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Market Update

Economic News

October 28, 2016

We mentioned on Wednesday Treasury yields were moving through support levels that had held since June, but those levels were decisively broken yesterday and that inspired a fresh wave of selling, sending yields to the May highs that prevailed before the poor jobs report sent them lower. Aiding in the yield back-up yesterday was a better-than-expected U.K. GDP number that quashed hopes for rate cut next Thursday, and the head of Japan's central bank stating that somewhat higher long-term rates are preferable to a flatter yield curve.

The data and central bank comments added to market perceptions that global central bank easing is slowing if not coming to an end. The 10-year yield now sits at 1.85%, the highest yield since May 25th. Plenty of support exists between here and 2.00% but the grind towards that level appears to be on so we would hesitate to step-in at these levels as momentum and sentiment still leans towards higher yields. As we approach 1.90% to 2.00%, selling is likely to abate and that is a level we anticipate will find more buying interest and less selling momentum.

Meanwhile, the initial estimate of third quarter GDP surprised to the upside with a strong 2.9% annualized growth beating the 2.6% forecast and the second quarter was left unrevised at 1.4%. It represents the highest GDP print in two years. The beat can be traced to net exports adding 0.83 percentage points to GDP, inventories 0.61% and business investment 0.52%. Those categories either subtracted from GDP in the second quarter (business investment –1.34%, inventories –1.16%) or were inconsequential (net exports 0.18%). Through the first nine months of the year GDP averaged 1.7%, close to the 1.8% Fed expectation for all of 2016. Bloomberg median forecasts for the final three months have GDP growing 2.3% (annualized) which would move yearly GDP to 1.8% and meet the Fed's projection. Keep in mind, however, that in 2015 GDP was 2.6%, so even meeting the Fed forecast will represent a 0.8% decline in year-over-year GDP.

Once again, the consumer carried most of the load in the third quarter but it was off the pace in the second. Personal consumption rose 2.1% short of the 2.6% forecast and well below the 4.3% second quarter rate. For the quarter, personal consumption added 1.47 percentage points to GDP while in the second quarter it was double adding 2.88 percentage points. It's been typical of this recovery for an outsized gain in personal spending in one quarter to be followed by a more tepid pace in the subsequent quarter and that was certainly the case this time.

It's not surprising that the consumer's contribution to GDP eased up in the just completed quarter as wage gains have remained stubbornly modest as the Employment Cost Index for the quarter was up 0.6%, or about 2.5% annually matching expectations. With more cylinders of the economic engine firing in the third quarter it will encourage the Fed and likely keep them on course to tighten 25bps in December. Surprisingly, Treasuries are trading slightly higher in price off the report, perhaps keying off the weaker-than-expected consumer consumption number and rationalizing that the other categories represent merely a rebound off a weak second quarter rather than a longer-term trend change.

Also in the GDP report, Core PCE (the Fed's preferred inflation measure) rose 1.7% quarter-over-quarter annualized which is higher than the 1.6% expectation but down from 1.8% in the second quarter. Thus, price pressure continues to resist ramping higher despite the near-constant Fed refrain that inflation moderation is transitory. Be that as it may, TIPs breakeven rates are moving towards 2.0% and that is contributing, in part, to the recent Treasury sell-off. So market-based indicators are finally moving in the Fed's desired direction and the 1/10th increase in Core PCE will further embolden Fed hawks to push for a December rate hike.

Finally, pending home sales for September gained 1.5% but that modest gain suggests the housing market is unlikely to see major improvement in the final months of the year. Pending home sales are recorded when a purchase contract is signed, while existing home sales are logged as the transaction closes, typically one to two months in the future. Seasonally, contract signings peak during the second quarter (April-June) which results in existing home sales reaching the highest volume in the summer months. The August pending home sales report, which was down 2.5%, combined with modest uptick in September supports the projection that new and existing home sales will be ending the year on a flat trend which continues the plateauing that has been in place since July 2015.

U.S. Treasury 10-Year Yield: Next Support 1.85% to 1.96%

The U.S. Treasury 10-Year yield has moved through the 1.73% - 1.80% support range that had held for the most part since late May, before that month's poor job report sent yields lower in early June and then lower again after the U.K.'s Brexit vote in late June. The move comes on the pricing in of an increasingly likely Fed rate hike in December and sentiment that other central banks are beginning to dial back various monetary stimulus measures as the effectiveness of such programs is increasingly questioned. Next support lies in the 1.85% to 1.96% range as shown in the graph.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	0.28%	-0.05%	1 Mo LIBOR	0.53%	+0.01%	FF Target Rate	0.25%-0.50%	3 Year	1.192%
6 Month	0.49%	+0.03%	3 Mo LIBOR	0.88%	+0.01%	Prime Rate	3.50%	5 Year	1.362%
2 Year	0.88%	+0.06%	6 Mo LIBOR	1.26%	UNCH			10 Year	1.708%
10 Year	1.85%	+0.11%	12 Mo LIBOR	1.58%	+0.02%				