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INSIGHT

MONTHLY COMMENTARY

U.S. Rates Update March 2019

MICHAEL Y. PAK, CFA | 8 APRIL 2019

The Final Four field in this year's version of March Madness undoubtedly caught most college basketball fans by surprise (unless perhaps you are an alum). Although Virginia and Michigan State were high seeds and widely expected to advance deep into the tourney, the surging play of upstart basketball programs at Auburn and Texas Tech shook up the college basketball world. While all four teams had great regular seasons and clearly deserve a shot at the National Championship, this widely unexpected Final Four match-up busted quite a few brackets during the month.

The madness in March however was not limited to the hardwood as the FOMC managed to surprise the market and bust even the most dovish expectations going into the March 20 meeting. The FOMC now expects only one more hike over the next three years (recall in December they were expecting up to three over the following two years) and 11 out of 17 participants expect no change in policy this year. FOMC members didn't stop there as plans around the framework for the balance sheet also took the market by surprise. While consensus expectations were for taper to start sometime around year-end at the earliest, the Fed "out-doved" itself by announcing it will begin tapering its Treasury holdings this May, reducing the cap on Treasury securities by half, to $15 billion, and ending reductions entirely by September. Additionally, beginning this October the first $20 billion of MBS pay downs will be invested in Treasuries across the curve with any residual amounts reinvested back into MBS. Once the balance sheet size reaches a more steady state, excess reserves will then contract more naturally/gradually over time as currency in circulation grows. The bottom line is the Fed's balance sheet will remain large with plentiful reserves and Treasury supply will be reduced in the medium term. The Summary of Economic Projections indicated downgraded forecasts for growth and the unemployment rate for the next two years, however the long-run inflation forecast was left unchanged at 2%. This is interesting in light of the Fed's pivot to an even easier policy stance which could indicate their ongoing concern over continued soft inflation data. However, despite the downgraded forecasts and shift in the dot plot, Powell did his best in the ensuing press conference to downplay the downgrades and emphasize that the committee still held a "favorable" outlook for the year and was not biased to adjust policy one way or another.

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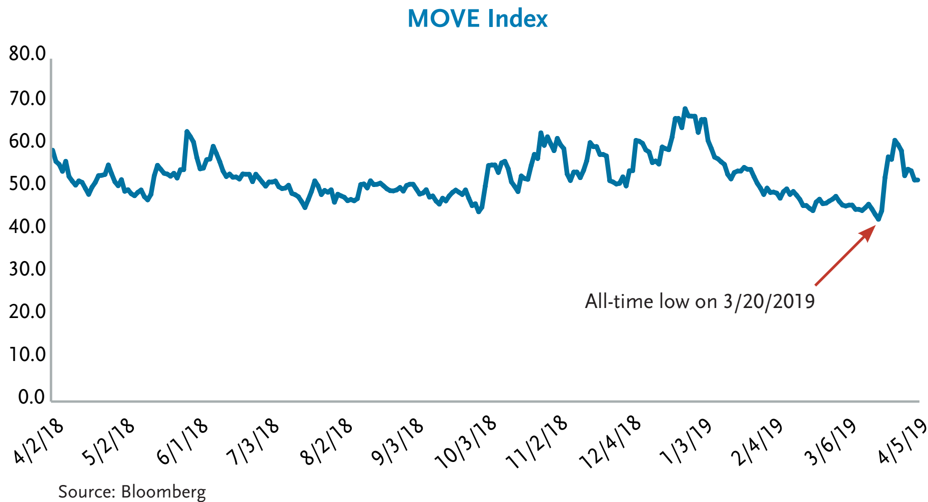
The reaction to the FOMC's second dovish meeting in a row was swift and impressive across all rate markets. Treasury yields rallied led by the front end of the yield curve as the market quickly priced in further rate cuts. The market moves over the ensuing days were dramatic and resembled a market that was caught flat-footed (complacent) in the face of a dovish Fed and weak data. As an example, the MOVE index, which is a gauge of interest rate volatility, hit an all-time low the day of the FOMC meeting, signaling this market complacency. A few days later Germany reported the weakest manufacturing PMI report (44.7 versus 48.0 expected) since 2012 and the ensuing flight to quality trade propelled global rates/curves to extreme levels.

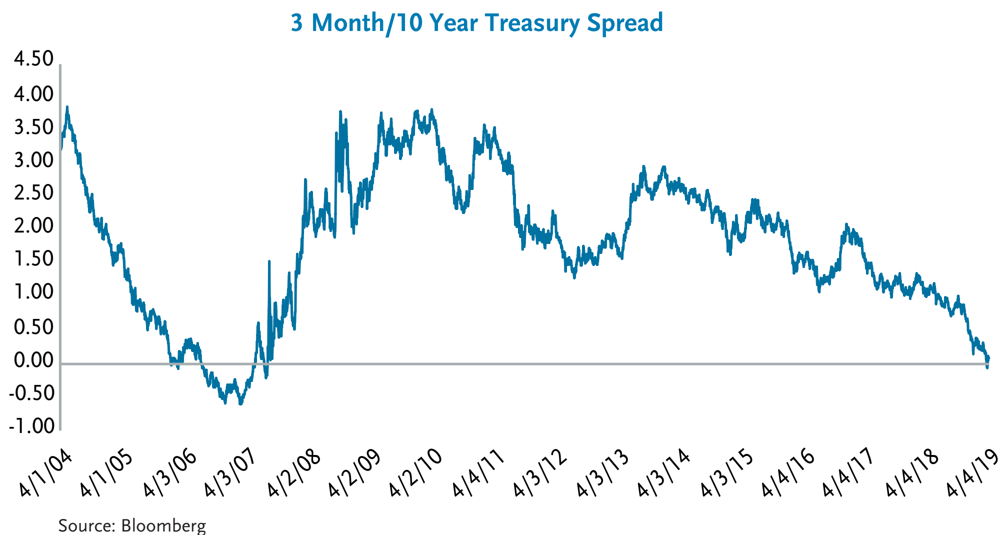
MOVE Index



Source: Bloomberg

At one point during the month, the Fed Funds futures market was pricing in three full 25 basis points (bps) cuts by end of 2020. As a result, the yield curve steepened, led by the 5 year with the 5s30s Treasury curve steepening to 67 bps (steepest since late 2017) and yields out to the 10 year point trading below 2.40% or the rate the Fed pays on excess reserves (IOER). The aggressive bid for duration eventually inverted the much-publicized 3 month/10 year Treasury curve during the month with that spread almost touching -6 bps. Recall this spread is closely followed by the Fed as they firmly believe it has "the strongest predictive power for future recessions" given its track record predicting past recessions. However, the main argument against the Fed model's validity mainly centers on the depressed term premium as a result of QE and the possible distortions that is causing in the curve. At any rate, similar arguments were made by, among others, Ben Bernanke when this curve inverted in 2006-2007 ahead of the financial crisis that began in 2008 so this time may "not" be different. The bottom line, however, is that inverted curves are not healthy for the banking sector and typically signal late-cycle dynamics. Also, for better or worse, the Fed clearly watches this spread given its predictive power in the past so as long as it remains inverted and inflation remains soft, the Fed is likely to keep monetary policy loose and therefore may cause rates to remain range-bound over the near-term horizon.

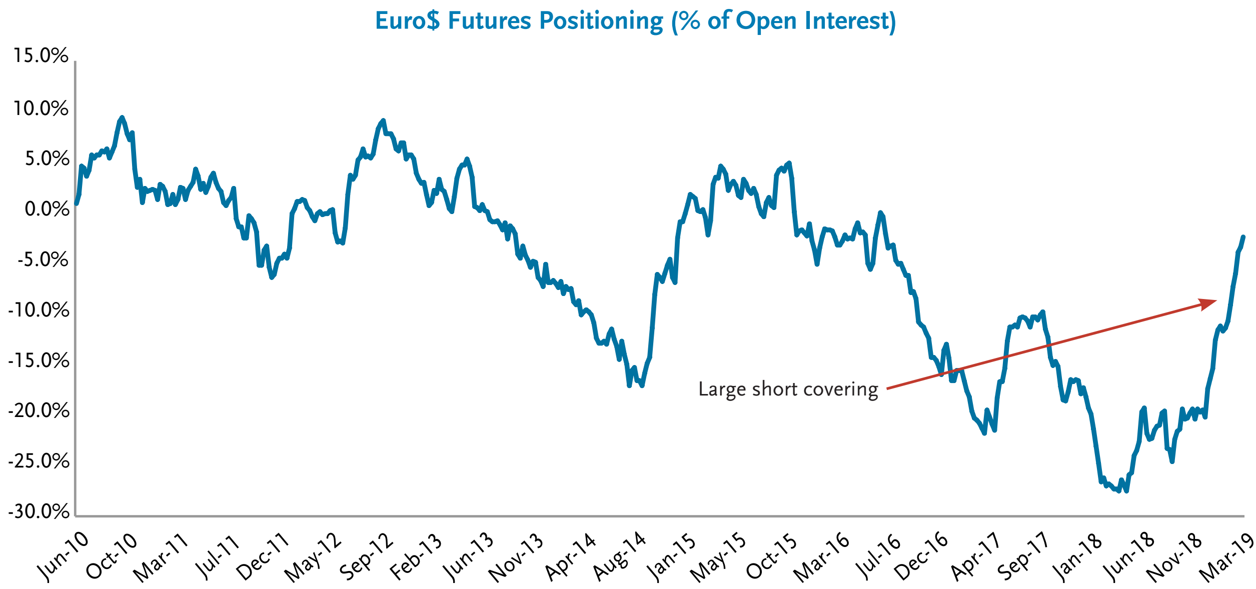
3 Month/10 Year Treasury Spread



Source: Bloomberg

The bid for duration eventually spilled over into the swap market as swap spreads initially widened on the announcement as cash Treasuries outperformed. This initial move wider made sense as one would expect cash Treasuries to outperform against a backdrop that included: an earlier end to taper, reduced Treasury supply/higher level of reserves in the medium term, and the reinvestment of MBS into Treasuries. However, the widening in swap spreads quickly reversed as various investor types aggressively bought duration in the swap market. This heavy receiving flow took 10 year swap spreads negative to -4.4 bps, their tightest level since October 2017. The bull steepening in the Treasury market was also interesting when viewed alongside the CFTC's Commitment of Traders (COT) positioning reports. As an example, the Eurodollar futures market (which was sitting near record short levels) saw massive short-covering over the month which fits with the bull-steepening action witnessed during March. Market positioning however now appears more balanced here and is another factor likely to keep rates range-bound in the medium term.

Euro$ Futures Positioning (% of Open Interest)



Source: Bloomberg and CFTC

The Treasury Inflation Protected Securities market (TIPS) did not react as one might expect from the dovish Fed meeting. The Fed made it very clear it is worried about missing its inflation goal. In the press conference, Powell stated "I don't feel that we have kind of convincingly achieved our 2% mandate in a symmetrical way." Normally one expects inflation-linked securities to outperform as the yield curve steepens and central banks stress a symmetrical inflation view. Instead the fear of lower growth and possible rate cuts overrode the notion the Fed can generate late-cycle inflation. ■

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