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Fixed Income Markets

We started 2018 with expectations of higher rates. The same factors that prompted three rate increases in 2017 also led to a string of 3.0% average quarterly GDP growth rates, a trend we anticipate to continue. As economic prospects brightened and the impact of the Tax Cuts and Jobs Act became clear, rates pushed upward, rather quickly.

Starting from 2.40%, the 10-year U.S. Treasury Bond reached 2.85% by early February, dropped to 2.70% as equity markets corrected and peaked at 2.95% in mid February. Then the trade talk started, leaving investors uncertain and unclear about how far it would develop. Until the back-and-forth stops, the uncertainty clarifies or both, investors will seek the sanctuary of U.S. Treasury bonds denominated in U.S. dollars. Rates moved down and ended the quarter at 2.74%.

On balance, markets gave a taste of how interest rates can move with an accelerated growth rate and moderate inflation. Most intermediate and long-term fixed income indexes are down 0.75% - 1.50%. As with equity markets, trade uncertainty has pushed aside positive economic data and momentum. The 10-year yield will resume its path toward 3% as the trade conflict subsides.

In late March, the FOMC raised the overnight rate a sixth time, to a range of 1.50% - 1.75%. It was the first meeting presided over by new Chairman Jerome Powell, but the second opportunity to speak publicly in the role, the first being through congressional testimony in February.

Powell differs from the last several Chairs, although he has taken pains to insist he will continue what Janet Yellen began. Trained as a lawyer, he is less academically tethered to economic theories than his predecessors and is more willing to go where the data leads him. His comments revealed an optimistic outlook for the economy and gave indications the FOMC would be closer to four moves in 2018 than the previously suggested three, which is more in line with our own expectations.

Of greater long-term importance is the progress on who sits around Powell in the remaining four open Governor seats, which includes the Vice Chairman. Marvin Goodfriend was nominated last November and still awaits approval from the Senate. The New York Fed named John Williams as its next President. Williams has been President of the San Francisco Fed since 2011 and will be taking over what is widely regarded as one of the most powerful seats on the FOMC with a vote at every meeting.

The Federal Reserve is methodically removing itself as a buyer in the U.S. Treasury and U.S. Mortgage-backed markets. While the U.S. Treasury is issuing more and more debt to finance its $870 billion 2018 deficit. These two dynamics will serve to pressure longer rates higher.

GDP growth since Q2 '17 has averaged 3.0%

Markets gave a taste of how interest rates can move against fixed income investors

FOMC raised rates a sixth time to 1.50% - 1.75%

Jerome Powell plans to continue the policies set for by Janet Yellen.

U.S. Treasury note issuance is growing at the same time the Federal Reserve is no longer buying