Fixed Income Weekly

FOR PROFESSIONAL INVESTORS

Headwinds for US Yields

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Key takeaways

- US yields have moved lower, the curve continues to flatten, and the recent range has been breached
- We remain cautious, despite the consensus view of higher interest rates and wider spreads following the Fed's balance sheet normalization, due to slow growth and weaker inflation
- Non-economic factors continue to influence markets and put downward pressure on yields

Full commentary

Our thoughts and prayers are with our neighbors in Texas, Louisiana, Florida, Mexico, Puerto Rico and all islands in the Caribbean for their health, safety and well-being.

Interest rates have breached the lower end of the range this week, breaking through the key support level of 2.10% on 10-year notes. There is not considerable technical support below this level so next week's economic data releases, especially inflation data, are extremely important for the near term level of yields and resetting of a range. The spread between the 2-year and 10-year US Treasury stands at 79 basis points, 20 basis points below its level at the time of the 2016 US presidential election. This is not however, indicative of confidence in the government's ability to spur growth or any structural reflation of the economy. Further elevating risk are potential policy changes coming out of this month's Federal Open Market Committee (FOMC) meeting, ongoing geo-political risk, and the still not fully realized impact of the devastating weather in the southern US.

The FOMC is expected to implement their balance sheet normalization process. The consensus view is that the impact from this should lead to higher interest rates, a steeper curve, and a general loosening in spreads over time. Given the Fed's desire to remove liquidity via balance sheet reduction while simultaneously containing any material pickup in realized volatility, as occurred in the 2013 taper tantrum, investors should be cautious of falling in line with the consensus. The process will, in all likelihood, take much longer than planned due to weaker growth and slower inflation, leading to prolonged lower interest rates. This also means reduced volatility across spread products, and less opportunity.

Geo-political risk also continues to exhibit downward pressure on yields. Economic growth and inflation could be much higher, but the threat of nuclear confrontation with North Korea would still mean lower yields. This weekend's reporting of Hurricane Irma took center stage, but North Korea-focused headlines should return relatively quickly. The North Korea situation is very concerning, and any US reaction to aggression must be cautious and well thought-out, considering the proximity of our allies in the region.

Hurricane Irma hit Florida this weekend and has helped to maintain pressure on yields. Initial estimates of the cost of this storm's damage have moved lower following the weekend, but the damage inflicted should not be discounted. This hurricane and the devastating Hurricane Harvey that struck Louisiana and Texas have caused extensive damage. We ultimately believe this will boost economic data in terms of a small bump to inflation data and a pickup in government and private spending on the recovery.

Last week's market developments

Monday, September 4
- Markit UK Construction PMI decreased to 51.1 for August

Tuesday, September 5
- Markit UK Services PMI decreased to 53.2 for August
- US factory orders growth decreased to -3.3% m.o.m. for July
- UK durable goods orders growth (final estimate) remained at -6.8% m.o.m. for July

Wednesday, September 6
- Germany factory orders growth decreased to -0.7% m.o.m. for July
- US ISM Non-manufacturing Composite increased to 55.3 for August

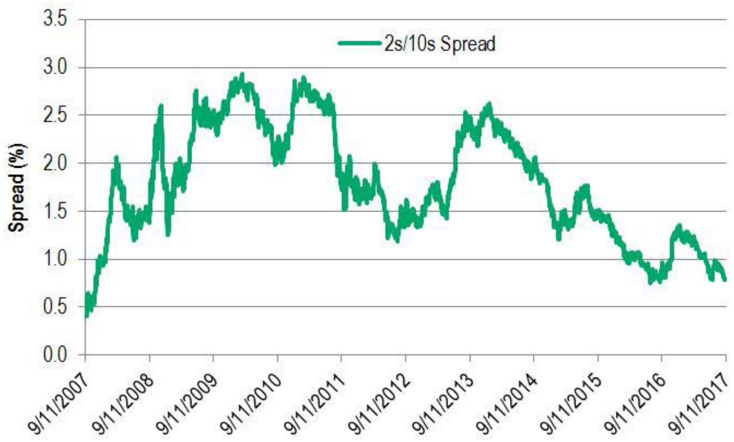
Thursday, September 7
- Germany industrial production growth increased to 0.0% m.o.m. for July
- Eurozone 2nd quarter GDP growth (second estimate) remained at 0.6% q.o.q.
- Japan 2nd quarter GDP growth (final estimate) decreased to 0.6% q.o.q.

Friday, September 8
- UK industrial production growth decreased to 0.2% m.o.m. (s.a.) for July
- UK manufacturing production growth increased to 0.5% m.o.m. (s.a.) for July

Source: Bloomberg, data as of September 11, 2017

It certainly feels as if risk markets are at an inflection point. The excess yield available to the marginal dollar of investment has been greatly diminished. The spread between risky and riskless assets is as low as it has ever been. Credit spreads are close to or tighter than they were going into the crisis. Equity prices have rallied and remain close to their all-time highs, yet interest rates have moved much lower and the yield curve has not been this flat since the crisis. The liquidity induced rally in asset prices feels as if it is at capacity, yet yields continue to move lower. We are biased to reducing risk in to the fourth quarter, as risk feels very asymmetric at this level of yields, and highly susceptible to non-economic factors.

Chart of the Week
10-year to 2-year Treasury Yield Spread



Source: Bloomberg; data as of September 11, 2017

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on September 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	June 14, 2017	1.00% - 1.25%	1.15%	September 20
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	October 26
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.06%	September 21
BoE	-25 basis points	August 4, 2016	0.25%	0.29%	September 14

Source: Bloomberg; data as of September 11, 2017

This week's market developments

Monday, September 11
- No data to report

Tuesday, September 12
- UK CPI is expected to increase to 0.5% m.o.m. n.s.a. for August
- UK Producer Price Index for manufactured products is expected to remain at 0.1% for August m.o.m.
- Japan Producer Price Index is expected to increase to 3.0% for August y.o.y.

Wednesday, September 13
- Germany CPI (final estimate) is expected to remain at 0.2% m.o.m. for August
- US Producer Price Final Demand Index is supposed to increase to 0.3% m.o.m. for August

Thursday, September 14
- US CPI is expected to increase to 0.3% m.o.m. s.a. for August

Friday, September 15
- US Empire Manufacturing Index is expected to decrease to 18.0 s.a. for September
- US Retail Sales Advance Change Index is expected to decrease to 0.1% m.o.m. for August
- US industrial production growth is expected to decrease to 0.1% m.o.m. for August
- US University of Michigan Consumer Sentiment Index (preliminary estimate) is expected to decrease to 95.0 for September

Source: Bloomberg, data as of September 11, 2017