CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

January 8, 2020

The early reports of a retaliatory missile strike by Iran on Iraqi military bases housing U.S. troops last night initially sent yields lower as thoughts of a widening crisis erupted. Initially, the 10-year Treasury rallied 12bps hitting a low of 1.70%, the lowest since early November. However, when reports started filtering out that no U.S. casualties were suffered the 10-year Treasury reversed course and is currently yielding 1.82%, unchanged from yesterday's close. While the limited (and perhaps telegraphed?) Iranian response offers what appears to be an off-ramp to further hostilities, tensions remain and that will limit yield back-ups that might otherwise imminent from a decent round of recent economic releases. For instance, yesterday's ISM Non-Manufacturing Report found continued strength in the services sector despite ongoing manufacturing weakness. Also beckoning investors attention, the December jobs report is due on Friday, and this morning's ADP Employment Change Report found 202.000 private sector jobs, easily beating the 167,000 expected. The BLS jobs report on Friday is expected to show 160,000 new jobs versus November's surprisingly strong 266,000 new jobs. While the December print is forecast to be down from November, the full panoply of numbers within the report are expected to signal continued strength in the labor market. Thus, if it wasn't for the increased geopolitical tensions yields would likely be higher. For more on the latest economic releases and our first-half 2020 rate outlook read on below.

- A rebound in sales and production lifted the ISM's gauge of U.S. services activity in December to 55.0, a four-month high, indicating the broader economy remains stable in the face of further deterioration in manufacturing. The improvement in non-manufacturing, or services, contrasts with the ISM's most-recent factory index, which contracted for a fifth month and posted the lowest reading since mid-2009. Nonetheless, service-related businesses constitute nearly 90% of the economy and as long as that sector performs it should keep the broader economy expanding. The question remains, however, if the manufacturing downdraft continues, how long can the services sector continue to stand strong?

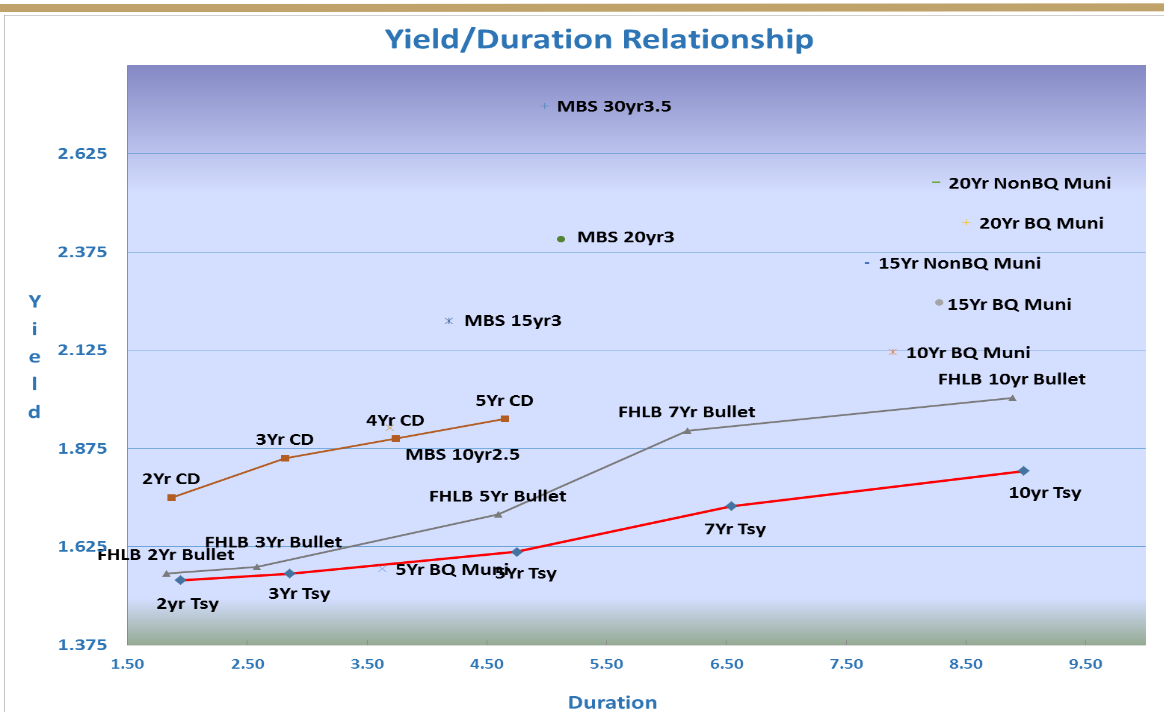
- Meanwhile, the trade deficit narrowed to $43.1 billion in November from $46.9 billion in October but that narrowing will likely be short-lived. A big part of the decline was a dip in imports but the inventory cycle is temporarily distorting those import flows which should reverse. Imports declined 1% in November following a 1.7% drop in October. On a year-over-year basis, imports fell 3.8%, while exports rose 0.3%. The trend in both has decelerated considerably since 2018; import growth peaked at 10.0% in September 2018, while that of exports peaked at 11.0% in May. The decline in imports was exacerbated by businesses liquidating inventories to better align lower demand with the existing stock of unsold goods but with consumer demand still decent, a modest uptick in imports appears likely once the inventory correction is completed. However, the year-over-year decline does point to global trade uncertainties as well as moderating demand.

- In another sign of the flagging fortunes of Boeing, factory orders for November declined –0.7% versus a gain of 0.2% in October, which was revised down from 0.3%. Ex-transportation, however, new orders rose 0.3% in November matching the gain in October. That ex-transport number speaks to the impact Boeing's troubles with the 737 Max are having on overall orders.

2020 First-Half Rate Outlook

In December, the front end of the Treasury curve (0-2yrs) continued its stability as the mid-month FOMC meeting forecast no change in the fed funds rate for all of 2020. That near as-expected outlook led to minimal volatility in short-end yields with the 2-year note yielding right on top of the effective fed funds rate of 1.55%. While we aren't convinced the Fed can go all year without altering rates, we do expect them to be on hold through the first half of 2020. Consensus GDP forecasts for this year are currently at 1.8%, while the Fed expects 2.0% GDP with 1.9% core inflation. With this modest growth and inflation outlook we see short-end yields holding pat during the first half of 2020.

The long-end of the Treasury curve (5yr-30yr) experienced more volatility in November and December but the back-up in yields as a result of the announced US/China trade deal, and typical year-end optimism, failed to breach support levels (1.97%-2.00%) that have held for two months. That being said, because of the aforementioned limited growth and inflation expectations we think yields remain range bound, especially with safe-haven trades inspired from increased Middle East tensions helping to cap upward yield moves. Thus, we would look to take advantage of any spike in yields and invest in longer duration plays, be it MBS or tax-free municipals.



Agency Indications— FNMA/FHLMC Callable

Maturity (yrs)	2 Year	3 Year	4 Year	5 Year	10 Year	15 Year
0.25	1.72	1.85	1.96	2.06	2.52	2.78
0.50	1.67	1.79	1.91	2.02	2.43	2.71
1.00	1.57	1.70	1.83	1.93	2.32	2.61
2.00	-	1.53	1.67	1.77	2.22	2.44
3.00	-	-	-	-	2.09	2.34
4.00	-	-	-	-	2.00	2.26
5.00	-	-	-	-	1.90	2.20
10.00	-	-	-	-	-	NA