CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

May 17, 2019

With the stalled U.S./China trade negotiations moving into a more testy war-of-words some concern has been expressed about whether the Chinese would get to the point in a tit-for-tat exchange of liquidating all or part of its holdings of Treasury securities. The question becomes if they did that what would that do to the Treasury market in general and to yields more specifically? We address that question in more detail below. In the meantime, Treasuries are back in rally mode this morning off another round of China trade-related rhetoric. Chinese state media reported that, "China is not interested in talking with the U.S. for now", and that has created another risk-off mood and Treasuries are once again testing lows from earlier in the week. The 10-year yield is at 2.37% this morning after touching 2.35% yesterday before finishing at 2.40%. The 2-year yield is at 2.18% after moving from a low of 2.15% yesterday to a high of 2.21%. Those low yield levels are at, or very near, YTD lows and frankly are likely to be challenged again as the geo-political issues (trade war escalation, Middle East saber-rattling, looming E.U. elections) seem likely to force another flight-to-safety trade at some point in the near future.

As the U.S./China trade negotiations have been reduced to tit-for-tat tariffs and increasingly strident rhetoric, there's been increased discussion on the possibility of the Chinese selling off large pieces of its Treasury holdings. First, consider that China's holdings of Treasury securities and Chinese foreign reserves peaked earlier this decade, and while there has been some decline in recent years, the level of Treasuries and foreign reserves still remains high. The latest estimate has the Chinese holding $1.12 trillion in Treasuries compared to $17.6 trillion that is publicly held.

The precise composition of China's holdings is not public information, but generally foreign official holdings are skewed toward the front-end of the curve, and thus we'd assume any selling pressure would mostly impact that sector. Based on data from the Treasury Department, 21% of overall foreign official holdings (globally, not just China) are less than one year to maturity, 39% are less than two years, and 73% are five years or less. That maturity ladder probably goes against most scaremongering on the subject that implies China selling Treasuries would push longer-term yields higher.

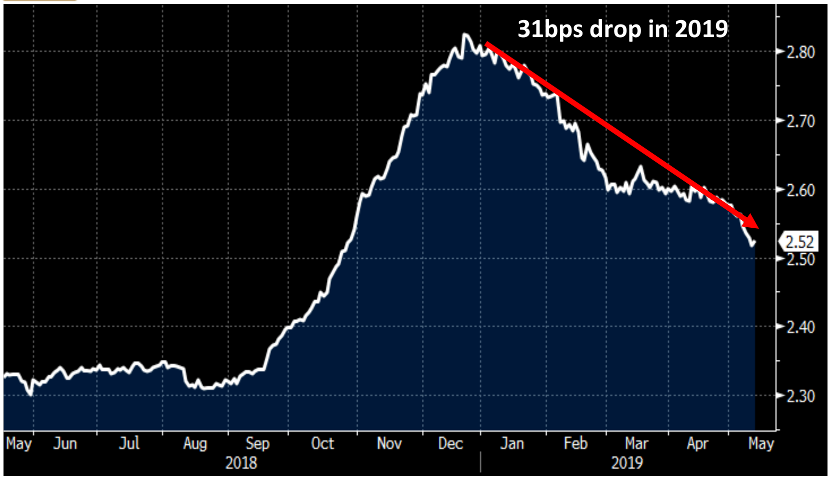
Thus, given the likelihood of the holdings being short-term in nature, selling all or part of the portfolio would likely be focused on that part of the curve. The impact of that selling, however, could be tempered as it's reasonable to expect if such selling commenced it would imply deteriorating U.S./China relations with global growth concerns heightened and that would lead to lower Treasury yields via the decreasing growth outlook. That's not to say that pockets of outsized selling pressure could increase yields at certain maturities. In addition, the heightened funding needs necessary to finance much of the Treasury purchases would likely increase repo rates, but that is a short-term effect and not a long-lasting driver of higher yields. In addition, short-term rates, like 3-month LIBOR, have been declining this year despite the Fed's holding pattern with fed funds. We discuss this in more detail below. In summary, we think any selling by China will disproportionately impact the front-end of the curve, perhaps flattening it some, but again that's likely to be overwhelmed in the longer run by concerns over global growth and what the selling tells us about U.S/China relations.

Away from the China story, the week got off to a rough start data-wise with weaker-than-expected April retail sales and industrial production. The implication of a stingy consumer and a manufacturing base retrenching off trade war-related angst and inventory overhang provided more fodder for the economy-is-weakening story. The soft import price report also piled on to the latest CPI release indicating inflation trends remained muted, at best. The news on the economic front, however, improved somewhat as the week has rolled on.

Housing starts and permits for April were better than expected and combined with Wednesday's NAHB Housing Market Index pointed clearly to a housing market appearing to bounce back after the doldrums in 2018. Starts and permits were both the strongest in three months, suggesting a brighter outlook for the sector amid lower mortgage rates and the Federal Reserve's rate-hiking patience. Starts rose in two of four regions, led by an 84.6% surge in the Northeast that was the most in almost two years. The South and West, however, saw declines of more than 5% but both areas were hit by heavy rains during the month and are likely to bounce back when the weather brightens. The NAHB Housing Market Index showed homebuilder sentiment rose to a seven-month high in May. Reports due next week are forecast to show existing home sales, which make up about 90% of the market, picked up in April while new home sales were seen easing from a one-year high.

We've been on about a possible renaissance in the residential housing market for awhile based on lower mortgage rates, higher incomes, and moderation in home price appreciation. With the latest reports, that seems to be the case and could lead to the sector being less of a drag on GDP going forward than it has been in quite some time.

3mo LIBOR Rate Continues to Fall



When the Fed moved from a rate-hiking posture to a pause the expectation was that markets would remain range-bound until the Fed started to signal an end to the pause whether it be back towards hikes or towards easing. As the graph shows, however, the LIBOR-based funding market has been declining since the Fed's last rate hike in December. From a high of 2.83% in December it's fallen 31bps from a combination of spread compression and generally improving risk sentiment. The drop in this important funding index reduces funding costs at the margins and represents an easing in the market despite the Fed remaining at 2.25%-2.50% on the funds rate since December.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	2.38%	-0.04%	1 Mo LIBOR	2.43%	-0.05%	FF Target Rate	2.25%-2.50%	3 Year	2.160%
6 Month	2.41%	-0.04%	3 Mo LIBOR	2.53%	-0.05%	Prime Rate	5.50%	5 Year	2.156%
2 Year	2.17%	-0.11%	6 Mo LIBOR	2.55%	-0.06%	IOER	2.35%	10 Year	2.318%
10 Year	2.37%	-0.10%	12 Mo LIBOR	2.63%	-0.08%	SOFR	2.43%		