CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

October 12, 2018

Global equities are mounting a half-hearted rebound after the bloodbath of the past few days and that has Treasuries in a spot of bother. We're quick to add, however, that the overseas rallies are recouping but a fraction of the losses this week, and Dow futures are pointing towards a 345 point higher open which is too just a drop in the bucket versus the deluge of losses for the week. Treasuries are off a bit with the 10-year down 2/32nds to yield 3.16%. For the week the 10-year yield is lower by 10bps, and given the magnitude of the stock selling one may think the bond rallies should have been larger. Maybe so, but technical indicators are turning more bullish so this tentative fixed income rally may just be getting its legs under it. In addition, the Goldman-Sachs Financial Conditions Index has tightened to a level last seen in June 2017, which coincides with the Fed pausing for six months after hiking to 1.00%. For now, the Fed continues to talk up the economy and expresses confidence in inflation approaching its 2% benchmark, but we discuss in more detail below that that confidence may need to be dialed back a bit.

We mentioned on Tuesday that from a data-perspective it would be all about inflation this week and apart from the equity meltdown that has been the case. If the Fed hoped to have the mid-year inflation pick-continue into early fall in order to justify continued rate hikes, they were somewhat disappointed in the September CPI reading that was the highlight of the week's inflation numbers.

Once again, CPI came in below expectations with Core CPI gaining just +0.1% month-over-month while the year-over-year print disappointing at 2.2% versus 2.3% consensus. The near-term trend is also headed lower as the 3-month annualized Core CPI rate dropped to 1.8% - the lowest since June and decidedly under the Fed's 2% target/benchmark.

As for headline CPI, the +0.1% print was just barely there as the unrounded number came at +0.059%. Treasuries treated the benign numbers with a collective shrug with longer-term (10yr and 30yr) maturities oscillating around unchanged despite another challenging day in equity-land. Despite the muted Treasury response, however, the CPI release represents new information as the late-cycle spike in inflation due to a 49-year low unemployment rate remains elusive.

Combing through the details of the Core CPI number, Owners Equivalent Rent and the other housing-related inputs were the key metrics keeping core-inflation at it's recent +0.2% MoM average. In a possibly troubling sign for those expecting gathering inflation, housing overall gained just 0.1% versus the usual 0.3%. In fact, CPI ex-shelter components rose 1.8% YoY. This is one of the first tangible fallouts from tighter monetary policy as 30-year mortgage rates have reacted quickly to Fed rate hikes, breeching the 5% level in the last week for the first time in nearly eight years.

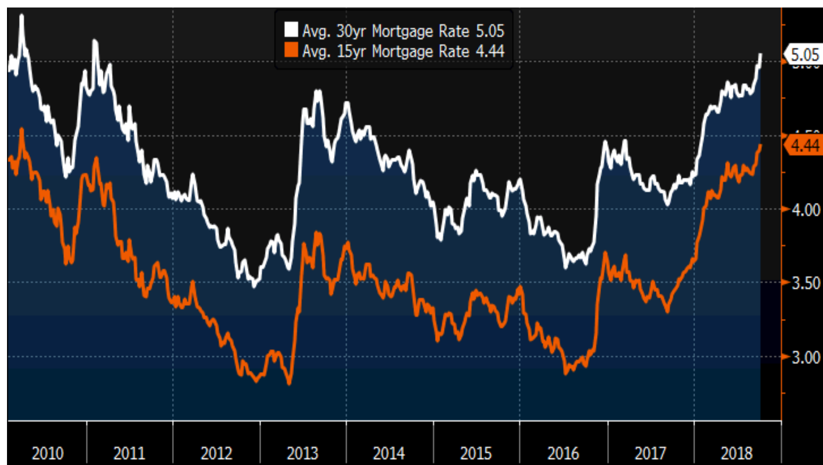
The details within the report portends that inflation is likely to continue decelerating into year-end and drag with it the Fed's preferred inflation metric: Core PCE. Core PCE typically runs about 30bps below Core CPI so that implies a sub 2% reading in Core PCE in the coming months. If that trend persists it will make the call for quarterly rate hikes that much harder to defend. We've mentioned before that the rate hikes this year were relatively easy to engineer while next year each hike will become successively more difficult and this week seems to have brought that thought into clearer focus.

With an equity meltdown, a president already blaming the Fed's previous rate hikes for the equity selloff, and housing-related numbers starting to reflect the impact of monetary policy tightening, rate hikes in 2019 will become a bit more contentious. It will also make it hard for yields on longer-term notes and bonds to advance as well. The equity and housing market are obviously having issues with the recent yield increases on longer-term debt so adding more to those yields is likely to further strain mortgage activity and weigh on equities as well. And if equity weakness persists it's likely large investors like pension and hedge funds will look to lock-in equity gains and move to the safety of fixed income, especially as recent long-end yield increases have increased the attractiveness of such investments.

One benefit of the softer-than-expected inflation numbers, however, was the bump it gave to Real Average Hourly Earnings for September. Real AHE increased 0.5% year-over-year versus 0.2% in August and all that gain was due to the drop in overall CPI from 2.7% to 2.3% rather than any pick-up in nominal wage gains.

While a +0.5% gain in real spending power is better than the near unchanged levels in prior months, it doesn't bode that well for future consumption if the Fed is intent on pushing toward positive real policy rates for the first time in this cycle. That fact alone is yet another reason to consider that the Fed's proposed rate hikes in 2019 will become more difficult to achieve if consumption does start to falter under the weight of greater borrowing costs.

After Seven Years Mortgage Rates Back Over 5%



The housing sector has been a reliably healthy sector as the economic expansion has advanced. While gains in housing prices have been fairly consistent, in the mid-5 to 6% range, higher mortgage rates have finally seemed to put a crimp in housing activity. Recent sales numbers, both new and existing, and mortgage-related activity have seen enough falloff that indicates higher rates are starting to bite affordability and put a dent in sales. Just this past week, average 30-year rates rose above 5% for the first time in seven years and that predictably led to declines in weekly purchase application numbers. If recent Treasury rate increases stick watch this space to gauge the impact to consumers.

Market Rates

Treasury Curve	Today	Chg Last wk.	LIBOR Rates	Today	Chg Last wk.	FF/Prime	Rate	Swap Rates	Rate
3 Month	2.26%	+0.05%	1 Mo LIBOR	2.28%	UNCH	FF Target Rate	2.00%-2.25%	3 Year	3.111%
6 Month	2.44%	+0.03%	3 Mo LIBOR	2.43%	+0.02%	Prime Rate	5.25%	5 Year	3.138%
2 Year	2.86%	-0.03%	6 Mo LIBOR	2.64%	+0.03%			10 Year	3.204%
10 Year	3.16%	-0.06%	12 Mo LIBOR	2.97%	+0.04%				