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INSIGHT

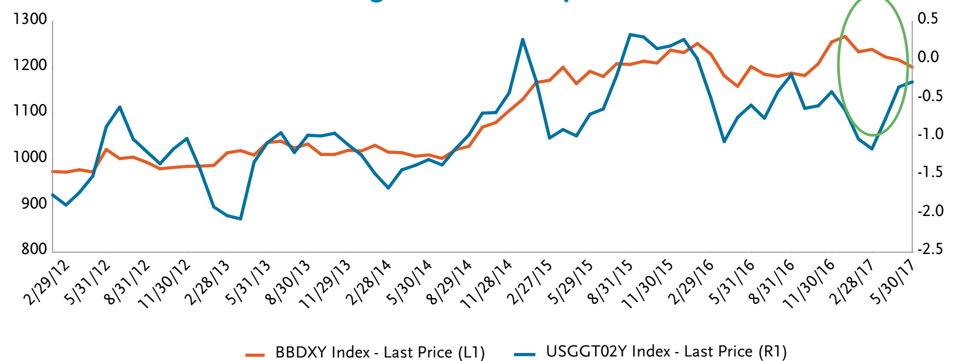
MONTHLY COMMENTARY

May Rates Update

TYLER TUCCI | JUNE 2, 2017

The month of May saw financial markets displaying similar anxiety to that seen in April as ongoing fears about the current state of play in U.S. politics and concerns about the condition of the Chinese economy overshadowed continued strength in U.S. corporate earnings and a respectable Q2 U.S. growth picture. Against this backdrop, 10y Treasuries closed the month a mere 6bp lower in yield from where they began the month and the U.S. Dollar index closed 1.5% lower on the month to run its streak of consecutive down months to three straight. It may not be much of a surprise, however, that the USD has given back all of its post-election gains as the new administration hasn't given the market much to go on. In addition to the vapid pace of policy progress, it appears the new administration has struck a nerve with several U.S. allies for reasons ranging from environmental to defense. Any potential fallout from this step back in global cooperation could continue to weigh on headlines in the future, which is a likely contributor to keeping the dollar trading at a discount to where real rate differentials would suggest fair value lies.

Trade Weighted USD vs 2y Real Rates



Source: Bloomberg

While the movement in Treasury yields was relatively orderly over the course of the month, the U.S. equity market continued its rapid ascent to overcome a notable drawdown mid-month. Though some market participants believe that the equity market simply has failed to take its cue from Treasury yields, which have fallen significantly in 2017, and is due a major correction it is also possible that there is another valuation dynamic afoot. Given equities and U.S. Treasuries are competing asset classes, market participants who have the option of owning either asset have to make a relative value decision between the two. They can either chose to collect

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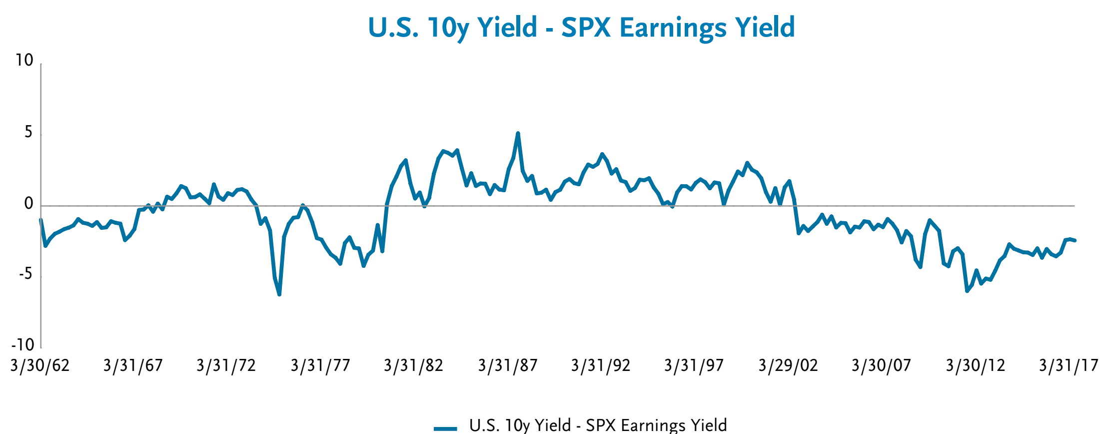
the yield to maturity of a Treasury or to participate in the upside of a firm or group of firm's future earnings via equity shares. When Treasury yields are relatively higher than earnings yield of a firm, investors with the choice of owning either will prefer to own Treasuries and vice versa when equity earnings yields are higher than Treasury yields. This relationship was dubbed "The Fed Model" by market participants and is a commonly used tool to look at the relative value between Treasury yields and the S&P 500. This relationship would then suggest that lower than expected Treasury yields themselves are a catalyst for higher equity prices as the lower yields make the additional risk of higher yielding equity shares more palatable all else equal. Looking at this relationship historically, the difference between 10y Treasury yields and the earnings yield on the S&P 500 is well below its average for the last 50 years. This suggests that there still could be scope for further equity appreciation at least versus Treasuries, if Treasury yields persist at these levels or lower.



Source: Bloomberg

Another factor currently clouding the U.S. rate valuation picture is the elusive nature of persistent inflationary pressures. After a jump higher in the opening months of 2017, inflation data have registered a notable deceleration as of late with core PCE failing to generate any upward thrust in excess of the 1.8% figure printed in two of the last three months. The loss in momentum of the inflationary trend has made it difficult to value both front end rates as well as long end rates. With the fall in the trajectory of inflation, the U.S. economy may now require less policy tightening from the Fed than expected at the outset of 2017. This would impact front end rate valuations in a meaningful way as the timing of each tightening as well of the pace of total tightening are major determinants of yield levels between the 1y and 5y point on the Treasury curve. Additionally, as outright levels of inflation are a key component of longer maturity Treasury pricing, a move away from the U.S. reflationary narrative could have a meaningful impact on the fair value of longer dated rates as well. If the incessant flattening in the 2y-10y Treasury spread is any guide, the confluence of a turn lower in inflation and an FOMC that is determined to move the policy rate higher has market participants quite concerned about the sustainability of the current recovery if the FOMC continues to tighten.

Indeed, even the FOMC seems somewhat flummoxed by the current inflationary regime. In the minutes for the May FOMC meeting, there appeared to be considerable debate around the current underlying trend. To be sure, the Committee remains steadfast that gradual progress to the Fed's long run goal of 2% inflation is still on the cards. However, in the short term, it appears that there is a degree of doubt. While dismissing recent misses in inflation data as transitory, there was concern that inflationary expectations remained weak and a few participants were concerned that progress towards the Committee's objective might have slowed, possibly endangering the credibility of the Fed's target from the low side.

This admission by the FOMC that the trajectory of inflation is concerning and potentially deleterious to their continued tightening plans is potentially a major shift in policy calculus. In recent speeches, FOMC chair Janet Yellen has surmised that the neutral real rate (R*) is somewhere near 0% which would suggest the nominal neutral rate is roughly 2%, if the FOMC is able to achieve their inflation target of 2%. However, if realized inflation is only going to average 1.5%-1.8% in core PCE terms, the theoretical nominal neutral rate decreases by as much as much as 2 tightenings. Furthermore, if nominal R* really is only 1.6%-1.8%, a fed funds

rate of 91bps could represent notably less easy monetary policy settings than previously thought. Of course, if nominal R* is sub 2% then the FOMC's current median projection of a long run fed funds rate at 3% is most likely erroneous, as tightening policy 1% higher than the assumed neutral rate could prove to be problematic. In order for their 3% estimate to look credible, it would seem that the more aggressive fiscal policy stance promised to American citizens would have to be realized to generate sufficient upward thrust in inflation to justify tightening in excess of 2%.

As the summer months descend upon us, it seems markets have entered the proverbial calm before the storm. The market is well prepared for a probable 25bp tightening from the FOMC in June and Q2 U.S. GDP growth is tracking a respectable 3.8% according to the Atlanta Fed Nowcast. Reasonably robust growth combined with the well telegraphed nature of the impending tightening should be at least somewhat supportive for risk markets without any near term major political risk events to agitate risk sentiment. However, this calm could be tested as summer turns to fall. The 19th National Congress of the Communist Party of China convenes in September at around the same time as the potential for a high stakes snap election in Italy. Both of these events, to name just a few potential post summer risk catalysts, have the potential to shake up market pricing significantly. So while relative calm may be expected near term, it appears likely it will be fleeting. ■

	4/28/17	5/30/17	52 Week High	52 Week Low
2y Treasury Yields	1.26	1.28	1.40	0.50
5y Treasury Yields	1.81	1.75	2.15	0.89
10y Treasury Yields	2.28	2.21	2.64	1.32
30y Treasury Yields	2.95	2.88	3.21	2.09
Yield Curve Steepness 2s to 30s	168.41	158.95	205.73	139.67
Barclays Aggregate Index	2007.89	2017.39		

Source: Bloomberg

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