INTEREST RATE OUTLOOK

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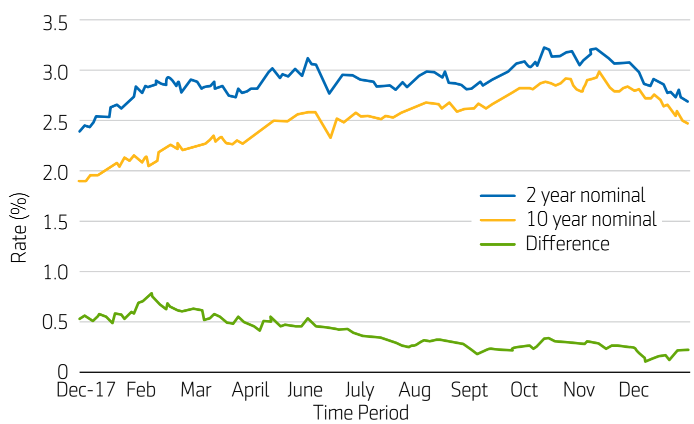
Treasury bonds rallied following the latest Fed meeting in January after the FOMC tempered its language regarding future interest rate increases, citing a healthy domestic economy, but also concerns of global economic headwinds and moderate inflation pressures. Additionally, the Fed reassured investors that it would be flexible in adjusting its policy on the Fed balance sheet, if needed. While we see the Fed slowing its projected increases, with zero or one interest rate hike in 2019, we believe the outcomes of these headwinds abroad and their effect on US economic growth may have a more compelling effect on the future of interest rates.

For much of January, Treasury yields across the curve stabilized, trading in a 20-25 basis point range. Rates were slightly lower in January, led by the belly of the curve. Five-year and seven-year rates fell the most, declining by seven basis points, while 10-year rates were five basis points lower. Two-year, three-year and 30-year yields declined slightly less, with two-year yields falling three basis points and three-year and 30-year yields falling by two basis points. This flattened the two year-10 year curve by two basis points, ending January at 16 basis points (Exhibit 1). Swap spreads were mixed, with spreads on short and long tenors tightening, and intermediate tenors widening. Two-year and 30-year swap spreads came in two basis points, while five-year spreads widened by two basis points. The dollar was weaker versus most major currencies.

Exhibit 1: Two year – 10 year Treasury yield curve



Source: US Department of the Treasury. As of February 1, 2018.

Market headwinds

While the US economy remains positive, slowing global growth, muted inflation pressures and waning benefits from the 2017 tax cut, are growing concerns. The effects of major global headwinds on US global growth remain the focus of the market and the Fed. One such event is the potential of a hard Brexit. The proposal Theresa May's government negotiated with the EU failed in Parliament, although UK PMs authorized May to re-negotiate. It remains unclear if the EU is willing to modify its existing proposal. A hard Brexit could be disastrous for the UK economy because it would make the UK the only country relying solely on World Trade Organization rules for trade with other nations. Although the UK only represents about 2% of global GDP, such an outcome could also impact Continental Europe, and potentially cause a modest headwind to US growth. We expect this to remain a secondary source of volatility in the next couple of months, with an extension to Brexit the most likely (and most positive for the markets) scenario.

Although we believe there will be a temporary reprieve to the Brexit situation in the short- to intermediate-term, the outcome of China trade talks is far more difficult to handicap. Uncertainty surrounding the US/China trade dispute is an impending concern, with the potential for the Trump administration to impose substantial tariffs on all Chinese imports by the end of March. This, combined with the potential negative impact on US growth from the tariffs put in place last year, remains the market's primary focus. We believe that the US will likely continue on a relatively more restrictionist trade agenda that reverses the multi-decade trend of trade liberalization.

From rate hikes to cuts

The Fed is also accounting for the potential impact these global risks may have on the US economy. Following the 25 basis point rate hike and reduction of its "dot plot" expectations in December, the FOMC spent most of January trying to assuage the fears of the market and refine its message to emphasize it will take a "data dependent" approach to future rate moves. A couple of Committee members went so far as to say the next move could be a rate cut, rather than a rate hike. Chairman Powell signaled an openness to changing the pace of balance sheet runoff which effectively puts everything, including the most likely scenario (doing nothing), on the table for the time being.

This culminated in the FOMC's January 30 statement and Powell's press conference where the FOMC went out of its way to officially lay to rest concerns it is on a "pre-ordained" policy path of rate hikes. The market reacted positively to this, spurring a rally in Treasuries, equities, and credit spreads. The FOMC's overt statements may not be indicative of what it will do in the future, but it did telegraph that it is not willing to play a game of chicken with the market.

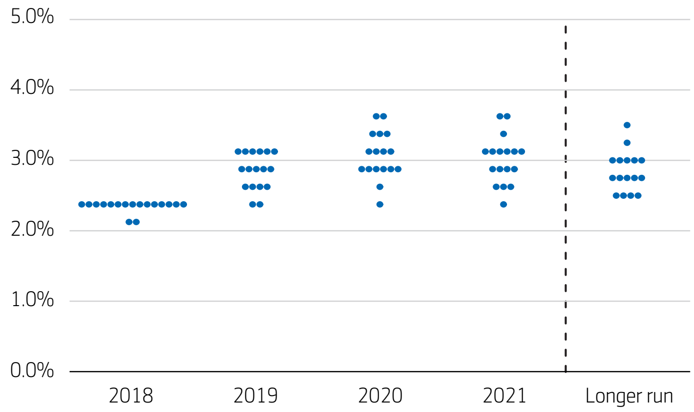
It is our belief the FOMC will do what gives it the most flexibility without whipsawing the market. In this case, its first step was a signal at the December meeting that it intended to pause. Now, it appears it is more confident in the economic data and has signaled a more protracted pause, including the possibility it could cut rates in the future. The outcomes of a number of macro variables including US/China talks, Brexit and global growth could impact this decision. It will be challenging for the FOMC to hike rates in 2019 until these issues are resolved, but even if they come to a positive resolution, the FOMC is likely to only hike rates once this year. Given our forecast is predicated on political outcomes, we see risks to our call in both directions at the present time.

Interest rate projections

With the FOMC shifting to neutral with an extended pause, we believe rate cuts are likely to occur in 2020. Despite its recent mild reprieve, US dollar valuations remain elevated, representing a modest headwind to the FOMC's ability to hike. Although the US labor market remains solid, inflation and inflation expectations remain below the Fed's target level of 2%, giving the FOMC some cover to take a break in their pace of hiking. If inflation gains strength, it will likely make the FOMC's decision on rates far more challenging.

The disparity between the market's expectations of future rate hikes and the FOMC's "dot plot" of the Committee's expectations for the level of fed funds rate remains elevated. The dot plot reflects two additional hikes in 2019, while the market is pricing in about a 50/50 probability of zero to one hike in 2019, followed by the FOMC cutting rates in 2020 and 2021 (exhibit 2). Considering the FOMC's change in tone since December, the dots are largely discounted and expected to move in a more dovish manner at the March meeting. We believe the FOMC will slow or stop its pace of rate hikes in 2019, depending on how other political events unfold. In the absence of a permanent solution on trade, we do not think the FOMC will be able to follow its new, lower projected path in 2019.

Exhibit 2: The Fed "Dot Plot"

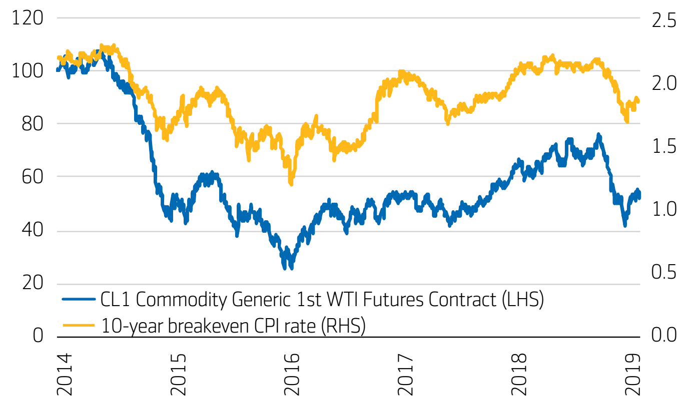


Source: The Federal Reserve. As of December 19, 2018.

Unwinding the Fed's balance sheet

Following the January meeting, the FOMC expressed openness to slowing the pace of winding down its balance sheet to reassure the markets. The tapering of its balance sheet appears to have had little direct influence on capital markets to date, however, the market is still showing signs of concern. For now, the FOMC's balance sheet runoff cap remains at $50 billion per month, although actual runoff has only been about 80% of that amount due to the slow level of MBS prepayments. We believe the easiest alternative the FOMC would be to change its official target closer to this actual runoff level later this year. With future rate cuts potentially on the horizon, the FOMC will need to articulate its end-game on balance sheet reduction, which is likely to entail some tapered reduction of portfolio runoff—roughly the inverse to how the FOMC began its balance sheet reduction. We expect the FOMC will allow mortgage-backed securities to continue to runoff, with Treasuries filling the gap. For a stable balance sheet, this implies some amount of net Treasury purchases.

Exhibit 3: Oil futures contract vs. implied 10-year breakeven CPI rate



Source: Bloomberg. As of February 7, 2019.

We expect inflation to remain a significant driver of rates over the next six to 12 months, and global sovereign rates will likely remain an anchor for Treasury yields. Inflation has ticked lower recently, and as mentioned, is now below the FOMC's 2% target. Implied inflation expectations from the TIPs market, after having dipped to 2016 levels in sympathy with the price decline of oil in December, recovered modestly in January (Exhibit 3). It is our belief that inflation will not surge higher over the coming year, which should keep longer rates from running away to the upside. To date, the Phillips curve has been relatively flat. With unemployment below 4%, the market (and the Fed) will remain vigilant for signs of an uptick in employment costs.

Our base case

We expect the US economy to continue to grow, albeit at a slower pace, pressuring rates a bit higher from here in 2019. Effects from the 2017 tax cuts are likely to continue to provide a boost to the economy, although the impetus from this boost is expected to fade. Said another way, we may have seen the apex in US economic growth for this cycle. It is, therefore, our belief that the risks to growth are skewed to the downside rather than the upside. The markets are suggesting the FOMC has limited near-term ability to raise rates and as a result, the curve is quite flat. This also implies that the market views the FOMC's projected path reflected in the dot plot as a policy mistake. Barring significant additional trade war escalations, a hard Brexit, or an FOMC policy mistake, we believe it will be very difficult for 10-year rates to break materially below 2.50% or above 3.10% in the near-term. In light of all these factors, we remain approximately neutral duration in both the near-term and intermediate-term. Longer-term, we believe the slowing economy will force the FOMC to start cutting rates, driving 10-year yields lower.

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