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U.S. Rates Update December 2018

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It was a December to remember (or dismember). The S&P 500 stock index plunged 9.2%, the worst December performance since 1931. Selloffs of this magnitude or worse are rare events, occurring in only 3% of monthly performance figures since equity returns started being recorded. Two thirds of these episodes happened before 1940, and the frequency of such sharp selloffs drops to 1% in more recent times.

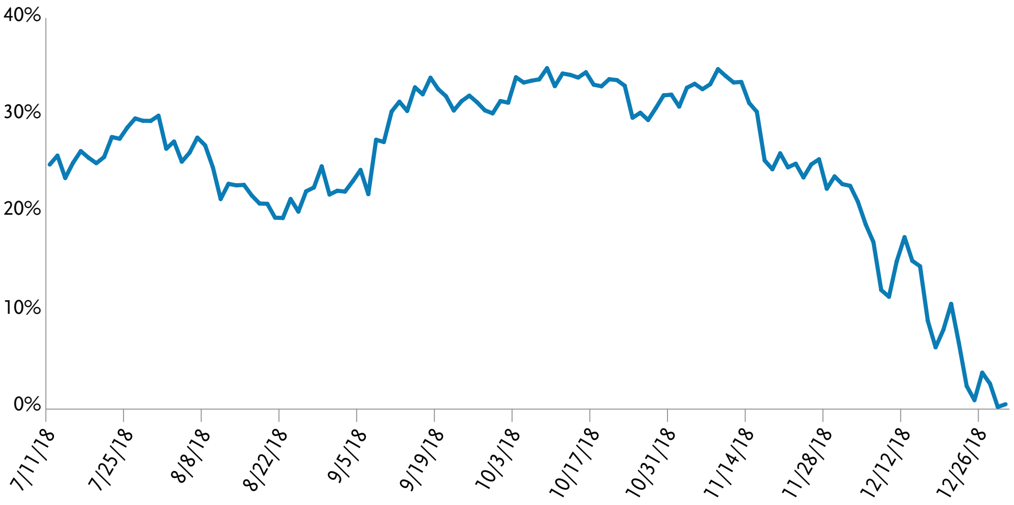
Corporate high yield index spreads rose more than 100 basis points (bps) during the month, with cumulative spread widening of 205 bps in the fourth quarter of 2018, the largest quarterly repricing of credit risk since 2011. Investment grade credits were also under pressure with index spreads wider by approximately 50 bps in the quarter. Commodities priced a dimmer global outlook, with oil (WTI) down 11% (-38% cumulative in Q4) and copper down 5% (-6% cumulative in Q4). Safe haven currencies rallied, with the Japanese yen up 3.5%. Emerging market bonds were relatively stable during the month of December, but closed the year with a benchmark return of -4.3%, resembling in performance the "taper tantrum" selloff of 2013.

It is hard to pinpoint just one single factor driving market turmoil since this was a year when multiple variables contributed to deflate previously high expectations about global growth and the related fair valuation of asset prices. The "synchronized global growth" narrative faded before the end of the first quarter, in part due to a sharper than expected deceleration of the Chinese economy. Various domestic factors contributed to more cautious sentiment domestically. The notion that the fiscal stimulus boost to the economy will dissipate going forward, and the lingering threat of trade wars and policy uncertainty due to high personnel turnover in the administration, weighed collectively on risk sentiment.

A unique factor that played out in December and arguably added fuel to the market turmoil was Fed communication seemingly out of sync with market expectations. Throughout the month, the Treasury curve priced more aggressively a view that there was no more room for further policy tightening beyond the already expected hike in December 2019 because, among other reasons, wider credit spreads themselves result in a tightening of financial conditions. The yield on the 2 year note declined from 2.79% at the end of November to 2.49% by year end, essentially pricing out completely any additional rate hikes. Ten year yields rallied 32 bps to 2.68% by the close of the year.

The decision to hike rates to the 2.25 – 2.5% range was largely expected, but happened in a context of extremely elevated noise coming from Washington. This included remarks made by President Trump on Twitter, expressing clear opposition to additional interest rate hikes. There were also rumors that suggested President Trump could take steps to remove Jerome Powell from the position of Fed Chairman. The decision to hike rates was in line with the Fed's still constructive view on the economy. But some speculation surfaced that the Fed also acted in a way to reaffirm the notion of institutional independence, and as a consequence, its post-meeting communication might have turned inadvertently too hawkish.

Fed Funds Futures Implied Probability of Two Rate Hikes in 2019



Source: Bloomberg

In its post-meeting statement, the Fed converged somewhat to more dovish market views, but a large gap remains between the Fed and the market's assessment of the amount of additional policy tightening that is right for the economy. The committee central interest rate forecast ("dots") for 2019 declined from three to two rate hikes in 2019, but maintained one last interest rate increase in 2020. This contrasts with market expectations – as priced in the Fed-funds futures curve – of no hikes in 2019 and the possibility of rate cuts in 2020.

The policy decision statement contained very modest modifications to the original language, adding the word "some" to qualify the expectation of "some further gradual increases" in the policy rate. The Fed also maintained a hawkish tone when commenting on balance sheet reduction. During the Q&A session that followed the rate decision, Fed Chairman Powell expressed the committee's belief that balance sheet reduction was progressing as planned, without creating any source of stress to the normal functioning of money markets – a current concern among many market participants.

In contrast with the elevated financial markets volatility, the month of December brought no big surprises in broad macroeconomic data. Inflation and employment numbers came in line with expectations, at 2.2% and 3.7%, respectively. Retail sales were particularly strong, consistent with still fairly robust consumer confidence figures. There were some signs of weakness in more cyclical sectors, with durable goods orders coming in weaker than expected. Sales of new homes disappointed, with contraction of activity in this sector advancing to -7.7% YoY.

We continue to see visible weakening in more interest rate sensitive sectors such as housing, but aggregate economic indicators are still at benign levels. It is too soon to say that the end of the expansion is imminent. However, warning signs are becoming more frequent and for this economic cycle, Treasury yields might have already peaked last October. ■

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