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INSIGHT

MONTHLY COMMENTARY

July Rates Update

TYLER TUCCI | AUGUST 1, 2016

U.S. Treasury yields continued to trade with a bullish impetus in July as the aftershocks of the Brexit vote pushed 10 yr & 30 yr yields to all-time lows of 1.31% and 2.08% respectively. While the long end of the Treasury curve reached all-time highs in price terms this month, 2 yr yields remained somewhat pinned as the market failed to price in an ease by the Fed despite the risk-off nature of the rally in the long-end of the curve. Reducing the pace of Fed rate hikes to almost nil helped drive equity prices to all-time highs as the search for yield has intensified, forcing buyers of risk assets to pay increasingly higher prices in exchange for increasingly less stable cash flows. This yield chase shows no signs of abating despite both equities and Treasury bonds reaching new all-time highs as the safety attributed to dollar-denominated assets continues to be in high demand.

After yet another dovish turn at the June FOMC meeting, the FOMC statement for July showed little change in FOMC thinking but did indicate that committee members were less concerned about near-term tail-risk events than in June. However, the balance of the statement did not have some of the other hawkish undertones that would be expected if the committee intended to tighten policy in September. As the FOMC set up its path to a tightening last December, language relating to risks to the committee's outlook was much more positive, describing risks as balanced or nearly balanced. This was not the case for the July statement as risks were said to only have diminished, which suggests they have not abated all together. Furthermore, the FOMC saw fit to once again acknowledge that it was still short of its inflation target of 2%, if committee members indeed planned to tighten seven weeks hence, they presumably would not admit to failing to achieve one of their required conditions for tightening. Finally, with recent polls tracking a 50/50 outcome in the U.S. election it would be hard to imagine the same Fed that deferred tightening from September to December while waiting for the certainty of a clear path, to act any differently this time around.

Unlike the FOMC meeting where no action was expected, market expectations heading into the Bank of Japan's policy announcement were significantly more optimistic. In the two weeks prior to the meeting, the yen depreciated by up to 6% against the dollar as expectations for a combined fiscal and monetary stimulus package, or "helicopter money," were fueled by reports of meetings between former Federal Reserve Chairman Ben Bernanke and BoJ officials. By publicizing meetings

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with Bernanke, who is considered to be the preeminent authority on the implementation of helicopter money, the BoJ may have inadvertently confused the market into thinking they were more committed to easing policy than they intended. This is not the first time the BoJ has confused the market with their policy intentions however, as they also decided to send their policy rate into negative territory earlier this year after Prime Minister Abe explicitly stated that he did not intend to use such policy.

Upon the release of the policy statement from the BoJ, on the eve of the final trading day of the month, it became evident that the BoJ did not share the market's sense of urgency on the economic situation. Instead of cutting the policy rate deeper into negative territory, a move that was widely expected, the BoJ simply elected to double current ETF purchases from ¥3 trillion to ¥6 trillion. The increase in ETF purchases, while positive for Japanese equities at the margin, potentially serves as more of an olive branch from the BoJ to the market than an actual solution to Japanese growth and inflation woes. While this lack of additional easing did disappoint the market, the BoJ did leave the door open for major policy changes in the near future by pledging to "conduct a comprehensive assessment of the developments in economic activity and prices under 'QQE' and 'QQE with a Negative Interest Rate' as well as these policy effects at the next MPM." This review may not necessarily end in additional policy easing though, as the July BoJ statement was fairly upbeat on the Japanese economic outlook. It is a stretch to understand how the BoJ views their current situation as a positive one, with real GDP sitting a 0.1% YoY and meaningful inflationary pressure nowhere to be found, it seems fairly evident the Japanese economy needs to remain on monetary policy life support.

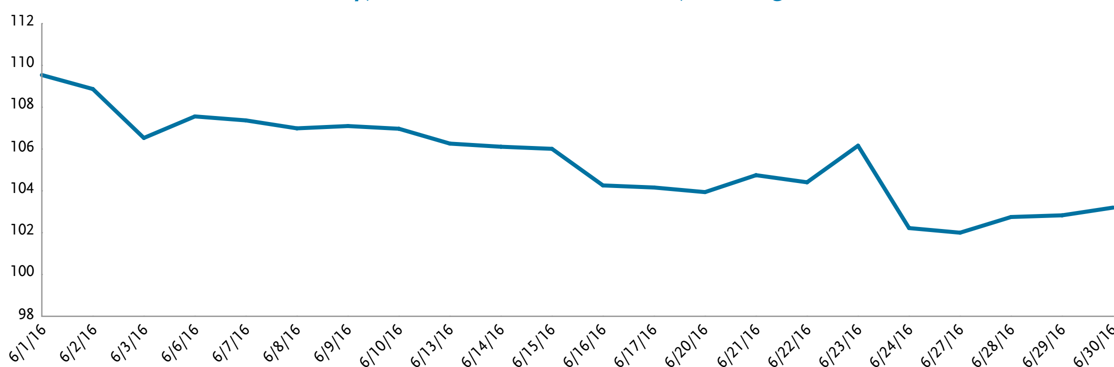
The final trading of the month saw the release of Q2 GDP in the U.S. and it was not at all encouraging. While consensus was looking for a number close to 2.0% YoY, the release from the Bureau of Economic Analysis showed only a meager 1.2% figure YoY for Q2 as well as a downward revision to 0.8% for Q1. The majority of the large miss came almost entirely as a result of an $8.1 billion decrease in inventories, but even more concerning is that the combination of the reported strong durable-goods spending, falling imports and the rare drop in inventories suggests there was large discounting in inventory in the second quarter. If firms have to cut prices aggressively to move inventory, it does not bode well for demand in the second half of 2016. Otherwise the mix of GDP subcomponents was as expected, there was a surge in consumption (+4.2%) more than accounting for all the growth in GDP, a third straight drop in business investment (-2.3%), a decline in residential investment (-6.1%), and a decline in government spending (-0.9%). Interestingly, the drop seen in Q2 business fixed investment was the third straight quarter in which it fell, the longest such streak since the last recession.

As the first half of 2016 comes to a close, the global economy still appears to be on unstable footing. With the U.S. managing a meager 1.0% GDP growth for 1H 2016 it appears as if it is not isolated from the demand issues plaguing the global economy. If this is indeed the case and U.S. growth isn't on the upward trajectory necessary to warrant further tightening of policy from the FOMC, then their monetary policy peers globally are left in a somewhat sticky situation. If the U.S. was growing at an adequate pace to necessitate tighter policy, other central banks would benefit significantly as higher U.S. interest rates would essentially loosen policy for the rest of the world. As the U.S. has failed to achieve any sort of meaningful liftoff, remaining global central banks now have to come up with further easing plans of their own instead of depending on the U.S. and the FOMC to do the heavy lifting for them. It seems the Brexit vote provided the cover the BoJ and Bank of England needed to ease further. The ECB has already acted by expanding QE following a round of deflationary fears in February. The Bank of England is now expected to ease and possibly expand QE even though Brexit is less than two months old. Japan did disappoint but few believe they are done. The Fed has "tightened" policy by simply standing still. The markets are now pricing in ECB and BoE to be on hold for 5 years. Clearly we are in uncharted territory.

	6/30/2016	7/29/2016	52 Week High	52 Week Low
2y Treasury Yields	0.58	0.66	1.10	0.50
5y Treasury Yields	1.00	1.02	1.83	0.89
10y Treasury Yields	1.47	1.45	2.37	1.32
30y Treasury Yields	2.28	2.18	3.14	2.09
Yield Curve Steepness 2s to 30s	169.91	152.34	234.09	145.52
Barclays Aggregate Index	2027.69	2040.51	2044.06	1917.21

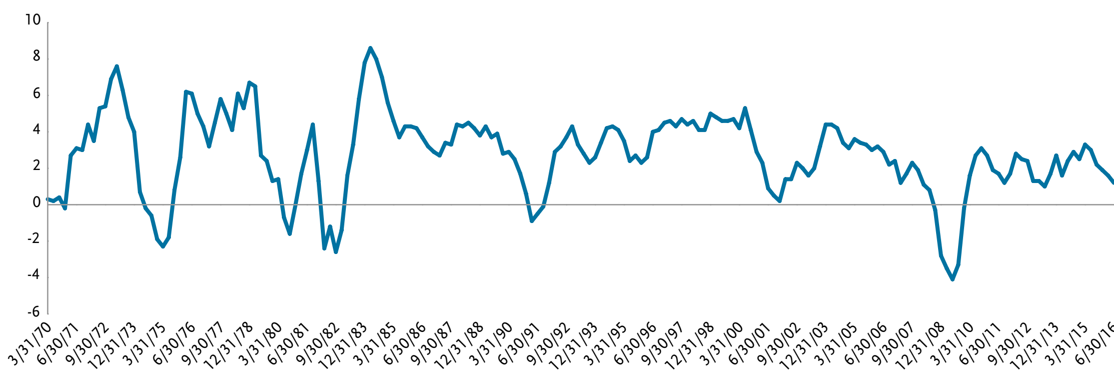
Source: Bloomberg

USD/JPY Performance Into the BoJ Meeting



Source: Bloomberg

U.S. Real GDP YoY



Source: Bloomberg

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