What’s Changed?

Over the past two weeks, the bond market has sold off sharply. At the time of this writing, the 2-year treasury note, which is closely tethered to the path of monetary policy has risen 53 basis points (bps) to 4.43%. This reflects a major shift in Fed expectations.

The futures market now assigns a near 50% probability of a 25 bp June 14 rate increase or roughly an 80% probability the Fed delivers on that at the July 26 FOMC meeting.

Remember that just a few weeks ago, the bond market was expecting a July rate cut with more to follow. Now, the market expects just one 25 bps cut and only in December.

The dramatic sell off in 2-year notes has coincided with a less dramatic but still large increase in 10-year notes. Their yield has risen 37 bps to 3.75%, the highest since March 9. In the process, the 2s/10s curve, our favorite yield curve measure, has inverted 20 bps to -67 bps.

The persistence of this inversion, which began last July, is expected to continue to weigh on money and credit creation. And it will continue to be a negative factor for many banks who depend on short-term rates (their cost of funding), being below long-term rates (their return on investment). So, what fundamentally has changed in the last couple of weeks?

The short answer is not much. Jobless claims are lower because of a correction in prior reporting but their trend still grinds higher. The housing market data — NAHB, mortgage applications, etcetera— have improved but this probably was to be expected after eight quarters in a row in which residential investment declined. The question is whether the recent bounce is sustainable.

Given high mortgage rates and tighter residential lending standards, we doubt it. The regional purchasing managers surveys (NY, Philadelphia, Richmond) remain atrocious. Manufacturing remains in recession against the backdrop of weakening global demand. In the last couple of days, commodity prices broke lower through a key support level. Industrially sensitive copper prices are moving back down.

Admittedly, some of the inflation data has been mixed-to-higher. The Q1 GDP deflator and core PCE figures were revised slightly higher, but this is old news. Forward-looking measures of inflation such as breakevens and 5y/5y inflation swaps remain relatively low and stable. Price expectations are anchored.

While our view is that the economic fundamentals have not changed, the equity market has held firm. Since the bond sell-off began, the broad market is trading near the high end of its range while the NASDAQ has increased nearly 3%. Perhaps this ebullience is impacting the bond market’s (and Fed policymakers’) expectations of what happens next. If it does, and the Fed is not yet done hiking interest rates, investors should become more, not less, worried about the economic outlook. Stay tuned.
Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. (“SMBC Nikko”), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko's economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.