CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

July 24, 2019

The FOMC rate decision is one week away and while odds still sit at 75% for a 25bps rate cut with 25% holding out hope for a 50bps rate cut, one would think the market would be marking time until the meeting. That observation, however, would be incorrect as the market is contending with several cross-currents (borrowing a phrase from Fed Chair Powell), and those currents are only intensifying. We go into more detail below on those issues, and the likely impact on rates, but in the meantime we also await new home sales later this morning with a pick-up in sales expected versus a somewhat disappointing May print. Existing home sales for June were released yesterday and disappointed against both expectations and May activity pushing further out the hoped-for rebound. The lack of a sustainable bounce in housing is yet another reason we expect the Fed to be in a rate-cutting mode next Wednesday.

With the FOMC rate decision one week away you could be excused for thinking the market will be marking time until the expected 25bps rate cut, but, in fact, there are plenty of cross-currents buffeting global economies that are likely to keep investors on edge. From Boris Johnson's ascension to Prime Minister of the United Kingdom, to tomorrow's ECB meeting, to the budget deal between the White House and bipartisan congressional leaders, to reported face-to-face meetings between high level Chinese and U.S. trade negotiators there are plenty of issues to keep the market's attention until next week's FOMC meeting. How that all may play out and impact yields is what we'll discuss today.

Tackling first the strictly domestic issue of the budget deal, removing the debt ceiling constraint to July 2021, and removing some of the spending constraints from the sequestration budget deal of 2011 would seem to be un unabashedly risk-on move that would pressure Treasury yields higher. Putting aside for another day the financial probity of raising spending levels when we're already facing trillion-dollar deficits in the "best economy ever", Treasuries reacted with a collective shrug. Perhaps investors are numb to deficit numbers, or perhaps they know budget deficits only matter when they matter, and right now they don't matter. While the glibness of that statement was intentional it's not meant to mask a greater truth that yields are not overly influenced by supply at this point.

Across the pond, Boris Johnson takes the reins of the U.K. government with 100 days to the October 31 Brexit deadline. Johnson thrust himself into the Brexit imbroglio by siding with the Leave campaign when it was considered a low-probability outcome. His decision was mostly a political one as he never before professed any real ideological opposition to being part of the E.U. Throwing himself into the campaign, however, he had no qualms about spreading half-truths and hyperbole on the issue, and he is credited, as much as anyone, with the resulting 52-48 vote to leave the E.U.

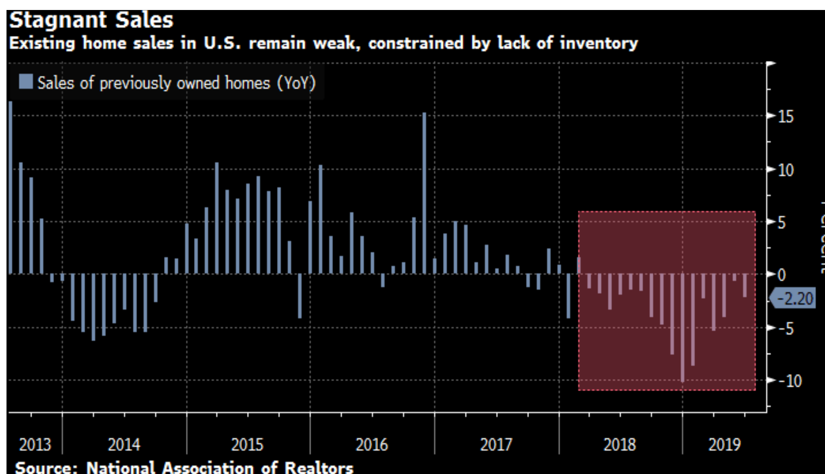
After the vote, then Prime Minister David Cameron—and a Remain proponent— resigned and the assumption was that Johnson would assume the position, but he proved spectacularly unprepared with little in the way of real ideas to effect a Brexit, and little preparation to be prime minister. In the end, the technocratic Theresa May was chosen to lead. After working doggedly over the past two years to get a Brexit deal approved in Parliament she failed and resigned as a consequence,

Enter Johnson again. While he has a history of entertaining, funny and bombastic statements, he also has a history of failing exhibit any deep understanding of policy issues. He has already stated he is prepared to get to October 31 with no deal in hand. Most analysts see a so-called hard Brexit as having recession-level impact to the economy and, thus, the Bank of England is already prepping markets that they will avoid rate hikes, and possibly move to rate cuts if the deadline approaches with no Brexit deal. While the Brexit issue has been on slow-burn for the last two years, under a more hard-line, and less diligent, Johnson the issue could be about to ignite and if it does it will provide a flight-to-safety Treasury bid.

In addition to the possible easing by the Bank of England, the ECB meets tomorrow, and while no rate change is expected, President Draghi is expected to lay the groundwork for a rate cut and/or resumption of quantitative easing in September. Thus, the ECB will very likely be in easing mode following the summer holidays, and the Bank of England will be on Brexit-fallout watch. So, with an expected 25bps rate cut in July, the FOMC may very well enter September with major cross-currents still buffeting the global economy keeping a second 25bps cut a very real possibility.

Finally, news that Trade Rep. Lighthizer is returning to China next week adds weight to the belief that movement on the trade front is approaching. The markets have become somewhat numb to the back and forth but there is expectation that a “deal” announcement is coming. When that happens expect a brief risk-on rally and Treasury selling but the limited nature of a probable deal will likely keep the market moves limited. Again, given the docile nature of yields now with rumors flying it seems the gravitational pull of 2% 10-year yields remains strong.

Existing Home Sales Continue Trending Lower



Existing home sales provide a window into 90% of the housing market and the trend in sales has been generally lower, despite the YTD 100bps drop in mortgage rates. The graph shows year-over-year changes in monthly sales dating back to 2013. As shown, housing activity has been struggling since early 2018 with limited inventory of entry-level homes continuing to hamper sales. Heading into 2019 the thought was a combination of increasing wages, moderating home price gains, and falling interest rates would spur an increase in activity. That hasn’t happened but the lack of a bounce in sales is another reason we expect the Fed will cut rates next week and follow that with a cut in September.

Agency Indications— FNMA/FHLMC Callable

Maturity (yrs)	2 Year	3 Year	4 Year	5 Year	10 Year	15 Year
0.25	2.20	2.28	2.36	2.47	2.79	3.01
0.50	2.12	2.19	2.28	2.37	2.71	2.95
1.00	1.95	2.06	2.14	2.23	2.61	2.85
2.00	-	1.81	1.92	2.01	2.47	2.68
3.00	-	-	-	-	2.34	2.59
4.00	-	-	-	-	2.23	2.52
5.00	-	-	-	-	2.14	2.46
10.00	-	-	-	-	-	NA