TCW

INSIGHT

MONTHLY COMMENTARY

September Rates Update

TYLER TUCCI | OCTOBER 4, 2017

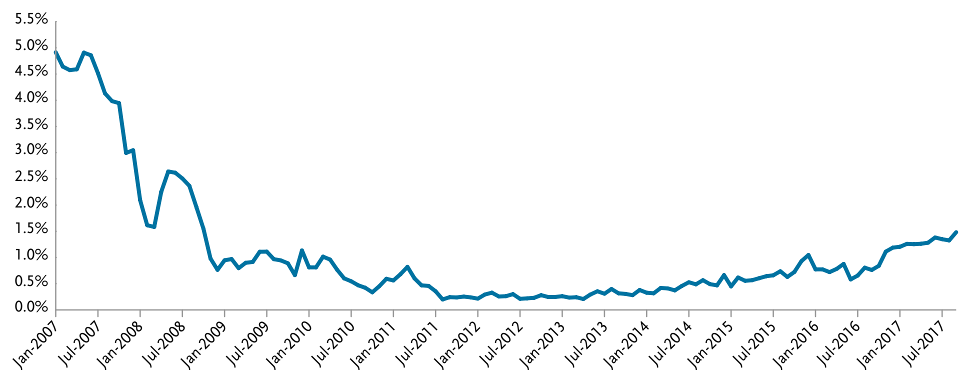
With summer trading firmly in the rearview, September kicked off the homestretch of 2017 with a slate of central bank meetings that market participants hoped would provide a clear indication of the direction of monetary policy or asset pricing for the rest of the year. However, as might be expected, a read of the central bank communiques suggests they have little more conviction than the average market participant and are waiting to see how the rest of 2017 develops. The summation of the month's events pushed U.S. 2y rates 15bps higher to reach 1.50%, the highest level in 10 years. Similarly impressive was the move in 10y rates, which sniffed 2% early in the month as a result of North Korean saber rattling, but subsequently moved higher to close the month at 2.33%. The dollar index, DXY, rose in concert with yields finishing the month up slightly and arresting six consecutive months of lower monthly closes.

U.S. Treasury Market Overview

	8/31/2017	9/29/2017	52 Week High	52 Week Low
2y Treasury Yields	1.33	1.48	1.50	0.71
5y Treasury Yields	1.70	1.94	2.15	1.15
10y Treasury Yields	2.12	2.33	2.64	1.59
30y Treasury Yields	2.73	2.86	3.21	2.30
Yield Curve Steepness 2s to 30s	139.67	137.14	205.73	131.81
Barclays Aggregate Index	2048.21	2038.46		

Source: Bloomberg

2y Treasury Note Yields



Source: Bloomberg

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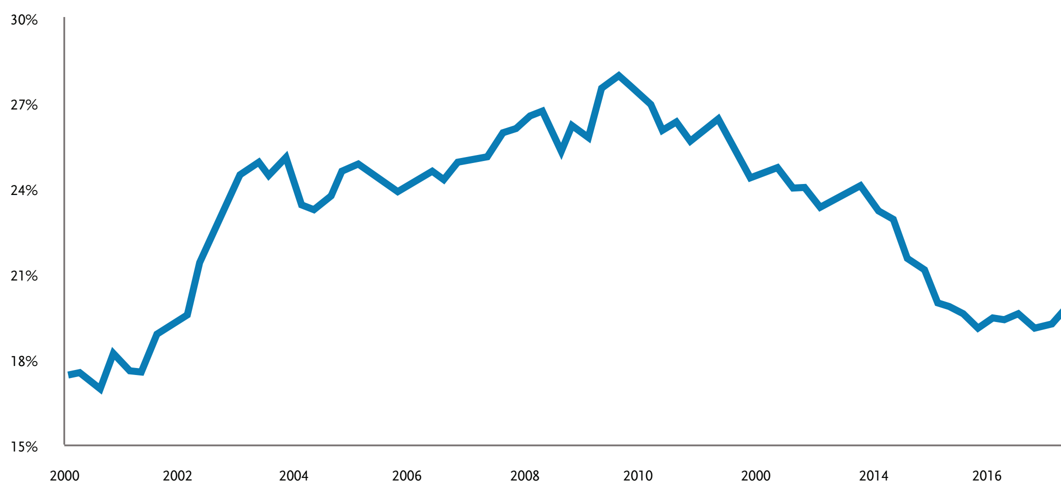
The European Central Bank kicked off September's monetary policy meeting schedule by leaving its key policy rates and asset purchase program unchanged, as had been widely expected. ECB President Draghi did however indicate that the bulk of the Governing Council's decisions regarding the asset purchase program (APP) for next year are likely to be made in October. He was willing to pre-commit to the idea that the ECB's expected sequencing of no rate increases until after the end of net asset purchases was not up for discussion, though. Correspondingly, the ECB introductory statement suggested President Draghi's strong commitment not to hike policy rates for the foreseeable future was a reaction to the rapid appreciation of the euro in 2017 as the statement included for the first time a section on the volatility of exchange rate moves. This notion of a higher euro impacting the ECB's ability to conduct policy was reinforced by Mr. Draghi who noted that the exchange rate had implications for the inflation forecast and that most Governing Council members had expressed concerns over this volatility. He took care to remind the audience that the exchange rate will be an input into the Governing Council's October decision on the APP and that inflation dynamics have yet to show self-sustaining momentum. Therefore, a 'persistent' easy monetary policy stance is required. The implications of a higher euro have already manifested themselves in the ECB staff forecast, which showed a 0.1% reduction in the inflation forecast for both 2018 and 2019 bringing the 2019 inflation forecast to 1.5%.

Judging by President Draghi's comments and the ECB staff's forecasts it appears the forward looking nature of financial markets has complicated the ECB's plan to move monetary policy off crisis settings. While it is to be expected that tightening of monetary policy should lead to incrementally tighter financial conditions, the ECB has seen asset markets frontload these tighter economics into the EUR exchange rate before any actual changes in policy. This phenomenon was also experienced by the FOMC in 2015 when the dollar rose nearly 20% over the course of the year in expectation of higher future policy rates in the U.S., although the FOMC had yet to take any steps to carry out policy tightening. Ultimately, the dollar appreciation slowed due to a recalibration of market pricing as the FOMC started on its tightening path. However, the Fed was forced to delay initiating policy tightening until late 2016, once the rapid pace of the dollar had subsided somewhat. It can be hoped that the ECB will have similar experience with their departure from emergency policy settings and that with hawkish global monetary policy breezes at its back, the velocity of change in the exchange rate will eventually slow as other central banks start to tighten policy. However, given the global underweight to EUR assets seen since the eurozone crisis in 2011, further signs of eurozone stability could continue to invite fresh waves of reallocation to euro assets. This could force the ECB to choose between keeping policy rates low to try to stem demand for the euro, thereby arresting any major exchange rate appreciation from these levels or continuing the path to normalization and hoping the advance will eventually stall out as it did in the U.S. It is important to note though, that when the FOMC was experiencing the run up in the USD, it was the only central bank talking about tightening policy. Currently, the ECB is just one voice in a chorus of hawkish central banks so it remains to be seen if the ECB will ultimately see a different result with the euro than the FOMC did with the dollar in 2015-2016.

Central Bank Currency Reserve Allocation to Euro Remains Near Cycle Lows



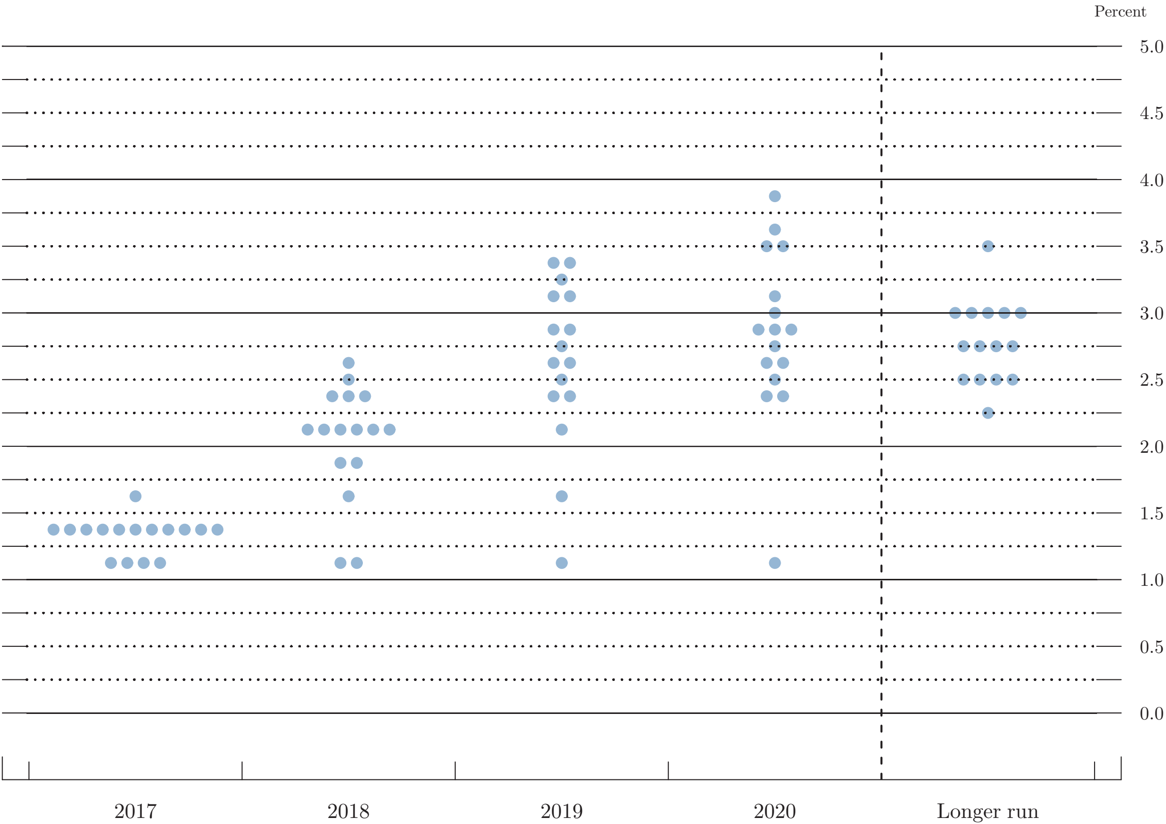
Source: GS FX Sales Strats (Securities Division), as of September 29, 2017, using latest IMF/Cofer data

As the ECB contemplated its next steps towards policy normalization, its neighbor, the Bank of England, remained stuck between a rock and a hard place in September. With interest rates remaining at a record low 0.25% and the quantitative easing program at £435 billion ($573 billion), inflation continues to run well above 2.0%, suggesting that British monetary policy is excessively loose. This may indeed be the case but with Brexit negotiations ongoing the central bank's Monetary Policy Committee had viewed an overly cautious approach to policy making as the most prudent route in current conditions. In September though, the BoE stance on excessively easy policy began to pivot with the post-meeting policy statement indicating: "If the economy continues to follow a path consistent with the prospect of a continued erosion of slack and a gradual rise in underlying inflationary pressure then ... some withdrawal of monetary stimulus is likely to be appropriate over the coming months." This hawkish rhetoric appears to be an escalation of the bank's previous guidance that the British economy was running out of spare capacity and further policy easing would not have much positive impact. By the end of the month the BoE's hawkish overtures had pushed market pricing to an 80% probability of a tightening at their November 2nd meeting.

As their counterparts in Europe consider an exit from emergency policy setting, FOMC members concluded their third quarterly meeting for 2017 by leaving the policy rate unchanged and announcing their intention to begin balance sheet normalization in October. At inception, the FOMC will allow for $6bln in Treasury runoff along with $4bln in MBS runoff and will accelerate run off for both, over time, on a preset schedule. The post-meeting statement continued to describe risks to the outlook as "roughly balanced" and added that headline and core inflation "declined this year" and are running below 2 percent. The statement also discussed negative near-term growth effects from the hurricanes, but the committee does not expect them to "materially alter the course" of medium term growth. As for future tightening plans, the summary of economic projections continued to show a third rate hike in 2017 and three hikes in 2018. However, the median projection declined for 2019 and is now consistent with just over two hikes that year. Overall, the FOMC's outlook for 2017 may have been slightly more hawkish than expected, with 12 out of 16 committee members forecasting at least one more hike before the year is out. In the days leading up to the meeting, it was thought possible that the committee was wavering on the need for another hike in 2017 due to the soft inflation prints since June and that a third tightening would have lost some support, which was clearly not the case. These persistently poor inflation prints may have impacted FOMC member thinking at the margin, though the quarter point fall in the median long run forecast, to 2.75%, indicates that the median member sees the current hiking cycle as nearly halfway over.

At the post-statement press conference, Chair Yellen affirmed her confidence in the transitory nature of the latest inflation undershoot, saying that she "believes this year's shortfall in inflation reflects developments unrelated to broader conditions." The Chair also stated firmly that the effects of hurricanes Harvey and Irma are "unlikely to alter the course of the national economy past the next two quarters." By dismissing weakness in the data as transitory, it appears, at least for the time being, that the Chair is prepared to move forward with policy normalization into the end of her first term and that the FOMC's reaction function is unchanged in the face of soft realized inflation data. After markets finished digesting this news Treasury real yields had popped 4-6bps across and the 5s30s nominal made new 2-month 'flats' as the curve flattened 5bps to 93.5bps. In the FX space, the crowded EUR was the biggest loser, falling nearly 1% as the U.S. dollar roared higher alongside Treasury yields. Interestingly, the FOMC tough policy talk in the face of lower inflation did not put additional pressure on TIPs breakevens which finished wider on the month suggesting the nominal market is aptly priced for current levels of inflation and FOMC policy expectations.

As September comes to a close, it appears the central banking meme for the rest of 2017 has emerged. The FOMC will continue to try to break away from the pack with higher policy rates and less accommodative Treasury market dynamics while other central banks attempt to move toward the exit from easy policy. This simultaneous exit may be possible, as the Bank of Canada has managed to tighten policy in 2017 without immediate disaster and the market seems to be having little trouble digesting the notion of a higher policy rate in the UK in short order. Despite these incremental successes, if there is one lesson the market teaches, it is that whenever multiple market actors attempt to do the same thing, adverse results often follow. Whether it is a crowded position that ultimately ends in a negative result or groupthink leading to a widely supported yet incorrect outcome, markets have a tendency to punish the herd over time. If global central bankers follow through on their intention to tighten policy in unison, we will see if that is the case for their simultaneous global exit from emergency rate policy.



Note: 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.

Source: The Federal Reserve

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents Under Their Individual Assessments of Projected Appropriate Monetary Policy, September 2017

Advance Release of Table 1 of the Summary of Economic Projections to be Released with the FOMC Minutes

Percent

Variable	Median[1]					Central tendency[2]					Range[3]				
	2017	2018	2019	2020	Longer run	2017	2018	2019	2020	Longer run	2017	2018	2019	2020	Longer run
Change in real GDP	2.4	2.1	2.0	1.8	1.8	2.2 – 2.5	2.0 – 2.3	1.7 – 2.1	1.6 – 2.0	1.8 – 2.0	2.2 – 2.7	1.7 – 2.6	1.4 – 2.3	1.4 – 2.0	1.5 – 2.2
June projection	2.2	2.1	1.9	n.a.	1.8	2.1 – 2.2	1.8 – 2.2	1.8 – 2.0	n.a.	1.8 – 2.0	2.0 – 2.5	1.7 – 2.3	1.4 – 2.3	n.a.	1.5 – 2.2
Unemployment rate	4.3	4.1	4.1	4.2	4.6	4.2 – 4.3	4.0 – 4.2	3.9 – 4.4	4.0 – 4.5	4.5 – 4.8	4.2 – 4.5	3.9 – 4.5	3.8 – 4.5	3.8 – 4.8	4.4 – 5.0
June projection	4.3	4.2	4.2	n.a.	4.6	4.2 – 4.3	4.0 – 4.3	4.1 – 4.4	n.a.	4.5 – 4.8	4.1 – 4.5	3.9 – 4.5	3.8 – 4.5	n.a.	4.5 – 5.0
PCE inflation	1.6	1.9	2.0	2.0	2.0	1.5 – 1.6	1.8 – 2.0	2.0	2.0 – 2.1	2.0	1.5 – 1.7	1.7 – 2.0	1.8 – 2.2	1.9 – 2.2	2.0
June projection	1.6	2.0	2.0	n.a.	2.0	1.6 – 1.7	1.8 – 2.0	2.0 – 2.1	n.a.	2.0	1.5 – 1.8	1.7 – 2.1	1.8 – 2.2	n.a.	2.0
Core PCE inflation[4]	1.5	1.9	2.0	2.0		1.5 – 1.6	1.8 – 2.0	2.0	2.0 – 2.1		1.4 – 1.7	1.7 – 2.0	1.8 – 2.2	1.9 – 2.2	
June projection	1.7	2.0	2.0	n.a.		1.6 – 1.7	1.8 – 2.0	2.0 – 2.1	n.a.		1.6 – 1.8	1.7 – 2.1	1.8 – 2.2	n.a.	
Memo: Projected appropriate policy path															
Federal funds rate	1.4	2.1	2.7	2.9	2.8	1.1 – 1.4	1.9 – 2.4	2.4 – 3.1	2.5 – 3.5	2.5 – 3.0	1.1 – 1.6	1.1 – 2.6	1.1 – 3.4	1.1 – 3.9	2.3 – 3.5
June projection	1.4	2.1	2.9	n.a.	3.0	1.1 – 1.6	1.9 – 2.6	2.6 – 3.1	n.a.	2.8 – 3.0	1.1 – 1.6	1.1 – 3.1	1.1 – 4.1	n.a.	2.5 – 3.5

NOTE: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The projections for the federal funds rate are the value of the midpoint of the projected appropriate target range for the federal funds rate or the projected appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. The June projections were made in conjunction with the meeting of the Federal Open Market Committee on June 13–14, 2017. One participant did not submit longer-run projections for the change in real GDP, the unemployment rate, or the federal funds rate in conjunction with the June 13–14, 2017, meeting, and one participant did not submit such projections in conjunction with the September 19–20, 2017, meeting.

1. For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.
2. The central tendency excludes the three highest and three lowest projections for each variable in each year.
3. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
4. Longer-run projections for core PCE inflation are not collected.

Source: The Federal Reserve

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