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August Rates Update

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While somewhat devoid of market moving catalysts, August was still a microcosm of the current global monetary policy conundrum. In the U.S., the Fed continues to push for tighter monetary policy as they feel their loose interpretation of their mandate dictates another tightening. Conversely, the Bank of England (BoE) decided the current state of their economy warrant a fresh round of bond buying and a deposit rate cut. In the past, this dichotomy between economies has been manageable as each central bank has been able to pursue their own optimal policy independently of their colleagues abroad. However, as financial markets have become increasingly more globalized and the impact of domestic monetary policy spills over borders via currency and asset pricing channels the coexistence of divergent, independent monetary policy has become all but impossible. Despite this juxtaposition, the FOMC will try to solider on as one of the few central banks globally with a tightening bias and hope the unintended consequences of their policy changes don't come home to roost.

Following the Bank of Japan's failed foray into negative interest rates earlier in the year, market participants have begun to question the efficacy of further monetary policy globally as both inflation and growth have continued to stagnate. In the face of this notion, the BoE kicked off August by showing they still had the gumption to re-enter the policy easing fray by cutting their bank rate by 25bps and announcing both a £60bln increase in QE Gilt purchases, (taking the target to £435bn) to be conducted over six months, as well as a program of up to £10bn of corporate bonds by firms making a "material contribution" to the UK economy. In addition, the BoE essentially waived their inflation mandate for the near term stating in their August fourth inflation report "The fall in sterling is likely to push up on CPI inflation in the near term, hastening its return to the 2% target and probably causing it to rise above the target in the latter part of the Monetary Policy Committee's forecast period, before the exchange rate effect dissipates thereafter." Risk assets responded to this blockbuster easing package in kind, as corporate credit spreads tightened and the FTSE 100 approached all-time highs. Despite recent negativity on the state of global monetary policy, the reaction from risk assets in the UK following the announcement of easing measures suggests that the market is still constructive on monetary policy as a tool to fortify the economic health of against an external shock like Brexit.

One of the highlights of what was generally a ho-hum month was a prepared speech on The Federal Reserve's Monetary Policy Toolkit: Past, Present and Future by Fed Chair Janet Yellen at the Kansas City Fed's annual economic symposium at Jackson Hole. With a cloud of uncertainty hanging over of the direction of monetary policy in the near term, the market looked to the chair for direction as the decision to

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tighten policy is ultimately hers. Yellen's speech did not offer any bombshells but did acknowledge that the case for a tightening of policy has "strengthened in recent months." However, she did not explicitly guide towards a tightening at either the September or December meeting suggesting a lack of conviction of the immanency of a tightening despite a desire to do so. The majority of her speech was not a discussion of monetary policy near term so much as it was an analysis of the ability of the Fed to use asset purchases and forward guidance to stimulate growth in the next recession. One of the most notable takeaways from her analysis on the future of monetary policy was the openness to the idea that policymakers may wish to explore the possibility of purchasing a broader range of assets in the next downturn. Unlike other central banks, the FOMC only purchased Treasury and MBS securities as opposed to including ETF and corporate during the QE1-QE3. The inclusions of a wider breadth of market securities present a new potential winkle for U.S. monetary policy.

It is unlikely that we will see these proposed new policy initiatives in the near term though, as the FOMC remains committed to their gradual tightening bias. While Chair Yellen was vague on near term policy designs in her speech, Vice Chair Stanley Fischer was unequivocally hawkish when speaking with the media at Jackson Hole just moments after the Chair concluded her comments. A veteran of global central banking, Vice-Chair Fischer has remained on the sidelines for the better part of this year, allowing his more dovish colleagues to play Fed mouthpiece. Now that he has reentered the public arena with his relatively hawkish policy framework as opposed to deferring to his colleagues there may be legitimate reason to believe the FOMC is actually as close to tightening policy as they suggest. Granted, we have heard this story from this Fed before, which has several false starts to their credit in the past twelve months but recent Fed speak suggests FOMC participants are quite keen on a tightening this year despite abhorrent 1H growth data. The market acknowledgement of September and December as "live" meetings is only lukewarm to this point with a 40% chance priced for September and a 60% chance for December.

Unlike August of 2015 which saw the People's Bank of China devalue the renminbi for the first time since 1994, inciting significant market volatility, a lack of trading volumes or meaningful news flow saw market price action fixate on potential paths of central banking policy this month. In this way, trading conditions were similar to those during the U.S. Quantitative Easing period (2008-2013) as asset price changes were almost entirely a function of the perceived future impact of central bank policy changes as opposed to other macroeconomic fundamentals. With the summer doldrums now nearly behind us, the focus will shift to a blend between the data and central bank action as the stretch run of 2016 begins in earnest.

	7/29/2016	8/31/2016	52 Week High	52 Week Low
2y Treasury Yields	0.66	0.81	1.10	0.50
5y Treasury Yields	1.02	1.20	1.83	0.89
10y Treasury Yields	1.45	1.58	2.37	1.32
30y Treasury Yields	2.18	2.23	3.14	2.09
Yield Curve Steepness 2s to 30s	152.34	142.28	234.09	139.67
Barclays Aggregate Index	2040.51	2038.18	2044.06	1917.21

Source: Bloomberg

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