TCW

INSIGHT

MONTHLY COMMENTARY

March Rates Update

TYLER TUCCI | APRIL 4, 2017

March left market participants with more questions than answers as an adjustment to monetary policy and a failed healthcare bill could not break Treasury yields out of recent ranges. Indeed, the FOMC decided to go ahead with another quarter point of policy tightening this month, but did not offer clear guidance on their subsequent policy plans. This policy uncertainty kept investors on the defensive, keeping risk assets and Treasury yields range bound. On the U.S. fiscal policy front, President Trump's first foray into legislative negotiation yielded mixed results as the Republican effort to repeal and replace the ACA fell short as the GOP could not whip the final 5-10 votes necessary to pass the bill in the House. This confluence of uncertainty from all facets of American policy could continue to cloud the global macro picture and keep the investment community on their collective heels until visibility improves.

Following a whirlwind end-of-February press tour which saw nearly all FOMC members make public statements in support of a March policy tightening, the FOMC pushed the policy rate 25bps higher at the conclusion of their March policy meeting. Despite broad based approval for the rate hike within the committee, Minnesota Fed President Neel Kashkari dissented in favor of an unchanged stance. President Kashkari notwithstanding, the policy statement released following the meeting was reasonably upbeat, voicing a view of an economy expanding at a moderate pace as the labor market continues to strengthen and household spending continues to rise. FOMC members also indicated that they believe inflation is on the right track, suggesting it had increased enough to characterize it as "close to the committee's 2% target," adding that they will continue to monitor developments relative to its symmetric inflation goal. While this introduction of the symmetric inflation goal verbiage into the statement was new, the idea of a symmetric inflation goal is something that Chair Yellen and other FOMC officials have stressed many times before. This explicit reference to the symmetric inflation goal is simply a reassurance that the Fed will not react too aggressively if core inflation were to drift somewhat above 2%.

In support of their view that inflation was trending in the right direction but was not yet a cause for concern, the committee boosted the core personal consumption expenditures forecast for 2017 from 1.8% to 1.9% but opted to leave 2018 and 2019 forecasts virtually unchanged. In addition, the median forecast of the fed funds rate, affectionately known was the "dot plot," for 2017 and 2018 were left unchanged at three tightenings expected for each year. The 2019 forecast was revised upward

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.

slightly though, as the median committee member now expects what would equate to 3.5 hikes in 2019 to reach a rate of 3.0% versus December's 2.875%. Similar changes were made to the long run or terminal rate which is now seen at 3.0% versus 2.9% in December. For the remainder of the committee forecasts, the growth rate was left virtually unchanged with the exception being an increase in the growth forecast for 2018 from 2.0% to 2.1% and a reduction in the natural rate of employment to 4.7% from 4.8%. Remarkably, despite the increase to the federal funds rate Treasury yields and the U.S. dollar both plunged in the aftermath of the FOMC meeting as market participants were looking for a more hawkish message and economic forecast mix than the one they received. Indeed, so pronounced was the asset market reaction that financial conditions eased markedly for the day, effectively undoing the policy tightening the FOMC had just levied.

Roughly half an hour after the statement's release, Fed Chair Yellen took to the podium for her quarterly post-meeting press conference to deliver additional thoughts on policy. As is frequently the case, the chair delivered an even handed assessment of the economy, opining that monetary policy was still accommodative but the FOMC was closing in on their inflation and employment mandates. The Chair was also vague on the future prospects for balance sheet normalization, but did indicate that whenever they were ready to get balance sheet reduction the process would be both gradual and predictable. Furthermore, Chair Yellen once again declined to provide any specific comments pertaining to the new administration or potential policy responses to any fiscal stimulus but did indicate some FOMC participants have "penciled in" fiscal adjustments.

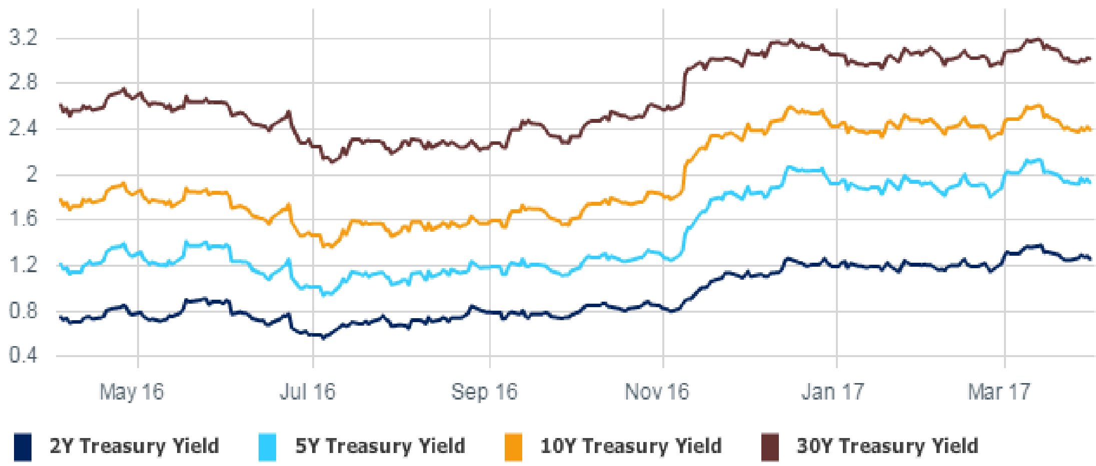
While Chair Yellen and her colleagues were planning the next steps for monetary policy, their fiscal policy counterparts on Capitol Hill were at work drafting a healthcare bill to replace the Affordable Care Act. Since the ACA became law in 2010, House Republicans have voted to repeal it 59 times but never got the chance to offer their own alternative. When finally given the opportunity to present a law of their own this month, the bill failed to make it to the House floor as Republican Party members could not agree on some of the legislation's finer points. Although President Trump's decision to tackle health care as his first major policy initiative may seem questionable, it remains an important first step towards large scale tax reform. Without replacing the ACA with something cheaper, President Trump will have a more difficult time passing meaningful legislation due to Senate rules and CBO scoring criteria. Along those lines, there were nearly $600bn in tax cuts in the healthcare repeal effort financed by significant reductions in Medicaid outlays. Without the Medicaid cuts to "pay for" this lost tax revenue, it will be hard for President Trump and Speaker Ryan to produce a tax reform plan of the originally planned $3tn size that will be deficit neutral beyond a 10y horizon.

As the first quarter of the year draws to a close, investors are still left without clear guidance on the future policy tightening path for the FOMC or what to expect from the Trump administration. If the FOMC is to be believed, it would appear their modal outcome for 2017 is three policy tightenings with a risk that as many as four hikes may be realized. However, given the market's reluctance to price in more than 2.5 or so tightenings for the year, it appears investors will force the Fed to actually make good on their forecasts for once before making any major changes in investment stance. Similarly, it appears as if the initial "Trump Trade" euphoria has died down and any further gains will most likely have to come as a result of delivered results and not intended progress. Regardless of whether the bull or bear case is delivered, global asset markets remain in "show me" mode suggesting sideways price action could continue until concrete progress is made in one direction or another.

	2/28/2017	3/31/2017	52 Week High	52 Week Low
2y Treasury Yields	1.26	1.25	1.40	0.50
5y Treasury Yields	1.93	1.92	2.15	0.89
10y Treasury Yields	2.39	2.39	2.64	1.32
30y Treasury Yields	3.00	3.01	3.21	2.09
Yield Curve Steepness 2s to 30s	173.03	175.15	205.73	139.67
Barclays Aggregate Index	1993.56	1992.51		

Source: Bloomberg

TSY Yield Curve Across Maturities



Source: Barclays Live

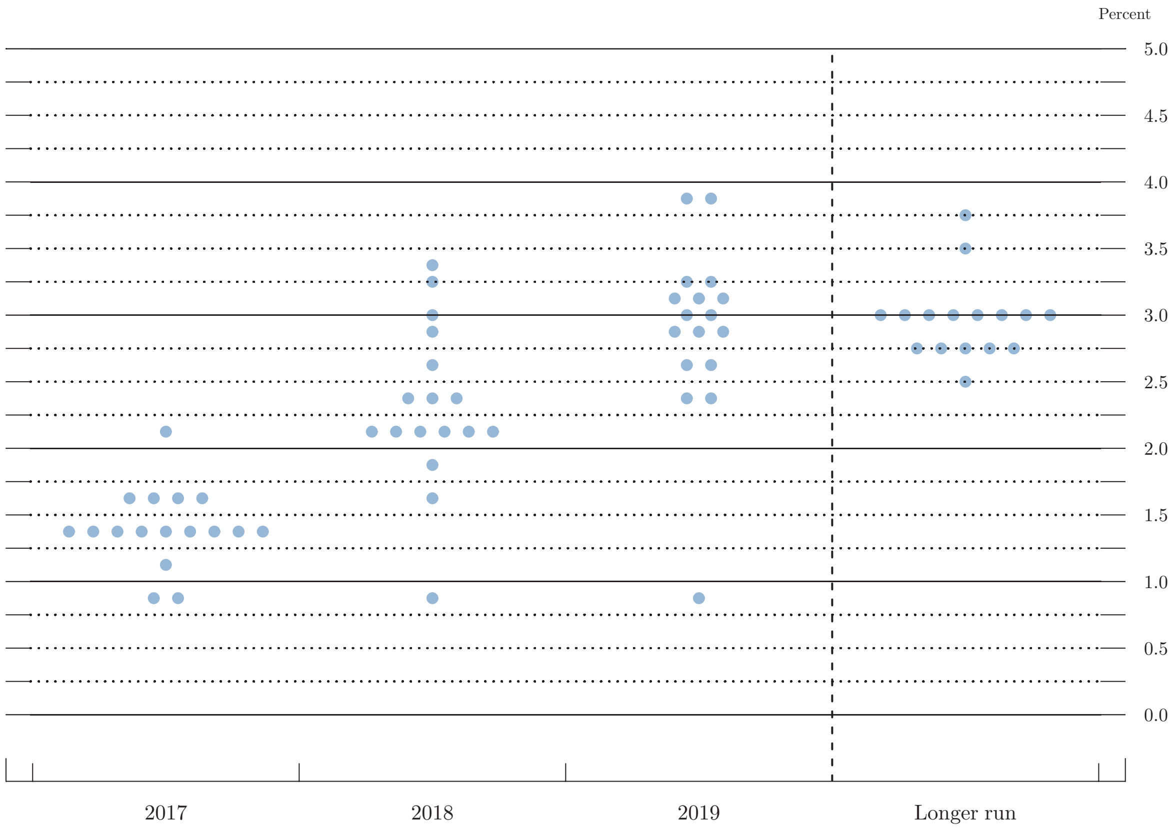
Percent

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

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 December projections were made in conjunction with the meeting of the Federal Open Market Committee on December 13–14, 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 December 13–14, 2016, meeting, and one participant did not submit such projections in conjunction with the March 14–15, 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



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: The Federal Reserve