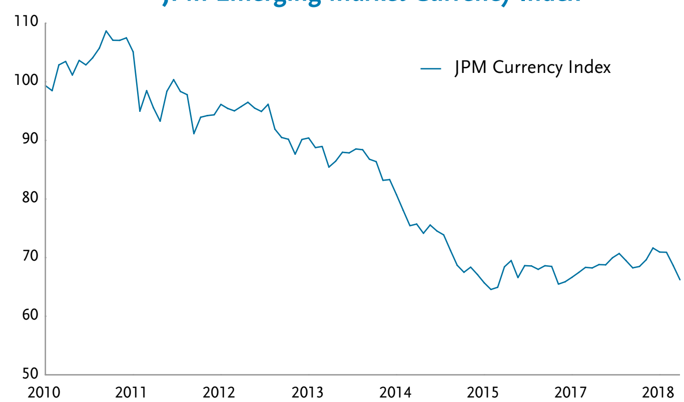
	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	April to May
Germany	11.70	11.60	11.60	10.10	4.80	5.10	4.80	4.70	6.90	46.10
France	11.10	10.50	10.40	9.20	4.00	4.20	4.00	4.60	4.20	-8.80
Italy	9.20	9.10	9.10	8.00	3.40	3.60	3.40	4.00	3.60	-9.10
Spain	6.10	6.00	6.00	6.00	2.70	2.S	2.80	3.10	2.80	-8.80
Netherlands	2.60	2.60	2.60	2.40	1.10	1.10	1.10	1.30	1.10	-9.00
Belgium	1.85	1.83	1.82	1.66	0.71	0.76	0.71	0.80	0.72	-9.70
Austria	1.47	1.45	1.45	1.29	0.55	0.58	0.55	0.63	0.58	-8.10
Finland	0.20	1.05	0.62	0.63	0.28	0.30	0.28	0.54	0.49	-10.30
Po ugal	0.49	0.49	0.49	0.52	0.46	0.49	0.46	0.62	0.57	-8.80
Ireland	0.58	-0.03	1.17	0.69	0.41	0.43	0.41	0.57	0.52	-8.60
Slovakia	0.18	0.23	0.14	0.19	0.19	0.14	0.14	0.17	0.13	9.10
Slovenia	0.16	0.16	0.25	0.24	0.11	0.12	0.11	0.13	0.11	-11.00
Supranationals	5.10	5.10	5.10	4.60	2.10	1.10	2.10	2.40	2.40	-0.10
Total PSPP	**50.80**	**50.20**	**50.70**	**46.20**	**20.90**	**21.80**	**20.80**	**23.60**	**24.20**	**2.50**

Source: ECB and Jefferies International

With European dysfunction sure to continue into the summer, the FOMC will be in a familiar position when they meet in June. Despite solid U.S. data, any volatility from a flashpoint abroad would be an unwelcome development and coul complicate FOMC hiking plans as has occurred in the past. To be sure, Chairman Powell may have a different reaction function than his predecessor but he will have to consider these additional factors nonetheless. None of the overseas events has risen to a sufficient level to cause a change in the tightening schedule, according to the futures market, which now expects one tightening in June and another in December.

As European events complicate American central bank policy, American central bank policy has started to complicate exchange and borrowing rates in emerging market countries. After strong performance in 2017, the JP Morgan EM Currency Index is now probing its 2015 low as higher interest rates abroad exert downward pressure on exchange rates. Notably, this pain pushed Urjit Patel, Governor of the Reserve Bank of India, to write an op-ed in a large U.S. periodical discouraging additional rate hikes. In his view, since the U.S. central bank is tightening monetary conditions and shrinking its balance sheet, it is creating a global dollar shortage, which hurts emerging markets. Judging by the sharp moves seen in EMFX this month, it wouldn't be a stretch to imagine Governor Patel isn't alone in his frustration.

JPM Emerging Market Currency Index



Source: JP Morgan

U.S. Treasury Market Overview

	April 30, 2018	May 31, 2018	52 Week High	52 Week Low
2 Year Treasury Yields	2.49	2.43	2.60	1.25
5 Year Treasury Yields	2.80	2.70	2.95	1.60
10 Year Treasury Yields	2.95	2.86	3.13	2.01
30 Year Treasury Yields	3.12	3.03	3.26	2.63
Yield Curve Steepness 2s to 30s	63.18	59.39	157.59	55.54
Bloomberg Barclays Aggregate Index	2,001.48	2,015.76		

Source: Barclays Bloomberg

June is shaping up to be a month as full of meaningful macroeconomic catalysts as we've seen in some time and could go a long way in setting the tone for the second half of the year. Not only will we have key central bank meetings in the U.S., UK, Eurozone, and Japan we should get new developments on the U.S./N. Korea situation with a potential summit between leaders in early June. Though summer months are thought of as a quieter time in the market, decreased volumes and watchfulness have often abetted volatility shocks. In recent memory we have seen: Greek bailouts, CHN devaluations, and Bund VaR shocks all take place between June and August. This summer could be similarly interesting. ■

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