CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

August 9, 2019

The July PPI numbers are out this morning and are mostly inline to below expectations, providing yet another signal of slowing global growth; in fact, the core number printed negative (-0.1%) for the first time in two years. The PPI numbers, however, are merely an appetizer until the more interesting CPI numbers are released next Tuesday. If the dust settles some over the trade/currency wars the CPI report may hold some significance to trading direction, but it seems the character of the market has changed this week to a clear focus on global growth concerns along with an eye to the daily currency fix in China. And if central banks far and wide are cutting rates that certainly says something about the direction of global growth, and currencies. As to China specifically, if officials keep the yuan around 7 to the dollar (currently it's 7.05), and no new trade shots are fired from the U.S. side then CPI might matter. But that brings up another matter and that is truly consequential economic releases aren't due until the first week of September so market direction for the remainder of August will look like this week, driven by trade and currency headlines. We explore those issues in more detail below.

The dichotomy between a domestic economy that seems to be running on most cylinders and a bond market that is racing to all-time low yields has created a lot of consternation among our clients. We view this difference in markets as follows: the bond market sees a slowing global economy with central banks fighting that slowdown with rate cuts. Those same investors also see nearly $15 trillion in negative-yielding debt across the globe so they are right to be skeptical that even lower yields will be the magical elixir to slowing growth. Meanwhile, the stock market is more focused on the somewhat insulated U.S. economy and a consumer that seems to be confident and flush with cash. The $64,000 question is if the global slowdown proves intractable to rate cuts will U.S. growth continue to remain immune?

Recent economic releases have been ok but signs of slowing momentum are appearing. The ISM Manufacturing Index has been declining since September and most recently has been flirting with contraction. Perhaps that's not surprising given global manufacturing PMI readings have gone deeply into contractionary territory off the back of slowing global growth and the impact of tariffs. The offset to that concern is that the U.S. economy is only around 10-11% manufacturing-based. The decline, however, does point to two things: (1) the trade war is not bringing manufacturing jobs back to the U.S., at least not yet, and (2) the much larger services sector is starting to show signs of slowing momentum if not weakening. That second point is made relevant by the ISM Non-Manufacturing survey having fallen for two straight months with the July index dipping from 55.1 to 53.7, missing expectations. Most of the indicators within the index were off as well, particularly the hiring component. Thus, while the services sector has held up better than manufacturing, it too has started to weaken, albeit just recently. While two months may not make a trend it is something to keep an eye on.

If the dust is allowed to settle on the trade/currency front, and economic releases like August jobs and the ISMs in early September don't show material deterioration then some increase in yields seems possible. Any back-up could be aided too by seasonality factors that point to the fourth quarter as a bearish period for bonds. That seasonality, however, may be challenged a bit more this year.

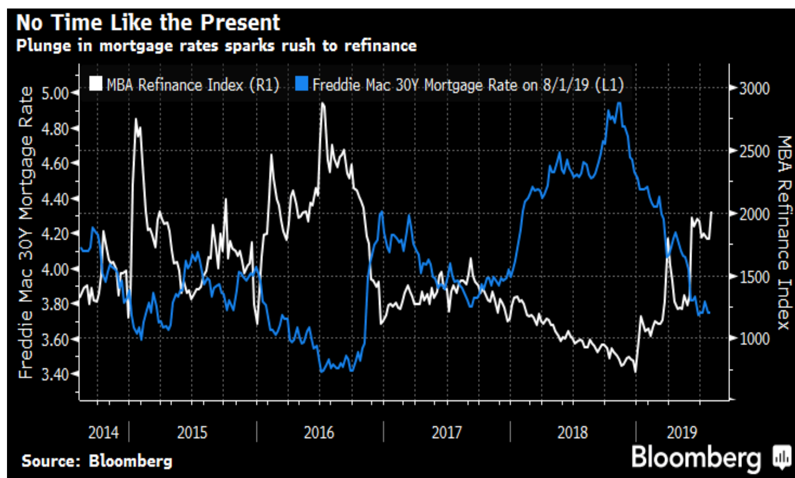
Five of the last seven years have seen bond yields rise in the fourth quarter as optimism for the new year pushed equities and bond yields higher. Will that be the case this year? Well, we don't have a tax cut stimulus to hang our hats on and a meaningful trade deal with China seems like a distant dream at this point. Add in the ongoing uncertainties of Brexit, a stumbling Eurozone and Japan, and what appears to all eyes will be a bruising election season and it seems optimism for 2020 may be hard to find.

Add in other geopolitical concerns like the increasing Hong Kong protests, provocative North Korean missile tests, and Iranian tensions and it certainly seems there are plenty of things that can and likely will lead to flight-to-safety trades in Treasuries. Thus, we don't see the atmosphere this year for a lengthy and material back-up in yields.

Also helping support yields is the notion that third quarter GDP is likely to be a sub-2% number with the consumer having to once again carry the day given the increasing uncertainty in the business community over tariff and currency issues. It does seem at some point the consumer may pause the spending splurge what with all the above issues swirling and that will embolden Treasury traders even more.

So while Treasuries have been rallying to levels approaching all-time lows, even with some easing in near-term tensions over the trade/currency issues, we don't see the elements to spur a big back-up in rates. A current range for the 10-year is probably around 1.60% - 1.86% but ultimately we see any back-ups as an opportunity to put funds to work before the next headline event, be it further signs of global slowing, another currency move by the Chinese, or another tariff/trade move that spawns another flight-to-safety trade in Treasuries.

Lower Mortgage Rates Point to Increased Refi's



With the latest rally in Treasury yields, mortgage rates are nearing 2016 lows and that will lead to another surge in refinancing activity and increased prepayments for mortgage bondholders. As the chart illustrates, 30-yr mortgage rates (blue line) have been declining since December and refinancing activity (white line) has been increasing. The rally this week should only accelerate the year-long trend. As the graph also shows, mortgages originated in 2018 are particularly susceptible to refinancing given the more than 100bps drop in mortgage rates during the past year. Keep that in mind when considering an MBS investment, or when monitoring your existing holdings.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	2.00%	-0.06%	1 Mo LIBOR	2.21%	-0.03%	FF Target Rate	2.00%-2.25%	3 Year	1.500%
6 Month	1.94%	-0.07%	3 Mo LIBOR	2.18%	-0.09%	Prime Rate	5.25%	5 Year	1.460%
2 Year	1.60%	-0.14%	6 Mo LIBOR	2.05%	-0.16%	IOER	2.10%	10 Year	1.580%
10 Year	1.70%	-0.18%	12 Mo LIBOR	1.98%	-0.21%	SOFR	2.09%		