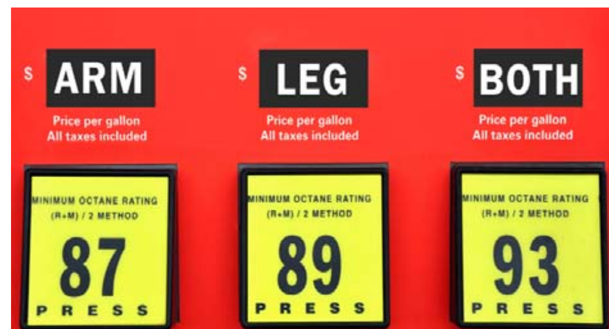
CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

April 20, 2018



A lot of reasons were tossed around to explain the negative Treasury action yesterday, with anecdotal comments from the Fed's Beige Book about the cost/inflation implications of tariffs given lots of column space, not to mention the ongoing rally in oil prices. However, if the selling was inflation-inspired it should have caused selling in the short-end too given the Fed's rate hiking, inflation-fighting credibility. But that was not the case. The short-end (2yr) held it's ground while the 10yr yield rose 3bps on the day. Thus, we think it was more a case that the considerable short-base in long Treasuries increased its bets once yields moved near 30-day highs. In the end, we don't see a strong fundamental reason to explain the selling, and with stochastics pointing to oversold conditions, we would be buyers on the cheaper prices. It's interesting to note too that 10yr yields have now traced out a series of lower yield highs dating back to the year-to-date high of 2.95% in February. With no economic releases due today the price action will be the only cue to work with, and the overnight trading was quiet and light. Currently, the 10yr note is down 4/32nds to yield 2.93%.

Earnings and trade anxiety set the tone for financial markets Thursday, with equities sliding amid a mixed slate of results while Treasuries fell on short-position building and renewed inflation concerns. The S&P 500 slipped for the first time in four days, with earnings misses from Procter & Gamble and Philip Morris weighing on the market. Meanwhile, tech shares slumped after Taiwan Semiconductor (a major Apple Supplier) issued a disappointing forecast that rippled through the tech complex. Meanwhile, keeping pressure on rates, commodities continued to surge in the aftermath of U.S. sanctions on Russia and heightened tariff concerns.

Speaking of tariffs, the Fed Beige Book of economic conditions, that was released on Wednesday, had a fair bit of ink spilled on the subject of tariffs with most business contacts not liking the idea. In fact, most of the comments felt the steel and aluminum tariffs would hurt business and curtail hiring. One unnamed company in the Boston Fed's region was quoted as saying that "these tariffs are now killing high-paying American manufacturing jobs and businesses."

In addition, researchers at the Federal Reserve Bank of New York said the tariffs would likely lead to job losses. The New York Fed research cited a 2003 paper by Trade Partnership Worldwide LLC, a Washington-based consulting firm that advocates on behalf of various industry groups, which concluded the effects of similar tariffs imposed by President George W. Bush in 2002 led to the loss of 200,000 jobs across the U.S. labor market. That number was bigger than the total headcount of U.S. steel producers at the time. "U.S. exporters that need steel or steel-related inputs will face higher input costs and will have to either increase export prices or reduce their profit margins," the New York Fed researchers wrote. "These effects could lead to lower employment in these steel-intensive industries and possibly plant shutdowns."

The combination of renewed angst over tariffs and trade, along with tepid earnings forecasts, made it a tough go for stocks and Treasuries paused after the recent strong flattening move, while renewed concern over rising input costs raised the specter of increasing inflation. We think, however, more of the Treasury selling is technical in nature and not rooted in fundamental concerns.

Finally, in a speech yesterday in Washington, Federal Reserve Governor Lael Brainard said the U.S. job market is strong, household balance sheets improved, business activity solid and banks are benefiting as a result. She leavened that optimism with a note against complacency, “If we have learned anything from the past, it is that we must be especially vigilant about the health of our financial system in good times, when potential vulnerabilities may be building.”

She also mentioned that while inflation expectations are currently well-anchored some signs of financial imbalances are starting to occur. Asset values and business leverage suggest elevated risk but current levels of bank capital are a “sign of strength.” In that regard, however, she urged prudence before easing capital and liquidity rules and is “reluctant” to see big banks reducing capital buffers, without post-crisis safeguards tested through a full economic cycle before reassessing them.

In conclusion, her thoughts were summarized in this quote, “At a time when cyclical pressures are building, and asset valuations are stretched, we should be calling for large banking organizations to safeguard the capital and liquidity buffers they have built over the past few years.” So, don’t look for Lael Brainard to champion any measure of deregulation, at least at this point in the economic cycle.

Reprieve From a Flattening Yield Curve

The seemingly relentless flattening of the Treasury yield curve took a breather, with the gap between 2-year and 10-year yields rebounding after touching just 41 basis points on Wednesday, the smallest differential in more than a decade. While some fundamental concerns were voiced over the long-end selling like the cost implications of tariffs as mentioned in the Fed’s latest Beige Book, and the recent run in oil and other commodities, the lack of movement on the short-end, where the 2yr held its ground, suggests the long-end moves may have been more technically inspired and more a consolidation before the longer-run flattening trend reasserts itself.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	1.81%	+0.06%	1 Mo LIBOR	1.90%	UNCH	FF Target Rate	1.50%-1.75%	3 Year	2.811%
6 Month	2.00%	+0.06%	3 Mo LIBOR	2.36%	+0.02%	Prime Rate	4.75%	5 Year	2.881%
2 Year	2.44%	+0.09%	6 Mo LIBOR	2.50%	+0.03%			10 Year	2.954%
10 Year	2.93%	+0.09%	12 Mo LIBOR	2.75%	+0.04%				