Monthly Market Overview

September 2018

Themes

US stock indices hit all-time highs in August despite turmoil in the Emerging Markets and the threat of further escalation of trade hostilities with China. Argentina was forced to raise its overnight rate to 60% to defend the currency after a surprise call by President Macri for an accelerated IMF $50BN bailout schedule. The US Treasury yield curve flattened, reflecting the expectation that the Fed will continue to raise short rates in the near-term.

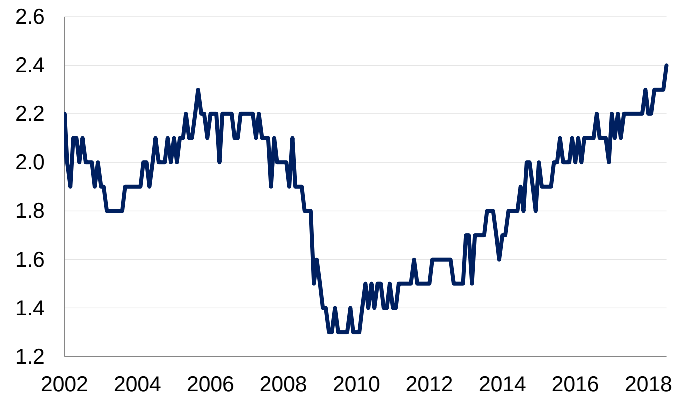
Average hourly earnings in the US jumped 0.4% in August, +2.9% year-over-year (YoY), well above expectations, which caused Treasury yields to jump. The unemployment rate remained at 3.9% due to a technical 469K decrease in the labor force related to student summer job transition. More impressive was underemployment (U6) falling 0.1% to a 17-year low of 7.4%. The prospect of a tight labor market with further wage cost pressures to come is even more compelling given job openings and quits as measured by the July JOLTS report hit all-time highs of 6.9 million and 3.6 million respectively.

The Fed is expected to raise short term rates by 25 basis points in its September 25/26th meeting. The question is whether it would move again in December and how fast and far will they move in 2019. On the dovish side, Atlanta's Bostic has indicated that his view is consistent with three hikes in 2018, while the more hawkish Mester indicated that she is comfortable with the current pace of one move per quarter. Lael Brainard (normally dovish) in her speech at the Detroit Economic Club said, given the strength of the economy, she could see the Fed raising rates above the median longer-term neutral rate of 2.9% over the near-term. The mainstream market view is consistent with a December move. More to the point, Rosengren in Boston, who will be a voting member in 2019, has made the case that the Fed needs, and can afford, more monetary ammunition ahead of the next downturn in the economy. He is correct in that assessment given Fed Funds at 2% and the Fed's securities portfolio still at $4TN in an economy that is producing average real growth of 3 – 4%, historically strong employment statistics by any measure, just over 2% inflation, and in its tenth year of expansion.

Despite the recent increase in yields post August employment report, there are several issues that could weigh on longer maturity US yields. There is concern regarding an escalating trade war with China, where $200BN of second round US imposed tariffs have been implemented, possibly followed by another $267BN. Argentina, Turkey, and Brazil continue to see their currencies and financial markets under extreme pressure. The ECB has just revised its growth estimates down for the Eurozone heading into its tapering of QE to €15BN of purchases per month (from the current €30BN) in Q4 before ending new purchases at the end of the year (subject to confirming data). The ECB will continue to reinvest all maturing principal and has said that it will not consider raising short term rates before September of 2019.

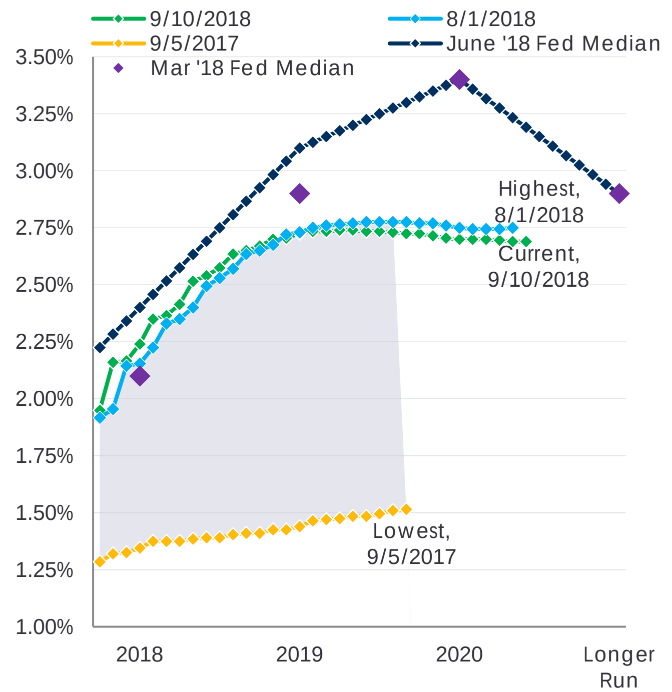
Despite indications that the BoJ is quietly discussing the effectiveness of QE, there is no sign of a dramatic shift in policy. That means that as long as ex-US developed market yields remain artificially low, it will be difficult for longer term US yields to rise much further. Lastly, the US Treasury's issuance of new debt is still skewed to intermediate and short maturity notes and T-Bills which will keep the supply of longer maturity bonds relatively low compared to demand from the retirement complex.

US quits rate, seasonally adjusted [%]



Source: Bloomberg

Federal Reserve vs market estimates



Source: Bloomberg

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Observations

Cross-asset volatilities

- Cross-asset volatility remains under pressure since February's Average Hourly Earnings print spooked markets, causing a significant volatility spike on the specter of imminent inflationary pressure.
- Programmatic volatility sellers have since resumed and have regained their influence on markets.
- This pressure coupled with an environment supportive of US risk assets has led the way back down in volatility levels.

The new Fed's monetary policy

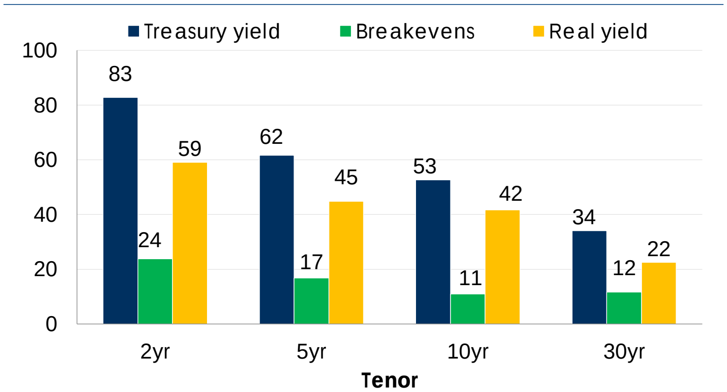
- Though Chair Yellen and members of her regime at the Fed often reiterated their "data-dependent" nature, Jerome Powell's Fed may prove to be even more so.
- The nature of a low current fed funds rate and a fully stocked SOMA portfolio means that Powell's Fed has inherited an asymmetrical reaction function – which could cause hesitation in hiking should there be signs of economic weakness in coming months.
- Additionally, with each meeting now being "live" with a press conference to follow, policy makers will have more opportunities to adjust policy.

High yield supply

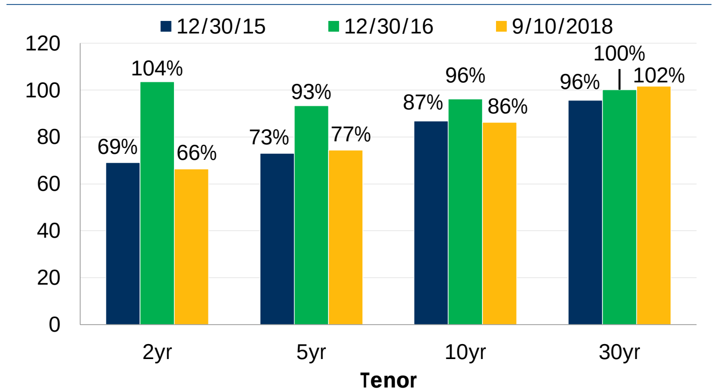
- A shift of investor demand from high yield credit to high yield loans partially explains low HY bond supply figures -- supply data relates to bonds not loans. Both are high yield and so comprehensive supply figures may be distorted.

Monthly charts

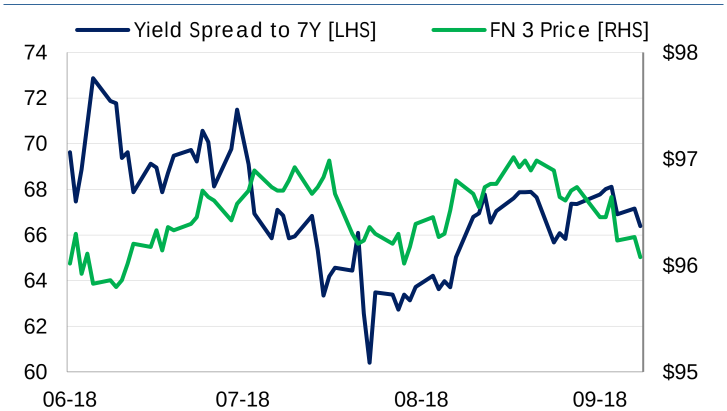
US rates shift [bp], 12/29/2017 through 9/10/2018



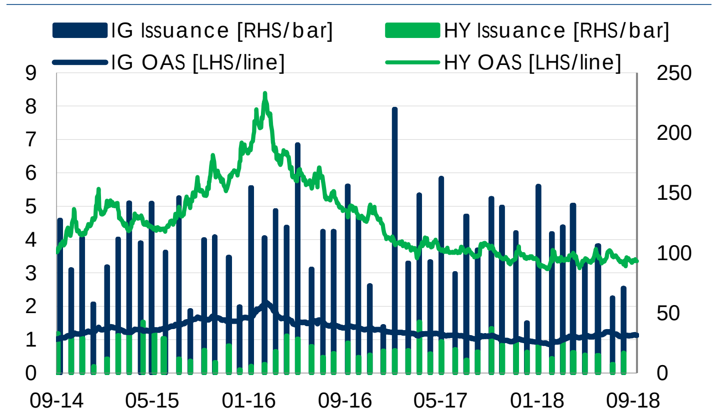
Ratio of AAA GO muni yields vs UST



MBS TBA spread to UST [bp] vs. FN 3 price



Corporate issuance [$BN] and spreads [%]



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