FTN FINANCIAL

AUGUST 9, 2019

# THE WEEKLY REPORT

This week has provided one fire drill after another. The ultimate question for international trade and currency conflicts will return in September in their impact on the real economy – a question dismissed this week but relevant for the next FOMC meeting.

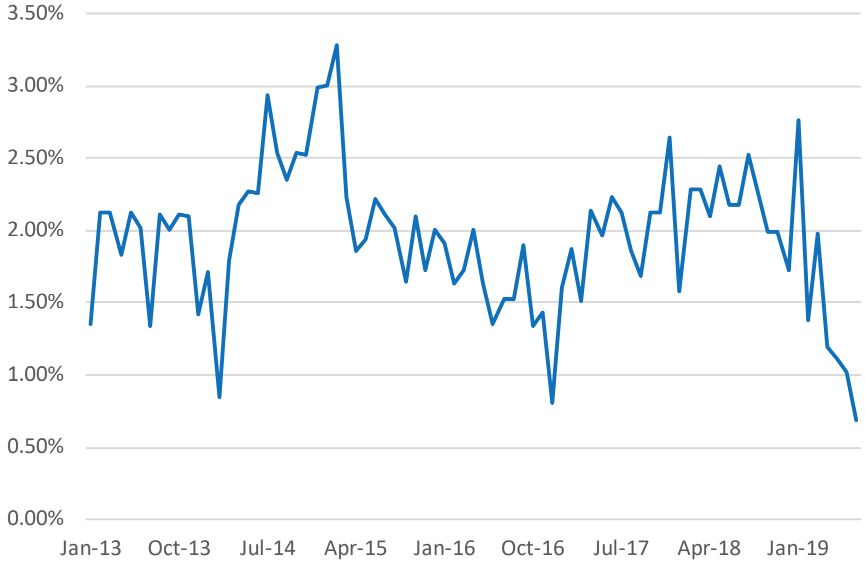
Consumption trends appear solid in the US, but as highlighted in FTN Financial's mid-year webinar this week, some of the brighter spots are dimming. Below is an unfriendly labor market indicator taken from the webinar slides.

Average weekly hours is not a headline number on payroll Fridays, but it's still a cog in the economy that can't be neglected. Growth in hours, year-over-year, was right in line with the best quarters of GDP growth from mid-2017 to mid-2018. A turn lower in the fourth quarter last year appeared to be a mirage when it moved back above 2.5% to start the year. Since January, though, the slide accelerated to less than 1% in July.

Combined with slowing job additions in 2019 and the inability of average wages to improve at a faster pace, the US economy's star attraction could tarnish in the second half of the year.

By the way, the drop in growth in hours worked has not been completely offset by increases in hourly earnings. Total earnings growth – hours x wages – is at its lowest point since the end of 2016.

**Annual Growth in Hours Worked**
**Monthly**
**2013 to July 2019**



*Source: Bureau of Labor Statistics*

## CONTENTS

**MARKET UPDATE** **P. 2**

Markets never stopped to take a breath this week. Before the excitement returns, the first order of business is to track the impact of the second biggest "surprise" in the US/China trade war. In many ways, August 1-August 9 resemble early May when the US first scuttled negotiations rather than rework old ground. For a week, at least, the Fed was barely on the radar as traders and investors rushed to deal with immediate problems with few facts in hand. Although it feels like something was left out, the Update provides a comprehensive set of charts with accompanying analysis.

**AGENCY UPDATE** **P. 10**

Second quarter results for the two housing GSEs arrived last week. Fannie Mae made some progress, while Freddie Mac is still in a slump compared with its earnings power last year.

Jim Vogel, CFA
901.435.8056
jim.vogel@ftnfinancial.com

*Disclaimer is on the last page of this report.*

# Volatile Trading Leaves More Questions than Solutions

*Financial markets moved in every conceivable direction this week, occasionally in different directions at the same time. Rather than draw conclusions from the volatility, the only job this week is to revisit what actually happened to understand current assumptions and fears about what's coming next. That's a tall order in itself.* Economic Weekly *also tackles the same task via the experience and insight of Chief Economist Chris Low.*

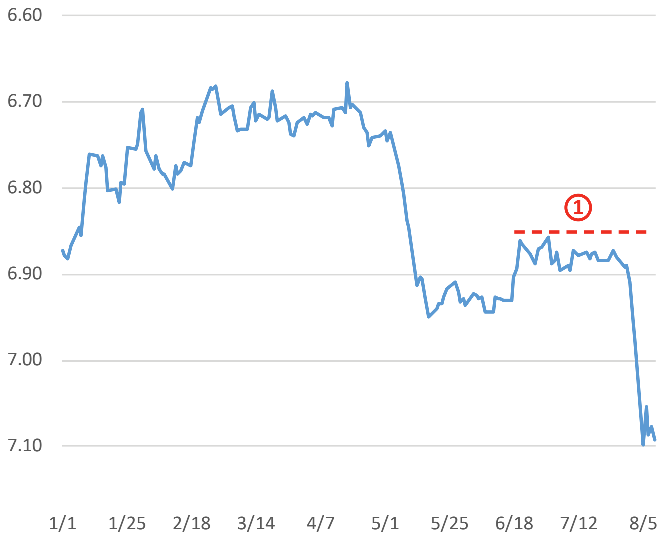
Summary

- The trade-related meltdown of risk assets forced UST to trade as much as 10-15bp through their intrinsic value as buyers rushed to buy bonds at any price. By the end of the week, the risk-aversion bid subsided to 3-7bp.
- Flows were enormous, exceeding the highs of 2018. Traders rebalanced positions, portfolio managers took profits in many asset classes to park the proceeds in Treasuries, and real money buyers bought aggressively in fixed income away from direct obligations of the US.
- Volatility was so high it generated wildly different forecasts for rates in the next 18 months from reputable analysts, including the potential for negative rates in the US.
- It is too soon to make sense of the yield curve. The beginning of curve stability will be an important sign of overall market stability.
- Stocks and oil prices hold an important key for rates through at least the middle of this month.

## Stocks responded to trade and rates responded to stocks

The August 1 tariff threat by the White House held through the weekend, provoking China to allow its currency to slip well below its established range. After allowing minor slippage in May as it sorted out its response to the collapse of trade negotiations, Beijing was all about yuan stability (1) until August 4.

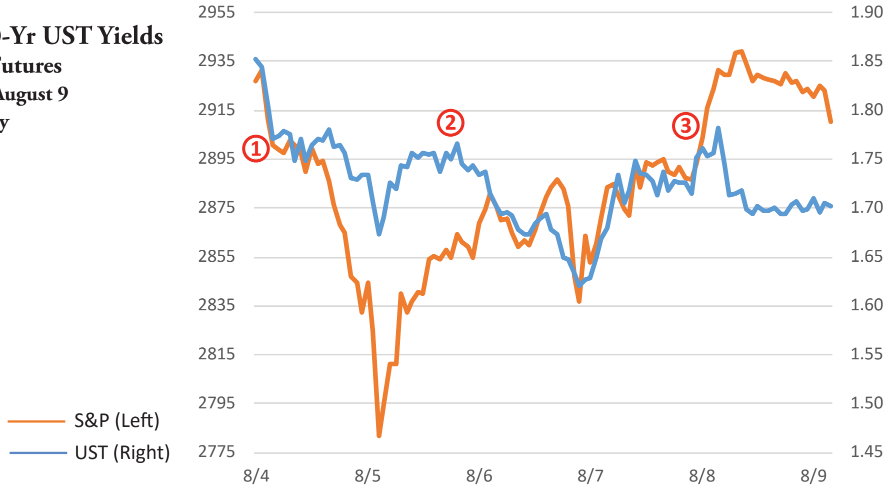
**Chinese Yuan/Dollar**
**Offshore Market, Inverted Scale**
**2019 YTD**
**Daily**



*Source: Refinitiv*

Fearing still further damage from global trade disruption, US equities fell as much as 5% in the 24 hours after the yuan fell. Yields had no choice but to fall – down 10bp in the first 10 hours (1) – but then detached from stocks on a combination of profit taking, non-dovish Fed remarks, and technical resistance (2).

**US Equities and 10-Yr UST Yields**
**S&P 500 Futures**
**August 4 to August 9**
**Hourly**



*Source: CBOE, FTN Financial, Bloomberg*

The overnight bounce in stocks on Monday appeared to reward the cautious approach by the bond market until stocks refused to bounce higher into the close on Tuesday. From that point, stocks/bonds hooked back up for until mid-morning Thursday (3). Headlines stated stocks were following bond yields on Wednesday, but the better read is bonds continued to fall relative to the entire week's action on stocks. See page 9 for a discussion of near-term stock market technicals.

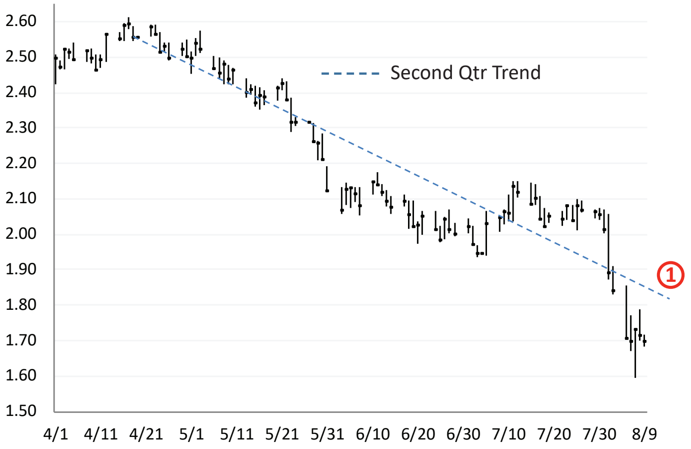
The most intense stretch of Treasury purchases accompanied the panicked decline in stocks on Wednesday's open. That included the trade of 10-yr UST at 1.59% for the intra-week low. **Yields below 1.65% on 10s reflected a 10bp haven factor related to first to stocks and then to oil**. See page 6 for an important discussion about crude prices.

## Thursday's whippy UST sell-off did limited damage to technicals

On a flatter curve, net yield changes this week ranged from 10-15bp. That followed the curve flattening the prior week for 12-20bp. The low yield in this week's volatility for 10s was 1.595% while the high reached 1.791% early Thursday afternoon. The intra-day high was close to what will be an important August technical for 10s. The quick retreat after a well-distributed 30-yr auction and government uncertainty in Italy lessened the immediate danger.

Yet, look ahead to the slope of the trend for 10-yr yields into the middle of this month. It is on a clear path to 1.80% (1) so that will be one important technical even though trading flows indicate support at 1.845%.

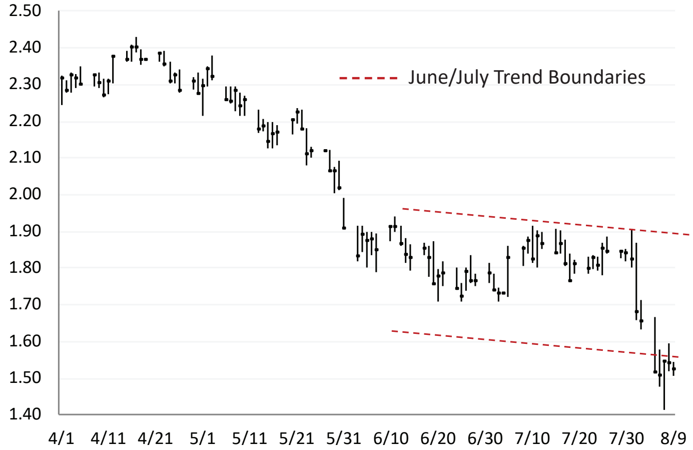
**10-Yr UST Yields**
**April 1 to August 9**
**Daily**



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

***10s would have to move above 1.80% on for two days to violate the trendline and another 15bp higher to represent a one standard deviation event. The 5-yr is still below the second standard deviation of the June/July boundaries with 1.72% as the first real danger area for momentum.***

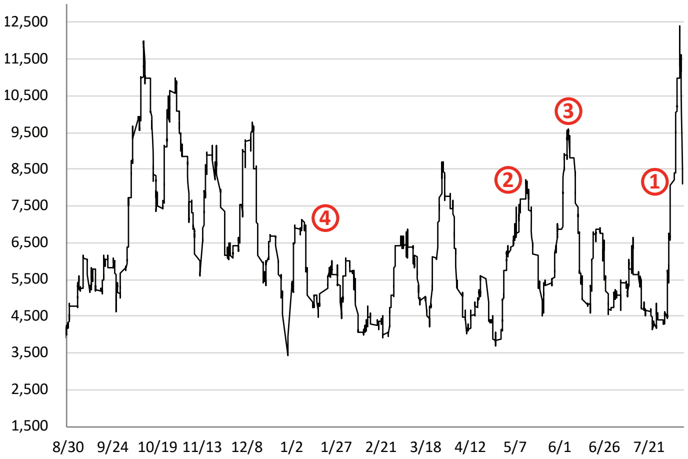
**5-Yr UST Yields**
**April 1 to August 9**
**Daily**



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

Most traders believe two-week rate moves of 22-35bp cannot last, that they will be challenged by large profit taking and then skepticism about who buys next. Looking only at prices or yields, that can be a valid approach to market analysis. Adding volume to the mix changes the picture. If the rally had ended August 2 (1), then the odds of a yield retracement toward 2% on 10s would have been higher. This week's cumulative buying, reached the highest level since February 2018 (not shown on the chart).

**5-Day Cumulative 10-Yr UST Futures Trading Volume**
**Daily**
**September 2018 to Present**



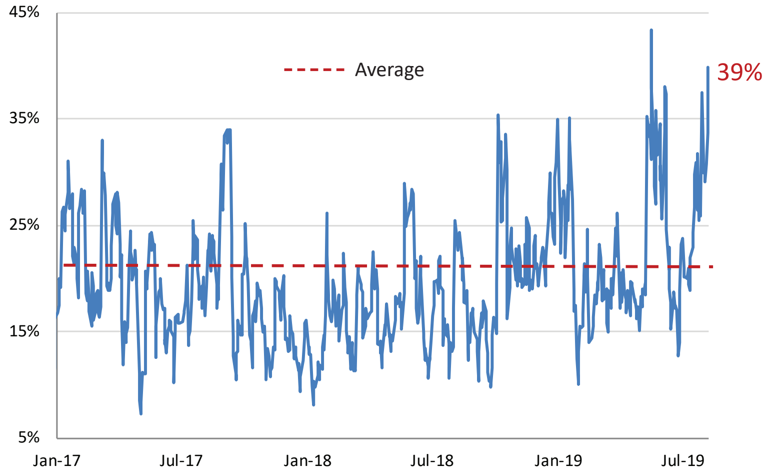
*Source: FTN Financial, CBOT*

The other two volume surges also have been on trade headlines: China talks collapse (2) and the threat of Mexican tariffs (3). Reactions to the Fed have been noticeable at the time but they don't stand out except for the January 4 pivot by Chair Powell (4). Evaluating the events of the last eight trading sessions and the volume that followed, it is difficult to forecast a combination of events/data that would create enough confidence to produce major Treasury selling before September.

### Volatility approaches 2019 highs

Global market correlations duplicated their 2019 peak this month, an indication of the growing importance of the trade war. The previous peak in May was signaled by the collapse of US/China talks when most thought the ink was about to start drying on an agreement. The chart finds the mean correlation across nine critical markets around the world.

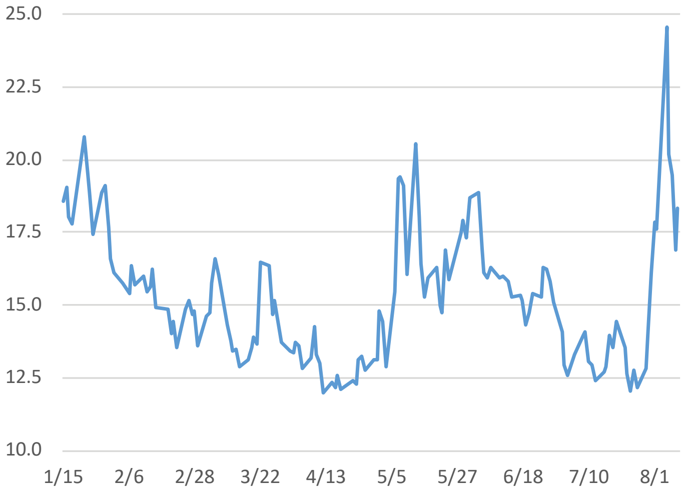
**Global Financial Markets**
**10-Day Cross-Sector Correlation of 9 Markets**
**2017 to Present**
**Daily**



*Source: FTN Financial*

Equity volatility surged from the low teens as high as 24.7% late Monday before returning below 20% once investors saw the worst was over. There was little lasting reaction to the US imposition of tariffs. Rather it was the unexpected reaction from China that forced stock investors to realize how serious escalating tensions had become.

**1-Mo Equity Volatility**
**VIX Index**
**January 15 to Present**



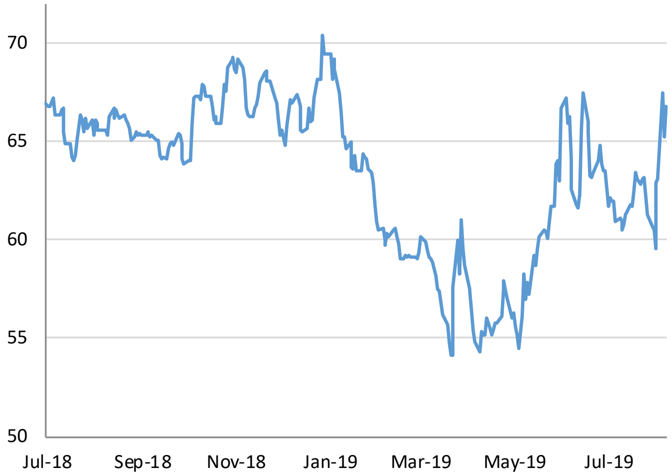
*Source: CBOE*

The VIX chart illustrates i) how equities have blithely assumed central bank easing would buoy prices and reduce volatility; and ii) the now 18-month long idea that trade wars would blow over. This week brought value adjustments in equities – with price/free cash flow descending from 24.4x to 23.6x – but still little recognition of the fundamental threat posed by a stiff-arm to globalization. A rational approach to gaining trade concessions from China (or anyone else, for that matter) would be to form trade alliances with other partners while leaving China on the outside. The present US course is to threaten retaliation against all major trading partners. Bottom Line: Equities constantly discuss the ramifications of deteriorating trade but do next to nothing about it outside selected tech and capital stocks.

***Equities are not the only ones with their heads in the sand. FTN's tracker of 60-day global market volatility ticked up this month but is well within the confines of a broadly declining trend channel. The current reading is just above 16% versus the long-term average of 18%.***

Even in the face of mild panic in bonds and fresh uncertainty about what global affairs will confront the Fed in September, implied option volatility on the 5-yr only returned to the highs of May and mid-June (before the FOMC).

**Implied Volatility on 1x5 At-the-Money Swaptions**
**Annualized Basis Points**
**July 2018 to August 9**
**Daily**



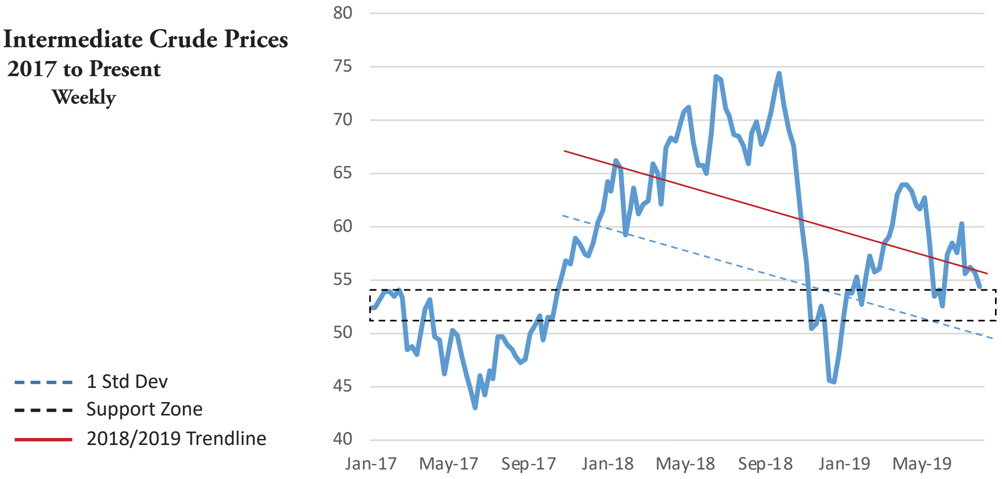
*Source: ICAP, Refinitiv*

## Stress knocks out oil rally

Equity volatility slept through the President's tariff announcement on August 1, but oil most certainly did not. Option pricing on oil (CBOE) spiked from 32% to 38% that afternoon as Brent fell 7.2% from a strong bid after the FOMC meeting. Technicals show this week created two major threats to oil's momentum.

- The rectangle (dashed black line) shows the long-term support zone for oil during the US expansion. The current level of about $52/barrel is in the middle of the zone.
- One standard deviation below the 2018 to present trendline (dashed blue) shows secondary support at $50/barrel.

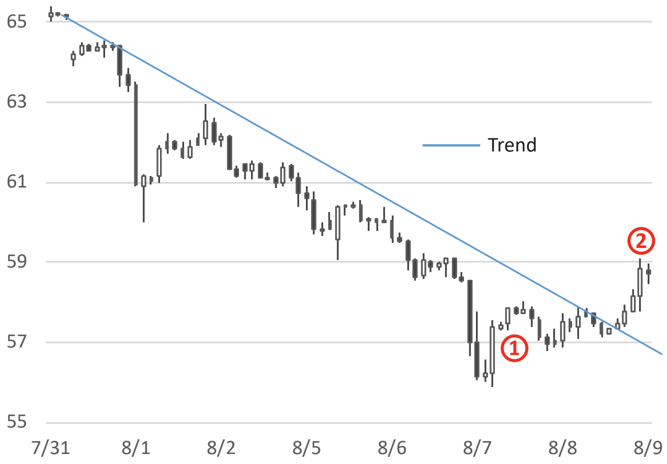
**West Texas Intermediate Crude Prices**
**2017 to Present**
**Weekly**



*Source: NY Mercantile Exchange, FTN Financial*

Short-term technicals on Brent crude are daunting as well. From the July 31 high above $65/barrel, the slide steepened until global risk assets caught a bid late on August 7. Also, Saudi Arabia tried to jawbone prices higher with a "whatever it takes" pledge to return prices to their previous level. A Bloomberg News columnist was quick to point out how previous pledges worked two years ago, but the resources to enforce the pledge are near exhaustion in 2019. So while oil traders noticed (1) the gain didn't hold until US equities remained firm on Friday morning. (2) They also got a boost from an announcement the Saudi Aramco IPO might be on again for next year.

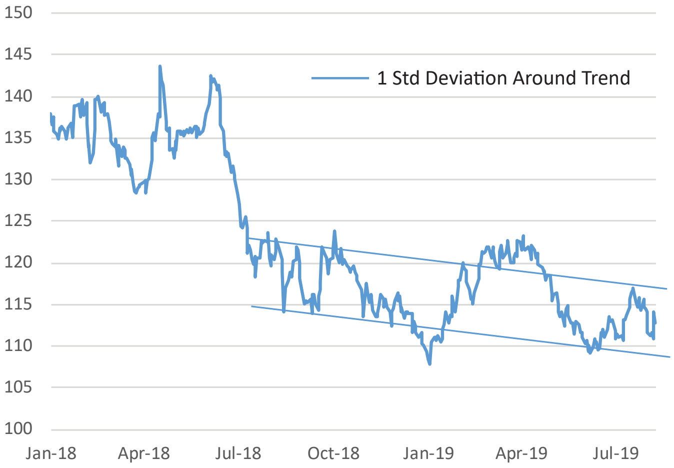
**Brent Crude**
**July 31 to Present**
**Frequency: Every 2 Hours**



*Source: Bloomberg*

Unlike oil, industrial metals have been in a slump since June of last year, when it became obvious falling PMIs for global manufacturing were not going to recover quickly. Metals trading suffered short bursts of panic this week, but the bigger story is the continued grind lower inside a well-defined channel. Oil's influence as a short-term barometer on inflation and inflation expectations is important for August, while industrial metals reflect a broader view of slowing demand that is pulling inflation ever lower around the world – and the appetite for risk assets along with it.

**Commodities: Industrial Metal Index**
**2018 to Present**
**Daily**

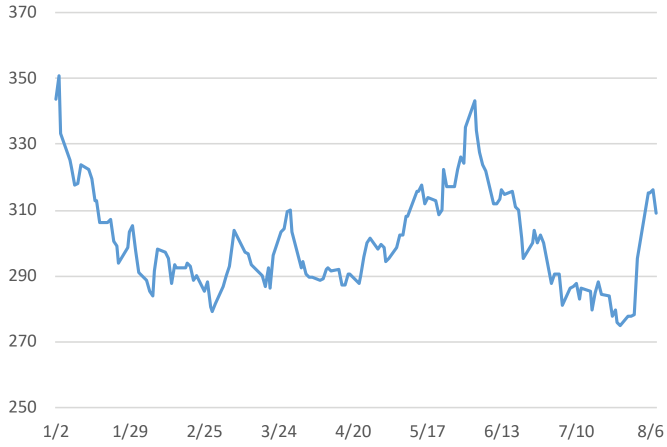


*Source: Bloomberg, FTN Financial*

### Outside emerging markets, credit spreads hold up surprisingly well

Because of the broad, obvious support for fixed income the pressure on domestic investment grade spreads has been minimal this month. Emerging market government bond spreads stopped short of the widening seen during the May US/China trade news, but they did not recover as much on August 8 as equities. Due to considerable volatility in international exchange rates – a topic for later, alas – Treasuries will have to glance daily at spreads in smaller countries. So far, no imminent danger visible but no relief either.

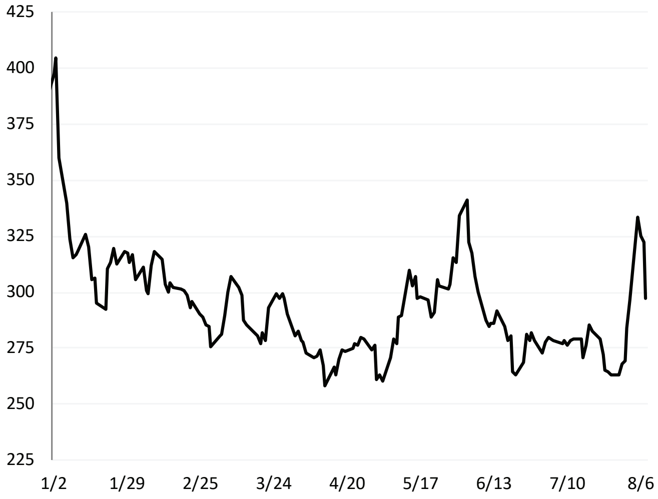
**Emerging Mkt Govts Spread to UST**
**2019 to Present**
**YTD**



*Source: FTSE Russell Index*

Domestic high yield saw profit taking August 1 to August 6, but staged a surprising recovery relative to investment grade names. The chart takes energy securities out of high yield as they fluctuate directly with crude prices.

**Basis Difference of High Yield Bonds to Intermediate Investment Grade Credit**
**High Yld less Energy Component**
**2019 YTD**
**Daily**



*Source: FTN Financial and FTSE Russell Index*

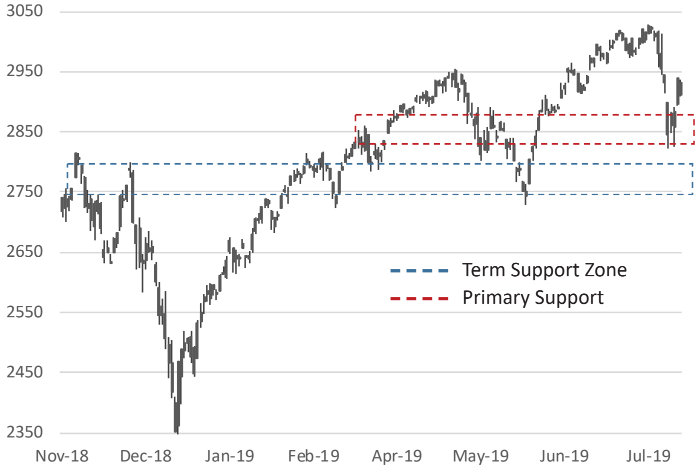
If equities can't get daily volatility under control, the underlying confidence in the US corporate market will take some hits. So far, that's not in view. Should large investors decide to pull back from new issues and take profits outside high yield, then the risk-aversion impact on UST yields could be in the 5-10bp range regardless of stock market performance.

### Equities bounced off 2019 support

The widely followed stock indexes remain resilient. Individual sectors have been punished this month and are yet to recover. Month to date, through noon on August 9, the S&P 500 is down 2.3%. Energy, banks, and machinery are down 5-7%. As noted on page 1, bonds for now are reacting to broad, index-style movement captured by futures and ETFs.

The first impression of the chart of the S&P 500 since the beginning of last November is the upward channel that took its worst hits in May. The August hit is not as bad. The May decline retraced to a 6-month support zone marked by the blue rectangle – ignoring for the time being the year-end melt down.

**S&P 500**
**November 1 to Present**
**Daily**



*Source: Standard & Poor's, FTN Financial*

For this summer, the real test will be the primary support zone (red rectangle) that provides the foundation for continued confidence that lower central bank target rates will provide necessary support for global equities. The bounces off the bottom of the zone on August 5-7 account for the disconnect between bond yields and stocks noted in the second chart on page 2. ***Two days below 2850 could be enough for 10-yr and 30-yr UST yields to revisit intra-month lows before the end of August.***

## Single-Family GSEs See Mixed Earnings in Second Quarter

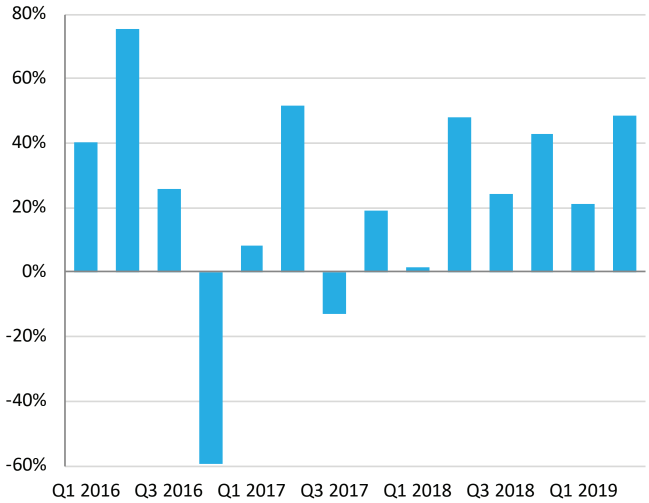
*A two-part review, leading with Fannie Mae then Freddie Mac on page 12.*

Fannie Mae rode improved top line growth vs Q1 and a large increase in credit benefits to a better bottom line for the second quarter. GAAP net income totaled $3.4 billion and comprehensive income was $3.37 billion. The second quarter goes a way to reverse the net income skid in Q4 2018 and Q1 2019. In 2018, quarterly net income regularly exceeded $4 billion, so the variance from the second quarter in 2018 was a decline of about 25%. All of that drop from last year was in the single-family business segment. Fannie Mae includes legacy/liquidity portfolio results in its single-family totals, so shrinking results from portfolio contribute to the change.

Improvement in credit income flows from better market valuations in the single-family credit book. As the economic cycle ages and household credit quality is not improving that much, the adjustments related to stronger home prices and lower cost of transferring credit risk to outside parties.

The second quarter was the seventh consecutive to avoid GAAP credit losses and the sixth of the last seven for a sizeable contribution to earnings.

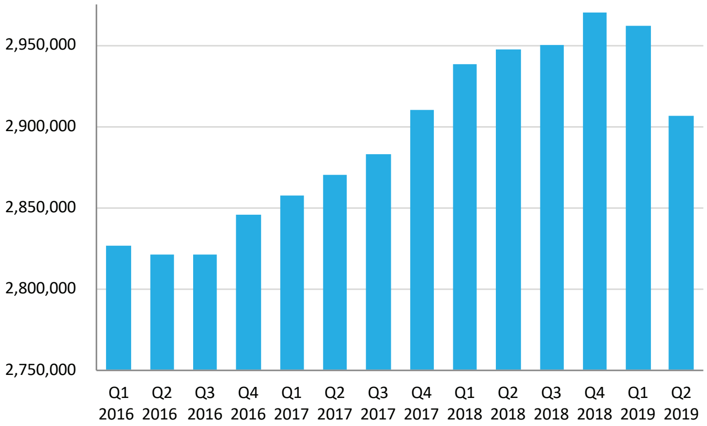
**Credit (Costs)/Recoveries as Percentage of Pre-Tax, Pre-Credit Operating Revenues**
**S-F Guaranty Business Line**
**2016 to Q1 2019**
**Quarterly**



*Source: FTN Financial, Fannie Mae*

Mortgage issuance was the highest since the end of 2017, but the average size of the total guaranty book was the lowest in almost two years. The blow was cushioned by a small increase in the average guaranty fee.

**S-F Guaranty Book, Quarterly Average**
**2016 to 2019 YTD**
**(Millions)**

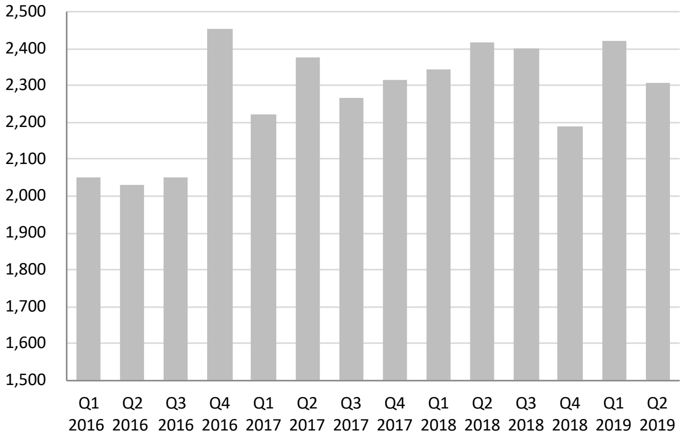


*Source: FTN Financial, Fannie Mae*

The first portion of the table below also shows the decline in the average credit book. There were no significant loan sales visible in the financial statements that would account for the sharp drop. The assumption is faster prepayments accounted for the erosion as originations failed to keep pace. ***Fannie Mae's share of GSE originations fell to 54% in the second quarter from its typical share in the high 50s to low 60s.***

Operating expenses in the single-family business have trended sideways in the last seven quarters. Second quarter administrative expense was only 4.4% above the rate in the fourth quarter of 2017. Pre-tax, pre-credit recovery operating revenue, then, has plugged along at an average of $2.3 billion since the end of 2016…right where it was in Q2.

**Fannie Mae S-F Guaranty Business Segment**
**Net Operating Revenues, Pre-Tax and Pre-Credit Expense**
**Trailing 3 Years**
**(Millions)**



*Source: FTN Financial, Fannie Mae*

**Fannie Mae S-F Guaranty Business Statistics**

| | Q2 2019 | Q1 2019 | Q4 2018 | Q3 2018 | Q2 2018 | Q1 2018 | Q4 2017 |
|---|---|---|---|---|---|---|---|
| Avg total S-F guaranty | 2,907,000 | 2,962,000 | 2,970,000 | 2,950,000 | 2,947,000 | 2,938,000 | 2,910,000 |
| MBS issuance | 120,100 | 88,000 | 107,700 | 130,000 | 111,300 | 121,000 | 126,882 |
| Effective avg guaranty fee | 43.4 | 43.3 | 42.4 | 43.3 | 42.7 | 42.6 | 42.4 |
| Fee new acquisitions | 46.7 | 50.4 | 42.5 | 51.2 | 49.0 | 47.1 | 45.2 |

**Fannie Mae S-F Guaranty P&L**

| | Q2 2019 | Q1 2019 | Q4 2018 | Q3 2018 | Q2 2018 | Q1 2018 | Q4 2017 |
|---|---|---|---|---|---|---|---|
| Net Guaranty Fees | 3,154 | 3,206 | 3,148 | 3,193 | 3,146 | 3,129 | 3,085 |
| Administrative Expenses | 517 | 541 | 569 | 522 | 529 | 521 | 495 |
| Expenses less Fee Inc | (330) | (243) | (389) | (271) | (201) | (265) | (273) |
| Operating Inc | 2,307 | 2,422 | 2,190 | 2,400 | 2,416 | 2,343 | 2,317 |
| Credit (Losses)/Recovery | 1,126 | 518 | 934 | 582 | 1,159 | 34 | 437 |
| Pre-tax income | 3,433 | 2,940 | 3,124 | 2,982 | 3,575 | 2,377 | 2,754 |

*Source: Fannie Mae, FTN Financial*

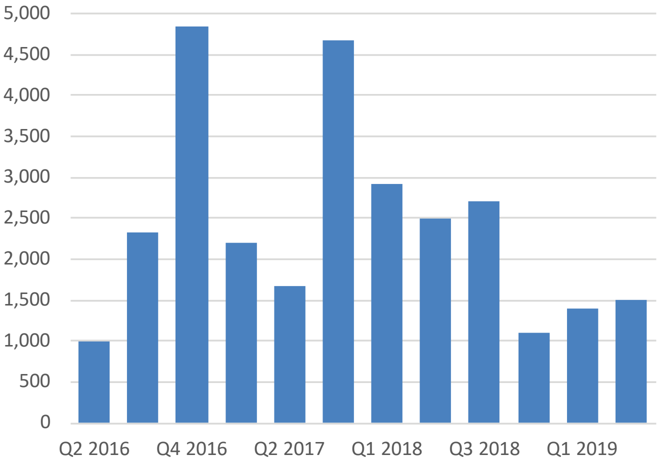
Multi-family net income increased more than 10% over the second quarter of 2018, yet sliding just slightly from the excellent results in the first quarter of 2019. The quarterly average tops $500 billion.

## Freddie Mac can't shake slump

Freddie Mac's second quarter net income was in line with the first quarter but still trailed the quarterly pace set in 2017-2018. This is the third consecutive quarter with net, comprehensive income below $2 billion. The second quarter's comprehensive total was $1.83 billion or $600 million less than the second quarter last year. Freddie Mac's comprehensive GAAP income best reflects operating results net of mark to market adjustments in hedges and trading positions.

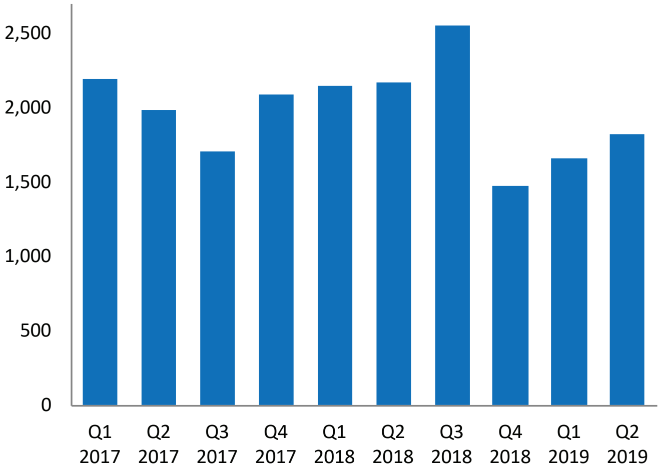
Net income was $1.5 billion for the quarter, little changed from Q1's $1.4 billion. Freddie Mac also reports non-GAAP results to remove a host of accrual adjustments that factor into earnings volatility in the published financials. The first chart shows GAAP net income, while the second reports non-GAAP comprehensive income.

**Freddie Mac Quarterly Net Income (GAAP Basis)**
**Q2 2016 to Q2 2019, Excluding Q4 2017**
**(Millions)**



*Source: Freddie Mac*

**Non-GAAP Comprehensive Income**
**Last 9 Quarters**
**(Millions)**



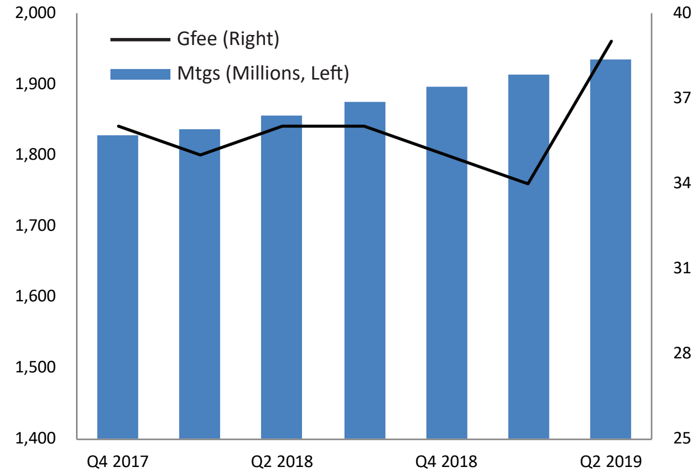
*Source: Freddie Mac*

***Second quarter comprehensive income was 14% behind the average of 2017-Q3 2018, and net income was 45% below the average of the same period.***

On the better news side of the ledger, the single-family guarantee business produced one of its better quarters in some time. Pre-tax, pre-credit operating income (GAAP) came in above $1.1 billion, up 10.8% from Q2 2018. The profitability burst – driven somewhat by faster prepays – would have been even higher if administrative expenses didn't grow at a 10.2% clip.

The chart highlights the two components of top line revenue for Freddie's primary enterprise.

**Freddie Quarter-End S-F Mortgage Book and Average G-Fees (GAAP Basis)**
**Q4 2017 to YTD 2019**
**Quarterly**



*Source: Freddie Mac, FTN Financial*

The table tracks quarterly performance back to the fourth quarter of 2017.

| Freddie Mac S-F Guaranty Business Statistics | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Q2 2019 | Q1 2019 | Q4 2018 | Q3 2018 | Q2 2018 | Q1 2018 | Q4 2017 |
| Ending guaranty book | 1,935,000 | 1,914,000 | 1,896,000 | 1,875,000 | 1,855,000 | 1,836,000 | 1,829,000 |
| MBS issuances | 102,000 | 70,000 | 77,000 | 81,000 | 84,000 | 66,000 | 98,000 |
| Eff avg guaranty fee (bp) | 39 | 34 | 35 | 36 | 36 | 35 | 36 |
| Fee on acquisitions (bp) | 44 | 40 | 40 | 41 | 41 | 40 | 35 |
| **Freddie Mac S-F Guaranty P&L** | | | | | | | |
| | Q2 2019 | Q1 2019 | Q4 2018 | Q3 2018 | Q2 2018 | Q1 2018 | Q4 2017 |
| Guaranty fees | 1,889 | 1,633 | 1,637 | 1,675 | 1,666 | 1,590 | 1,641 |
| Administrative Expenses | 400 | 374 | 420 | 372 | 363 | 336 | 363 |
| Net (Expenses)/Oth Inc | (356) | (301) | (135) | (65) | (281) | (270) | 43 |
| Operating Inc | 1,133 | 958 | 1,082 | 1,238 | 1,022 | 984 | 1,321 |
| Credit (Losses)/Recovery | (7) | (30) | 66 | 164 | 83 | 2 | (160) |
| Pre-tax income | 1,126 | 928 | 1,148 | 1,402 | 1,105 | 986 | 1,161 |

*Source: Freddie Mac, FTN Financial*

The multi-family business improved from the first quarter, although it still trails the run rate of recent years. Competitive forces apparently still compress gain-on-sale income Freddie was once able to capture in its pipeline. Net income for the segment fell 16% from the second quarter of 2018.

This material was produced by an FTN Financial Strategist and is not considered research and is not a product of any research department. Strategists may provide information to investors as well as to FTN Financial's trading desk. The trading desk may trade as principal in the products discussed in this material. Strategists may have consulted with the trading desk while preparing this material and the trading desk may have accumulated positions in the securities or related derivatives products that are the subject of this material. Strategists receive compensation which may be based in part on the quality of their analysis, FTN Financial revenues, trading revenues, and competitive factors.

The views expressed herein accurately reflect the author's personal views about the subject securities or issuers. No part of their compensation was, is or will be directly or indirectly related to the specific recommendations or views contained in the Notes.

Although this information has been obtained from sources which we believe to be reliable, we do not guarantee its accuracy, and it may be incomplete or condensed. This is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security. All herein listed securities are subject to availability and change in price. Past Agency updates not indicative of future results, while changes in any assumptions may have a material effect on projected results. Ratings on all securities are subject to change.

FTN Financial Group, FTN Financial Capital Markets, FTN Financial Portfolio Advisors and FTN Financial Municipal Advisors are divisions of First Tennessee Bank National Association (FTB). FTN Financial Securities Corp (FTSC), FTN Financial Main Street Advisors, LLC, and FTN Financial Capital Assets Corporation are wholly owned subsidiaries of FTB. FTSC is a member of FINRA and SIPC—http://www.sipc.org/.

FTN Financial Municipal Advisors is a registered municipal advisor. FTN Financial Portfolio Advisors is a portfolio manager operating under the trust powers of FTB. FTN Financial Main Street Advisors, LLC is a registered investment advisor. None of the other FTN entities including, FTN Financial Group, FTN Financial Capital Markets, FTN Financial Securities Corp or FTN Financial Capital Assets Corporation are acting as your advisor and none owe a fiduciary duty under the securities laws to you, any municipal entity, or any obligated person with respect to, among other things, the information and material contained in this communication. Instead, these FTN entities are acting for their own interests. You should discuss any information or material contained in this communication with any and all internal or external advisors and experts that you deem appropriate before acting on this information or material.

FTN Financial Group, through FTB or its affiliates, offers investment products and services. Investment Products are not FDIC insured, have no bank guarantee and may lose value.