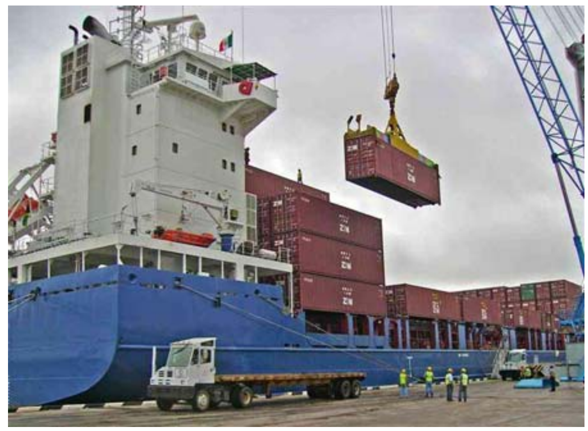
CenterState
CORRESPONDENT DIVISION

Market Update

Economic News

September 5, 2018



Treasuries are rebounding after some selling yesterday as a risk-off tone is once again in place. The market is torn, however, between mostly solid domestic economic fundamentals set against emerging market concerns, trade war saber rattling, and an increasingly embattled White House. That has the 10-year yield trapped in a range between 2.80% -2.90% and for the time being it seems that range will persist. Speaking of trade, the just-released July Trade Balance Report will likely add fuel to the rhetorical fires as the trade deficit widened by the most in three years increasing 9.5% to -$50.1 billion from a revised -$45.7 billion in June. Exports fell 1% (driven by steep drops in aircraft and soybeans), while imports rose 0.9% in a broad-based manner. The wider gap will be a drag on third quarter GDP as exporters moved product ahead of announced tariffs in the second quarter. The July trade deficit with China widened to a record -$36.8 billion versus -$33.5 billion in June. Expect that result to embolden the Trump White House to move ahead with proposed tariffs on $200 billion in Chinese goods.

Because of Labor Day the usual Wednesday ADP Employment Change Report will be released tomorrow and is expected to print 200,000 private sector jobs in August which would be off the 219,000 in July but if it is as-expected it keeps the likelihood high for a solid Bureau of Labor Statistics Employment Report this Friday. That report is expected to improve over July's somewhat soft release with monthly private sector job growth of 194,000 versus 170,000 the prior month while the unemployment rate is expected to tick lower to 3.8% from 3.9%, matching the May cycle low print.

The monthly average gain in private sector jobs over the last year has been 199,000 so the August BLS report is expected to be just under the average but an improvement off the weaker-than-expected July headline print. Once again, however, average hourly earnings will be the key metric and it's expected to increase 0.2% MoM versus 0.3% in July. Year-over-year average hourly earnings are expected to remain at 2.7% for the fourth straight month indicating little upward movement in wages. The average over the past year has been 2.6%YoY, so a slightly above-average print is expected but one that fails to signal the hoped for acceleration in wage growth that workers and the Fed are looking for.

Except for the employment report emerging markets and trade developments will continue to override most of the economic releases this week, especially with the latest salvo of an additional $200 billion in tariffs on Chinese goods launched last week by the Trump administration. That should prompt some type of tit-for-tat response from the Chinese which should continue to underpin the bid for Treasuries. In addition, the emerging market currency crisis has reemerged with Argentina stealing the headlines from Turkey with a nearly 20% decline in the peso last week. With the Fed set to hike later this month, and thus keeping the pressure on foreign currencies, it's likely the crisis will continue. It all seems to infer a positive backdrop to long-term Treasuries and our curve flattening call.

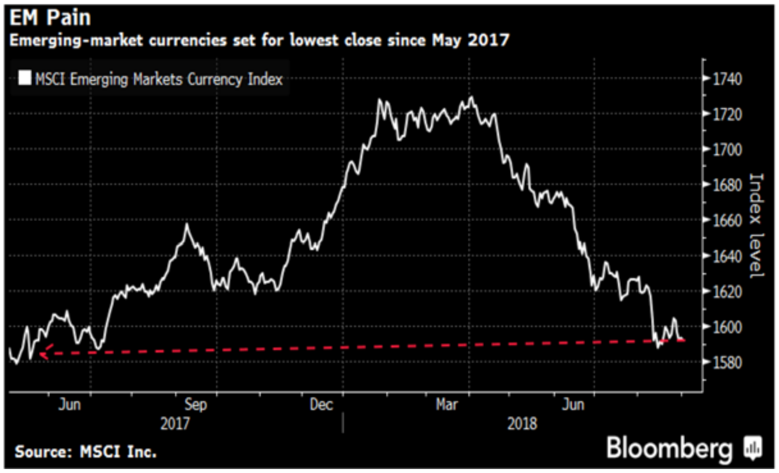
With the Mexico trade agreement in hand, the administration may feel emboldened to hue to a tough negotiating stance with Canada, China and the E.U. The fact an agreement with Canada was not announced last Friday, contrary to many pundits predictions, tells you that the U.S. is likely striking a take-no-prisoners stance. The substance of the trade deal with Mexico is perhaps more U.S. jobs but at a likely higher cost to consumers down the road. That is probably a useful template for a Canadian deal when one is announced.

A bigger battle looms with China. Mexico and Canada, being geographic neighbors, have developed an extensive supply chain over the NAFTA years and both had a mutual interest to get to a deal. While China is our largest trading partner they also have designs on becoming the largest economy in the world and a power player on the world stage. They are much closer to a U.S. economic equal than Mexico and Canada.

Trying to wrest something that can be clearly seen as a U.S. win is probably not going to be easy so how the Trump administration approaches the negotiations will be illustrative. The White House is torn internally with a faction that wants to strike a hardline with China and refuse almost all concessions while there is another faction that seeks more of a conciliatory but tough approach that more resembles trade deals done in the past. Again, given the deal with Mexico and most likely an upcoming deal with Canada the more hardline faction in the White House may feel emboldened to press their hand with the Chinese.

If the Chinese negotiations appear to become heated and/or protracted Treasuries will be the beneficiaries as global growth prospects become a bit more uncertain in the face of contentious trade talks. Also, with the Fed set to hike later this month, the emerging market currency crisis will likely get worse before getting better and that will keep flight-to-safety bids in Treasuries as well. Thus, despite strong domestic economic numbers the geopolitical angle appears will continue to provide a tailwind for Treasuries and so any back-up in yields seems to us more a buying opportunity rather than a turn to a more bearish trading environment.

Emerging Markets Remain Under Pressure



Emerging market currencies fell again yesterday as South Africa entered a recession and Indonesia's currency tumbled towards record lows, adding concern that the contagion is spreading. The MSCI index of Emerging Market currencies dropped for a fifth time in six days, and hit the lowest close in more than a year. Turkey's lira slid anew on worry the central bank will disappoint at its rate meeting next week, while Argentine's peso fell to a record low and Indonesia's currency sank to the lowest in two decades even after the central bank intensified its defensive efforts. Meanwhile, the dollar rose for a fourth straight day as the threat of an additional tariffs on Chinese product reverberated through the currency markets. With the Fed set to hike this month the pressure on EM is not likely to relent any time soon.

Agency Indications— FNMA/FHLMC Callable

Maturity (yrs)	2 Year	3 Year	4 Year	5 Year	10 Year	15 Year
0.25	2.77	2.98	3.15	3.30	3.71	3.95
0.50	2.77	2.96	3.13	3.28	3.70	3.94
1.00	2.75	2.93	3.09	3.23	3.62	3.87
2.00	-	2.84	3.01	3.14	3.61	3.75
3.00	-	-	-	-	3.49	3.65
4.00	-	-	-	-	3.37	3.57
5.00	-	-	-	-	3.26	3.49
10.00	-	-	-	-	-	NA