Market Update

Economic News

January 18, 2019

The news yesterday that the U.S. is weighing rolling back China tariffs in an attempt to calm markets was greeted by stocks trading higher but the luster wore off some when key administration officials denied any such deal was in the works. While the truth probably lies somewhere in between the risk-on tone prevailed, and that had Treasuries on the defensive but holding their ground. Most maturities on the yield curve traded lower in price but stayed in well-defined yield ranges that have held since early this year. This morning, the 10-year note is yielding 2.75% which is near the top of the 2.70% -2.75% range that has prevailed since January 7th. If the trade tariff news moves from rumor to reality those yield ranges will get tested to the upside, but with the government shutdown continuing, a larger move higher is probably not in the cards right now as the headwinds from political dysfunction here and overseas (read Brexit) continue unabated. In any event, below we spend more time looking at various scenarios this year for the Fed and the economy, and what that might mean for yields and the shape of the curve.

This week we've missed both December retails sales numbers along with housing starts and permits as the government shutdown trudges into day 28 with no indication the impasse will be broken anytime soon. As we miss yet another important economic release it's also becoming more concerning as to how much the shutdown is costing the economy.

Initially, the White House said the cost estimate was approximately 0.1% of GDP for every two weeks of the shutdown. They then revised that estimate to include contractors and an additional cost for the impact to secondary businesses and services. That moved the estimate to 0.3% to 0.5% for every two weeks. Given that higher estimate, and four weeks into the shutdown, we could be closing in on a 1.0% cut in first quarter GDP. Last year's fourth quarter GDP was most likely around 2.6% while the latest Bloomberg consensus estimate for first quarter GDP is 2.2% and that will likely be adjusted lower. The equity market has taken the approach so far that any dip in first quarter GDP will be recouped in the second as deferred demand is unleashed once the government reopens and back pay hits federal employee bank accounts. The longer this drags on, however, the worry builds that some permanent damage to confidence and potential economic output may limit the rebound. That won't become apparent until we get there, but it is a nagging risk and one that grows the longer the shutdown lasts.

With a shortage of economic releases, and the shutdown impasse firmly in place, we thought we would highlight BMO Capital Markets three possible economic scenarios and the Fed and rate reaction that may result. The first scenario is the most pessimistic as it becomes apparent that the cumulative impact of the nine hikes to date and quantitative tightening have inflicted more restraint on the economy than previously believed. Combined with global growth struggles this leads to a material slowdown in economic activity and consumer and business confidence. With consumer spending ebbing, business investment slows as well while the continuing trade war machinations work to slow global growth. While a recession may be avoided in this scenario it's a touch-and-go affair and one that causes both consumers and businesses to tighten their purse strings. This scenario is likely to see long-end rates rally on the deteriorating growth outlook but eventually a bull steepening develops as the Fed begins easing to combat the slowing economy and the front-end of the curve follows the fed funds rate lower.

The second scenario is the goldilocks scenario that has the expected Fed pause providing enough residual monetary stimulus to keep growth on track but not too strong to stir inflationary forces. This scenario also assumes a speedy resolution to the trade war that allows global growth prospects to regain their footing. This scenario is likely to see longer-term rates rise on the prospect that continued labor market gains will lead to higher wages and an increase in demand-driven inflation. The front-end of the curve meanwhile will be tethered to the Fed's promise to pause and the seeming willingness to let inflation build more than previously thought. This yield curve steepening is likely temporary, however, as the Fed's pause ends and results in the Fed getting to 3.0%, or so, in order to quell the stirring inflationary forces.

The third scenario is a little less pessimistic than the first but not goldilocks like the second. In this hypothetical, the Fed pauses as global growth prospects continue to dim and that feeds back into domestic markets with continued bouts of volatility that tightens financial conditions. The domestic economy slows noticeably but continues to grow nonetheless. The continued job growth feeds into wage gains that leads to some demand-driven inflation. That contributes to a bear steepening curve with higher long-term rates on the inflationary impulse. Because of the flatter growth profile the Fed pause is longer than the goldilocks scenario but eventually the Fed resumes hiking on increasing inflation momentum. As a consequence the Fed hikes more times than the other scenarios in order to counteract the greater inflationary forces.

Given our preternaturally pessimistic persuasion we're inclined to give more weight to the first scenario (call it 40%) with the Goldilocks scenario and the third scenario equal at 25%. However, given the volatile nature of our political situation, and that of our closest allies (see Brexit), another heretofore unknown scenario is also possible and we'll assign that a 10% probability.

Consumer Confidence Takes a Shutdown-Induced Hit

With two-thirds of the economy tied to consumer consumption gauging the confidence of said consumers can be a look into their future purchasing proclivities. This month they were the most downbeat on the economy since November 2016, a third straight monthly drop after reaching a 16-year high just three months earlier. The Bloomberg Consumer Comfort Index's monthly expectations gauge dipped to 44.5 in January as more respondents said the economy is getting worse. The government shutdown was mentioned by an increasing number of respondents as a factor in their dimming outlook.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	2.40%	-0.02%	1 Mo LIBOR	2.51%	-0.01%	FF Target Rate	2.25%-2.50%	3 Year	2.695%
6 Month	2.49%	-0.01%	3 Mo LIBOR	2.78%	-0.02%	Prime Rate	5.50%	5 Year	2.681%
2 Year	2.58%	+0.04%	6 Mo LIBOR	2.86%	-0.01%	IOER	2.40%	10 Year	2.792%
10 Year	2.75%	+0.05%	12 Mo LIBOR	3.03%	-0.01%				