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The Aerial View

Fixed Income & Markets Update

When All Assets Are Rich

- **10-year yields rose 18 bps last week, largely driven by the 13 bps increase in real yields, as the market reconsiders its full-year yield assumption**
- **Traditional flight-to-quality assets did not rally on Friday with yields higher and the Yen weaker**
- **Government shutdown and debt ceiling are nagging market distractions in this and the coming weeks**

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Volatility returned with a vengeance last week, as the generally strong start of the year for risk assets was at least partially reversed for certain asset classes.

To be sure, it has been a Goldilocks start to the year, with generally rising sovereign yields largely ignored by stocks and bonds under the guise that yields were climbing for the right reasons. The thinking was that the synchronized global growth that became a predominant theme late last year was occurring without any signs of inflation. Additionally, central banks remained largely supportive, with the ECB continuing with at least some form of QE, while the Fed's message of slow and steady hikes transcended the changing of the guard at the FOMC.

While yields have been on the rise since the start of the year, the curve has been mixed as various points of the belly have generally underperformed both the short and long ends of the curve. Fed Funds Futures started the year expecting two hikes, so the firming of the odds of a third hike throughout January did not prove to be particularly onerous.

Additionally, up until recently, the long end was the outperformer on benign inflation expectations, as the curve continued to flatten with 5s30s compressing to 41 bps following the FOMC meeting last week.

USD Weakness

Some fairly large moves in FX were also mostly discounted, as the yearlong decline in the USD accelerated at the start of the year. While much of mid-to-late 2017 USD weakness was centered on EURUSD, recent weakness has been more widespread. For instance, the 10% decline in the DXY last year was mostly driven by the 15% increase in EURUSD, which led the majors and most EM currencies.

More recently, USD weakness has been far more widespread, with the 3.3% fall in DXY this year more closely mirrored by the 3.8% increase in the Euro. The acceleration of Dollar weakness since last October has also broken rate differential relationships, as a widening gap between the UST and Bunds has been negatively correlated with EUR over the last three months, after being almost perfectly correlated for the first eight months of 2017.

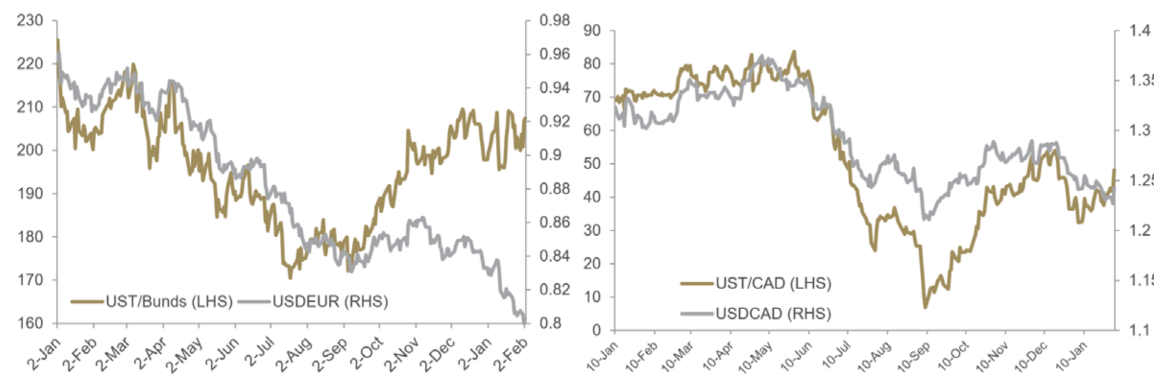
While EURUSD interest rate correlations broke down last year, yield differentials remained correlated with many other currencies. For instance, the CAD exhibited a fairly stable 90+% correlation with interest rate differentials throughout 2017. However, more recently, these relationships have also been stressed, as the Treasury/CAD correlation now stands at -30%, an even larger contra-indicator than the Euro.

Yield Differentials Now a Contra-Indicator

IR Correlations Completely Breakdown in 2018

	DXY	EUR	CAD	GBP
2015/2016	0.70	0.69	0.67	0.88
2017	0.68	0.66	0.96	0.49
2017 -Jan - Aug	0.95	0.95	0.94	0.33
2017 -Aug - Dec	0.65	0.44	0.94	0.02
2018 YTD	-0.23	-0.19	-0.28	-0.11

Source: BNY Mellon, Bloomberg



Source: Bloomberg

Risk Assets

Risk assets had been immune to these cross-currents, as US stocks continued to hit successive new all-time highs, while corporate spreads tightened despite starting the year at levels last seen in mid-2007. The Goldilocks thesis was tested last week, however, with the rise in yields breaking through some key technical levels.

While yields have been on an upswing throughout January, they didn't break through last March's post-election high until a few weeks ago, while real yields remained below their post-election high water mark. With both of these thresholds broken last week, as 10-year yields rose 18 bps largely driven by the 13 bps increase in real yields, the market is reconsidering its full-year yield assumptions.

The immediate catalyst for the rise in yields was firming inflation readings of both wage and production costs. In particular, the employment cost index matched its strongest gains since emerging from the crisis. This was followed by the highest reading of prices paid within the ISM in six years.

The monthly employment report proved the capstone for inflation concerns, as the jobs readings exceeded expectations on both the job creation and wage gains front. In absolute terms, 200,000 new jobs were created while average hourly earnings rose 2.9% on a y/y basis, their highest since collapsing in 2009. In relative terms, we have not seen a beat from both of these data points in the same month since August 2016, while wages have fallen short of expectations 75% of the time in the past two years.

Fed Policy

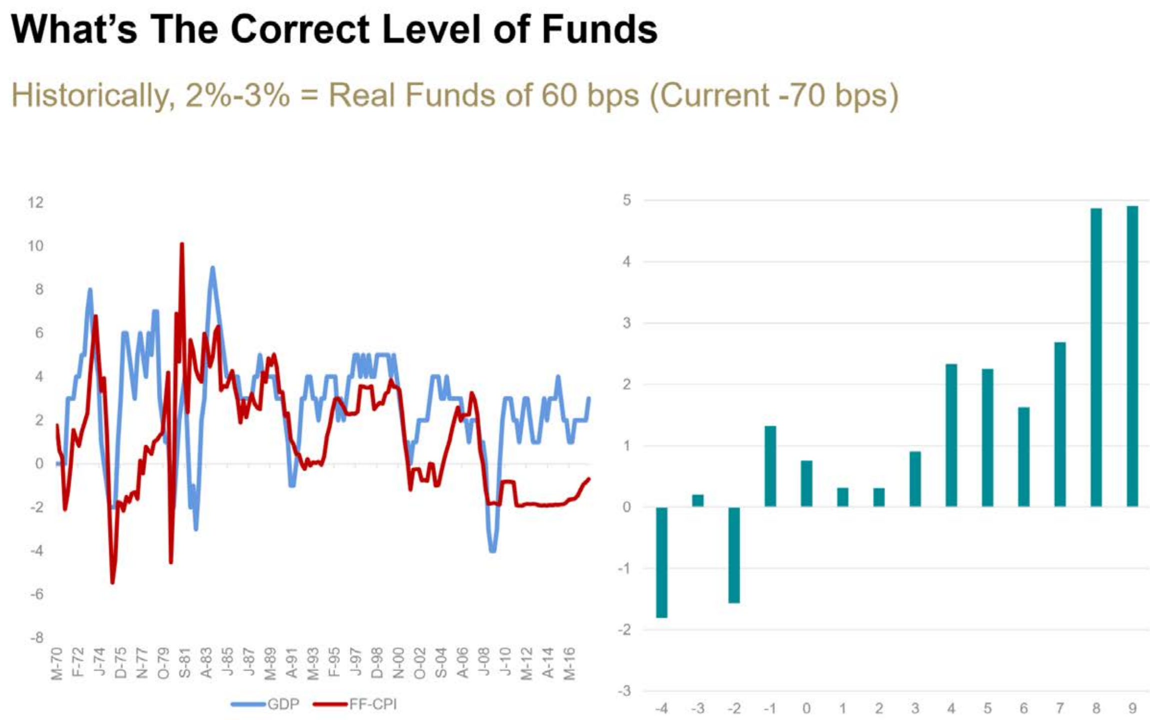
The FOMC left rates unchanged last week, although the market interpreted the policy statement as hawkishly leaning. In particular, we felt that the following sentence in the policy statement: *"Inflation on a 12-month basis is expected to move up this year and to stabilize around the Committee's 2 percent objective over the medium term"*, as reflecting increased confidence in their inflation expectations.

At present, the Fed expects GDP to average 2.5% this year with inflation slowly moving towards 2% by 2019. It is worth noting that the Fed's preferred measure of inflation, the PCE indicator, indicated a 1.7% core inflation rate for the 4Q:17 period when it was reported last week.

Real Yields hold key for Path of Rates

This data contributed to the 18 bps increase in Treasury yields last week with the long end leading the curve higher. The US was also not alone in seeing rates turn higher, as Bunds were up to 16 bps higher, while Gilts were 13 bps wider on the week. Most of the weakness in the US and globally was attributed to higher real yields, with 10Y TIPS reaching their highest levels since 2015.

This has led to discussion on the return of term premiums, which have been largely absent since the successive series of QE were implemented. As the attached chart indicates, real yields surged to two-year highs, but nonetheless remains well below average levels witnessed before the crisis. Prior to 2007, real yields averaged 2.2% versus the current 70 bps range.



In addition to firming inflation data released last week, early estimates of 1Q:18 GDP point to growth of between 4% (NOWCAST) and 5.4% (GDPNOW). Our inclination is to approach the accuracy of both these measures with caution early in the quarter, although we acknowledge they support investor concerns that monetary policy is falling behind the curve.

We think that this may be particularly at play in the Eurozone, where Euro strength and higher EGB yields have prevailed despite the ECB's contention that nascent inflation continues to require extraordinary stimulus measures. That view has been somewhat tested by various governing council members who have stated that QE should be terminated as soon as possible. Of course in typical ECB fashion, other board members remain committed to aggressive stimulus.

VIX Surges

What appears clear is that the typical response to volatility spikes may be atypical as all asset classes appear rich. In particular, we saw a 50% increase in the VIX last week, as the S&P fell 3.9%, posting full-day losses four times last week that culminated with a 2.5% decline on Friday. Given that commentary has pointed towards the rise in yields as a primary catalyst for this volatility, it is no surprise that Treasuries did not experience a flight-to-quality bid last week.

This has been fairly unique over the past several years, as yields fell in each of the four days in 2017 that corresponded with a 1% loss in stocks. 2016 was far more volatile, with 22 days with stocks falling 1% or more. In those instances, yields also fell on 19 of those occasions.

The other long held assumption that the JPY strengthens on volatility spikes was also tested on Friday, as the Yen weakened 1.4% last week and 0.7% on Friday. We sense that a breakdown of these relationships may be challenging to algo portfolios that struggle to rebalance in this type of environment.

Equities Still Maintain Gains Despite Worse week in over a Year

	S&P 500	Info Tech	Industrials	Financials	Health	Staples	Energy	Cons. Disc	Util	Materials	Telephone	REITS
2017	19.4%	36.9%	18.5%	20.0%	20.0%	10.5%	-3.8%	21.2%	8.3%	21.4%	-6.0%	7.2%
Jan 1- Jan 26	7.5%	8.8%	6.4%	8.1%	10.8%	3.0%	7.5%	10.5%	-3.1%	6.0%	0.5%	-2.4%
Jan 26 - Current	-0.6%	0.4%	-0.2%	0.2%	-1.7%	-1.4%	-1.8%	-1.3%	-1.5%	-2.7%	2.3%	-1.1%
Friday, Feb 2, 2018	-2.1%	-3.0%	-2.0%	-2.2%	-1.3%	-1.8%	-4.1%	-0.9%	-0.7%	-2.6%	-2.6%	-1.0%
YTD 2018	3.3%	4.4%	2.9%	5.0%	5.2%	-0.8%	0.6%	7.1%	-5.3%	0.0%	-0.8%	-4.8%
Forward P/E	17.18	17.65	18.01	13.72	16.13	18.53	20.95	20.09	16.23	16.84	11.23	11.23
Source: Bloomberg, Factset		Laggards	Leaders									

Corporate Bonds

While we saw a spike in Treasury and equity volatility, the responses from other asset classes were somewhat muted. In particular, corporate spread widening was limited to high yield, as the risk premium of investment grade bonds narrowed. The IG index closed out the week at 88 bps, 2 bps tighter than the start of the week as spreads push towards 2007 tights.

HY spreads widened 15 bps to 348 bps, with an associated 5.89% average yield. Triple-C's underperformed, widening 35 bps during the week, which could have been worse had oil not been relatively stable last week.

The USD was noticeably stronger on Friday, but this has hardly reversed the negative bias which saw the DXY weaken by 9.9% since the start of 2017. The inability for higher US yields to reverse this trend indicates that investor concern had gained the upper hand over the past several quarters. Whether these concerns are driven by relatively stronger economic gains outside of the US, or idiosyncratic issues with the supply and demand for Treasuries is indiscernible.

We did take note of the net decline in Treasury holdings from China near the end of last year, during a period when its reserves increased, its currency strengthened and trade rhetoric intensified. US debt issuance is also set to expand significantly, with the quarterly refunding expected to increase issuance by $43 billion through April, presuming the debt ceiling issue is resolved by then. Overall issuance is additionally expected to expand by 80% over the course of the year, with a net gain of up to $500 billion due to the combination of greater deficits and less Fed reinvestment.

Government Shutdown

Lest we forget, the latest government shutdown is looming by the end of the week as the current continuing resolution is set to expire. As far as we can see, there has been little progress in resolving the immigration issues that were the crux of the short government shutdown last month. Just as important is the approaching X-date for the debt ceiling which has been accelerated by up to a month towards the end of February/early March.

There is currently a hump on the March 1 and March 8 bill maturities, which only developed last week as the X-date became clearer. Treasury has been using extraordinary measures since early December when the last debt suspension ended. None of the budget continuing resolutions since December 8 have dealt with the debt ceiling, and we would expect continued ignorance in the event of another CR this week, as Washington has used the debt ceiling as a point of political leverage.

The data front is significantly lighter this week, and we only have the BOE meeting on the central bank calendar. There is a steady procession of Fed speakers, with eight Fed presidents expected to make various presentations. We have already heard from Kashkari last week, who characterized the wage data in Friday's employment report as impacting the path of rate hikes if sustained.

We will be on the lookout for additional clues on Fed thinking, and whether recent data potentially shifts rate hikes towards a more aggressive path, or if there is some reconsideration on the terminal value of funds. If either of these topics emerge, it would influence either a flatter or steeper curve. Chairman Yellen has officially handed over the baton to Jerome Powell, who is expected to be confirmed on Monday.

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