TCW

INSIGHT

MONTHLY COMMENTARY

June Rates Update

TYLER TUCCI | JUNE 30, 2016

While the early days of June belonged to the Fed and their latest retreat towards a dovish policy stance, it was the stunning result of the June 23 British referendum vote and subsequent market reaction that will be forever engrained in the minds of market participants. Indeed, the Leave vote carried the day by a tally of 52% to 48% as populist sentiment proved too formidable an opponent for the status quo. Brexit aside, June was a historical month by several other standards as sovereign yields made all-time lows in Australia, Italy, and Spain saw the lowest yields in several centuries and Dutch 10y debt yields dropped to the lowest levels seen in the last 500 years. In the context of a market that has seen over 600 interest rate cuts by central banks globally since September of 2008, this may be less surprising than it seems at first look.

When market participants refer to black swan or tail risk events, trading days like those around the fall of Lehman and the announcement of QE1 are usually among the first to come to mind. This month, the decision by the British constituency to leave the European Union (EU) joined those momentous macroeconomic events as 10y U.S. Treasuries rallied 20bps the day following the vote as investors scrambled for safety. The day's price action was quite telling about the level of anxiety in markets as the referendum's result isn't legally binding and the end game is far from clear. Nonetheless, the newfound source of uncertainty exacerbated the bid for higher quality assets and served to push the trade weighted U.S. dollar almost 3% higher on a month-over-month basis as investors fled risky assets. At the core of the panic and subsequent price action was not just simple uncertainty, but also the unsettling realization that Eurozone projects continued success isn't a foregone conclusion. Ever since European Central Bank (ECB) President Mario Draghi promised to do "whatever it takes" to preserve the single currency union in 2011, market participants had taken him at his word and believed the EU would endure. Following the vote however, market price action suggested investors were markedly less sure that the appeal of EU unity outweighed the remaining nation's desire for their own sovereignty.

The morning following the referendum result, British Prime Minister and Remain supporter David Cameron made good on his promise to tender his resignation in the event the electorate voted Leave. Prime Minster Cameron has agreed to remain Prime Minister until the fall at which point new leadership will have to

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 holds a bachelor's degree in Economics and Finance from Elon University. Mr. Tucci has completed level I of the CFA exam and Levels I and II of the CMT exam.

decide whether or not to invoke Article 50 of the Lisbon Treaty. Under this article, the UK would have a two-year period to re-negotiate its relationship with the EU and reach a withdrawal agreement starting once the UK officially notifies the EU of their decision to leave. The European Council members, except for the UK, would then have to unanimously vote on the guidelines under which the European Commission would negotiate the terms of the withdrawal agreement. A final agreement would then need to be approved both by the UK and at least 20 out of 27 of the remaining Member States. The final agreement would also need to be approved by greater than 50% of the European Parliament. During this period the UK would still be required to abide by EU treaties, and the two-year period may only be extended if approved by all remaining 27 member States.

If not for the British referendum, the June FOMC statement would have been the biggest macro catalyst of the month as Fed Chair Janet Yellen surprised the market with both a dovish statement and meaningful downward revisions to Fed Funds projections. For the statement, the Fed gave a nod to May's dismal NFP report saying, "the pace of improvement in the labor market has slowed." They also noted that household spending has improved but business investment remained soft. Notably, this statement was released without any dissents suggesting that FOMC members are generally more on board with a risk management approach then they may have been in past meetings.

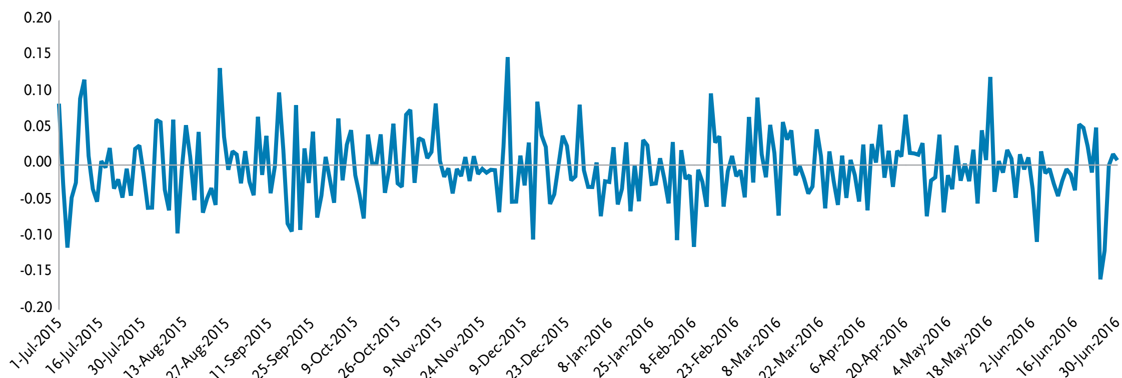
Though the statement showed a Fed that had turned lukewarm on the idea of further policy tightening, it was the Staff Economic Projections that showed a how large the shift towards dovish policy was. Not only did the central tendency fed funds rate projection for 2016 move from 90bps-140bps to 60bps-90bps but the median projections for 2017, 2018 and the longer run fell significantly. Since the inception of the release of the Staff Economic Projections in 2012, the long run median forecast, referred to as the terminal rate, has fallen 120bps to reach 3% most recently. This most recent unexpected reduction in the Fed forecast of future hikes may be a positive development for a Fed who has not quite been able to get its finger on the pulse of the post 2008 global economy. This low growth, low productivity backdrop that the global economy has been mired in does not necessarily beg for higher rates and this most recent revision to FOMC suggests a potential paradigm shift toward this reality.

As a consequence of this month's macro events, both the Bank of Japan (BOJ) and the ECB are now faced with additional headwinds to their objectives of returning inflation towards their target. With the Fed taking further steps to back away from their tightening bias and uncertainty stemming from Brexit, both central banks are faced with the prospects of having the impact of their own previous policy moves undone. However, early reports suggest that neither central bank plans to stand down in the face of uncertainty and are both planning additional policy moves. For the ECB's part, initial reports suggest that a move away from the capital key that governs QE bond purchase allocations could be in the fold. By moving away from the capital key, the ECB will be able to purchase more securities issued by economically weaker periphery nations, which could be more beneficial than purchasing additional, already quite negative German Bunds. Conversely, the BOJ has been slightly less forthcoming with their current thought process as it pertains to additional QE leaving market participants to only guess at their intentions. Given the recent strengthening in the Yen, it is clear that the BOJ will have to take action sooner rather than later as deflation looms and Prime Minster Shinzo Abe's popularity wanes. Both of these announcements were well received by the market as Treasury yields pushed lower while global equities pushed higher, suggesting that central banks still retain non-trivial influence in the setting of asset prices for the time being.

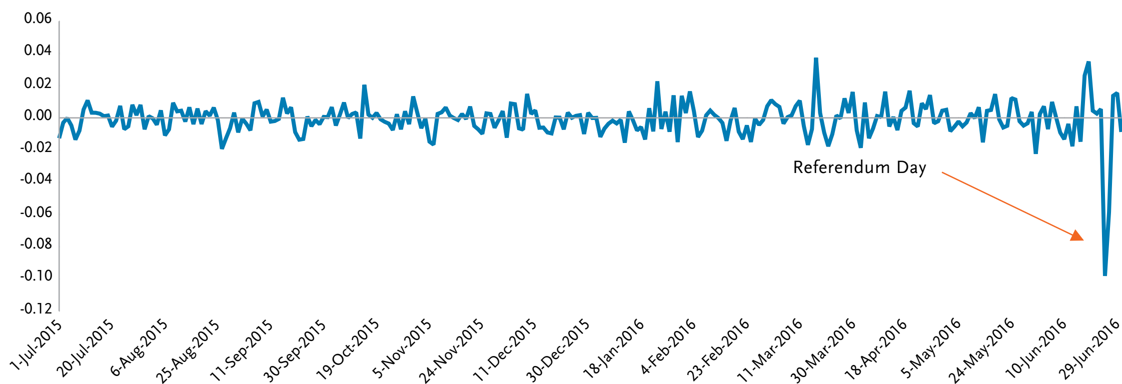
When the dust settled at the end of the month, 30y Treasury yields had reached 2.30%, just shy of all-time yield lows. However, despite a nearly 40bp rally in Treasuries, global risk assets recovered reasonably well in the days following the British referendum. It remains to be seen if this stability can carry over into July as negotiations between the UK and the EU have yet to begin in earnest while other EU members contemplate their own future. Interestingly, in the first political election in the EU following Brexit, the Podemos party in Spain failed to garner enough votes to form a majority government. This is quite notable because Podemos is Spain's resident Eurosceptic party and it might be expected that their platform would have received further credibility and potentially more votes after seeing a Leave vote succeed in the UK. Whichever way the EU goes from here, closer or further apart, the global macro picture has been significantly altered as the knock on effect of this vote and subsequent votes are sure have a significant impact on markets globally.

	5/31/2016	6/30/2016	52 Week High	52 Week Low
2y Treasury Yields	0.88	0.62	1.10	0.50
5y Treasury Yields	1.37	1.04	1.83	0.89
10y Treasury Yields	1.85	1.50	2.47	1.40
30y Treasury Yields	2.65	2.31	3.25	2.25
Yield Curve Steepness 2s to 30s	176.70	168.16	257.46	162.19
Barclays Aggregate Index	1991.90	2027.98	2027.98	1905.57

Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents Under Their Individual Assessments of Projected Appropriate Monetary Policy, June 2016

Percent

Variable	Median[1]				Central tendency[2]				Range[3]			
	2016	2017	2018	Longer run	2016	2017	2018	Longer run	2016	2017	2018	Longer run
Change in real GDP	2.0	2.0	2.0	2.0	1.9 – 2.0	1.9 – 2.2	1.8 – 2.1	1.8 – 2.0	1.8 – 2.2	1.6 – 2.4	1.5 – 2.2	1.6 – 2.4
March projection	2.2	2.1	2.0	2.0	2.1 – 2.3	2.0 – 2.3	1.8 – 2.1	1.8 – 2.1	1.9 – 2.5	1.7 – 2.3	1.8 – 2.3	1.8 – 2.4
Unemployment rate	4.7	4.6	4.6	4.8	4.6 – 4.8	4.5 – 4.7	4.4 – 4.8	4.7 – 5.0	4.5 – 4.9	4.3 – 4.8	4.3 – 5.0	4.6 – 5.0
March projection	4.7	4.6	4.5	4.8	4.6 – 4.8	4.5 – 4.7	4.5 – 5.0	4.7 – 5.0	4.5 – 4.9	4.3 – 4.9	4.3 – 5.0	4.7 – 5.8
PCE inflation	1.4	1.9	2.0	2.0	1.3 – 1.7	1.7 – 2.0	1.9 – 2.0	2.0	1.3 – 2.0	1.6 – 2.0	1.8 – 2.1	2.0
March projection	1.2	1.9	2.0	2.0	1.0 – 1.6	1.7 – 2.0	1.9 – 2.0	2.0	1.0 – 1.6	1.6 – 2.0	1.8 – 2.0	2.0
Core PCE inflation[4]	1.7	1.9	2.0		1.6 – 1.8	1.7 – 2.0	1.9 – 2.0		1.3 – 2.0	1.6 – 2.0	1.8 – 2.1	
March projection	1.6	1.8	2.0		1.4 – 1.7	1.7 – 2.0	1.9 – 2.0		1.4 – 2.1	1.6 – 2.0	1.8 – 2.0	
Memo: Projected appropriate policy path												
Federal funds rate	0.9	1.6	2.4	3.0	0.6 – 0.9	1.4 – 1.9	2.1 – 2.9	3.0 – 3.3	0.6 – 1.4	0.6 – 2.4	0.6 – 3.4	2.8 – 3.8
March projection	0.9	1.9	3.0	3.3	0.9 – 1.4	1.6 – 2.4	2.5 – 3.3	3.0 – 3.5	0.6 – 1.4	1.6 – 2.8	2.1 – 3.9	3.0 – 4.0

Source: The Federal Reserve

Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The projections for the federal funds rate are the value of the midpoint of the projected appropriate target range for the federal funds rate or the projected appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. The March projections were made in conjunction with the meeting of the Federal Open Market Committee on March 15–16, 2016. One participant did not submit longer-run projections in conjunction with the June 14–15, 2016 meeting.

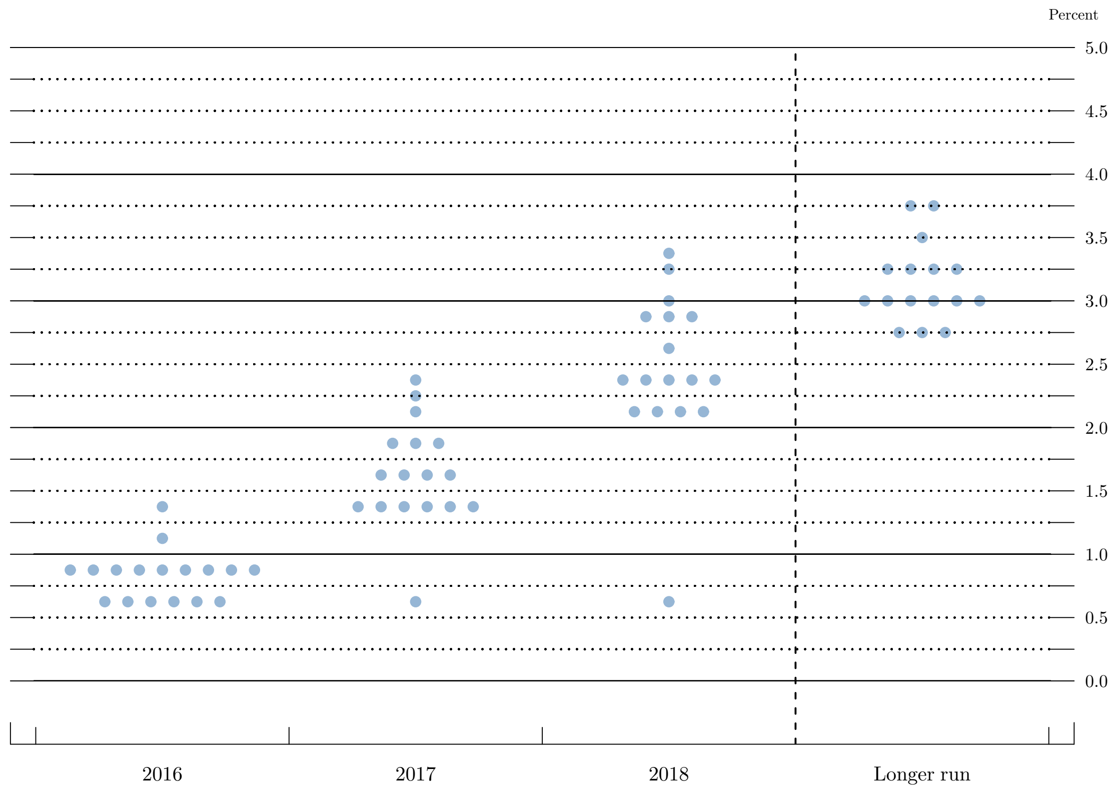
1. For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.

2. The central tendency excludes the three highest and three lowest projections for each variable in each year.

3. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.

4. Longer-run projections for core PCE inflation are not collected.

FOMC Participants' Assessments of Appropriate Monetary Policy: Midpoint of Target Range or Target Level for the Federal Funds Rate



Source: The Federal Reserve

Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections.

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

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