FFTW Weekly Commentary

FOR PROFESSIONAL INVESTORS

Trumpidation

May 22, 2017

by Ken O'Donnell, CFA
Head of Short Duration
kenneth.odonnell@fftw.com

Key takeaways

- As chaos envelopes Washington, D.C., the euphoria that engulfed markets in the weeks following the election has faded.
- Three themes will likely continue to determine the path of interest rates in the medium term: US tax reform, monetary policy normalization and Federal Reserve (Fed) balance sheet reduction.
- Even though markets have been anticipating future changes, the US Fed has been operating in the present.

Full commentary

The Trump administration has become a fixture in the headlines. In the last week alone, we have experienced the controversial firing of FBI Director James Comey, the potential disclosure of classified information to Russian diplomats, and the appointment of a special counsel to investigate Russian intervention in the US election. As chaos envelopes Washington D.C., the euphoria that engulfed markets in the weeks following the election has faded. In the words of Senate Majority Leader Mitch McConnell, "…we can do with a little less drama from the White House". Looking through the latest headlines, three interconnected themes will likely continue to determine the path of interest rates in the medium term: US tax reform, monetary policy normalization and Fed balance sheet reduction.

Expectations for tax reform legislation and other pro-growth fiscal policies are quickly fading. In the weeks following the US election, fiscal stimulus was identified as the tide that would lift all boats and caution was thrown to the wind as deflationary concerns quickly abated. The broad shift in sentiment appeared to overcome the inertial forces that have constrained global growth since the great recession. Dreams collided with reality as the republican health care bill failed to garner enough support in congress to warrant a vote. While House Republicans were able to successfully pass a subsequent bill, the Senate has opted to craft their own legislation which will further extend the timeline. The failure of the republican healthcare bill has significant implications for US tax reform as revenue gains from Trump-care were expected to offset revenue losses from potential tax cuts. The Trump reflation trade has sustained a heavy blow. While market reaction was more pronounced in fixed income markets than equities, substantial momentum has been lost.

Whereas markets have been anticipating future changes, the US Fed has been operating in the present. Recent changes in monetary policy were largely in response to improvements in current labor and inflation data. Absent a major change in fiscal policy, investors expect normalization to occur at moderate pace. Market based measures suggest that Fed policy rates will peak at roughly 3.00% which is broadly consistent with the Fed projections. Forward curves are forecasting a significant reduction in the term structure as the terminal rate nears. This flattening of the yield curve has typically been interpreted as a signal of waning confidence in the economic outlook and elevated recession risk. Admittedly, market projections may change as inflation data has disappointed to the downside in recent months. Nonetheless, this wouldn't be the first time that removal of monetary policy stimulus preceded a recession.

Recent comments from Fed officials imply that the committee is keen to address the size of the balance sheet in the coming year. Fed balance sheet normalization presents new and interesting challenges for the Federal Open Market Committee (FOMC). With little data to draw on, the Fed is increasingly reliant on academic exercises to predict the market's reaction to a reduction in balance sheet reinvestment. The US Treasury will need to increase Treasury issuance following a Fed balance sheet taper as the US Treasury seeks to offset the funding gap. The market reaction to the increase in issuance will depend largely on how the US Treasury chooses to fund the shortfall. An extension of the average maturity of the Treasury market is largely seen as leading to higher interest rates and steeper yield curves.

The ebb and flow of these themes will likely dominate markets in the medium term. Continued chaos in the White House will, at best, slow the pace of legislation and depress sentiment sending yields lower as the yield curve bull-flattens and the reflation trade falters. The Fed would likely respond by slowing the pace of normalization and delaying balance sheet adjustments. Conversely, an improvement in the political climate would have the reverse effect. My bet is on "Continued Chaos", it is horse racing season after all…

This week's market developments

Monday, May 15

- US empire manufacturing decreased to -1.0 for May

Tuesday, May 16

- Japan Tertiary Industry Index growth decrease to -0.2% m.o.m. for March
- UK CPI growth increased to 0.5% m.o.m. for April
- UK Core CPI growth increased to 2.4% y.o.y. for April
- UK PPI output growth increased to 0.4% m.o.m. for April
- Eurozone 1st Quarter GDP growth remained at 0.5% q.o.q.
- US housing starts decreased to 1,172,000 for April
- US industrial production growth increased to 1.0% m.o.m.

Wednesday, May 17

- Eurozone CPI growth decreased to 0.4% m.o.m. for April
- Japan 1st Quarter GDP growth (prelim estimate) increased to 0.5% q.o.q.

Thursday, May 18

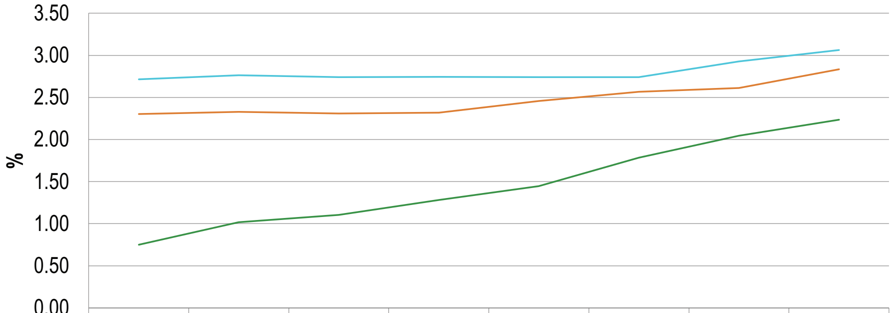
- UK retail sales growth (ex auto/fuel) increased to 2.0% m.o.m. for April
- US Leading Index growth decreased to 0.3% m.o.m. for April

Friday, May 19

- Eurozone consumer confidence (advance estimate) increased to -3.3 for May

Source: Bloomberg, as of May 22, 2017

Chart of the Week
US Treasury Forward Yield Curves



	1Mo	6Mo	1Yr	2Yr	3Yr	5Yr	7Yr	10Yr
Current YC	0.75	1.02	1.11	1.28	1.45	1.79	2.04	2.24
3y Forward	2.30	2.33	2.31	2.32	2.46	2.57	2.61	2.84
5y Forward	2.72	2.76	2.74	2.74	2.74	2.74	2.93	3.06

Source: Bloomberg, as of May 17, 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	March 15, 2017	0.75% - 1.00%	1.01%	June 14
ECB	-5 basis points	March 10, 2016	0.00%	-0.18%	June 8
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.06%	June 16
BoE	-25 basis points	August 4, 2016	0.25%	0.32%	June 15

Source: Bloomberg

Next week's market developments

Monday, May 22
- Japan All Industry Activity Index growth is expected to decrease to -0.5% m.o.m. for March

Tuesday, May 23
- Markit Eurozone manufacturing PMI (prelim estimate) is expected to decrease to 56.5 for May
- Markit Eurozone services PMI (prelim estimate) is expected to remain at 56.4 for May
- Markit US manufacturing PMI (prelim estimate) is expected to increase to 53.0 for May
- Markit US services PMI (prelim estimate) is expected to increase to 53.3 for May
- US new home sales are expected to decrease to 610,000 for April

Wednesday, May 24
- US existing home sales are expected to decrease to 5,650,000 for April

Thursday, May 25
- UK 1st quarter GDP growth (prelim estimate) is expected to remain at 0.3% q.o.q.
- Japan national CPI growth is expected to increase to 0.4% y.o.y for April

Friday, May 26
- US durable goods orders growth (prelim estimate) is expected to decrease to -1.4% m.o.m. for April

Source: Bloomberg, as of May 22, 2017