FFTW Weekly Commentary

FOR PROFESSIONAL INVESTORS

Up, Up, and... Aground?

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Key takeaways

- The Federal Open Market Committee voted on Wednesday to raise the Federal Funds rate for only the third time since 2008.
- Inflation and economic growth appear to be hovering around 2 percent.
- The slowdown in growth may be driven by structural factors including demographics and geographic mobility.
- If inflation does not materialize, interest rates will likely hover around their current levels.

Full commentary

Last Wednesday, the Federal Open Market Committee voted to raise the target range for the Federal Funds Rate by 25 basis points with only one dissenting vote – that of President Kashkari, President of the Federal Reserve Bank of Minneapolis, who said that his vote was driven by a lack of change in economic data and his belief that job market slack has not been eliminated. The move, which is only the third hike since the Federal Funds rate dropped to 0.25% in December 2008, comes on the back of an improved economy, with many investors yearning for a normalization in yields. Monetary policy committee members maintained their projection that this year would see two more hikes in rates.

Even though the move has been both well anticipated and telegraphed, the dovish nature of the announcement took markets by surprise, with the belly of the curve rallying the most. The nature of the hike became abundantly clear to investors as they parsed its text, noting that inflation in Personal Consumption Expenditures remained a little under 2 percent with no indication that it would rise substantially in the near future. The yield of the 10 year note dropped by 8 basis points in a matter of minutes and the dollar traded down sharply. Stocks rallied, with the S&P 500 rallying over 60 basis points immediately after the announcement, and the NASDAQ composite rallying close to 70 basis points before they both gave up some of their earlier gains.

It is worth noting that inflation came close to hitting its 2 percent target largely on the back of earlier increases in the price of oil, which have now dropped about 10% from their levels in early March, and it remains to be seen if the target will be met or missed at the next meeting. Chair Yellen added that evidence suggests that the neutral real Federal Funds rate may now be close to zero on account of slowing population growth and slowing productivity growth, implying that the Federal Funds rate may be bounded above by 3 percent.

It is perhaps too soon to say definitively that the economy has undergone a structural slowdown, but circumstantial evidence to this effect keeps piling up – the fraction of the population that relocates to another state in any year has declined as housing prices in high productivity cities on both coasts make it hard for residents from lower productivity areas to move there in search of jobs, and much of the migration tends to be vertical – primarily along the coastlines. In addition, there has been a decline in an important measure of entrepreneurial activity - the number of jobs created by establishments less than one year old has declined from its peak of nearly 5 million in 1999 to a little over 3 million in 2015. Even though Silicon Valley shows no sign of letting up in its pace of innovation, it has never dominated the number of new jobs created in the US. On the contrary, it has, over time, been as important to start restaurants that cater to hungry programmers as it is has been for well-fed programmers to start new software companies.

While each of these factors taken in isolation does not paint a gloomy picture of the economy, taken in combination, they suggest that it will be hard to substantially raise economic growth much beyond the 2 to 2.5 percent level that it currently seems to hover around (the New York Fed's GDP Nowcast model is currently projecting growth of 2.8% for the first quarter of 2017 and 2.5% for the second quarter). This, in turn, suggests that interest rates will not rise much more, but will remain range bound.

This week's market developments

Monday, March 13

- Japan Tertiary Industry Index increased to 0.0% m.o.m. (s.a.) for January

Tuesday, March 14

- US PPI Final Demand growth decreased to 0.3% m.o.m. (s.a.) for February

Wednesday, March 15

- US Empire Manufacturing decreased to 16.4 for March
- US CPI growth decreased to 0.1% m.o.m. (s.a.) for February
- US Retail Sales Advance growth decreased to 0.1% m.o.m. (s.a.) for February

Thursday, March 16

- Eurozone CPI growth increased to 0.4% m.o.m. (s.a.) for February
- US Housing Starts increased to 1,288,000 for February

Friday, March 17

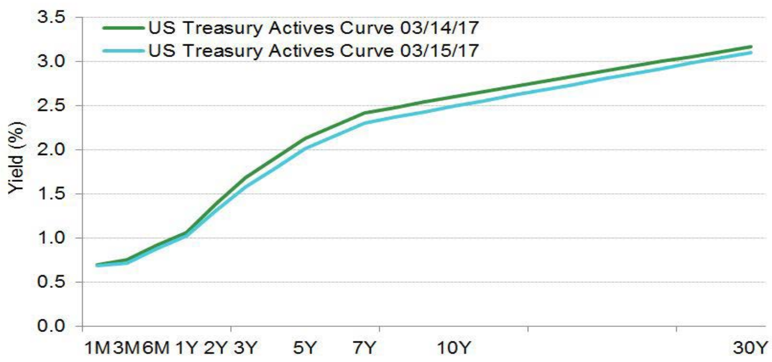
- US Industrial Production growth increased to 0.0% m.o.m. (s.a.) for February
- University of Michigan Sentiment Index (prelim estimate) increased to 97.6 for March
- US Leading Index decreased to 0.6% m.o.m. (s.a.) for February

Source: Bloomberg, as of March 20, 2017

This thinking appears to have been embedded in risk premia as well: the equity risk premium, which has declined to about 3 percent relative to the 10 year note and 2 percent relative to corporate bonds, appears vulnerable to bad news. If, for any reason, inflation surprises to the upside, markets will sell off sharply across virtually all asset classes. But if not, we appear to be headed for a period of lower volatility and diminished returns, with rates perhaps rising a bit before running aground on the shoals of low inflation, low risk premia and low growth.

Chart of the Week

US Treasury Actives Curve, March 14 & March 15, 2017



Sources: Bloomberg, as of March 15, 2017

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on June 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	December 14, 2016	0.75% - 1.00%	0.97%	May 3, 2017
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	April 27, 2017
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.06%	April 27, 2017
BoE	-25 basis points	August 4, 2016	0.25%	0.38%	May 11, 2017

Sources: Bloomberg, as of March 20, 2017

Next week's market developments

Monday, March 20

- German PPI growth is expected to decrease to 0.4% m.o.m. for February

Tuesday, March 21

- UK CPI growth is expected to increase to 0.5% m.o.m. (s.a.) for February
- UK PPI Output growth is expected to decrease to 0.3% m.o.m. for February

Wednesday, March 22

- Japan All Industry Activity Index growth is expected to increase to 0.0% m.o.m. for January
- US Existing Home Sales is expected to decrease to 5,550,000 for February

Thursday, March 23

- UK Retail Sales ex Auto & Fuel growth is expected to increase to 0.3% m.o.m. (s.a.) for February
- US New Home Sales are expected to increase to 565,000 for February

Friday, March 24

- Markit Eurozone Manufacturing PMI (prelim estimate) is expected to decrease to 55.3 for March
- Markit Eurozone Services PMI (prelim estimate) is expected to decrease to 55.3 for March
- US Durable Goods Orders growth (prelim estimate) is expected to decrease to 1.4% m.o.m. (s.a.) for February
- Markit US Manufacturing PMI (prelim estimate) is expected to increase to 54.8 for March

Source: Bloomberg, as of March 20, 2017

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