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INSIGHT

MONTHLY COMMENTARY

April Rates Update

TYLER TUCCI | MAY 1, 2017

Though the majority of April was devoid of meaningful macro catalysts, the market spent the better part of the month worrying about known unknowns, driving 10y Treasuries yields as low as 2.16%. Chief among these market concerns were the continued escalation of the conflict between N. Korea and the U.S., anticipated weakness of the Q1 U.S. GDP print and significant uncertainty around the future of U.S. fiscal and healthcare policies. Ultimately, these concerns would prove to be overstated for now and 10y yields would rotate back higher towards the 2.30% level by the end of the month. So far in 2017, 10y Treasury yields have been stuck in neutral between the ~2.30%-2.60% levels, waiting for a decisive catalyst to push yields up towards 3% or down towards 2%.

While 2016 saw both the UK referendum and the U.S. presidential election defy pollster's forecasts, the first round of the French presidential election saw a return to consensus outcomes. As polls had predicted, Emmanuel Macron won the first round of the presidential election, with 23.9% of the votes. In the second round he will face Marine Le Pen, who won 21.4%. François Fillon and Jean-Luc Mélenchon took 19.9% and 19.6%, respectively. According to opinion polls, Mr. Macron is a heavy favorite against Ms. Le Pen with most polls suggesting a victory for Mr. Macron against Ms. Le Pen, with between 62% and 64% of votes. Opinion polls may have been wrong many times in the past, most notably ahead of the U.S. election and the UK's EU referendum, but they were fairly accurate for the French first round. Given he is at the center of the political spectrum, Macron is expected to gain strong support from both the Socialists and the Republicans in the second round, which should be sufficient to keep Le Pen out of office. Given his pro-EU stance, Macron would maintain partnership between France and Germany which could bring some renewed optimism to the European project, which has faced its share of challenges in the last year.

The Bank of Japan held its monetary policy meeting on April 26-27, and reaffirmed its commitment to currency policy stances. This includes, keeping targets for front end and 10y rates at -0.1% and 0% respectively and continuing to purchase JGBs at more or less the same pace of about ¥80 tn a year, as widely expected. In its quarterly outlook report, the BOJ slightly increased its real GDP growth forecasts for both 2017 and 2018, but slightly cut its consumer price forecast for FY2017. While the cut to the price outlook was broadly in line with market expectations, the BOJ appeared more bullish on the economy than expected. In terms of the risk balance, it highlighted the downside risks to prices in particular, stating that momentum toward achieving 2%

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"is not yet sufficiently firm, and thus developments in prices continue to warrant careful attention." The BOJ continues to project achievement of a CPI of 2% around 2018 but pledged to make policy adjustments as appropriate, taking economic activity, prices and financial conditions into account.

Similarly, the ECB left its key policy rates unchanged including the rate on the deposit facility at -0.40%, and made no changes to the asset purchase program, in line with consensus expectations. Also as expected, there was no change to the forward guidance, including to the downward policy rate bias and the expectation not to raise rates until "well past" the end of net asset purchases. ECB President Draghi noted that the key discussion within the governing council had been on the risks to economic growth. He stated that, in light of recent data, the risks to growth are "moving towards a more balanced configuration," but also that risks are "still tilted to the downside." On the issues of rate rises and tapering asset purchases, President Draghi specifically read out part of his own recent speech, noting that, from today's perspective, there is "no reason to deviate" from this message. With the first round of the French election now in the rearview mirror there are some market participants looking for the ECB to begin an exit of their easing program as early as June. This notion may be somewhat nearsighted though given the ECB will have to navigate any volatility stemming from an adverse reaction to the second round of the French election as well as the upcoming Italian election in September before the path is remotely clear of political risk.

The final trading day of the month saw the release of the anxiously awaited U.S. GDP series for the first quarter of 2017 which showed the U.S. economy had expanded 0.7% for the quarter, as expected. The biggest drags were from a sizeable deceleration in personal consumption expenditures (PCE) and declines in inventory investment and government spending. But those were more than offset by notable pickups in capex and residential investment. While this print on a standalone basis is suggestive of meager growth in the U.S., it may not paint a complete picture. Since 2004, 12 out of 14 Q1 GDP releases, including the most recent print, for the first quarter have missed market consensus by an average of 0.7%. In that light, a growth rate of 0.7% for the first quarter is suggestive of a somewhat stable growth backdrop. In either case, given recent history it appears it is best to wait for the second quarter growth numbers before forming a more complete view of U.S. economic growth.

As the second quarter of the year begins in earnest, the gap between market expectations and what is realized in terms of global macroeconomic picture may begin to narrow. Either U.S. economic data will start to outperform and suggest that a bounce back from 0.7% QoQ GDP is underway, or U.S. economic signals will continue to disappoint and market participants may have to grapple with the reality that the U.S. economy remains stuck in the mud. Similarly, the gap between political reality and political bluster may begin to close somewhat as the constraints on policy promises from Capitol Hill become clearer. Currently, forecasters are optimistic, penciling 3%-4% in for Q2 GDP estimates to start the quarter. If these forecasts are indeed realized, it may be seen as confirmation there is still room for further economic upside surprise to come and sub 1% first quarter growth was an anomaly as it has been in the past. However, if Q2 estimates fail to be realized, market participants may have to start reassessing what realistic levels of growth are moving forward.

	3/31/2017	4/28/2017	52 Week High	52 Week Low
2y Treasury Yields	1.25	1.26	1.40	0.50
5y Treasury Yields	1.92	1.81	2.15	0.89
10y Treasury Yields	2.39	2.28	2.64	1.32
30y Treasury Yields	3.01	2.95	3.21	2.09
Yield Curve Steepness 2s to 30s	175.15	168.41	205.73	139.67
Barclays Aggregate Index	1992.51	2007.89		

Source: Bloomberg

Real Gross Domestic Product, Advance Release

Annualized Quarterly, % Chg.	Q116	Q216	Q316	Q416	Q117
Real GDP	+0.8	+1.4	+3.5	+2.1	+0.7
Consumer Spending	+1.6	+4.3	+3.0	+3.5	+0.3
Nonresidential Investment	-3.4	+1.0	+1.4	+0.9	+9.4
Structures	+0.1	-2.1	+12.0	-1.9	+22.1
Equipment	-9.5	-2.9	-4.5	+1.9	+9.1
Intellectual Property Products	+3.7	+9.0	+3.2	+1.3	+2.0
Residential Investment	+7.8	-7.7	-4.1	+9.6	+13.7
Chg in Private Inventories ($ bil)	40.7	-9.5	7.1	49.6	10.3
Net Exports ($ bil)	-566.3	-558.5	-522.2	-605	-602.7
Government Spending	+1.6	-1.7	+0.8	+0.2	-1.7
Real Final Sales (of Dom. Product)	+1.2	+2.6	+3.0	+1.1	+1.6
Real Final Sales to Dom Purchasers	+1.2	+2.4	+2.1	+2.8	+1.5
Real Final Sales to Priv Dom Purch	+1.1	+3.2	+2.4	+3.4	+2.2
GDP Price index	+0.5	+2.3	+1.4	+2.1	+2.3
Core PCE Deflator	+2.1	+1.8	+1.7	+1.3	+2.0

Source: BEA, Natwest Market

BOJ Economic and Price Outlook (as of April 2017)

		April 2017 Outlook			
		FY2016	FY2017	FY2018	FY2019
Real GDP	BOJ: April	+1.4	+1.6	+1.3	+0.7
	(as of January)	+1.0	+1.3	+0.9	+0.9
	Consensus	+1.29	+1.30	+1.07	n.a.
Core CPI	BOJ: April	-0.3	+1.4	+1.7	+1.9
	(as of January)	-0.2	+1.5	+1.7	n.a.
	Consensus	-0.24	+0.83	+1.00	n.a.

Note: FY2019 core CPI excludes impact of planned consumption tax rate hike.

Source: Goldman Sachs

BOJ QQE with Yield Curve Control (announced September 21, 2016)

	Actual			BOJ target
	Dec-2015	Dec 2016	Mar 2017	Pace of annual increase
Monetary Base (Y tn)	356.1	437.4	447.3	**80.0**
BOJ balance sheet (Y tn)				
JGBs	282.0	360.7	377.1	**80.0**
Commercial Papers	2.2	2.3	2.0	0.0
Corporate Bonds	3.2	3.2	3.2	0.0
ETF	6.9	11.1	12.9	**6.0**
of which Capex related ETF	--	0.22	0.30	**0.30**
J-REIT	0.27	0.36	0.38	0.09
Lending support scheme	31.2	40.7	45.7	
For economic growth area (incl. USD loan)	6.7	8.0	8.7	Limit: 12.3
of which USD loan ($bn)	12.0	15.2	20.7	Limit: $24.0bn
Measures to stimulate bank lending	24.5	32.7	37.0	No limit
Support for financial institution in disaster area	0.3	0.5	0.5	Limit: 1.0
Total with others (Y tn)	383.1	476.5	490.1	--
Bank notes	98.4	102.5	99.8	
Current deposits	253.0	330.2	342.8	--
Total liabilities with others (Y tn)	383.1	476.5	490.1	--
Rate on Current Account Policy Rate Balance (%)		**-0.10**	**-0.10**	
Nominal 10-year JGB yield target (%)		**0.00**	**0.00**	

Source: Goldman Sachs

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