TCW

Manager of the TCW, MetWest, and TCW Alternative Fund Families

INSIGHT

MONTHLY COMMENTARY

April Rates Update

TYLER TUCCI | MAY 3, 2016

After spending the majority of 2016 trading with bullish tailwinds, 10y yields pushed higher in April as risk assets stormed back after a disappointing start of the year. However, what was at one point a nearly 20bp sell off in 10y treasury yields had been cut in half to finish the month at 1.83% as global macroeconomic data continued to disappoint. The fact that risk assets were able to maintain a bid despite a slide in U.S. macroeconomic data including: Q1 GDP, Vehicle Sales, Labor Market Conditions Index, suggests that financial markets still believe in the steady hand of some global central banks. It remains to be seen how much longer this faith in central banking policy as a whole will prevail, but if the recent rejection of Bank of Japan (BoJ) policy is any indication, the market may be looking for central banks to stand down in the coming months.

After delivering a credit focused easing package in March, the European Central Bank (ECB) Governing Council left all key rates unchanged in April but pledged to pursue, "an appropriate degree of monetary accommodation as long as needed to underpin the momentum of the euro area's economic recovery, and in order to accelerate the return of inflation to levels below, but close to, 2%." Despite this directive, ECB President Mario Draghi seemed unconcerned with the lack of upward inflationary pressures observed in Europe since the announcement of further easing measures in early March. Seemingly of greater concern to the ECB President were remarks made by German Finance Minister Schaeuble suggesting that the ECB policies are causing extraordinary problems including the rising of the Alternative for Germany party. Despite President Draghi's vehement rejection of this notion it is becoming increasingly difficult for the single currency union to cater monetary policy to both the haves and have nots simultaneously. Currently, Euribor futures are pricing roughly 80% of one 10bp rate cut before the end of 2016 indicating that the market expects Draghi to continue to cater to the have nots notwithstanding objections from Berlin.

One of the most important events for the month of April was the release of the FOMC's April meeting statement. Despite initial excitement over the removal of the warning of global risks to the U.S. economic outlook the totality of the statement read in a much more even handed fashion. To counterbalance the removal of the international risks statement, which has disappeared and reappeared in various forms in the past, the Fed downgraded their assessment of the U.S. economy to "having slowed" from "moderate." Additionally, the committee continued to acknowledge that inflation is still running below the 2% target not only because of earlier declines in energy prices but also as a result of falling prices in non-

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 has completed level I of the CFA exam and Levels I & II of the CMT exam. Mr. Tucci holds a BA in Economics and Finance from Elon University.

energy imports. If the Fed indeed plans to highlight realized inflation as a core driver of policy as they are mandated to do, the notion that a June tightening is even remotely possible is hard to reconcile with such downtrodden language pertaining to a key input into realized inflation. Implicit in this acknowledgement is the idea that international macroeconomic conditions still are a meaningful driver of policy even if not spelled out directly as it was in March.

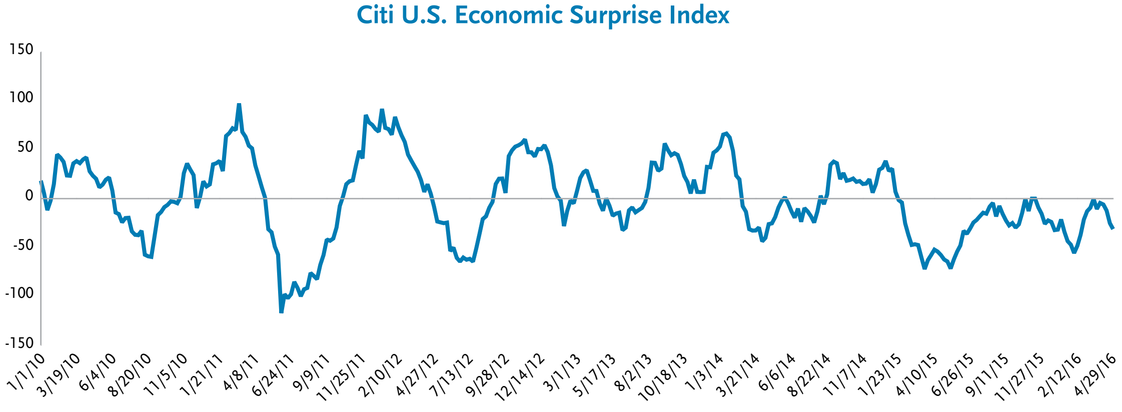
Japan continued to be the land of the rising yen in April as yet another BoJ policy disappointment saw the central bank leave all parts of its monetary policy unchanged at its April policy meeting. This decision to stand pat pushed the yen 2.5% higher against the U.S. dollar following the meeting as market participants were expecting the BoJ to push back against the recent 10%+ rally in USDJPY. Perversely, this policy decision was made following the release of a series of data pointing to significant deterioration in the Japanese consumer. The core consumer price index for March dropped 0.3%, its fastest decline since April of 2013, while household spending dropped 5.3% Y/Y, much lower than the forecasted -4.2%. To this end, the BoJ did extend their timeframe for reaching their 2% CPI target from "around 1H 2017" to "during 2017." The credibility of this inflation target timing borders on laughable however, as this was the sixth such adjustment to the ETA to target since the inception of Abenomics. At this point it is unclear if Abe is too weak politically to push through another round of easing or if the BoJ prefers to use their June policy meeting as a platform for easing instead. In either case, it appears the BoJ believes they can bear the brunt any FX related deflationary pain for the time being.

It is possible that one of reasons for recent Fed uber-cautiousness around their policy message has been a result of tepid real GDP growth. While U.S. labor markets signal that the U.S. economy has nearly returned to full heath, GDP signals a quite different reality. Indeed, the last 5 QoQ GDP prints have averaged 1.7%, which includes the 3.9% print from Q2 2015. As such, real GDP expanded by a paltry 0.5% annualized in the first quarter of 2015 below the 0.7% consensus figure and has printed increasingly lower over the past four quarters. The report internals were no more encouraging as consumer spending rose by a meager 1.9% and the savings rate pushed up to 5.2% in Q1 2016 from 5.0% in Q4. Business related GDP inputs were similarly disappointing as nonresidential investment fell 5.9% annualized, the largest drop since 2009, because of a remarkable decrease in both nonresidential spending on equipment and structures. It is notable that the habits of both the consumer and the domestic business were mirror images of each other in Q1 as both showed significant trepidation about committing capital in one form or another. This kind of behavior points toward expectations of more of the same in Q2, which may be reasonable given the continued inventory overhang and exceptionally poor trajectory with which the first quarter ended.

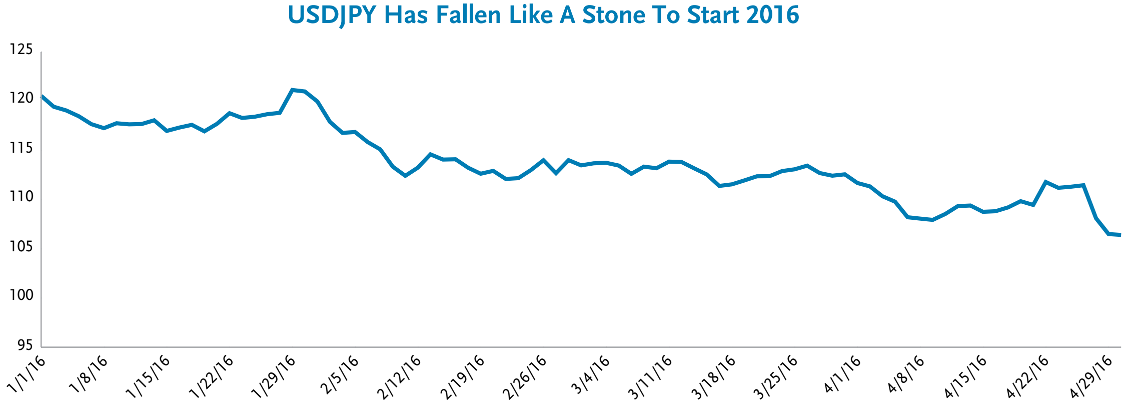
As the first quarter draws to a close, market participants are looking toward Q2 to deliver the rebound in U.S. economic data necessary to get the Fed's tightening cycle back on track. This hope for a spring rebound is eerily similar to the same period in 2015, during which 30y Treasury yields sold off nearly 100bps after recession and deflation fears had pushed yields to all-time lows in January and February 2015. Similarly, Treasury yields did indeed push markedly lower in January and February 2016 as well, driven by similar recessionary fears seen in early 2015. While the set up into May is strikingly similar to that of last year, it may not yield the same bearish result for treasuries. In 2015, the end of April was the trough of U.S. economic data disappointment for all of 2015 as indicated by the Citi Economic Surprise Index. In 2016, however, forecasts like the one produced by the Atlanta Fed GDP model, which shows just 1.8% forecasted growth for Q2, suggest that we are in for further economic weakening.

	3/31/2016	4/29/2016	52 Week High	52 Week Low
2y Treasury Yields	0.72	0.78	1.10	0.53
5y Treasury Yields	1.20	1.29	1.83	0.97
10y Treasury Yields	1.77	1.83	2.50	1.53
30y Treasury Yields	2.61	2.68	3.25	2.38
Yield Curve Steepness 2s to 30s	188.77	189.09	257.46	171.68
Barclays Aggregate Index	1983.77	1991.39	1962.61	1955.63

Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2016 TCW