FFTW Weekly Commentary

FOR PROFESSIONAL INVESTORS

Waiting on a FriEnD…?

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Key takeaways

- Most market participants anticipate no change in the policy rate following next week's FOMC meeting
- Growth has been helped by an increase in exports and consumer spending
- New home sales have recently shown strength due to still low mortgage rates and an improving labor market
- The US dollar has firmed and reported corporate earning have surprised to the upside supporting equity valuations

Full commentary

US interest rates moved higher on the week and the yield curve steepened. US 10-year yields closed at 1.85%, the highest level since late May. The 10-year was up 11 basis points on the week with two-year yields up three basis points. Stronger economic data and a Federal Reserve (Fed) rate hike coming closer in to view were the primary drivers for the move higher in yields. Most market participants anticipate no change in the policy rate following next week's Federal Open Market Committee (FOMC) meeting but most do expect a hike at the December meeting. Across either meeting fully 85% of the market expects a rate hike before year end.

Recent US economic data support a rate hike. Today's third quarter GDP came in stronger than expected at 2.9%. That was the fastest growth rate in two years and up from the 1.4% reported in the second quarter. Growth was helped by an increase in exports and by an increase in inventories. The report showed consumer spending was also solid.

New home sales reported earlier in the week also showed some strength. Sales were up 3.1% versus August to a 593,000 annualized rate. Improving labor markets with both job and wage growth coupled with still very low mortgage rates are helping home sales. In fact recent new home sales are the highest they have been since 2007. The Case-Shiller home price index for August was also released this week and showed an increase of 5.1% versus a year ago with prices supported by stronger wages, low rates and limited housing supply.

So, much like last year, the stage is set for a Fed rate hike in December. The question is will markets face the same kind of melt down we saw last time around? Risk assets did very poorly in the weeks following the last FOMC rate hike. US equities moved down over 10% and US high yield was down over 6%. Indeed oil prices moved sharply lower in January but who expected that a well telegraphed 25 basis points hike in the Fed funds would be responsible for all that volatility?

Risk assets have since recovered that under-performance and then some. After falling more than 10%, US equities are up 4% year-to-date and the excess return for US high yield so far in 2016 is an astonishing 12.9%. 10-year yields at 1.85% are a full 40 basis points lower than they were at the start of the year. Meanwhile, measures of volatility including the MOVE index and the VIX continue to trend lower.

What this means of course is that the reward for risk taking are lower now than they have been in some time. Yield advantages for taking credit risk and duration risk are quite low. At the same time the markets see the Fed moving toward hiking the policy rate and reducing the level of unconventional policy accommodation. We hear increased chatter about the need for additional fiscal policy measures as we approach the limitations of monetary policy measures. We see potential for volatility around elections in the US where both candidates are advocating measures which will increase government spending.

In our view things are different now than they were last December when the Fed hiked with the US economy expanding and oil prices stable. The US dollar has firmed and reported corporate earnings have surprised to the upside supporting equity valuations. We seem to have made it through the historically scary month of October without an issue. But given tight valuations, low implied volatilities, and potentially market moving events on the calendar, we would exercise caution. After all it is Halloween and things should be at least a little scary!

This week's market developments

Monday, October 24

- Markit Germany Manufacturing PMI (prelim estimate) increased to 55.1 for October
- Markit Germany Services PMI (prelim estimate) increased to 54.1 for October
- Markit Eurozone Manufacturing PMI (prelim estimate) increased to 53.3 for October
- Markit Eurozone Services PMI (prelim estimate) increased to 53.5 for October
- Markit US Manufacturing PMI (prelim estimate) increased to 53.2 for October

Tuesday, October 25

- US Consumer Confidence Index decreased to 98.6 for October

Wednesday, October 26

- US Wholesale Inventories growth (prelim estimate) increased to 0.2% m.o.m. (s.a.) for September
- Markit US Services PMI (prelim estimate) increased to 54.8 for October
- US New Home Sales decreased to 593,000 for September

Thursday, October 27

- UK GDP growth (advance estimate) decreased to 0.5% q.o.q. for the 3rd Quarter
- US Durable Goods Orders (prelim estimate) decreased to -0.1% m.o.m. (s.a.) for September
- Japan National CPI growth remained at -0.5% y.o.y. for September

Friday, October 28

- Germany CPI growth (prelim estimate) increased to 0.2% m.o.m. (s.a.) for October

Source: Bloomberg, as of end October 31, 2016

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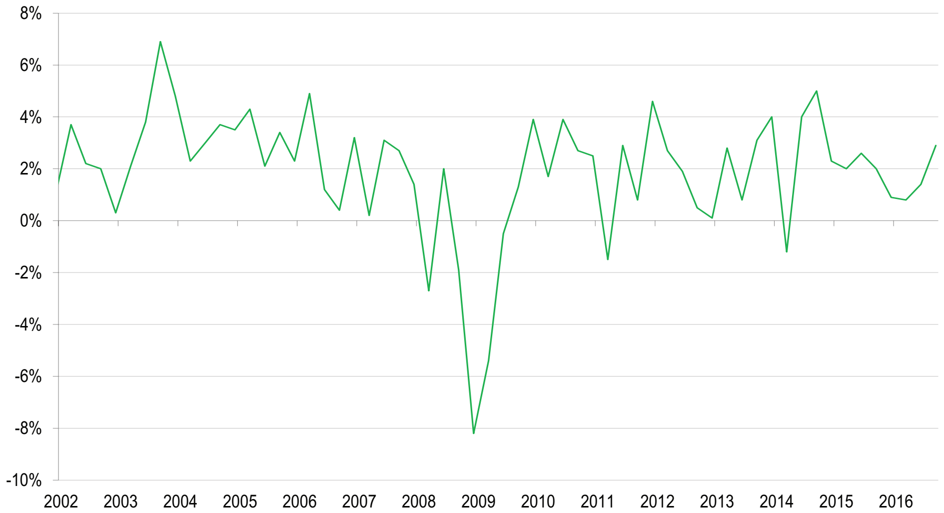
Chart of the Week
GDP US Chained 2009 Dollars Q.o.Q SAAR



Source: Bloomberg, as of September 30, 2016

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on December 2016 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.50 %	November 2, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.18 %	December 8, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.06 %	November 1, 2016
BoE	-25 basis points	August 4, 2016	0.25%	0.41 %	November 3, 2016

Source: Bloomberg

Next week's market developments

Monday, October 31
- Germany Retail Sales growth is expected to increase 0.2% m.o.m.
- UK Mortgage Approvals are expected to increase to 62,900 for September
- Eurozone GDP growth (advance estimate) is expected to remain at 0.3% q.o.q. (s.a.) for the Third Quarter
- US Personal Income growth is expected to increase to 0.4% m.o.m. (s.a.) for September
- US Personal Spending growth is expected to increase to 0.4% m.o.m. (s.a.) for September

Tuesday, November 1
- Markit UK Manufacturing PMI is expected to decrease to 54.5 for October
- US Construction Spending growth is expected to be 0.5% m.o.m. (s.a.) for September
- US ISM Manufacturing growth is expected to increase to 51.7 for October

Wednesday, November 2
- US ADP Employment Change is expected to increase to 165,000 for October

Thursday, November 3
- Markit UK Services PMI is expected to decrease to 52.5 for October
- US Factory Orders growth is expected to remain at 0.2% for September

Friday, November 4
- US Change in Nonfarm Payrolls growth is expected to increase to 175,000 for October
- US Unemployment Rate is expected to decrease to 4.9% for October

Source: Bloomberg, as of end October 31, 2016

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