TCW

INSIGHT

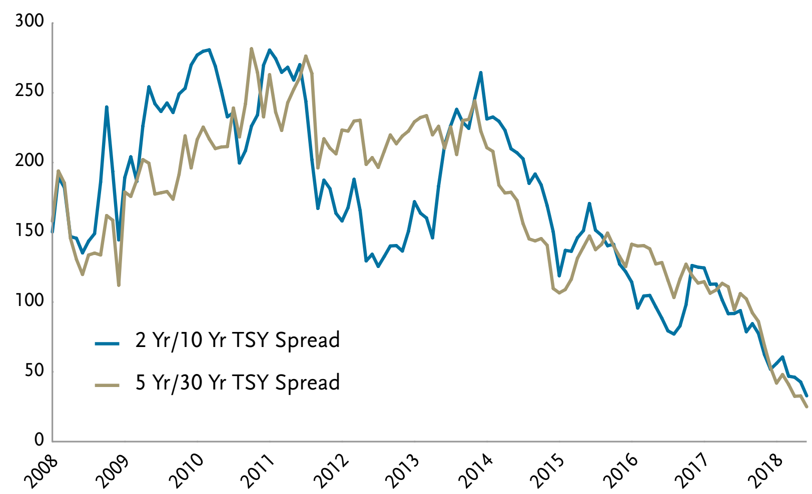
MONTHLY COMMENTARY

June Rates Update

TYLER TUCCI | JULY 11, 2018

While equities were rocked by global headline risk intermonth, Treasuries were unchanged for June with 10y notes closing at 2.86% a mere basis point away from where they opened the month. As 10y yields remained in place the front end of the yield curve continued its grinding selloff, encouraged by a hawkish Fed. This front end led weakness pushed the spread between 2y and 10y notes as low as 31.5bps, good for a decade low. Similarly, the spread between the 5y and 30y note closed the month at 25bps also good for a decade low.

U.S. Treasury Spreads



Source: Bloomberg

The June FOMC meeting saw the committee deliver an optimistic, hawkish message signaling a high degree of satisfaction with the economic backdrop and the current pace of policy normalization. The continued decline in the unemployment rate was acknowledged, as well as the pickup in household spending. The reference to market-based measures of inflation compensation remaining "low" was dropped. The Committee said it expects further gradual "increases" (rather than "adjustments"), consistent with sustained expansion, a "strong" labor market, and inflation near the Fed's symmetric 2% objective. No mention was made of recent international developments and the forward-looking language was removed from the Fed statement. Chairman Powell's no nonsense, straight to the point approach was quite apparent in the overall statement which ran 320 words, a light read when considering statements under previous chairs have run well past twice that on occasion.

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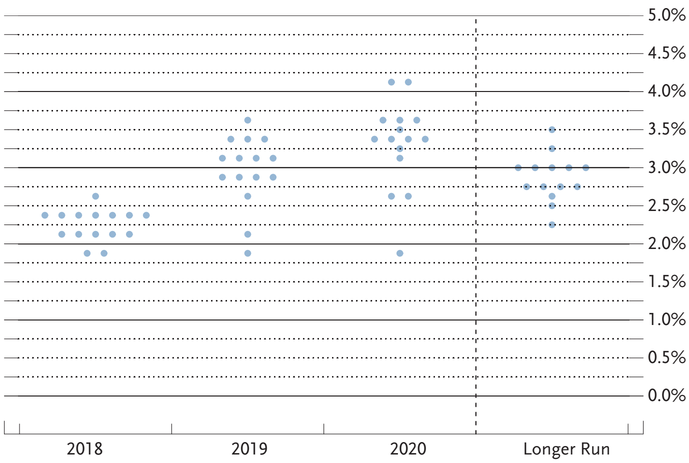
The FOMC SEP release came with several marginally hawkish upgrades as well, hitting the front-end and risk-assets (EM-centric) in kind, while the curve flattening accelerated with 10s30s in swaps going notably negative. The hawkish signposts were as follows: 1) the 2018 median dot rose to 2.375% from 2.125%, 2) the 2019 median dot rose to 3.125% from 2.875%, 3) the statement cut reference to rates remaining below long-run levels for some time, 4) the FOMC's median long-run estimate of NAIRU remained at 4.5%, suggesting the FOMC sees value in inducing higher employment via "restrictive" policy (2020 dots above "neutral rate"). Hawkish reaction aside, the Fed still expects a total of eight hikes through 2020: 4x 2018, 3x in 2019, and one thereafter (from 3x, 3x, 2x prior).

FOMC Participants' Assessments of Appropriate Monetary Policy



Source: Federal Open Market Committee

Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

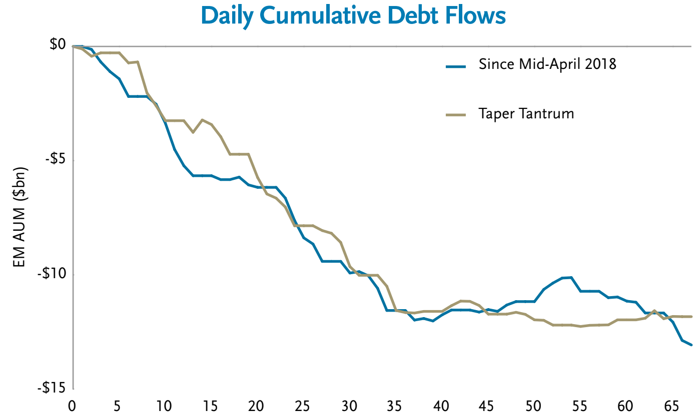
In his second quarterly press conference as chair, Chairman Powell was again able to effectively stay on message. On several occasions, reporters tried to pin Powell down on how high inflation would be allowed to get before policymakers on the Federal Open Market Committee revised their rate hike path. Clearly there was some angst about the signal from the Fed's "dot plot" that a majority of Committee members felt four rate hikes in 2018 would be appropriate. In a departure from his predecessors, Chair Powell responded frankly "If we thought inflation was going to take off, then obviously we'd be showing higher rates," adding that, "We can't be too attached to these unobserved variables."

On the other side of the monetary policy universe, the ECB decided not to delay their QE decision until next month, and announced a short three-month taper to finish QE at the end of December. The step-down to €15bn per month in new purchases from October will coincide with almost €21bn in QE reinvestment also due that month. While this announcement failed to draw much of a market reaction, ECB President Draghi's message regarding interest rate policy definitely did as he confirmed he expected no change in the policy rate through at least summer 2019.

This is certainly not a pre-commitment that the ECB will aim to raise the depo rate a year from now. Rather it is an indication that a six-to-nine months gap between the end of QE and the first interest rate rise is a reasonable period of time during which to assess how the economy is performing and to decide whether a tightening in policy may be appropriate. Of course, the markets are also well aware that Draghi's last press conference before he departs the ECB is on 24 October 2019 – and so his choice of words will now focus attention on whether Draghi manages to deliver an interest rate hike before he steps down.

As developed market policy makers plot their course, their policies continue to be a source of consternation for emerging market countries. When front end yields start to climb in developed markets, dollar capital becomes scarcer and more expensive and debt service costs increase for some emerging market borrowers. This relationship appears to have asserted itself in June as increases in spreads and cumulative capital outflows proved comparable in magnitude to those experienced during the taper tantrum. Naturally, the impacts have been felt by those EMs with higher dependence on foreign funding, such as Turkey, India, Malaysia, Argentina, and Mexico. Additionally, the moves in local rates markets may also be exacerbated by the lack of credible monetary policymaking in the face of tighter global liquidity conditions and depreciating currencies.

Daily Cumulative Debt Flows



Source: IIF, Citi Research

As the first half of the year draws to a close, we have seen 10y Treasury yields sell off 45bps, the S&P 500 rally nearly 4% and the spread between 2y and 10y Treasuries flatten from 51bps to 25bps. Interestingly, these moves are somewhat in line with consensus at the outset of 2018 as opposed to the first half of 2017 which saw Mr. Market finding points of maximum pain in asset pricing at just about every turn. Expectations for the path forward however, are less one sided as market participants have started to take sides on the outcomes of a packed risk event calendar for the remainder of the year. With plenty of scope for variance in the second half of 2018, we have a number of sufficient catalysts to break Treasury rates out of their doldrums. ■

U.S. Treasury Market Overview

	5/31/18	6/29/18	52 Week High	52 Week Low
2 Year Treasury Yields	2.43	2.53	2.60	1.25
5 Year Treasury Yields	2.70	2.74	2.95	1.60
10 Year Treasury Yields	2.86	2.86	3.13	2.01
30 Year Treasury Yields	3.03	2.99	3.26	2.63
Yield Curve Steepness 2s to 30s	59.39	45.67	157.59	37.64
Bloomberg Barclays Aggregate	2,015.76	2,013.28		

Source: Barclays Bloomberg

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