Monthly Market Observations

May 2017

Themes

During the month of April, the markets were preoccupied with several geopolitical issues including cruise missiles fired at a Syrian air strip, escalation of hostilities with North Korea, and the existential threat to the Eurozone tied to the outcome of the first round of the French elections. The US unemployment rate fell to 4.4% in April, the lowest level in 10 years, as employers added 211,000 non-farm payroll jobs, with little net revision for February and March. The U6 unemployment rate, which includes discouraged and part-time workers seeking full-time employment, dropped 0.3% to 8.6%, again down to pre-recession levels. The April release confirmed that the anemic March payrolls number was largely a weather specific aberration. Along with the latest Job Openings (JOLTS) at 5.7 million and ever lower jobless claims, these results confirm the continuation of a healthy US labor market which is at, or very close to, full employment.

The release of the May FOMC minutes will likely contain discussion/information regarding the plan to reduce reinvestment in the Federal Reserve's securities portfolio towards the end of this year. The Fed's portfolio will have $425BN of maturing Treasuries in 2018 (25% of the gross issuance of US nominal Treasury notes in 2016, excluding 30 year Bonds, TIPs, & FRNs), and $363BN in 2019. Assuming an 8% constant prepayment rate, the Agency MBS portfolio would have roughly $175BN and $150BN of paydowns (maturing principal) respectively in 2018 and 2019. It is unlikely that it will opt to cease reinvestment altogether given the size of these maturities. More likely, the Fed will taper its reinvestment by roughly 25% initially for several months followed by further reductions later this year.

In Europe, inflation and growth numbers have materially improved with HICP, Eurozone headline inflation, rapidly approaching the ECB's 2% target and 1st quarter real GDP coming in at +1.7%. If this trend persists, there will be more pressure on the ECB to consider raising the deposit rate from -0.4% and, more importantly, slowing its security purchases. The current securities purchase program is set at €60BN per month and expires at the end of 2017 – only months away. Any announced tapering could well mean higher German yields along with wider credit spreads above Germany for peripheral countries such as Italy and Spain. The knock-on effect could be to drive US note/bond yields higher as foreign investors source increasingly attractive yields in Europe and buy fewer US bonds.

Going forward, continued discussion of US Fed reinvestment tapering coupled with the prospect of reduced Eurozone bond buying by the ECB, both likely to happen near the end of 2017, should push real yields higher in the US Treasury market, especially in longer maturities. On the short end of the US yield curve, one would expect the Fed to continue to raise the Fed Funds rate with at least two more increases this year, given a relatively benign market environment, solid employment gains in the US, and much improved European inflation/growth (which no longer pose a threat to the global economy). Moreover, if the US is at or near full employment today and tight labor markets begin to push up wage inflation, consumer price inflation will likely follow, which will also put pressure on inflation expectations and bond yields. All this before consideration of any potential stimulus that would result from future tax cuts or infrastructure spending, which would clearly put even more pressure on inflation and deficits. Currently, the bond market is not fully pricing these risks.

Observations

- Labor market at or very close to full employment
- Risk that wage inflation picks up, spurring higher CPI
- Fed expected to reduce reinvestment – end of 2017
- EU inflation, growth numbers materially improved
- ECB will be under pressure to reduce QE soon
- Higher Eurozone yields would pressure US rates

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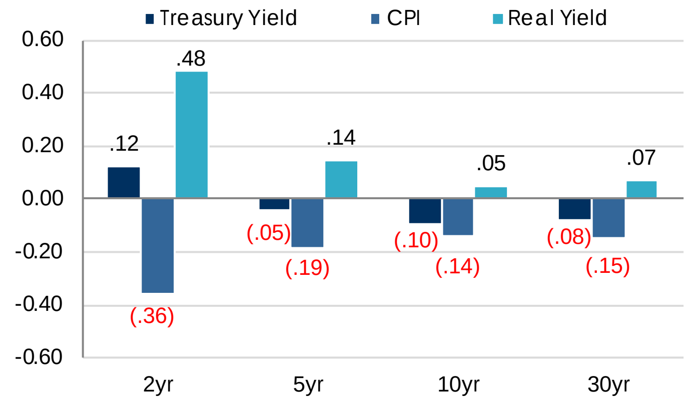
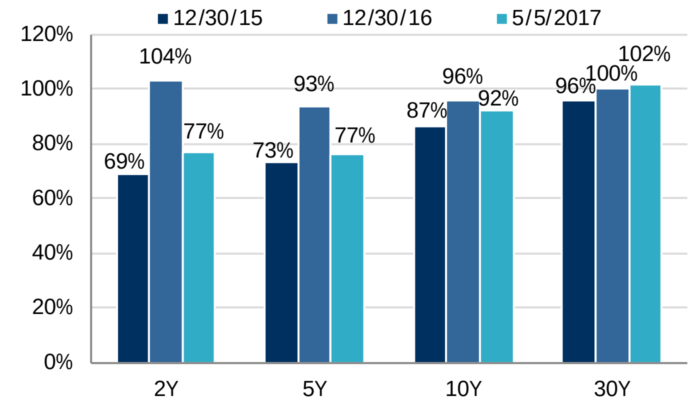
Monthly charts

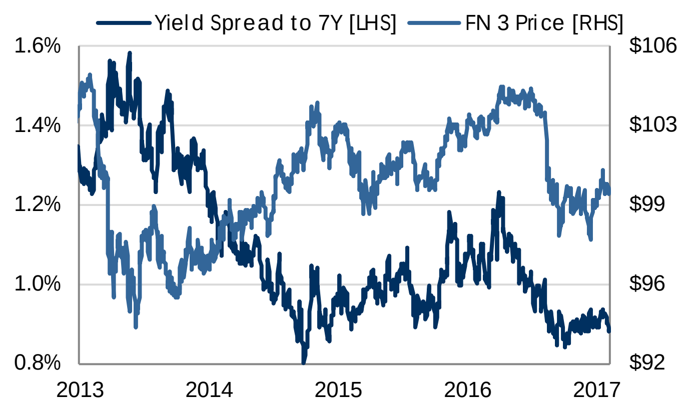
US rates shift [%], 12/30/2016 through 5/5/2017



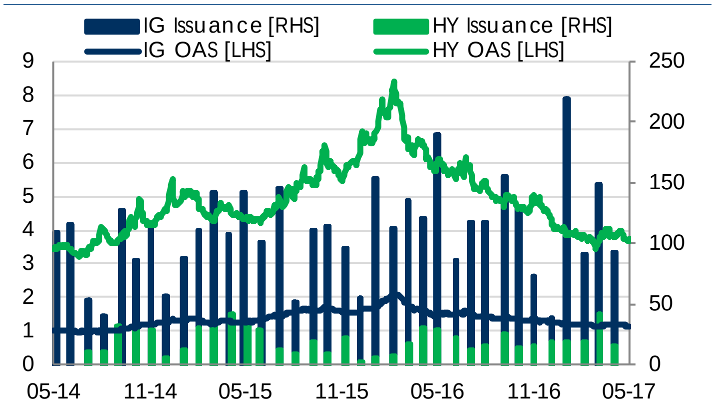
Ratio of AAA GO muni yields vs USTs



MBS TBA spread to UST vs. FN 3 price

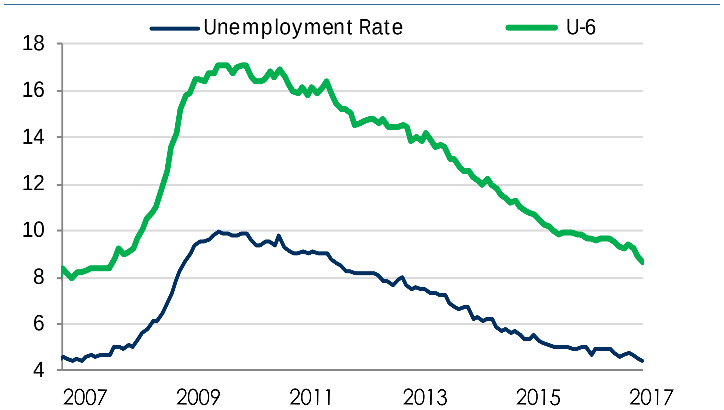


Corporate issuance [$BN] and spreads [%]

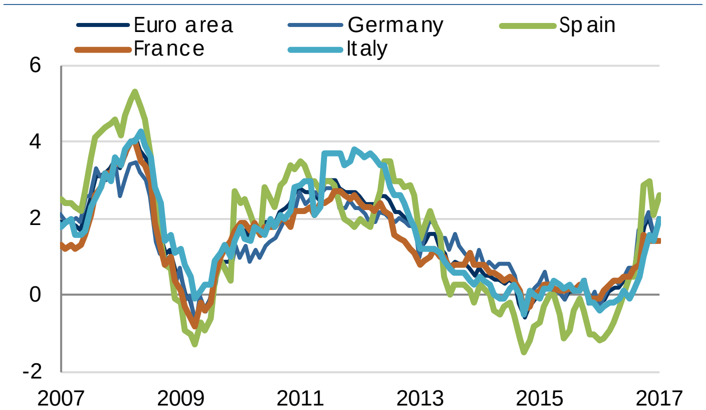


Additional charts

US Unemployment rate [%]



HICP Inflation YoY [%]



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