FTN FINANCIAL
SEPTEMBER 6, 2019

THE WEEKLY REPORT

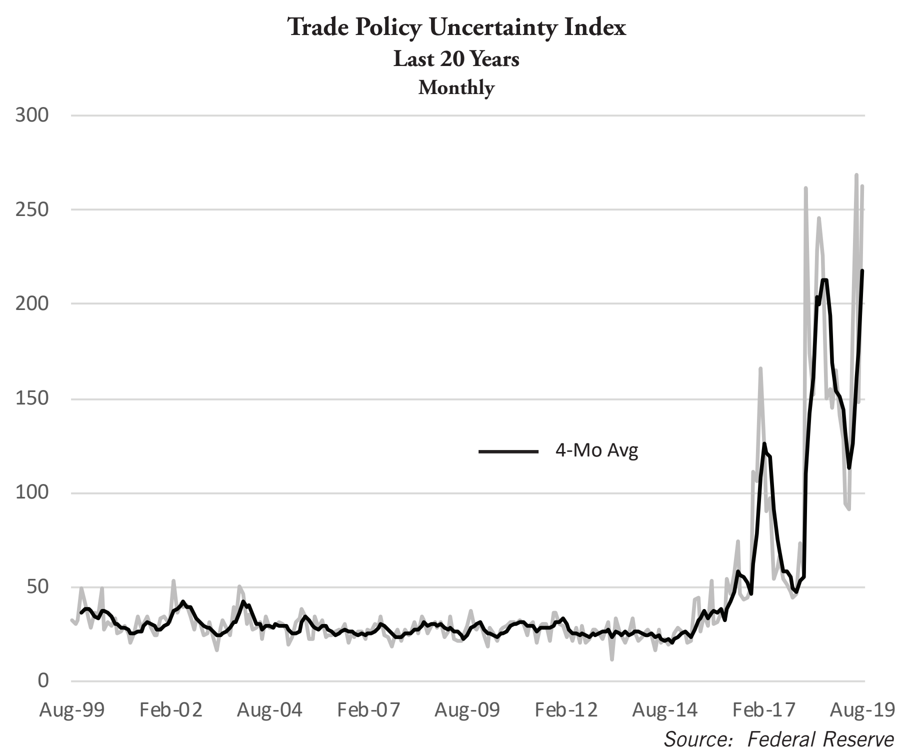
Economists are ill-prepared to analyze disruptions in international trade, but they're trying. Five Fed staffers published a simple paper this week outlining measurable risks to the global economy from the uncertainty already caused by the last 18 months. The study is based on trade uncertainty from 1985-2015 with conclusions extended to 2018-2019 turmoil.

First, look at the "uncertainty" index below that maps press reports and company statements that discuss trade policy. It moved from background noise for most of the last 20 years to full-throated roar after the election. In two additional waves, it has progressed to new heights with the June and August readings. When Chair Powell discussed the apparent improvement in July, it is likely he referenced this index as it fell below 150 that month.

Tracking news reports has become the latest tool among researchers and hedge funds eager to discover new leading indicators. According to the Fed's research, talking about trade does lead actual changes in investments and GDP. It later tests the impact of new tariffs to confirm the talk/action equation. The study finds the relationship between uncertainty and broad government data plus a slowdown in business investment as reported directly in company financial statements (through Q1 2019).

"We find that the rise in [uncertainty] in the first half of 2018 accounts for a decline of global GDP of about .8 percentage points by the first half of 2019," the report observes. "…renewed uncertainty…points to additional knock-on effects that may push down GDP in the second half of 2019 and in 2020."

https://www.federalreserve.gov/econres/ifdp/files/ifdp1256.pdf



Source: Federal Reserve

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INTEREST RATES AND DERIVATIVES **P. 2**
The week started with a bad data print, but for traders all was forgiven by Thursday. Yields saw the biggest two-day rise since early July for Sept 3-5, as good news stole most of the headlines. Only modest payroll improvement on Friday, however, did flatten the yield curve. Chair Powell's late-day comments didn't change things into the close. The odd combination of reactive trading to some news and zero reaction to equally important news keeps our recommendations in favor of buying bond price declines that stay within the range.

MARKET UPDATE **P. 6**
The news the US and China will entertain trade talks next month breathed fresh life into already optimistic stock prices. That was a global event. Equally global, however, was most risk markets did not break from their July/August channels. That leaves room for them to spring haywire again on the next risk development. A thorough look at market developments around the world via nine charts.

PERFORMANCE **P. 10**
The reasons behind the strongest single month for Treasury performance in 10 years were obvious throughout August. Investors are still trying to make sense of the rally's repercussions. The monthly return report guides toward some critical thoughts for September, several of which already are in play before the first week is over.

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Disclaimer is on the last page of this report.

Traders Emphasize Strong Data, Brush Off Weaker Reports

The review of August's rally, included here on page 10, said the rally's components set the stage for September. That proved correct quite quickly. Updating the components on the 10-yr for the 11bp increase in the final two days of the week – the largest 2-day increase since the first full week of July – finds that market sense of upbeat data drove most of the change.

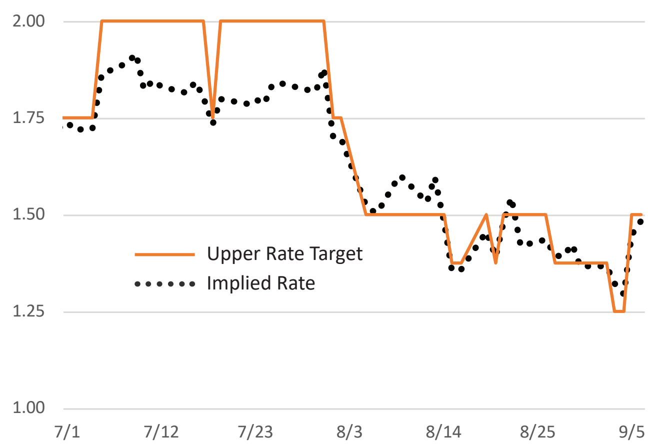
Data changes translated into 2.5bp of additional yield between the close on September 3 and mid-day September 6.

	10-Yr Yield		Major Themes
Sept 3	**1.46%**		Sept 3 - Sept 6
Infl Expectations		0.03%	US/China trade mtg scheduled
Real Ylds (Fed)		0.03%	Cuts in doubt past Sept FOMC
Real Ylds (Supply)		0.01%	Corporate supply 2019 high
Risk Premium		0.01%	Mild retreat on stock gains
Liquidity		0.01%	Decreased volatility
August 30	**1.55%**	0.09%	

Source: FTN Financial

There are no shades of gray in this next chart, but the move from an expectation of 1.25% a year from now to 1.50% in September 2020 is the most dramatic turn based on data in the last two months. The collapse from 2.0% to 1.5% in August, of course, was based on the US/China trade war (see the cover).

Fed Funds Upper Target
12 Months Forward
Implied by UST Curve
July 1 to Present
Daily



Source: FTN Financial, Bloomberg

Higher rates at the end of the week had several causes, but the rate increases held based on data swings from below expectations to well above forecasts on September 5 data:

- September 3 ISM manufacturing **49.7** vs 51.3
- September 5 ADP employment **195k** vs 148k
- September 5 ISM services **56.4** vs 54.0
- September 6 Payrolls **130k** vs 160k

Economic Weekly outlines the approach the FOMC will use in considering the size of future rate cuts. Data releases in the next seven trading sessions are not going to alter the decision at the next meeting – widely assumed a reduction to 2.0%. ***But, that doesn't stop investors from using any unexpected developments to fast forward through the next 4-5 rate decisions. The obvious result is increased short-term volatility in rates and buy/sell opportunities for real money investors.***

FTN Financial recommendations, in order of strength for intermediate maturities:

- Buy 7s with UST yields above 1.495% Currently 1.495%
- Buy 10s with UST yields above 1.555% Currently 1.550%
- Buy 5s with UST yields above 1.420% Currently 1.420%

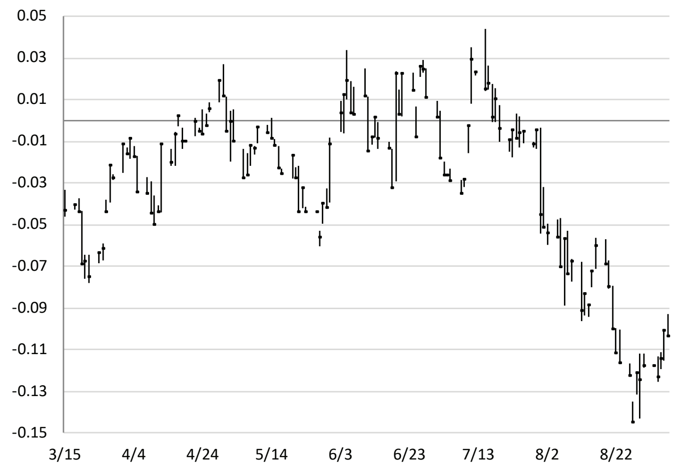
Watch daily notes and updates for any changes to these levels – or thoughts on slowing down/selling. They are designed, however, to run through September 12…just before retail sales the next day. They are designed, however, to run through September 11…just before the ECB meeting and retail sales.

Market too focused on September FOMC

The split among FOMC members on whether to cut rates again puts all the attention on the very next meeting. As the first chart indicated, however, the important question for intermediate rates is where the Fed will be in 2020. That's why the most dramatic curve shift to start September was a steepening in the 2s/5s curve.

It has more room to steepen on additional data that reflect a soft slowdown rather than the sub-50 print on ISM manufacturing.

UST 2s/5s Curve
March 15 to Present
Daily



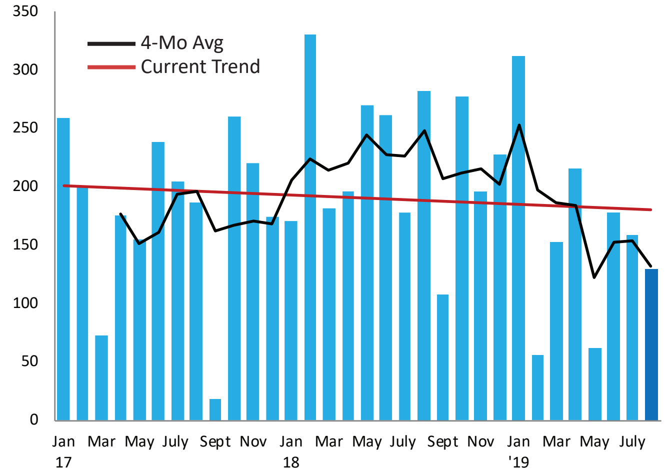
Source: FTN Financial

Payrolls flatten longer Treasuries

When the stock market rose 2.5% from September 3 to September 5, 30-yr Treasury yields rose as much as 14bp to 2.09%. The long end was particularly vulnerable to hedging large investment grade deals (see page 9). But even after the credit wave subsided, 30s fell another 3bp after the payroll report.

The directional split between rates for intermediate bonds and the longest bonds ties directly back to the previous section about the intense focus on the FOMC on September 18, and to a lesser extent on the ECB on September 12. Intermediate are all about central banks, while 30s are in a different world. Trending the impact of slowing jobs growth and five consecutive months of downward revisions illustrates the 30-yr's take on the vulnerably economy.

Nonfarm Payroll Trends
2017 to August 2019



Source: Bureau of Labor Statistics and FTN Financial

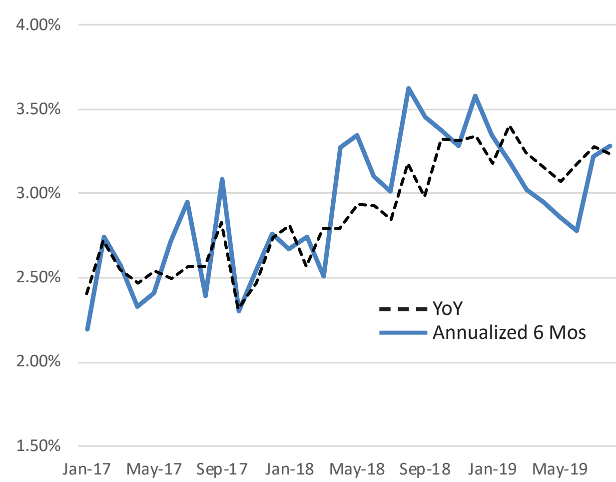
It's not so much that the 4-month average is falling, it is how quickly it has dropped from the second half of 2018. That trajectory confirms the trend for US purchasing manager surveys this year, even taking into account the upside surprise on ISM non-manufacturing.

From Chris Low's post-data note:

> Weaker-than-expected job growth is one more reason supporting rate cuts, though it's not clear if a 130k rise is weak enough to support 50bp over 25bp. Nevertheless, the slowdown in the US economy is unmistakably broad, especially considering the government added 30k census workers in August and private-sector hiring added just 96k.
>
> Average hourly earnings rose 0.39%, the biggest increase in months and enough to keep the year-on-year change at 3.23%. Bear in mind, however, this is not necessarily a sign of strength. If there were layoffs, usually the lowest paid workers are cut first, resulting in higher average pay among those left behind. The same logic applies to the workweek. Layoffs take part-timers first. The workweek rose 0.3% in August. The manufacturing workweek rose 0.5%. Aggregate hours worked rose 0.4%, the most since a 0.5% rise in March.
>
> Bottom line: Weak job growth is one more reason to think the Fed will continue to provide accommodation at its next meeting in two weeks, but probably not with a 50bp cut. The job losses in mining – likely related to a slowdown in the fracking – are particularly troubling as weakness in fracking reflects slowing industrial demand, not just in the US but globally.

Adding one other reason to Chris's logic, the improvement in average hourly earnings pulls back from a sharp slump in the second quarter and doesn't take the improvement back to the 2018 trend.

Growth in Average Hourly Earnings
Year-over-Year and Annualized 6-Month Trend
2017 to August 2019
Monthly



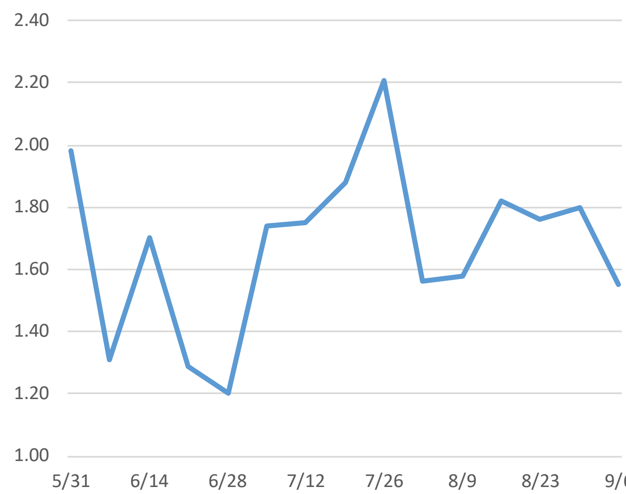
Source: BLS, FTN Financial

In remarks at a meeting in Europe on September 6, Chair Powell said the latest jobs data were consistent with a view the US labor market is in a strong position. Otherwise, his remarks were largely in keeping with his recent speeches, not quite as dovish as New York Fed President John Williams on Wednesday morning.

On balance, Q3 tracking forecasts fall this week

Leaving the final word on whether data was a plus or minus this week to GDP tracking models. Note the downturn in the version published by the Federal Reserve Bank of New York. As of September 6, it mirrors the size of the decline calculated by the Federal Reserve Bank of Atlanta as of September 4.

Third Quarter GDP Tracking
Federal Reserve Bank of New York
Weekly
May 31 to September 6

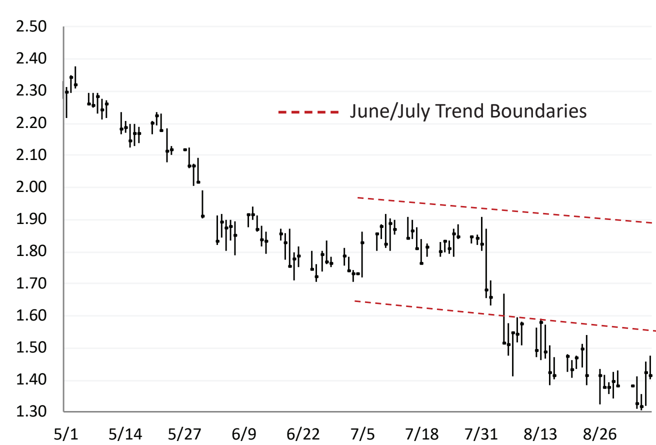


Source: NY Fed

Technicals water down the week's drama

Yield volatility this week was eye-catching in real time. From the perspective of recent charts, however, it didn't register as an event. The 5-yr UST yield chart shows the bump off the bottom of the range to an intra-day high of 1.476%. Yet, it remained well under the trend from the end of May through July.

5-Yr UST Yields
May 1 to September 6
Daily



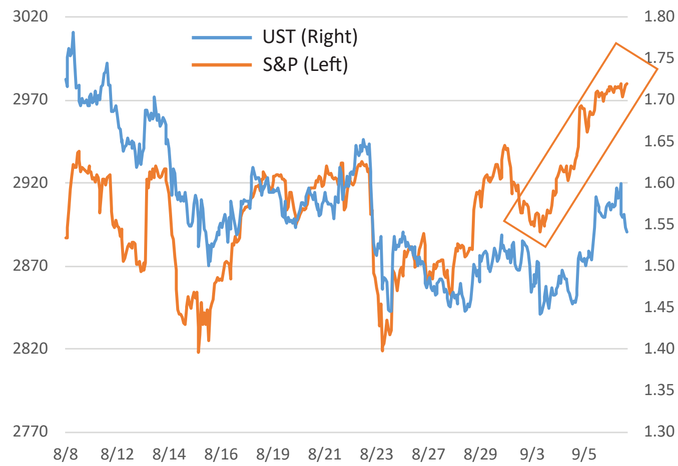
Source: FTN Financial
Note: 8/9 Yld as of 1:00 pm EDT

Risk Falls in Many Sectors, but Not Outside Key Trends

In contrast to the methodical but alarming review of trade policy uncertainty produced by the Federal Reserve this week (cover), markets sprung to attention at news China and the US would hold a trade meeting in early October. Risk fell immediately.

The leading indicator for trade reaction are stocks, of course. Valuations surged versus the previous four weeks, approaching previous highs from July.

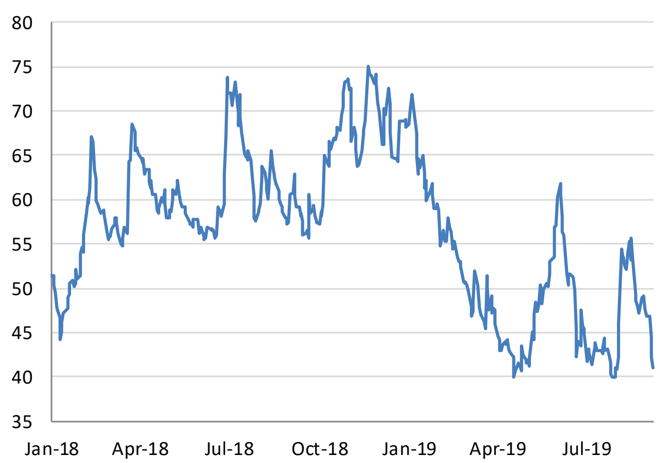
US Stocks vs 10-Yr UST Yields
August 8 to September 6 (12:00 pm EDT)
Hourly



Source: CME, FTN Financial

The response in Asia and Europe equities was even better than in the United States. On the all-important credit front for China, default swap spreads fell first on trade and then again after it lowered bank reserve requirements the night of September 5.

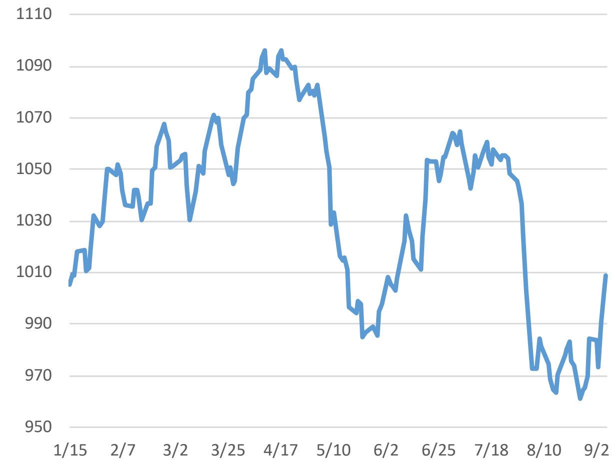
5-Yr Sovereign Credit Default Spreads for China
Quoted in US Dollars
2018 to Present
Daily



Source: Refinitiv

Emerging market equities appeared to enjoy the same short-term rally to start September, but they actually just recovered about 1/3 of August losses.

Emerging Market Equities
January 15 to Present



Source: MSCI

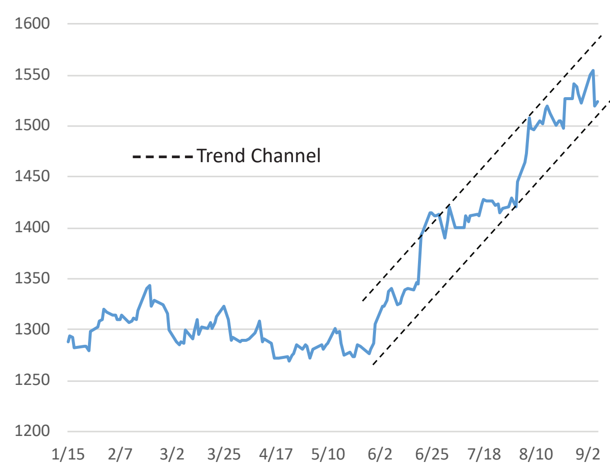
The weakest link outside developed economies, of course, remains Argentina. Deteriorating developments have been crowded off center stage, so here's the gloomy update.

Argentina 5-Yr Credit Default Spreads
2019 YTD
Daily

Source: Reuters

The international price of risk, inflation, currencies and interest rates – gold – had an excellent week despite emerging market question marks with a decline of 2.0% from its high on September 4. ***It trades inside the trend channel, however, leaving room for a rebound at the next hint of a problem.***

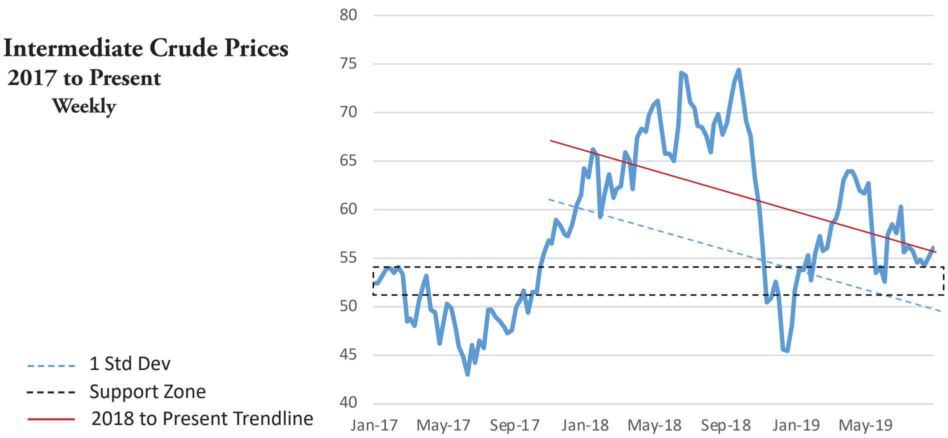
Gold Prices
January 15 to Present



Source: CMX-Commodity Exchange

Crude oil is another market still following a risk-averse trend. West Texas Intermediate closed the week right at the 2018/2019 trendline.

West Texas Intermediate Crude Prices
2017 to Present
Weekly



Source: NY Mercantile Exchange, FTN Financial

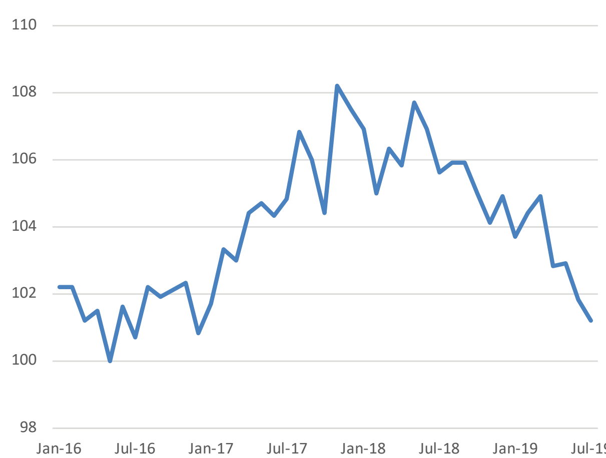
While several countries in South America endure political struggles that have crushed their currencies, the fight for Brexit and political control in the UK has simmered to the point the pound is at its strongest in a month.

UK Pound/Dollar
August 12 to Present
3-Hourt Intervals

Source: Bloomberg

Since the risk depths on September 3 in Europe, German rates have risen/fallen in line with US Treasury yields rather than the continued downturn in its own economy. The latest bad print arrived September 6. The down turn in industrial production slowed just slightly in July, but the results were well below expectations. Economists keep expecting a bounce.

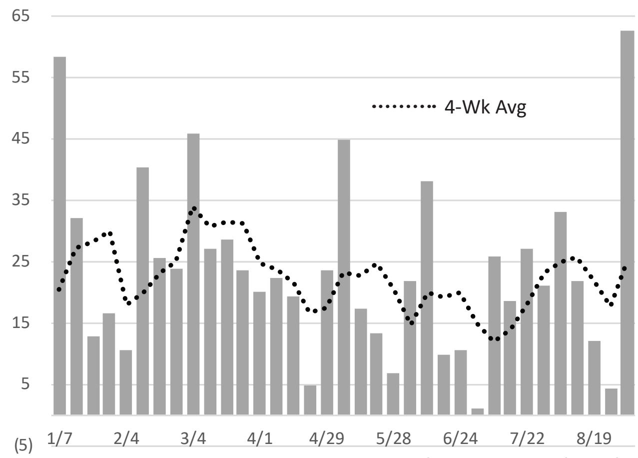
German Industrial Production
Including Construction
2016 to July 2019
Monthly



Source: Bundesbank

Finally, there have been no limits on the pent-up appetite for investment grade credit risk to start the month. August was busier than usual, but that didn't stop the first three days of the week from setting a new duration supply record for 2019.

Investment Grade Fixed-Rate Supply
10-Yr Equivalents
Second Quarter to Date
Weekly
(Billions)



Source: FTN Financial

Flattening Responds to Market and Economic Risk

The reasons behind the strongest single month for Treasury performance in 10 years were obvious throughout August. Investors are still trying to make sense of the rally's repercussions. Deconstructing components behind the yield decline suggests what might change rates in the fall. Based on low odds of a near-term bounce in global economic indicators, the most likely source of higher rates would be increased inflation expectations if central banks ease as much as anticipated. That would translate into a steeper curve.

In FTN's analysis, the decline in risk premiums for 5-yr and 10-yr UST was partially offset by the very real impact of dealing with supply – both in terms of duration sold for the month and the rebuild in Treasury bills after the debt ceiling was extended for two years. The table outlines the five major components of Treasury rates and how they changed in August:

	10-Yr Yield		Major Themes
Sept 3	**1.46%**		Sept 3 - Sept 6
Infl Expectations		0.03%	US/China trade mtg scheduled
Real Ylds (Fed)		0.03%	Cuts in doubt past Sept FOMC
Real Ylds (Supply)		0.01%	Corporate supply 2019 high
Risk Premium		0.01%	Mild retreat on stock gains
Liquidity		0.01%	Decreased volatility
August 30	**1.55%**	0.09%	

Source: FTN Financial

Unlike other months of intense stress, August broke tradition by maintaining largely stable credit spreads. Investment grade levels widened 17bp, and FTN's global credit index moved out only 24bp, remaining below the level at the end of May. The table on page 11 shows August at +229 (LIBOR basis). It was +239 three months ago. Typically, excess returns on investment grade credit slip much worse than August's -1.05% when Treasuries rally significantly. A look at the last nine years would have suggested excess returns would fall 2.00% or worse last month. The appetite for investment grade corporates as stocks gyrated each week indicated the fixed income market actually had a better month than total returns indicate by themselves. Corporate supply enjoyed an excellent reception despite a heavy calendar in July-August and even more on the horizon next month. While higher inflation expectations would send rates higher this fall, faster deterioration in credit could easily push real yields lower, along with an increasing risk bid for Treasuries.

> August will be remembered for its stock market volatility and the cross-market impact around the world. The strongest equities/Treasury ties, however, peaked the first full week of the month and reconnected for only 1-2 days thereafter. So, although risk markets intensified yield curve flattening, global fears about deepening economic pain and likely failure of political attempts to address the threats accelerated the flattening in the second half of the month. The 2s/10s curve fell 6bp during the first week of volatility, then another 10bp the balance of the month even as VIX fell from 24% to 18%. Total yield curve flattening was powerful enough that duration-neutral bellwether UST returns improved with each incremental step out the curve.

Measured in "home" currencies, global governments produced similar returns to Treasuries – between 2%-4%. Exchanging back into dollars on a duration neutral basis, however, money moved outside US fixed income lost between 1.5%-2.6%. A reflexive desire for simplicity over relative value is evident across this short list of better sectors vs paired also-rans in terms of duration adjusted results for the month and the quarter to date:

Winners	Also-rans
US	Overseas
Long Supra govt bonds	IG Credit
Single-A Corps	BBB Corps
CMBS	MBS
Coupon UST	TIPS
On-the run UST	Off-the-run UST
US GSE debt	Tax-exempt municipals

For more on the winner/loser dynamic, see page 6 *TWR* August 16.

Summary results by sector

Mortgages: The flattening Treasury curve with a 50bp downdraft in 10-yr yields was hand-tailored to make mortgages underperform. Using traditional, duration-hedged analysis, though, makes them look worse than they were. In nominal terms, returns of .89% on the index were roughly comparable to 2-yr UST. The goal is to at least get close to the 3-yr, but it closed at 1.28%. Excess returns at -60bp, then, overstate the "downside" to single-family mortgages. Included in the -60bp was the economic cost of 7bp related to higher option volatility.

In conventional 30-yr mbs, by the way, 3.0% coupons did produce total returns of 1.45%. Of course, it was the higher coupons at 4.0% and above that lost the least on a hedged basis. All conventional 30-yr coupons beat GNMA comparables on nominal returns – by as much as 25bp – but GNMAs won on a hedged analysis. 15-yr conventionals roughly matched 30-yr pass throughs on nominal returns but won on excess return metrics. 15s still lagged on a quarter to date analysis, though.

CMBS could not keep up with Treasury hedges either, but nominal returns topped 2.38%. Treasury duration matched returns were negative 23bp.

			Change	
	Aug 30	Jul 31	Month	Dec 14
UST 2s/10s	-2	13	-15.0	-152
UST 5s/30s	58	70	-12.2	-52
UST 10-Yr Yield	1.50	2.01	-0.51	-0.7
UST 10-Yr TIPS	-0.05	0.26	-0.31	-0.5
5-Yr Swap Spread	-6.8	-2.5	-4.3	-18.8
Mortgage Index LOAS	50.0	40.5	9.5	52.4
Agency Avg LOAS	7.3	2.9	4.4	17.2
1x5 Swaption Vol (bp)	71.6	62.8	8.8	-13.7
Inv Grade Credit LOAS	137.8	120.6	17.2	19.9
FTN Financial Crdt Indx	229.0	205.2	23.8	-29.0
High Yield LOAS	428.9	412.6	16.2	-97.0
US Dollar	98.9	98.6	0.3	8.6
Dow Jones Industrials	26403	26864	-1.3%	66%
S&P 500	2926	2980	-1.6%	56%
NASDAQ	7963	8175	-2.5%	78%
FTSE	7207	7587	-4.1%	33%
DAX	11939	12189	-2.1%	22%
Nikkei	20704	21522	-3.7%	30%
Shanghai	2886	2933	-1.5%	-1%
Hang Seng	25725	27778	-7.1%	30%
Commodity (Bloombrg)	76.4	79.0	-2.5%	-26%

Source: FTN Financial, FTSE Russell, Bloomberg

Investment grade credit: As mentioned, the big picture for corporates was positive. Longer maturities produced nominal returns better than 5.85% versus equities down 1.3%-2.5% in the US. Intermediate excess returns of -33bp matched those of the intermediate index as a whole, so credit erosion was not a factor so much as the premium commanded by Treasuries. Bank equities were roughed up, losing 7.4% in August, but bank corporate bond excess returns represented the single best large sector. Within industrials, the opposite was true. Energy stocks lost 8.1% and energy credit excess returns were the worst in the group.

Agencies: GSE debt obligations were the strongest taxable sector outside Treasuries. Longer maturities led the way with excess returns of .55% and nominal results of 6.7%. Longer bullet spreads contracted 5bp, and intermediates came in .5bp during August. On a duration neutral basis, callable spreads widened but not as much as nominal spreads did versus the lower, flatter UST curve. Excess returns to UST were 14bp while they fell short of LIBOR by the same amount.

Municipals: Tax-exempt issues returned 1.58% in August, failing to keep up with Treasuries or swaps. Excess returns were even below corporates, at -104bp for the month. Intermediate and longer bonds fared about the same in terms of duration-neutral results. Taxable municipals surpassed corporates with ease, generating 5.9% and only trailing Treasuries by 15bp across the curve.

TIPS: Inflation protection was over done in July and more than surrendered its gains in August. Even though demand for TIPS did pick up, flows into long coupons swamped the relatively small number of investors that put money into the idea inflation expectations fell too far. Expectations may have fallen too much, but with TIPS timing is everything. Total returns were 2.55% while excess returns fell 58bp short of coupon UST.

Risk Sectors

- Which story was more relevant in August? That US stocks at one point were down 4.5% for the month (Aug 14) or that they dropped less than 2% on net? In almost every facet, it was the latter. Equity confidence – after the initial shocks – helped support credit sentiment and pointed to asset allocations that depend on a lift from central bank easing in the fall. Also, if necessary, there are many sectors with 3-month and 6-month gains to be liquidated if central banks cannot plug the economic leaks by the end of the year. Reflecting both political and economic risks, losses in Asia and Europe were several percentage points higher than the US. Emerging markets excluding China fell 4.6%.
- Commodities fell 2.5% last month, avoiding broader losses thanks to 8%-13% gains in precious metals. Brent prices fell 7.3%, and WTI 5.9% on the month, and industrial metals were far worse. Some iron ore markets saw 29% declines; copper was down more than 5%; tin down 9%. Major grains fell as much as 11%; cattle down more than 5% and hogs down 20%.
- High yield returns stayed in the black for August, a feat not accomplished in May. Nominal results were only about 30bp, but clearly better than equities as a group. Excess returns fell 120bp short of Treasuries and 135bp below LIBOR swaps. Energy names were the worst performers, losing 2.54% in nominal terms in August. Financials were the strongest sector. Industrials averaged around 75bp.
- Emerging market government bonds fell 50bp in August. Emerging market bonds overall returned 25bp, falling 2.85% below Treasury performance while beating equities by almost 5 percentage points. Latin America led the way lower among larger regions despite the 3.6% improvement in Mexican fixed income.

Investment Grade Sector Returns: August

Returns on a duration adjusted basis hedge maturity exposure against UST and LIBOR-based interest rate swaps.

		Duration Adjusted	
	Returns	UST	LIBOR
Total	2.61	-.42	-.75
Intermediate	1.50	-.25	-.43
Treasuries	3.40		-.37
Mortgages	.90	-.60	-.70
Corporates	3.15	-1.05	-1.58
Agencies	2.30	.14	-.14

Source: FTN Financial