

U.S. Taxable Fixed Income Markets

Tuesday Morning Comments

Overnight

European equities were lower Monday as were U.S. futures. Overnight global equities are mixed with U.S. futures lower again. European sovereigns were lower Monday but have bounced overnight. Treasuries are better from Friday's close with the 2yr 2.5bps better at 4.69%.

Last Week

Last week was exceptionally busy for markets with plenty of important data and, of course, the FOMC meeting.

In the data, the CPI for May came in close to expectations but has generally been cooling, with the headline up +0.1% for the month (down from +0.4% last) and the YoY headline dropping to 4.0 %from 4.9%. The Core was up +0.4% MoM and +5.3% for the YoY, down from 5.5%, but a bit firmer than expected. Importantly to the Fed and markets, though, the "super-core" inflation read was nearly double April's level.

Wednesday's PPI came in generally cooler than expected with the headline falling -0.3% from +0.2% in April. The YoY headline dropped to 1.1%, down from 2.3% last month. The Core MoM was +0.2%, as expected, while the YoY Core dropped to 2.8% from 3.1%. Thursday's Retail Sales data came in much stronger than estimates, but down from the previous month. Retail Sales for May showed a gain of +0.3% vs an expected drop of -0.2%, but down from April's +0.4%. Ex-Autos and Gas came in at +0.4% vs an expected +0.2, but lower than April's +0.5%.

Import / Export Prices showed some sharp declines. Import Prices for May dropped -0.6% vs +0.3% in April. (Ex-Petroleum was down -0.2%.) The YoY decline was -5.9% vs -4.9%. Export Prices dropped -1.9% for the month (vs -0.1% last) and -10.1% for the YoY (vs -6.0% last).

The weekly Jobless Claims came in higher than expected, continuing their upward trend. The Philly Fed Business Outlook for June came in at -13.7 vs -10.4 in May.

Friday's preliminary U of Michigan Sentiment Surveys came in better than expected and the important 1yr inflation expectations dropped more than expected to 3.3% from 4.2%

On Wednesday, **the Fed** kept rates unchanged, as the market had been expecting. Despite the pause, the Fed's message was much more hawkish. In their new Summary of Economic Projections, the median forecast for the Year End Funds Rate jumped 50bps to 5.625%. That would be 2 more hikes out of the last 4 meetings this year. Drilling down on the DOTS, only 2 members think the Fed is done hiking this year. Four members think there will be one more hike, and nine members think there will be two more hikes.

*Joe Tamburo**Managing Director, Rates Trading
joe.tamburo@hilltopsecurities.com**Last week was exceptionally busy
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Beyond that, two members would like to see three more rate hikes, and there is even one more that wants four more hikes!

For year end 2024, the DOTS show their estimate for the Funds Rate increased to 4.625% from 4.25%. In addition to raising their projections for the Funds Rate, they also raised their GDP projection for this year to +1.0% from +0.4%. They lowered their Unemployment Rate projection to 4.1% from 4.5%. (it's currently at 3.7%). Their PCE inflation projection dropped slightly to 3.2% (4.4% currently), but they raised their Core projection to 3.9% from 3.6%. (currently 4.7%) They don't see inflation dropping back to their 2% goal over the next two and a half years.

So, they seem to see a stronger economy going forward, with a solid Labor market, and persistently high inflation.

That would explain the hawkish message and higher for longer Funds Rate, but what happened to the lags in Monetary policy? Of course, they maintain that they will be data dependent but, again, they seem to be fully focused on old data.

We can only hope this is just messaging and not their actual intention, otherwise the likelihood of overtightening increases. Despite the super hawkish tone, it is important to remember that they did Pause, and it's the first pause since they began hiking last March. It's also important to note that the vote for a pause was unanimous, despite nearly all members projecting the need for more tightening.

Manufacturing and Prices for Goods have moderated, but the Consumer is still holding up well, which has kept Services Prices and Employment firm. It seems like the Fed may maintain their hawkish stance until the Consumer falters. I'm not sure how many more hikes that translates to, but higher rates for longer seems to be the plan. According to Chairman Powell, they haven't pre-determined what they will do at the July meeting but "cuts are a couple of years out", (despite their own projections).

Despite the mixed messages from the Fed, the major takeaway for the **Rates market** seems to be higher rates for longer.

As of Friday's close, **Fed Funds Futures** were pricing in 72% chance of a hike in July, that's actually down from 86% from the previous week. Futures are, however, pricing a year end Funds Rate of 5.21%, that's up +15bps from the week before, but it's not as much as the Fed is forecasting at 5.625%. The market is pricing in a Terminal Rate of 5.29% in November (less than 1 hike), but the first cut has now been pushed back to March of 2024.

1yr SOFR futures moved +21bps higher for the week.

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Those higher estimates for this year and next have steadily pushed the **2yr Note** back within striking distance of the cycle high at 5.08%. 2yrs got to a high yield of 4.795% late Wednesday after the hawkish FOMC statement before closing at 4.715%, +12bps higher for the week. 2s were most sensitive to the data and the Fed, rallying initially Tuesday on the cooler headline CPI, before selling off on the hotter Core. The issue put in a 30bp range, but continued the trend toward higher rates over the past 6 weeks.

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The 10yr closed at 3.76%, only 2bps higher in yield for the week, and traded in only a 17bp range, given all the movement in the front end. The high yield for the week was 3.845%, just shy of the recent 3.855% high yield set 3 weeks ago. Support behind that looks to be 3.875%, 3.90%, 4.08%, 4.335%. 10s have been trading in a fairly tight range but have been trending a bit higher in yield since early May. The longer view shows lower yield tops since the cycle high was set at 4.335% back in October. That declining yield trend line comes in around 3.875% this week. The issue closed Friday not far off the midpoint of the rally from that 4.335% level to the low yield at 3.25% in April. We'll see if recent strength in the employment and Consumer data helps extend yields in the long end or if the Fed's renewed hawkishness cements calls for a recession down the road.

The 2s10s curve continued its inversion again last week, reaching -98.5bps before closing -9.5bps flatter to -95.5bps. The early March gap to -87.5bps was filled and now the curve is trading back to pre-SVB levels. With the front end of the curve following the Fed to higher rates, it seems inevitable the spike to -111bps set on March 8 will be reached again. That's the most inverted the curve has been since 1981.

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Rates Vol continued to sell off with Rates with the MOVE Index back at early February levels.

Swaption Vol got hit again as rates backed up, with short locks and short maturities again faring worst. Vol on 1m1y is now down about half from its highs in mid March on the banking liquidity situation. Longer locks and longer maturities fared better.

U.S. Equity markets finished the week higher, with the S&P 500 and Nasdaq composite both making 52wk highs: S&P +2.6%, Dow +1.3%, Nasdaq +3.3%. **The VIX** closed below 13.5 for the first time since February 2020.

The **U.S. Treasury cash balance** rose to \$250bn on June 15, up from \$88bn on June 8, and just \$23bn on June 1.

Issuance looks to be similar to last week with the 3 & 6mo auctions unchanged at 123bn, and a 4mo TBill (\$46bn last week), plus the 4wk and 8wk Bills, and Treasury will issue a 42Day Cash Management Bill for 50bn. Estimates are for the Treasury to grow their cash balance to the \$400-500bn area over the next month or so.

Looking ahead

Looking ahead, the data this week will be on the lighter side without much in terms of top tier data. Weekly Jobless Claims and Existing Home Sales will be released Thursday, along with the Leading Index. We'll get the preliminary June PMIs on Friday.

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In contrast, the FedSpeak will ramp up with NY Fed President Williams and Fed Vice Chair Barr speaking later this morning. Then Chairman Powell will testify in front of Congress tomorrow and Wednesday. The Senate Banking committee will also be holding confirmation hearings for Fed nominees tomorrow. There will be plenty of other Fed officials on the tape this week to further confuse us.

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Also on our radar, the Bank of England is expected to raise rates to 4.75% on Thursday.

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