TCW

INSIGHT

MONTHLY COMMENTARY

December Rates Update

TYLER TUCCI | JANUARY 3, 2017

Although the 120bp range, between a high of 3.21% and a low of 2.08%, seen in 30 Year Treasury yields in 2016 was in line with historical norms, the events that catalyzed movement within that range were far from the status quo. Indeed, 2016 saw: Japan adopt a negative interest rate policy, crude oil trade as low as $35/brl, the UK vote to leave the European Union, the election of Donald Trump to the presidency in the U.S., and a 25bp increase in the U.S. policy rate from the Federal Reserve, to name just a few key risk events. For a year full of out-of-consensus events, risk assets still performed quite well with the S&P 500 reaching all-time highs, U.S. investment grade corporates up 6% and U.S. High Yield corporates up 15% for the year.

The first major catalyst in the holiday-shortened month of December was the ECB's announcement that it would reduce asset purchases from €80 billion per month to €60 billion beginning in April. This reduced purchase program will run until the end of 2017 but the ECB has already specified that it could extend the program beyond 2017 if necessary. In addition to the reduction in asset purchases, the ECB also removed the yield floor of -40bps on their asset buying program which will allow them to buy more, shorter-dated bonds and help support a steeper yield curve. While this reduction in planned purchases saw long-term bond yields increase on the news, other markets responded as if the ECB had eased policy. For example, Eurozone stock indexes rose and the euro weakened significantly.

This bifurcated reaction between the FX and Rates markets suggests that the ECB still retains a measure of credibility in its assurances that the ECB was not tapering their asset purchase program, despite decreasing the size of the purchases. It may have been telling however, that when pressed about the notion that a reduction in the asset purchase program was not the same as the taper, ECB President Draghi stated that the ECB "seemed to be fairly far away from any such high-class problem." President Draghi's statement, while made somewhat tongue in cheek, suggests that the ECB does not view the current economic state of Europe to be one that is conducive to a tighter monetary policy framework any time in the near future. This notion was further reinforced by new ECB growth and inflation projections, which show that the ECB staff no longer expects Euro Area inflation to return to the ECB's 2% target by 2019. As the ECB no longer foresees reaching the inflation target in the next three years, any talk of a full-blown ECB taper in the near future should fall by the wayside for the time being. Without monetary policy to help keep borrowing costs and the euro suppressed, it would be increasingly more difficult to generate any meaningful inflationary pressure to push EU inflation readings back toward target anytime soon.

While the ECB elected to ease policy in roundabout fashion at their December policy meeting, the FOMC decided to tighten policy at their own December meeting, raising

Tyler T. Tucci
Assistant Vice President
U.S. Fixed Income

Tyler Tucci is an Assistant Vice President in the U.S. Fixed Income Rates group. Mr. Tucci trades foreign exchange products and is also responsible for assisting in the evaluation of interest rate derivatives and global monetary policy. Prior to joining TCW in 2015, Mr. Tucci was a Short Term Markets and Interest Rate Derivative Strategist at the Royal Bank of Scotland. Mr. Tucci holds a bachelor's degree in Economics and Finance from Elon University. Mr. Tucci has completed level I of the CFA exam and Levels I and II of the CMT exam.

the policy rate from 25-50bps to 50-70bps. This move did not come as much of a surprise to market participants, as it was fully priced into Fed Funds future contracts prior to the meeting. Similarly, the release of the FOMC Statement did very little to tip the committee's hand, delivering an even handed, non-committal assessment of the US macroeconomic backdrop. However, the Fed did not bring the year to a close without delivering one final surprise to the market in the form of an upgrade to the policy-tightening forecast for 2017. The median participant now looks for three hikes in 2017, up from two in September, and the mean outlook for the funds rate at the end of next year was revised up 7 basis points from 1.31% to 1.38%. The level of the funds rate projection for 2018 and 2019 was shifted up slightly, though the pace of hikes in those years was generally little changed from the September projections. Interestingly, this upgraded 2017 tightening guidance did not come with any upgrades to the FOMC's economic forecast projections. The Fed expects slightly better growth next year: 2.1% versus its prior forecast of 2.0%. The 2018 growth forecast was left unchanged at 2.0%. Also, the estimate of long-run growth was unchanged at 1.8%. Despite offering very little in terms of forward guidance, the act of tightening policy another 25bps seemed to temporarily reawaken the animal spirits in the US Treasury market as yields surged higher, led by the belly of the curve. This bearish impulse was enough to push the yield on 5y notes over 2%, a level not seen since 2011.

Following the release of the statement, Chair Yellen held her quarterly post-meeting press conference where she went out of her way to downplay the upward revisions to the forecasted pace of tightening for 2017. The chair reminded media members that FOMC projections can move upwards or downwards as a result of changes in just a few individual forecasts and does not indicate a change in stance from the committee as a whole. When pressed on the potential impact of President-elect Trump's policies, Chair Yellen suggested that it was far too early to know how these policies will unfold. As such, it does not seem that potential changes to fiscal and regulatory policy will steer the Fed, at least in the near term, as they remain model driven. On a longer time horizon, it is indeed possible that President-elect Trump's policies will eventually change the approach to monetary policy at the FOMC as he will get to appoint a new chair in 2018 as well as fill two vacant FOMC governor seats in the near future. In the meantime, it seems committee members are quite content to wait and see what 2017 holds before making any aggressive changes to policy.

This will undoubtedly be a fascinating year in financial markets as monetary policy makers attempt to hand the reins over to their fiscal policy counterparts as the importance of the global geopolitical backdrop increases. In that light, the environment for macro-driven investing may be more favorable than seen in some time as risk assets could begin to reflect global socioeconomic trends as opposed to central bank-driven supply and demand. While the handoff between monetary and fiscal policy occurs in Washington, financial markets may have begun attempting handoff of their own as expectations have moved away from stagnant growth and inflation and toward a more robust growth and inflation backdrop. While the newfound economic optimism is a welcome development, market participants may be setting themselves up for disappointment yet again. Remember, the market was looking for four hikes from the FOMC in 2016 at the onset of the year, only to see just one hike materialize. Similarly, expectations of nearly 3% YoY real GDP growth to begin 2016 proved quite optimistic since growth struggled to exceed 2%. It remains to be seen whether or not 2017 will similarly fail to meet expectations but the market is currently indicating it has a significant amount of faith in the incoming U.S. presidential administration and the Federal Reserve. Hopefully, this optimism will prove to be justified, however if 2016 is any indication, the market may be again setting itself up for disappointment.

	11/30/2016	12/30/2016	52 Week High	52 Week Low
2y Treasury Yields	1.11	1.19	1.30	0.50
5y Treasury Yields	1.84	1.93	2.12	0.89
10y Treasury Yields	2.38	2.44	2.64	1.32
30y Treasury Yields	3.03	3.07	3.21	2.09
Yield Curve Steepness 2s to 30s	191.67	187.36	205.73	139.67
Barclays Aggregate Index	1973.59	1976.37		

Source: Bloomberg Barclays Live

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents Under Their individual Assessments of Projected Appropriate Monetary Policy, December 2016

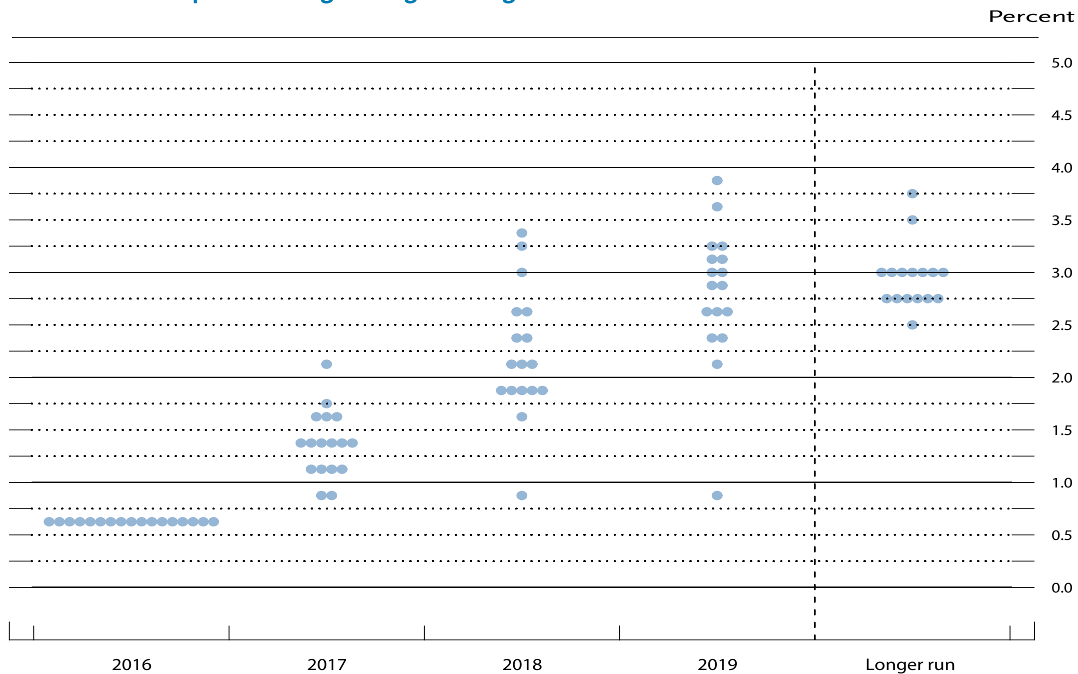
Percent

Variable	Median[1]					Central tendency[2]					Range[3]				
	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run	2016	2017	2018	2019	Longer run
Change in real GDP	1.9	2.1	2.0	1.9	1.8	1.8 – 1.9	1.9 – 2.3	1.8 – 2.2	1.8 – 2.0	1.8 – 2.0	1.8 – 2.0	1.7 – 2.4	1.7 – 2.3	1.5 – 2.2	1.6 – 2.2
September projection	1.8	2.0	2.0	1.8	1.8	1.7 – 1.9	1.9 – 2.2	1.8 – 2.1	1.7 – 2.0	1.7 – 2.0	1.7 – 2.0	1.6 – 2.5	1.5 – 2.3	1.6 – 2.2	1.6 – 2.2
Unemployment rate	4.7	4.5	4.5	4.5	4.8	4.7 – 4.8	4.5 – 4.6	4.3 – 4.7	4.3 – 4.8	4.7 – 5.0	4.7 – 4.8	4.4 – 4.7	4.2 – 4.7	4.1 – 4.8	4.5 – 5.0
September projection	4.8	4.6	4.5	4.6	4.8	4.7 – 4.9	4.5 – 4.7	4.4 – 4.7	4.4 – 4.8	4.7 – 5.0	4.7 – 4.9	4.4 – 4.8	4.3 – 4.9	4.2 – 5.0	4.5 – 5.0
PCE inflation	1.5	1.9	2.0	2.0	2.0	1.5	1.7 – 2.0	1.9 – 2.0	2.0 – 2.1	2.0	1.5 – 1.6	1.7 – 2.0	1.8 – 2.2	1.8 – 2.2	2.0
September projection	1.3	1.9	2.0	2.0	2.0	1.2 – 1.4	1.7 – 1.9	1.8 – 2.0	1.9 – 2.0	2.0	1.1 – 1.7	1.5 – 2.0	1.8 – 2.0	1.8 – 2.1	2.0
Core PCE inflation[4]	1.7	1.8	2.0	2.0		1.7 – 1.8	1.8 – 1.9	1.9 – 2.0	2.0		1.6 – 1.8	1.7 – 2.0	1.8 – 2.2	1.8 – 2.2	
September projection	1.7	1.8	2.0	2.0		1.6 – 1.8	1.7 – 1.9	1.9 – 2.0	2.0		1.5 – 2.0	1.6 – 2.0	1.8 – 2.0	1.8 – 2.1	
Memo: Projected appropriate policy path															
Federal funds rate	0.6	1.4	2.1	2.9	3.0	0.6	1.1 – 1.6	1.9 – 2.6	2.4 – 3.3	2.8 – 3.0	0.6	0.9 – 2.1	0.9 – 3.4	0.9 – 3.9	2.5 – 3.8
September projection	0.6	1.1	1.9	2.6	2.9	0.6 – 0.9	1.1 – 1.8	1.9 – 2.8	2.4 – 3.0	2.8 – 3.0	0.4 – 1.1	0.6 – 2.1	0.6 – 3.1	0.6 – 3.8	2.5 – 3.8

Source: Federal Reserve
Advance release of table 1 of the Summary of Economic Projections to be released with the FOMC minutes

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 September projections were made in conjunction with the meeting of the Federal Open Market Committee on September 20–21, 2016. 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 September 20–21, 2016, meeting, and one participant did not submit such projections in conjunction with the December 13–14, 2016, 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.

FOMC Participants' Assessments of Appropriate Monetary Policy: Midpoint of Target Range or Target Level for the Federal Funds Rate



Source: Federal Reserve

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: Bloomberg Barclays Live

BLOOMBERG is a trademark and service mark of Bloomberg Finance L.P. BARCLAYS is a trademark and service mark of Barclays Bank Plc, used under license. Bloomberg Finance L.P. and its affiliates (collectively, "Bloomberg") or Bloomberg's licensors own all proprietary rights in the BLOOMBERG BARCLAYS INDICES. Neither Bloomberg nor Barclays Bank Plc or Barclays Capital Inc. or their affiliates (collectively "Barclays") guarantee the timeliness, accuracy or completeness of any data or information relating to BLOOMBERG BARCLAYS INDICES or make any warranty, express or implied, as to the BLOOMBERG BARCLAYS INDICES or any data or values relating thereto or results to be obtained therefrom, and expressly disclaims all warranties of merchantability and fitness for a particular purpose with respect thereto. It is not possible to invest directly in an index. Back-tested performance is not actual performance. Past performance is not an indication of future results. To the maximum extent allowed by law, Bloomberg and its licensors, and their respective employees, contractors, agents, suppliers and vendors shall have no liability or responsibility whatsoever for any injury or damages - whether direct, indirect, consequential, incidental, punitive or otherwise - arising in connection with BLOOMBERG BARCLAYS INDICES or any data or values relating thereto - whether arising from their negligence or otherwise. This document constitutes the provision of factual information, rather than financial product advice. Nothing in the BLOOMBERG BARCLAYS INDICES shall constitute or be construed as an offering of financial instruments or as investment advice or investment recommendations (i.e., recommendations as to whether or not to "buy," "sell," "hold" or enter into any other transaction involving a specific interest) by Bloomberg or its affiliates or licensors or a recommendation as to an investment or other strategy. Data and other information available via the BLOOMBERG BARCLAYS INDICES should not be considered as information sufficient upon which to base an investment decision. All information provided by the BLOOMBERG BARCLAYS INDICES is impersonal and not tailored to the needs of any specific person, entity or group of persons. Bloomberg and its affiliates express no opinion on the future or expected value of any security or other interest and do not explicitly or implicitly recommend or suggest an investment strategy of any kind. In addition, Barclays is not the issuer or producer of the BLOOMBERG BARCLAYS INDICES and has no responsibilities, obligations or duties to investors in these indices. While Bloomberg may for itself execute transactions with Barclays in or relating to the BLOOMBERG BARCLAYS INDICES, investors in the BLOOMBERG BARCLAYS INDICES do not enter into any relationship with Barclays and Barclays does not sponsor, endorse, sell or promote, and Barclays makes no representation regarding the advisability or use of, the BLOOMBERG BARCLAYS INDICES or any data included therein. Customers should consider obtaining independent advice before making any financial decisions. ©2017 Bloomberg Finance L.P. All rights reserved.

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2017 TCW

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup