CenterState
— CORRESPONDENT DIVISION —

Market Update

Economic News

February 22, 2019

The government shutdown caused a bit of a data blackout but the backlog of reports is beginning to trickle out, and for most of yesterday's releases they paint a picture of an economy if not faltering at least taking a pause. The Philly Fed Business Outlook took a dive in February to the lowest level in nearly three years. December durable goods orders ex-transportation missed expectations while capital goods orders were negative for the fourth month out of the last five. Finally, existing home sales for January disappointed with the lowest sales in over three years, but there is perhaps a silver lining to the last report. The 2.8% year-over-year median price change is finally below the 3.2% year-over-year wage gains. Coupled with the recent 51bps drop in mortgage rates (30yr rates peaked at 5.17% in November versus 4.66% now), housing affordability appears poised to improve. That may bode well for the spring selling season but for now the slowdown that began last year definitely continued into January.

Apart from yesterday's economic data dump the other big item of note this week was the minutes from the January FOMC meeting. Now reading Fed minutes can truly be a mind-numbing exercise, but we do this so you won't have to. If one can stay focused through the subtlety, however, they do provide some nuggets of useful information. In reading the minutes it's always important to remember each word and punctuation is placed there after great deliberation. Fed minutes can be many things but it most assuredly is not a document assembled in a slapdash, careless manner.

There are four takeaways we found most interesting in the minutes. First, even with all the talk of "patience" and concern for softening global economies, and ongoing geo-political issues, the Fed is still ever-so-slightly biased towards hiking at some point in the future. Second, the balance sheet unwind could be ending sooner rather than later, perhaps by the end of this year. Third, the dot plots are going to be a thorn in the side of the Fed this year as they are likely to continue reflecting a tightening trend if the current format/construct is retained, despite the professed patient policy stance. Fourth, members appear divided as to what it will take to hike rates which will keep the reaction function cloudy.

Addressing each of those points in more detail, the minutes tried to provide a basis for why the Fed tightened in December but adopted a much more dovish attitude in January. While participants were generally upbeat about the economy, most felt their next growth projections for 2019 would be dialed back from the December outlook. Recall that the December forecast for 2019 GDP growth was 2.3%. The minutes revealed several participants now expected 2019 growth to be closer to the longer-run rate of 1.8-2.0%. The lack of a pick-up in business investment was cited as a key component to that growth adjustment. Despite the dialing back of growth expectations, discussions of the future rate path focused more on what it would take to hike again—inflation increasing, and/or growth surprising to the upside. There was no talk of what it would take to cut rates. Thus, despite the downward growth adjustments, ongoing concerns with trade, Brexit, and the global slowdown story, a majority of Fed participants expressed confidence that the economy would handle the headwinds rather than succumb to them.

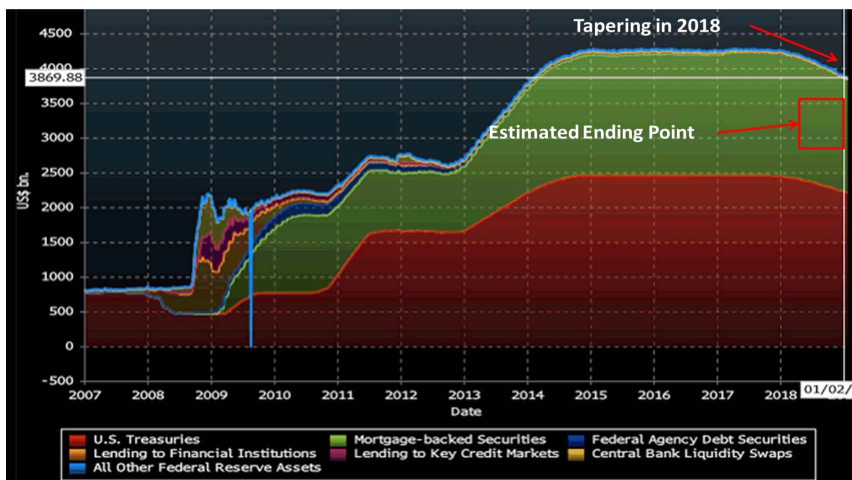
As for the balance sheet, the Fed is likely to announce as early as the March meeting a plan to end the tapering perhaps by year-end. The current $50 billion/month pace of unwind is likely to put the balance sheet at $3.5 trillion by year-end.

Given the post-crisis rise in currency-in-circulation, the preference/need for the biggest banks to hold larger amounts of excess reserves, and the Fed's stated preference to err on the side of having ample reserves available, a $3.5 trillion balance sheet may be where the quantitative tightening ends. They also stated a preference to hold only Treasuries at some point. Thus, as MBS prepayments/maturities are received it's likely those will be reinvested in Treasuries as necessary.

The third takeaway from the minutes is that the Fed will be wrestling with the dot plots this year. The minutes spent a fair amount of time describing that the dot plots are each participants' outlook on the appropriate fed funds rate for each year if the economic forecast unfolds as expected. The median rate is merely a numerical result, not the Fed's consensus forecast as the market has adopted it to be. There was some discussion of revising the format of the dot plots but that's not likely to happen before the March meeting when we'll get refreshed rate and economic forecasts. Despite trying to communicate the above points about the dot plots if the March median reveals further rate hikes, which will probably be the case given the current format, the short-end is likely to come under pressure if the Fed can't message it adequately. Expect more discussions about altering the format of the dot plot now that we are at, or near, a neutral fed funds rate.

Finally, the Fed seems truly divided as to what would be the catalyst for additional rate hikes. "Several" participants noted that rate hikes would only be appropriate if "inflation outcomes were higher than in their baseline outlook." Meanwhile, "several" others noted that "if the economy evolved as they expected, that would be sufficient to raise rates." There wasn't mention of what it would take to cut rates, so the bias to tighten remains, even with the current patient stance. With a fed funds futures market pricing in no change for this year, the tightening bias may work to keep pressure on the short-end.

Fed's Balance Sheet Tapering— Almost Done?



The January FOMC minutes left the impression the Fed will finish balance sheet tapering as early as year-end. While we're unconvinced that the modest tapering done to date contributed to either higher rates, or year-end market volatility, the fact the balance sheet is likely to be held around $3.0-$3.5 trillion will put that matter to rest, which we applaud. The MBS portfolio (shown in green) will be allowed to taper slowly via prepays/maturities. The Fed seems to prefer, however, that any MBS cash flow be reinvested in Treasuries. Given the slow nature of the repayment we don't expect that to weigh on mortgage spreads to any great extent.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime/MM	Rate	Swap Rates	Rate
3 Month	2.44%	+0.02%	1 Mo LIBOR	2.48%	-0.01%	FF Target Rate	2.25%-2.50%	3 Year	2.556%
6 Month	2.50%	UNCH	3 Mo LIBOR	2.66%	-0.02%	Prime Rate	5.50%	5 Year	2.543%
2 Year	2.50%	-0.01%	6 Mo LIBOR	2.69%	-0.05%	IOER	2.40%	10 Year	2.671%
10 Year	2.66%	-0.02%	12 Mo LIBOR	2.87%	-0.05%	SOFR	2.39%		