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INSIGHT

MONTHLY COMMENTARY

May U.S. Rates Update

MICHAEL Y. PAK, CFA | 6 JUNE, 2019

U.S. rates markets staged an impressive May rally, kick-started primarily by renewed trade tensions with China and U.S. threats to blacklist a large Chinese technology firm. The move marked a surprisingly abrupt change in tone after both countries were seemingly making progress in trade talks since the start of the year. The break-down appeared more ominous this time around with China taking a less acquiescent stance and digging in its heels, rallying its citizens around a sense of nationalism and retaliating with tariffs of its own against U.S. imports. The usual chatter of China possibly boycotting U.S. Treasury auctions and/or outright selling its Treasury holdings again made its way into the market, although those are unlikely scenarios for the moment. A Chinese newspaper article raised the prospect of China "weaponizing" its rare earth exports for additional leverage although this also is not a new tactic. China used this threat as a bargaining chip in past negotiations, however it only added fuel to the growing fire. Since an estimated 80% of rare earth imports into the U.S. emanate from China, this potential threat only served to turn up the temperature on trade talks with heightened focus on the potentially affected U.S. sectors of defense, electronics and autos. To close out the month, U.S. Treasuries moved another leg higher when President Trump unexpectedly ensnared another country into a trade battle. This time Mexico was threatened with new and potentially rising tariffs unless it "substantially stopped the inflow" of immigrants illegally entering the U.S.

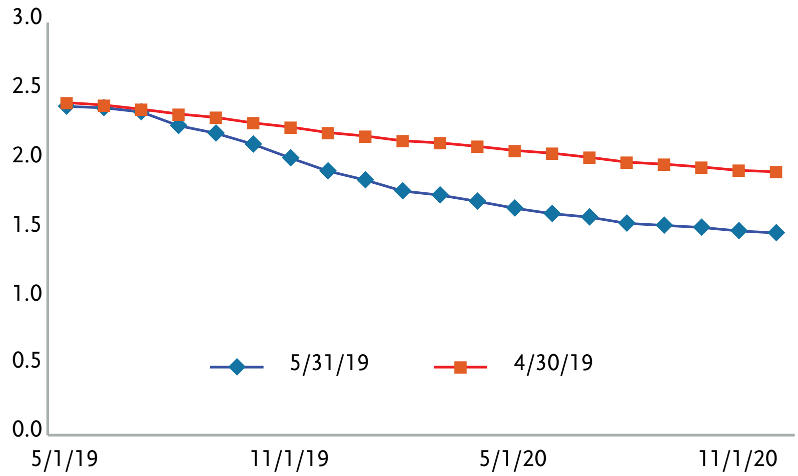
The moves across U.S. rates markets were swift and dramatic in response to the deterioration in trade talks and its negative implications for global growth. The S&P 500 sold off 6.35% over the month while U.S. Treasuries rallied over 35 basis point (bps) across the curve in a classic risk-off fashion with the 2yr point closing the month at 1.92%, its lowest level since January 2018 (the 2yr Treasury had priced at 2.12% in the auction only 3 days earlier). As the usual safe havens (yen and gold) rallied on the month, the bid for duration/hedging needs spilled over from Treasuries into the swaps market. Spreads tightened across the curve on the back of receiving flows from the mortgage community as well as from dealers hedging short option positions. Interest rate curves re-inverted at various points and by month end, the

Michael Y. Pak, CFA
Senior Vice President
Fixed Income

Mr. Pak is a Senior Vice President in the Fixed Income group where he trades Money Markets, Treasuries, and Agencies. Prior to joining TCW in 2015, he was a Fixed Income Portfolio Manager at Columbia Threadneedle where he managed institutional separate accounts and mutual funds with a focus on the Investment Grade Credit and Rates sectors. Previously, he was a generalist Portfolio Manager at Western Asset focused on short duration strategies. Prior to Western Asset, he worked on the cash desk at PIMCO and the investment department at Teledyne, Inc. Mr. Pak holds a BA in Economics from UCLA and an MBA from the Marshall School of Business at USC. He is a CFA charterholder.

much-watched 3mo/10yr Treasury curve sat at -22bps and rate volatility, as measured by the MOVE index, spiked to close near its YTD high. On the last day of the month, after the president's tweet regarding tariffs on Mexico, volumes went through the roof in Treasury futures with the equivalent of $600bln in 10yr notes changing hands. When all was said and done, the Fed Funds futures market was pricing in almost 4 full 25bps cuts by end of 2020 (2 in 2019 and 2 in 2020) and various Wall Street firms led by JP Morgan and Barclays threw in the towel and called for 50-75bps in cuts by this year-end, citing "trade-related headwinds to growth" and "deteriorating financial conditions" which will likely push the Fed into action.

Fed Funds Futures



Source: Bloomberg

In the midst of this volatility and repricing of expectations for the Fed Funds rate, the FOMC itself has remained remarkably quiet. The open question remains will the Fed eventually be forced into action to forestall a possible recession or will it stick with its "patient" mantra, potentially triggering a deeper, broader risk-off scenario. The few comments we did get from Fed officials were mixed, with Rosengren and Williams in particular continuing to show cautious optimism and stating that the economy remains well-positioned to withstand a shock. Kaplan and Barkin on the other hand struck a more cautious tone by highlighting that trade tensions could indeed be a headwind for the economy. That being said, official comments overall suggest that the Fed is still comfortable remaining on hold barring a significant change in its expectations for economic and financial conditions. Thus, no preemptive "insurance" cuts appear to be in the cards for now.

Although domestic economic data continues to print on the softer side, the focus has clearly shifted to the uncertainty over global trade and the possible repercussions, especially in a world where the bar for slapping tariffs on trading partners appears very low. At any rate, the scheduled meeting between Trump and Chinese President Xi Jinping during the G-20 meetings in June is unlikely to yield any significant progress aside from possibly a few market-friendly tweets/headlines which will only temporarily placate markets. Given that U.S. elections are still over a year away, voter sentiment will likely be less relevant this year, so Trump likely has a modestly long runway to negotiate with trading partners, which implies a protracted trade war. Also, at this early stage, signs of any trade tension angst have yet to appear in domestic data/consumer sentiment readings. However, inflation readings are still printing on the lower side and the boost from fiscal stimulus is a distant memory. Therefore, the Fed's ability to overlook any potential downside in domestic data against the current geopolitical backdrop is limited and it's likely a question of when, not if, the Fed comes around to market pricing.

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	4/30/2019	5/31/2019	Change
2yr Treasury	2.27	1.92	-0.35
5yr Treasury	2.28	1.91	-0.37
10yr Treasury	2.50	2.12	-0.38
30yr Treasury	2.93	2.57	-0.36
10yr TIPS Breakeven	1.95	1.74	-0.21
3mo Treasury Bill	2.42	2.34	-0.08
3mo LIBOR	2.58	2.50	-0.08
Fed Funds	2.45	2.40	-0.05
SOFR	2.76	2.49	-0.27
U.S. Dollar Index	97.48	97.75	0.27
LIBOR/OIS	0.17	0.16	-0.02

Source: Bloomberg

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup