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INSIGHT

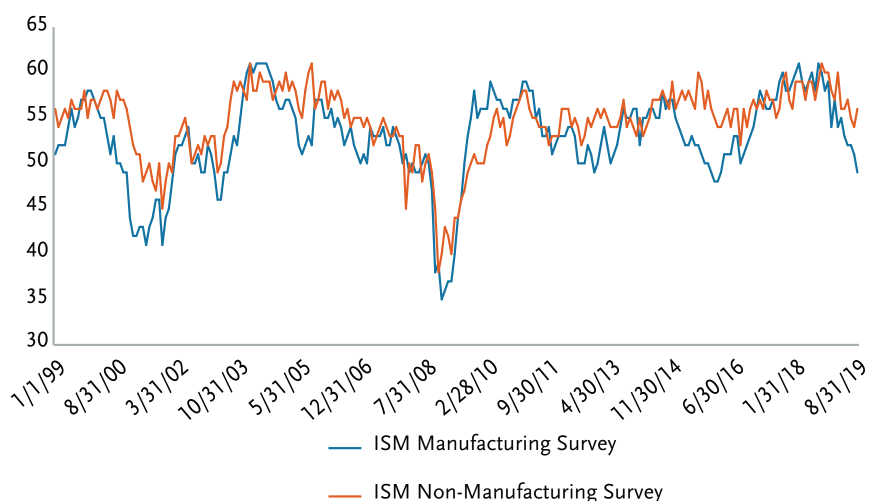
MONTHLY COMMENTARY

U.S. Rates Update August 2019

MICHAEL Y. PAK, CFA | 13 SEPTEMBER 2019

The traditionally quiet month of August was anything but as the temperature started rising (again) in U.S./China trade talks. This on-going conflict with its implications for global growth was the primary catalyst sparking market volatility however other pressure points included weaker domestic data prints (e.g. non-manufacturing ISM 53.7 versus 55.5) and political turmoil in Argentina which drove that country's stock market (MERVAL) down almost 40% in just one day. Against a backdrop of illiquid, late-summer markets, these events swiftly drove U.S. rates to extreme levels, bull-flattening the curve as the flight-to-quality bid extended out to the long end (The 30yr Treasury alone rallied 56 basis points (bps) on the month, trading through its all-time low yield of 2.09%). However, juxtaposed against the bid for safe haven assets was first-tier economic data that was firm overall (e.g. retail sales, GDP, jobless claims). These data releases painted a picture of a U.S. consumer who still appears to be in good shape for now but one wonders how much longer it can continue driving the domestic expansion. This is especially true in light of manufacturing data that continues to weaken and on-going trade uncertainty that keeps chipping away at business confidence. It is likely only a matter of time before the slowdown in manufacturing spills over into the services sector and upends the consumer if these negative sentiments continue clouding the economic outlook.

ISM Manufacturing & Non-Manufacturing Surveys



Source: Bloomberg

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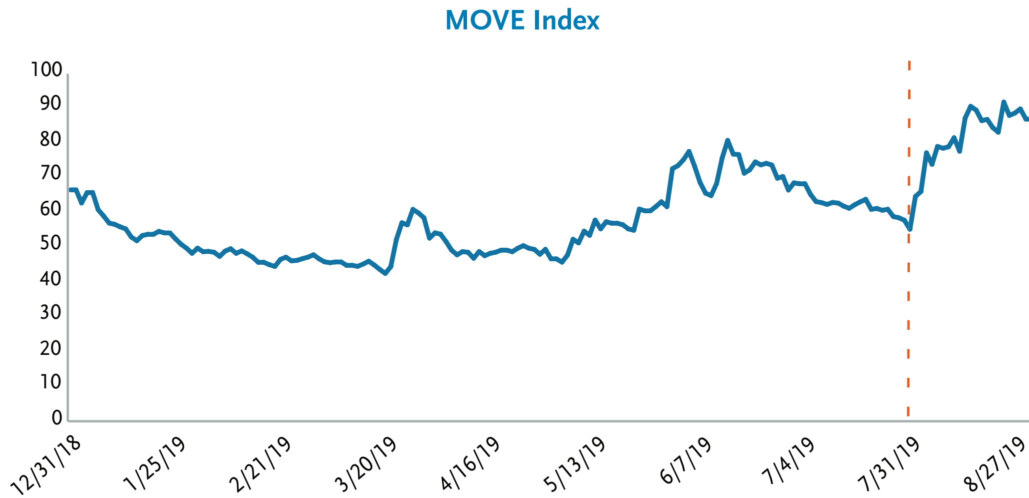
Mr. Pak is a Senior Vice President in the Fixed Income group where he trades Money Markets, Treasuries, and Agencies. Prior to joining TCW in 2015, he was a Fixed Income Portfolio Manager at Columbia Threadneedle where he managed institutional separate accounts and mutual funds with a focus on the Investment 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.

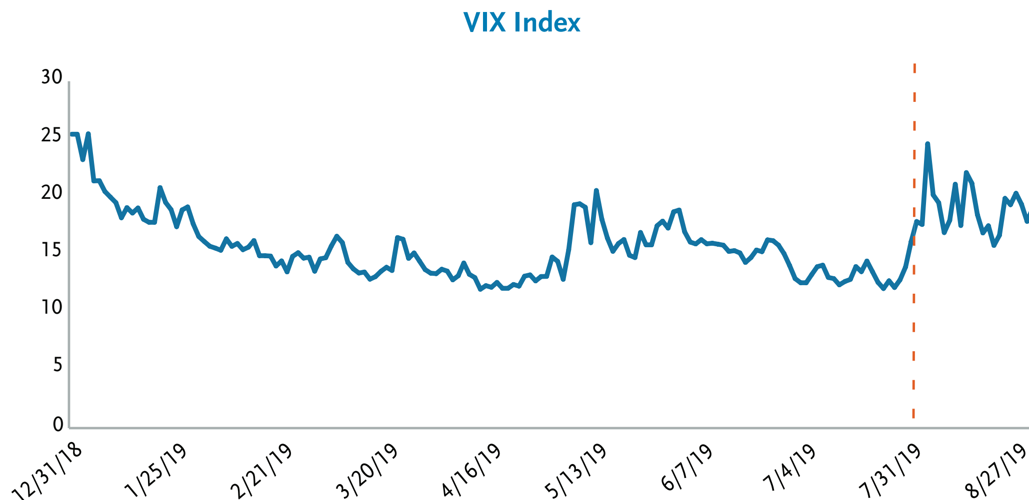
The volatility was ignited early in the month by President Trump's surprise tweet stating that an additional 10% tariff would be slapped on the remaining $300bln of Chinese goods. Just a few days later, China subsequently hit back by allowing the Yuan to depreciate above the psychological 7.00 USDCNY level and halting purchases of U.S. agricultural goods. This tit-for-tat exchange sparked a risk-off move with the 3mo10yr curve further inverting and hitting an intra-month low of -51bps, 2yr swap spreads trading negative for the first time ever and rate and equity volatility spiking towards YTD highs (rate vol as measured by MOVE, equity vol as measured by VIX). By month-end, the Treasury curve as measured by the 2yr10yr spread sat at -1.4bps its lowest level since May 2007. Volumes in U.S. rates products ballooned to near record levels against this backdrop of geopolitical instability and massive move in the Treasury market. Per the CME, average daily volume in Treasury futures alone hit an all-time high of 6.88mm contracts with average daily volume across all rates futures (Treasury, Eurodollar, Fed Funds) exceeding 10mm contracts which is up 58% YOY.

MOVE Index



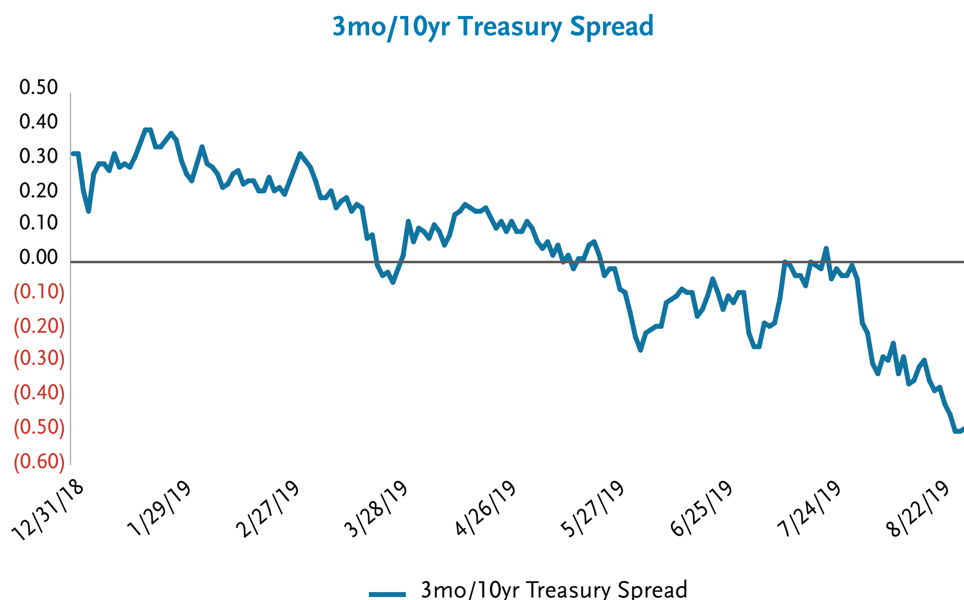
Source: Bloomberg

VIX Index



Source: Bloomberg

The rate rally spilled over into global markets as well with curves flattening across G7 countries and the German 2yr10yr curve for one sitting at its flattest level (+23bps) since September 2008. Weaker than expected Chinese retail sales and industrial output along with tepid growth data out of Germany were also catalysts behind these moves. Flatter and inverting curves here and abroad were not the only indicators flashing caution over the month however. The probability of a recession over the next 12 months per the New York Fed's recession indicator closed near 30%, its highest level since the financial crisis.



Source: Bloomberg

The Treasury curve attempted to steepen at various points during the month on a few disparate events namely German preparations for stimulus measures, St. Louis Fed President Bullard talking up negative rates, and Treasury (again) exploring longer-dated issuance (e.g. 50yr/100yr Treasuries). However, the powerful bull flattening momentum overwhelmed these cursory factors and they were largely dismissed by the market. This was not a surprise especially since most of these issues have already proven to be ineffective and disruptive to the banking sector (negative rates) or already been discussed (ultra-long Treasury issuance) over the past few years and largely frowned upon by the market. The FOMC minutes and Fed conference in Jackson Hole were also non-events with the only notable points being an emphasis on overseas developments (e.g. Brexit, Hong Kong) and the importance of maintaining optionality and flexibility for future rate moves. Otherwise, Fed communication over the month highlighted dynamics already known to markets – that an on-going debate existed within the Fed over the magnitude of further policy rate adjustments.

By month end, the market eventually settled at a 100% probability of one 25bps cut at the September FOMC meeting although odds reached as high as 50% for an *additional* 25bps cut during the depths of the rate rally. So against the back drop of economic data that does not seem to augur for more accommodation *at the moment*, the price action in the Treasury market and signals from inverted curves put the Fed in a difficult spot. With the market (and President Trump) clamoring for aggressive easing and screaming Fed policy error, the seemingly divided Fed will still likely deliver the one 25bps that is fully priced into the market with the focus thereafter turning to the Summary of Economic Projections. Here the market will get a glimpse at the likely path of the Fed's policy rate going forward and the degree to which the committee potentially marks down its projections for growth and inflation in light of the current geopolitical environment.

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	7/31/2019	8/30/2019	Change
2yr Treasury	1.87	1.51	(0.37)
5yr Treasury	1.83	1.39	(0.44)
10yr Treasury	2.01	1.50	(0.52)
30yr Treasury	2.53	1.96	(0.56)
30yr TIPS Breakeven	1.79	1.60	(0.18)
3mo Treasury Bill	2.07	1.98	(0.08)
3mo LIBOR	2.27	2.14	(0.13)
Fed Funds	2.14	2.13	(0.01)
SOFR	2.55	2.16	(0.39)
U.S. Dollar Index	98.52	98.92	0.40
LIBOR/OIS	0.21	0.28	0.07

Source: Bloomberg

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