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INSIGHT

MONTHLY COMMENTARY

December Rates Update

TYLER TUCCI | JANUARY 12, 2018

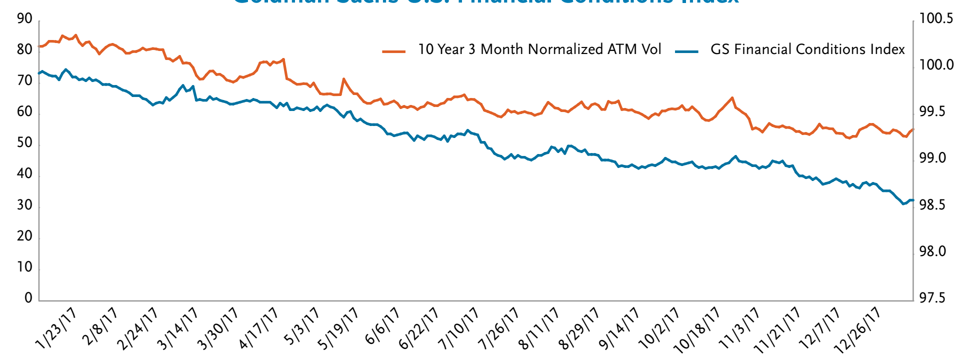
After final review, it is remarkable what an unremarkable year 2017 was in global rates. Despite three consecutive quarters averaging about 3% GDP, a 6/10th drop in the U-3 rate, six consecutive CPI misses, and three Fed rate hikes, 10 year Treasury yields finished 2017 a mere 7 bps higher than where they began the year at 2.40%. Narrow ranges and low volatility persisted across sovereign benchmarks in 2017 as the Japanese 10 year note unsurprisingly took the top spot for narrowest range at 16 bps, followed by Bunds at 46 bps, France at 58 bps, Gilts (UK) at 60 bps, USTs at 61 bps, and BTPs (Italy) at 65 bps. While it would be difficult to boil all of 2017 down to a single chart, the collapse in 10 year 3 month volatility graphed against the loosening in Chicago Fed Financial Conditions Index illustrates the volatility selling/curve flattening regimen seen all year.

U.S. Treasury Market Overview

	10/31/17	11/30/17	52 Week High	52 Week Low
2 Year Treasury Yields	1.78	1.88	1.98	1.13
5 Year Treasury Yields	2.14	2.21	2.36	1.60
10 Year Treasury Yields	2.41	2.41	2.63	2.01
30 Year Treasury Yields	2.83	2.74	3.21	2.63
Yield Curve Steepness 2s to 30s	104.09	85.29	191.66	82.32
Bloomberg Barclays Aggregate Index	2037.02	2046.37		

Source: Bloomberg Barclays

10 Year 3 Month Normalized ATM Volatility vs. Goldman Sachs U.S. Financial Conditions Index



Source: Bloomberg Barclays

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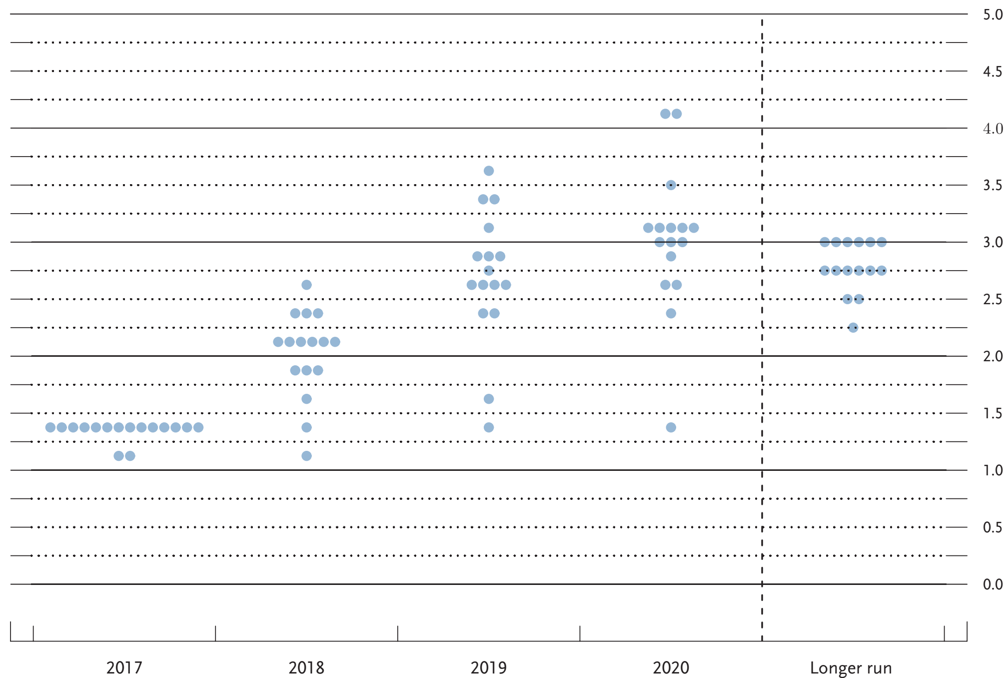
Tyler Tucci is an Assistant Vice President in the Fixed Income Rates group. Mr. Tucci trades foreign exchange products and is also responsible for assisting in the evaluation of interest rate derivatives and global monetary policy. Prior to joining TCW in 2015, Mr. Tucci was a Short Term Markets and Interest Rate Derivative Strategist at the Royal Bank of Scotland. Mr. Tucci holds a BA 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 most notable monetary policy event in December was FOMC Chair Janet Yellen's decision to raise the policy rate another 25 bps to 1.25%-1.50% in her final meeting as chair. This policy action came with two dissents, one from Minnesota Fed President Kashkari and the other from Chicago Fed President Evans who preferred to take no policy action. These dissents were somewhat expected, but more importantly neither of these regional bank presidents will be voting members of the FOMC in 2018. In terms of the FOMC statement, commentary around economic activity remained upbeat with upgraded language about the labor market saying it is expected to "remain strong" rather than "strengthen somewhat further." On inflation, the policy statement was a carbon copy of the prior meeting's commentary save a change in the current conditions paragraph, which no longer characterizes core inflation as "soft." This is a very small change but it is a touch more hawkish than previous statements.

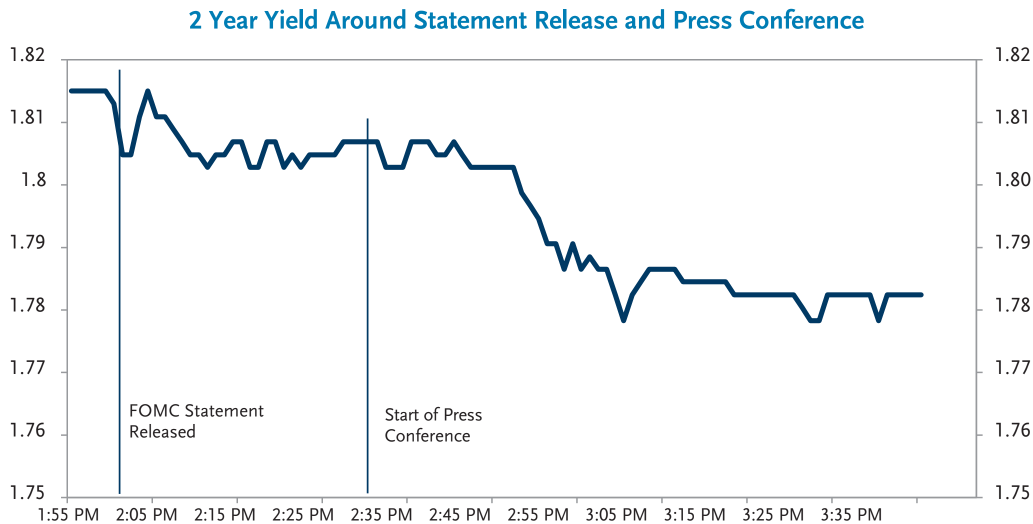
For the Summary of Economic Projections, the FOMC now projects the labor market to remain strong with a lower unemployment rate of 3.9% and stronger GDP growth across the forecast horizon, particularly next year where growth is expected to be 2.5% (vs. 2.1% previous), likely due to the recently enacted federal tax cuts. Despite these positive revisions, the Fed's forecast for core inflation and the dot plots are largely unchanged, with median expectations of three more hikes in 2018 and CPI of 1.9% in 2018 and 2.0% in 2019 and 2020. The 2020 dot was revised slightly higher to reach 3.06% from 2.875%, an increase of almost one full hike.

Federal Reserve Open Markets Committee Policy Rate Forecast



Source: The Federal Reserve

The fixed income market rallied following the release of the FOMC statement and during Chair Yellen's press conference, as many market participants seemed to take the combination of a sizeable upgrade to the growth numbers and no upward movement in the 2018 and 2019 dots as an indication that the FOMC has now mostly accounted for the impact of the tax cuts, but did not feel that their impact warranted additional tightening, at least over the next two years. However, it is quite possible that FOMC members would prefer to see the realized impact of the now passed tax cuts before recalibrating their own forecasts. Regardless of view, it seems unwise to put too much weight on projections from a lame duck FOMC Chair and a policy voter base that will be largely different in 2018.



Source: Bloomberg, Goldman Sachs Global Investment Research

And yes, December finally saw the passing of the well-discussed Republican led tax reform bill. While we will have to reserve comment on the actual, realized impacts of this bill for another monthly update, there were some clear takeaways in terms of changes from current law that can be interpreted immediately. For financial market participants, the decrease in the corporate tax rate from 35% to 21% is the most interesting feature of the bill. The significantly lower tax rates will serve to push earnings higher but how this earnings windfall is spent will be paramount in determining the knock-on impact of the bill. If corporations are content to use profits to buy back shares or debt, then the bill will only be a temporary stimulus on equity or debt prices. However, if the higher profitability leads to increased capital expenditures we could see a non-trivial boost to domestic GDP growth in addition to any boost to share prices. Potentially the second most market moving feature of the tax bill will be the new rules around the repatriation of earnings abroad. Under the new legislation, earnings abroad accumulated since 1986 would be repatriated back to the U.S. at a tax rate of 8% and liquid earnings would be taxed at 15.5%. Repatriation is expected to raise $339 billion over 10 years. This repatriation could potentially spark a round of USD buying as U.S. corporations bring back cash from overseas. It remains unclear if this will have a meaningful impact on the USD because whether or not U.S. corporations need to buy USD is dependent on whether or not this overseas cash was already invested in a U.S. asset. If that is generally the case, the impact on the dollar could be fairly muted.

As 2017 draws to a close, we could not have a more interesting market backdrop going into 2018. We are at record low levels in volatility, record high equity prices, and amongst the tightest High Yield spreads seen in the last 20 years. That is not to say this unprecedented calm cannot persist, and it may, but asset prices have seldom moved in a straight line for this period of time without something unforeseen happening. However, it is just that sort of thinking that could see risk assets continue to climb the wall of worry. If market participants decide that risk assets still look attractive on a relative basis to the risk-free rate despite having questionable-at-best outright valuations, there is potential that the market could press higher still. Regardless of which outcome manifests itself, 2018 will most likely secure its place in market history books.

Federal Reserve Open Markets Committee Summary of Economic Projections

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	2.5	2.5	2.1	2.0	1.8	2.4 – 2.5	2.2 – 2.6	1.9 – 2.3	1.7 – 2.0	1.8 – 1.9	2.4 – 2.6	2.2 – 2.8	1.7 – 2.4	1.1 – 2.2	1.7 – 2.2
September projection	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
Unemployment rate	4.1	3.9	3.9	4.0	4.6	4.1	3.7 – 4.0	3.6 – 4.0	3.6 – 4.2	4.4 – 4.7	4.1	3.6 – 4.0	3.5 – 4.2	3.5 – 4.5	4.3 – 5.0
September projection	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
PCE inflation	1.7	1.9	2.0	2.0	2.0	1.6 – 1.7	1.7 – 1.9	2.0	2.0 – 2.1	2.0	1.5 – 1.7	1.7 – 2.1	1.8 – 2.3	1.9 – 2.2	2.0
September projection	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
Core PCE inflation[4]	1.5	1.9	2.0	2.0		1.5	1.7 – 1.9	2.0	2.0 – 2.1		1.4 – 1.5	1.7 – 2.0	1.8 – 2.3	1.9 – 2.3	
September projection	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	
Memo: Projected appropriate policy path															
Federal funds rate	1.4	2.1	2.7	3.1	2.8	1.4	1.9 – 2.4	2.4 – 3.1	2.6 – 3.1	2.8 – 3.0	1.1 – 1.4	1.1 – 2.6	1.4 – 3.6	1.4 – 4.1	2.3 – 3.0
September projection	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

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 19–20, 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 September 19–20, 2017, meeting, and one participant did not submit such projections in conjunction with the December 12–13, 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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