Weekly Market Summary

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Will a Substantial Improvement in the Economy Lead to a Substantial Rise in Yields?! Better Not Ask Mnuchin!!

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U.S. central bankers sent a strong message last Wednesday that an expansion with "*substantial underlying economic momentum*" could sustain additional increases in interest rates this year. Based on minutes of their January 30th - 31st meeting released in Washington two days back, Federal Reserve officials "*anticipated that the rate of economic growth in 2018 would exceed their estimates of its sustainable longer-run pace and that labour market conditions would strengthen further*." A number of participants also "*indicated that they had marked up their forecasts for economic growth in the near term relative to those made for the December meeting.*" Markets were quick to react (though still with a 30 min. lag!): Stocks reversed their earlier strong gains for the day and bond yields rose sharply on the Fed's more hawkish posture. The S&P 500 Index ended the day down 0.6% after being up as much as 1.2% earlier, whilst the yield on 10-year Treasuries rose to 2.95% -- a four-year high. The minutes also marked the end of Chair Janet Yellen's tenure at the central bank, as she turned the reins over to Jerome Powell in early February (the latter will appear before the House Financial Services Committee for his semi-annual testimony on February 28th, and his market wisdom will be widely scrutinized!). The key question facing policy makers (and traders) is now one of pace – i.e. whether three hikes or four will be sufficient to keep supply and demand in balance as corporations take advantage of lower tax rates and aggressive incentives to ramp up investment resulting from a fiscal stimulus signed into law by president trump last December. "*The Fed is finding more confidence in their baseline outlook*," said Harm Bandholz, chief U.S. economist at UniCredit Bank AG, who is forecasting three more rate increases for 2018. "*The risk of four*" rate hikes is "*higher than two*."

Meanwhile, on the inflation front, the collective position of the Federal open market Committee ("FOMC") remained one of cautious optimism that it will move toward their 2% target in the medium term. "*It was noted that the pace of wage gains might not increase appreciably if productivity growth remains low*," the minutes said. That said*, "a number of participants judged that the continued tightening in labour markets was likely to translate into faster wage increases at some point*." The economy continues to gain strength, and the minutes said a decline in the foreign exchange value of the dollar was also likely to put upward pressure on inflation (lower exchange rates usually translate - with a lag - into higher prices for imported goods). Worth noting that the January meeting opened with staff presentations on inflation and "*participants emphasized the critical need for the FOMC to maintain a credible longer-run inflation objective.*" The central bank has missed its 2% inflation target for most of the past five years, and suggested it lacks a convincing explanation for what causes inflation, or a model that accurately predicts future inflation. In a presentation at the January meeting, economists on the Fed's staff told policymakers that the most popular explanations had significant flaws: One class of theories says inflation is produced by excess demand for available resources. This suggests inflation should rise as growth approaches its natural speed limit, a pattern that can be seen in some historical data but is difficult to find in recent decades. Another class of theories argues, with some circularity, that inflation is determined by expectations about inflation, and those have remained low in past years.

Released within 24 hours of each other, minutes of the European Central Bank (ECB) policy meetings – out yesterday – painted a similar economic optimism and identified similar analytical challenges. Like the Fed, the Governing Council of the ECB embraced brighter economic prospects, reinforcing the notion of a virtuous synchronized pickup in global growth and of lessened concern about "*low inflation*." It assessed the economic expansion as "*robust and broad-based,*" whilst expressing more confidence that inflation would converge over time to its 2%. The account of the ECB's January monetary policy meeting also revealed dissent over the Bank's communications on its policy intentions (dubbed the central banks' "forward guidance"), with its hawkish members pushing for a change in the Bank's communications, and arguing economic conditions were now strong enough to drop a commitment to boost the quantitative easing programme in the event of a slowdown. "*However, it was concluded that such an adjustment was premature and not yet justified by the stronger confidence.*" The central bank is now buying € 30 billion of bonds a month under its € 2.5 trillion QE programme (marketed in early 2015 as the € 1.1 trillion programme, but who is counting really?!? ☹) and will continue to do so until at least September.

Then US Treasury Secretary Steven Mnuchin – an ex-Goldman Sachs banker with little known qualifications and zero experience in politics or policy outside his loyalty for Trump and Wall Street (Goldman in particular, I am guessing ☺), spoke AGAIN !!

"*You can have wage inflation and not necessarily have inflation concerns in general*" was how the US Treasury Secretary - yesterday - allowed the world to share his vast economic "*wisdom*", brushing aside signs that investors are growing nervous about rising prices. All economists of this world are likely to have scratched their heads following this comment! ☺. But let us be fair: Mnuchin's comments remain far more genuine than his boss' outlandish, bombastic and eye-popping tweets!! And whilst an unexpectedly big jump in average hourly earnings in January set off a stock-market swoon as investors worried about higher inflation and interest rates, not to mention already surging yields on concerns that widening budget deficits under President Donald Trump will fuel inflation, Trump's chief economic cheerleader Mnuchin continues to deflect any suggestion that the president's policies could have an impact on inflation. He sidestepped the idea that the tax cuts and increased federal spending Trump has signed into law amount to an economic stimulus (the government will issue more than $1 trillion in new debt this year, analysts say, in part as a consequence of higher budget deficits!). Mnuchin's remarks also reflect the administration's public argument for the tax cuts. Kevin Hassett, chairman of the White House Council of Economic Advisers, has said that the law signed in December will help boost productivity gains by encouraging companies to invest in efficiency-enhancing equipment, allowing the economy to grow faster without spurring inflation. Moreover, the Treasury secretary has suggested that the U.S. is less vulnerable to oil-driven inflation because of rising energy production in the country. "*We are no longer fully dependent on foreign oil,*" Mnuchin said. "*Energy is always a big concern in terms of inflation, among the geopolitical risks*."

What Happens Next??

At this point, it is more likely a matter of when - not if – the 10-year Treasury yield hits 3.00%. And that apparent inevitability raises a pressing question: How to trade bonds when that happens??

If history is a guide, the last time the 10-year yield was above 3.00% was in January 2014 but that did not last long! A combination of economic & political/geopolitical factors - including depressed Chinese economic data, Russia's intervention in Ukraine, oil prices nosediving, Ebola outbreak, ISIS forces spreading across the Middle East – saw the 10-year US Treasury yield move steadily lower throughout that year, closing at 2.17% on the last trading day of 2014 (versus a January 2014 Bloomberg survey that reported a 3.75% year-end consensus by polled economists). Would this time around be different? And do 10-year yields hit 3.00% and continue to move sharply higher afterwards? "*Certainly as we get closer to 3 percent, people will get nervous,*" said Michael Cloherty, head of U.S. interest rate strategy at RBC Capital Markets. "*I would expect flows to pick up as we're closer and closer to 3% and to see some choppiness in the market*." (I couldn't have said it better!☺ Seriously, readers still listen to this non-sense?)

Treasuries, of course, do not exist in a vacuum, and future price movements will be highly correlated to gains/losses in the equity markets (logically when stocks stabilize and march higher, yields rally again and vice-versa, though it is conceivable that both bonds and stocks could suffer large losses, should investors – especially international names – decide to dump various US assets at the same time). Some strategists say a 3.00% 10-year yield represents the end of the stock market rally, with corporate borrowing costs becoming too punitive and fixed-income looking too appealing. Others, like Jonathan Golub, chief U.S. equity strategist at Credit Suisse Group AG, say 3.50% would be the level to watch. Regardless of the exact level, bond traders will most likely find that the best barometer of which way yields are headed (after 3%) will come from stocks. A bout of selling in equities probably means the "*tug-of-war*" between the two asset classes is alive and well, serving as a cap on yields and perhaps preventing too much tightening from the Federal Reserve. If stocks shrug the jump to 3.00%, then it is a green light for the bond selloff to carry on!

10-Year UST Yield Projections*

DJIA \ WTI OIL	**56.00**	**59.00**	**62.00**	**65.00**	**68.00**
23,500	2.35%	2.47%	2.60%	2.70%	2.80%
24,000	2.45%	2.57%	2.68%	2.79%	2.90%
24,500	2.55%	2.67%	2.78%	2.89%	3.00%
25,000	2.65%	2.77%	**2.89%**	3.00%	3.10%
25,500	2.75%	2.87%	2.97%	3.07%	3.17%
26,000	2.85%	2.97%	3.03%	3.13%	3.23%
26,500	2.95%	3.02%	3.09%	3.17%	3.30%

**These projections are my simplistic estimates, and assume that President Trump's "beautiful" IQ would not show up in fury tweets over coming weeks, Donald trump Jr. would keep missing out on business opportunities because of his high ethics, Jared Kushner's active diplomacy will bring peace to the Middle East & Ivanka Trump will always remain attractive ☺*

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