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INSIGHT

MONTHLY COMMENTARY

July Rates Update

TYLER TUCCI | AUGUST 2, 2017

U.S. Treasury yields were little changed for July as generally light volumes and lack of a clear directional catalyst kept fixed income market participants on the sideline or on vacation. This lack of interest in the fixed income market was not felt in the FX marketplace as the U.S. dollar index plunged another 2% in July to run its streak of negative months to five straight. Against this backdrop U.S. equities continued their ascent with the S&P cash index climbing 2% for the month with the VIX volatility index plunging as low as 8.8, an all-time low. This constant push lower in volatility as proxied by the VIX has moved to the forefront in investors' minds, but has yet to see any sustainable mean reversion whatsoever in 2017.

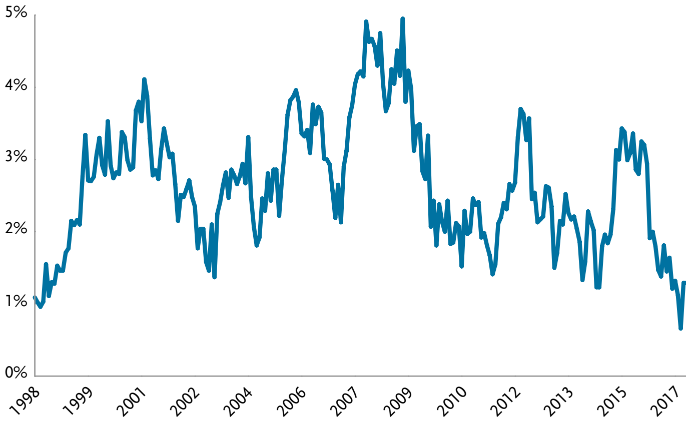
Though markets have not seen much volatility as of late, there was significant movement of FX exchange rates against the USD this month in a decidedly one way fashion with the dollar moving notable weaker against the euro, yen and sterling. One of the reasons the U.S. dollar has lost some of its luster in recent months may be that the FOMC is no longer the only central bank globally to discuss an exit from emergency policy settings. In July, the Bank of Canada (BoC) did one better than simply discussing the potential for higher rates, it actually raised the policy rate to 0.75%, for the first time in seven years. While at first look, the attempt to move past crisis era policy towards normalcy is commendable; the hike may prove to be penny wise and pound foolish as inflation remains near the lower end of the BoC's 1-3% band. Additional pain from higher policy rates will potentially come home to roost in the Canadian household, where balance sheets are more levered than at any time in recent memory and wage gains at their weakest since 1997. A historically large debt burden with little means for repayment is troubling but increasing the service cost of debt on a constituency that cannot afford the increased payment could prove devastating under the right conditions. Further headwinds to the Canadian economy can be found in the housing

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.

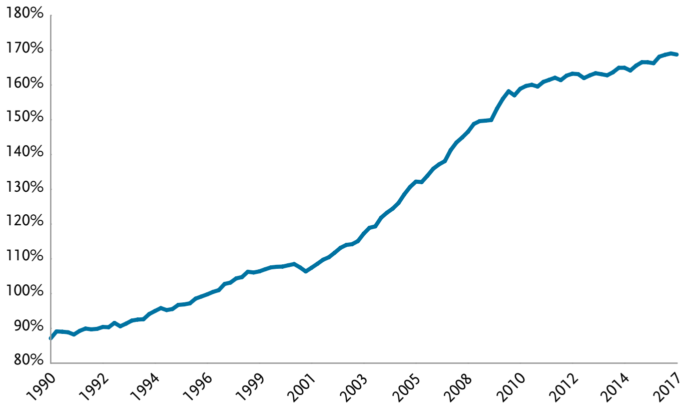
sector where the well-publicized fall and then private purchase of a non-bank home lender has already taken place. Though the idea of mortgage related instability anywhere in the developed world post the U.S. experience in 2008 is tough to imagine, it's almost as if Canadians paid no mind to their neighbor's pain to the south. It seems that period of rapid decline in U.S. home equity value was lost on Canadians, who have levered up their outstanding mortgage sector debt by a mind boggling 74% since Q1 2008.

Canadian Employee Average Hourly Wages YoY



Source: Bloomberg

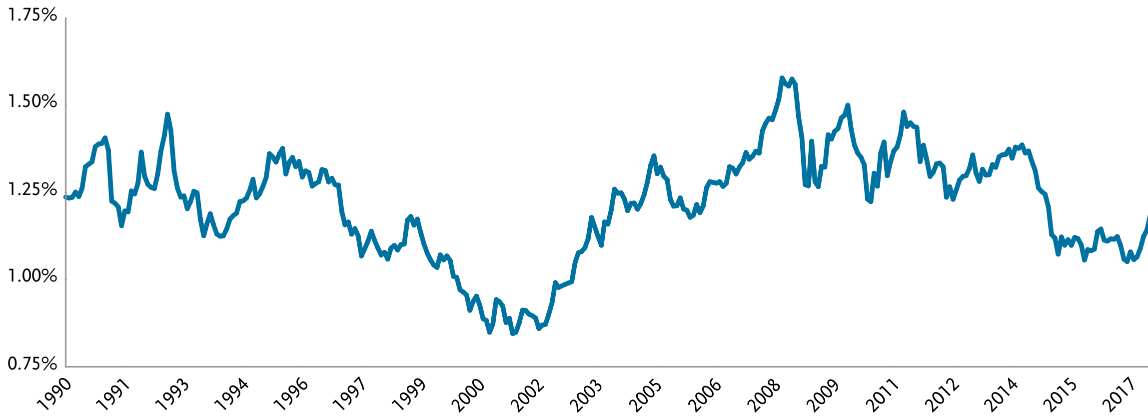
Canadian Household and Nonprofit Institutions Debt to Disposable Income



Source: Bloomberg

While BoC Governor Stephen Poloz was tightening policy, ECB President Mario Draghi was also giving hawkish monetary policy lip service on his side of the Atlantic. In multiple public appearances over the course of the month, including the July 20th ECB meeting, President Draghi tiptoed the line between optimistic hawkishness and pragmatic dovishness with the clear understanding markets were hanging on his every word. What market participants did not find in his commentary, was a reason not to buy the euro which exploded over 3% higher month over month against the dollar. Since touching 1.0495 in March of this year, the euro has had five months straight of month-over-month gains to reach a total gain for the year of nearly 13%. Similarly, German 10yr yields also continued their ascent this month reaching as high as 62bps in yield before falling back to 55bps by the end of the month. The revival of the euro area and euro area assets has been a popular theme as of late and investors have poured cash back into euro assets as eurozone skepticism recedes from view for the time being.

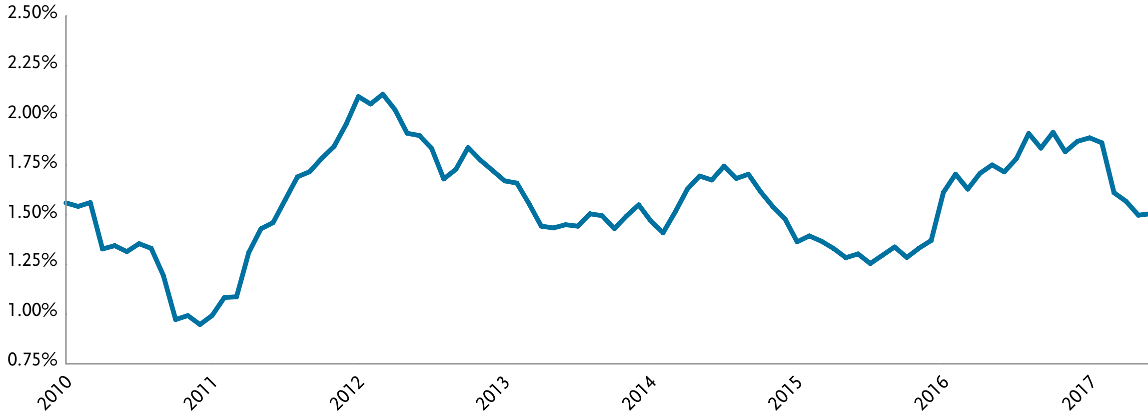
EUR/USD Currency



Source: Bloomberg

As their central banking colleagues try to play policy catch up, the FOMC did as little as humanly possible to preannounce their intentions for the rest of the year at the July FOMC meeting. The one minor surprise found in the statement was a more explicit firming in the committee's guidance about the timing of an announcement to start its balance sheet unwind, which they now expect to begin "relatively soon." The committee did however stop short of explicitly saying that they would make an announcement in September but the implicit hinting is likely sufficient to conclude a September start is likely. Additionally, the FOMC also walked back their inflation language, characterizing core inflation as now running firmly below target instead of "somewhat below" as they communicated in the June statement. While it may be tempting to call this downgrade to inflation dovish, it may be that the FOMC is simply acknowledging that realized inflation has been lower and not changing their outlook. Given, their readiness to unwind the balance sheet, it would be hard to imagine the FOMC is now looking for notably lower future inflation. The rest of the statement was merely housekeeping and made several small tweaks to the description of economic conditions. The committee upgraded its description of job growth to "solid, on average," downgraded its description of household spending a touch following the weak retail sales report seen earlier in the month.

PCE CYOY Index



Source: Bloomberg

Now that the FOMC has embarked on its policy path for the second half of the year in earnest, it appears the global events schedule could prove much more tumultuous than the first half of the year, which provided little resistance to their policy plans. After being afforded the opportunity to push through two rate hikes with relative ease, the final months of the year will see multiple European elections, the 19th National Congress of the Communist Party of China and a potential ECB taper to name just a few key catalysts that could change the macro landscape and adversely impact the FOMC's plans. This is a line of thinking that the market is very familiar with, judging by the sub 50% probability for one more rate hike this year priced into the futures market. This pessimism going into the second half leaves the FOMC in the unenviable position of having to convince markets to price in an additional tightening this year or hike into an unprepared market, which as shown by the Taper Tantrum in 2013, could have series consequences. In order for the market to go with the FOMC willingly, inflation metrics including core PCE would have to stabilize and prove the free fall in inflation in the first half of the year was simply a rough patch and nothing more ominous. No matter the outcome, late summer into early fall has historically played host to some unforeseen volatility events so the unexpected should be expected.

	6/29/2017	7/31/2017	52 Week High	52 Week Low
2y Treasury Yields	1.37	1.35	1.43	0.64
5y Treasury Yields	1.85	1.84	2.15	1.02
10y Treasury Yields	2.27	2.29	2.64	1.46
30y Treasury Yields	2.81	2.90	3.21	2.19
Yield Curve Steepness 2s to 30s	144.03	154.48	205.73	132.87
Barclays Aggregate Index	2024.24	2030.01		

Source: Bloomberg

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