CenterState
— CORRESPONDENT DIVISION —

Market Update

Economic News

August 1, 2018

As the 10-year Treasury flirts with 3.00% the FOMC concludes its two-day meeting this afternoon where they're expected to keep rates unchanged but lay the last groundwork for a September rate hike. Without a press conference, and no updates to the economic and rate forecast, the only drama is in parsing the post-meeting statement for subtle changes in thinking that may reveal shifts in future monetary policy. The focus today will be whether they remove the "policy remains accommodative" language in the statement and/or add "for now" in respect to the plan for future gradual rate hikes. There was some debate in the June minutes over whether to axe the accommodative phrase but it survived. The "for now" qualifier was added in Powell's recent Congressional testimony so it wouldn't surprise us if it get's added to today's statement as a signal the Fed could take a break from hiking at some point in the near future. We're of the opinion, however, that the "accommodative" phrase remains for now but gets axed in September when the actual rate hike occurs. In any event, we'll be back this afternoon with a summary of the Fed rate decision and what it means going forward.

While the FOMC meeting is the focus of the market today, there are other central bank meetings this week that have and will hold sway over the markets. First, the Bank of Japan's rate meeting yesterday was considered more dovish than expected and that led to a rally in Japanese bonds that swept into Treasuries and carried them higher. The rumors prior to the meeting were that the Bank of Japan would begin to ratchet higher the rate peg and thus allow longer-term bond yields to continue drifting higher. Instead, while they did decide to widen the yield band on the 10-year bond from a 0.10% cap to 0.20%, they softened that stance with the addition of forward guidance declaring that "rates will remain extremely low for an extended period." Thus, don't expect the zero overnight rate policy to change anytime soon. They wrapped all this up in a lowered inflation outlook. The impact of the various moves was more dovish than market expectations and that fed into other sovereign debt markets including Treasuries.

The third central bank meeting of the week will be the Bank of England on Thursday, In that one, the expectation is that the central bank will hike rates 25bps to 0.75%. It will be the first hike since last November when the rate was lifted from 0.25% to 0.50%. While the odds of a 25bps hike on Thursday are more than 90%, the odds are also signaling that that will be the only hike in 2018. With GDP expected to hit only 1.4% this year, and CPI expected to touch 2.2%, the need to move the policy rate considerably higher just isn't there. And with Brexit negotiations, or the lack thereof, roiling in the background, the BoE is probably taking the opportunity to move a little more off 0% while it can, but getting rates anywhere close to the Fed's level just doesn't seem feasible, It's for this reason that dollar strength will likely continue.

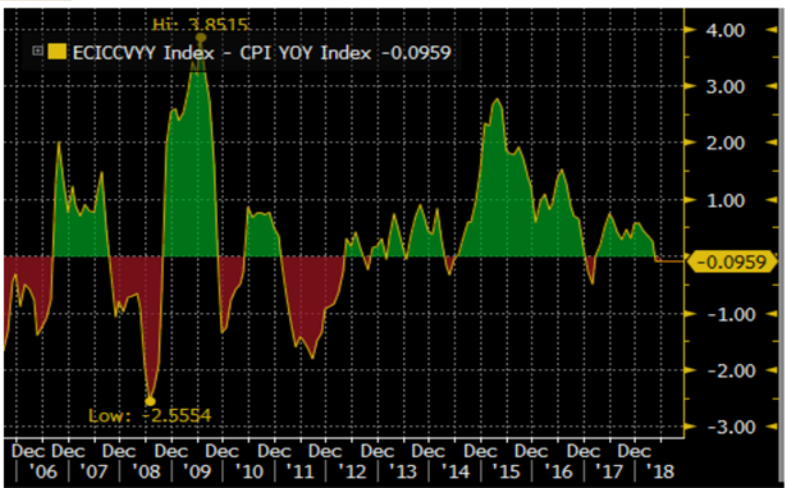
Away from central bank actions, yesterday Personal Income & Spending numbers for June were released and while last Friday's GDP report included these numbers, yesterday's report gives us a look at the momentum heading into the third quarter in addition to important inflation readings. The Fed's preferred inflation metric, core PCE, came in at +0.1% in June versus +0.2% in May, matching expectations. Year-over-year core PCE was 1.9%, unchanged from May which was downwardly revised from 2.0%. May's spending numbers were revised markedly higher (0.5% from 0.2%), and while June's spending (0.4%) was solid it didn't quite match May's. Nevertheless the report indicates spending was solid heading into the third quarter with inflation pressure modest.

Also out yesterday was the most expansive look at wage growth that we have in the form of the quarterly Employment Cost Index. In that report, total compensation rose 2.8% YoY versus 2.7% in March and 2.4% in June 2017. The quarterly increase was 0.6% missing the 0.7% expectation with the wages and salary component increasing just 0.5% in the June quarter versus 0.9% in March. Benefits, however, rose 0.9% versus 0.7% in March.

The results should also mollify the Fed that while wages and salaries are increasing they are doing so at a moderate pace, despite the 3.9% unemployment rate. That moderate rate of wage and salary gains will, if it persists, allow the Fed to remain patient in hiking. Thus, a fourth hike this year in December is still far from a given. In fact, when measuring the impact of inflation on wage gains, real wages—adjusted for inflation-were negative in the June quarter (more on that below).

Finally, the Conference Board's Consumer Confidence reading for July was released with the confidence reading touching 127.4 versus 127.1 in June and beating the 126.0 expectation. The confidence reading has been oscillating between 125 and 130 for most of 2018 but while that measure has plateaued, the consumer expectations reading continues to move lower. The measure peaked in March 2017 at 112 and has vacillated between 100 and 110 since then. The latest reading of 101.7 continues the trend of a slow decline in consumer expectations. Perhaps the constant dust-ups over trade and tariffs combined with modest wage growth is denting consumer expectations. We've often said, as it pertains to the consumer, watch what they do not what they say, it does make the future personal spending/retail sales numbers of real interest as we determine whether those lower expectations are manifested in reduced spending.

Real Employment Cost Index



The quarterly Employment Cost Index is the broadest measure of wage, salary and benefit costs in the U.S. and in the June quarter employment costs accelerated from a year ago by the most of this economic expansion on a nominal basis, clocking in 2.8% YoY versus 2.7% in the first quarter and 2.4% in June 2017. But when adjusted for inflation, the growth disappears, While the 2.8% YoY gain was notable, when offset against the latest CPI of 2.9% YoY, real annual compensation was actually negative for the last quarter. In any event, while employment costs are increasing the gains are modest and certainly reasonable in the context of more rapidly rising inflation.

Agency Indications— FNMA/FHLMC Callable

Maturity (yrs)	2 Year	3 Year	4 Year	5 Year	10 Year	15 Year
0.25	2.67	2.94	3.15	3.31	3.78	4.01
0.50	2.70	2.97	3.16	3.31	3.74	4.00
1.00	2.69	2.93	3.12	3.23	3.68	3.94
2.00	-	2.86	3.04	3.20	3.67	3.83
3.00	-	-	-	-	3.56	3.73
4.00	-	-	-	-	3.45	3.65
5.00	-	-	-	-	3.34	3.57
10.00	-	-	-	-	-	NA