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Oil and Rates Giving Their Relationship Another Shot

For 3 months, they were almost inseparable. Then in June, they went their separate ways. Now oil and rates are back together in July, for the most part.

Specifically, movement in oil prices was highly correlated with movement in rates (represented below by 10yr Treasury yields) after the onset of the Iran war. The reasoning was simple: higher fuel prices implied higher inflation, and higher inflation tends to result in higher rates.

The oil/rates correlation is never perfect, but it generally remained strong until ceasefire confirmation in early June. At that point, oil went south while bonds decided to stick around for a while for their own reasons (and also because gas/diesel prices haven't fallen nearly as fast as oil prices).

MBS and Treasury

	Price / Yield	Change
MBS UMBS 6.0	99.58	+0.48
10 YR Treasury	4.9238	-0.1198
30 YR Treasury	5.3131	-0.0931

Pricing as of: 11/20 3:54PM EST

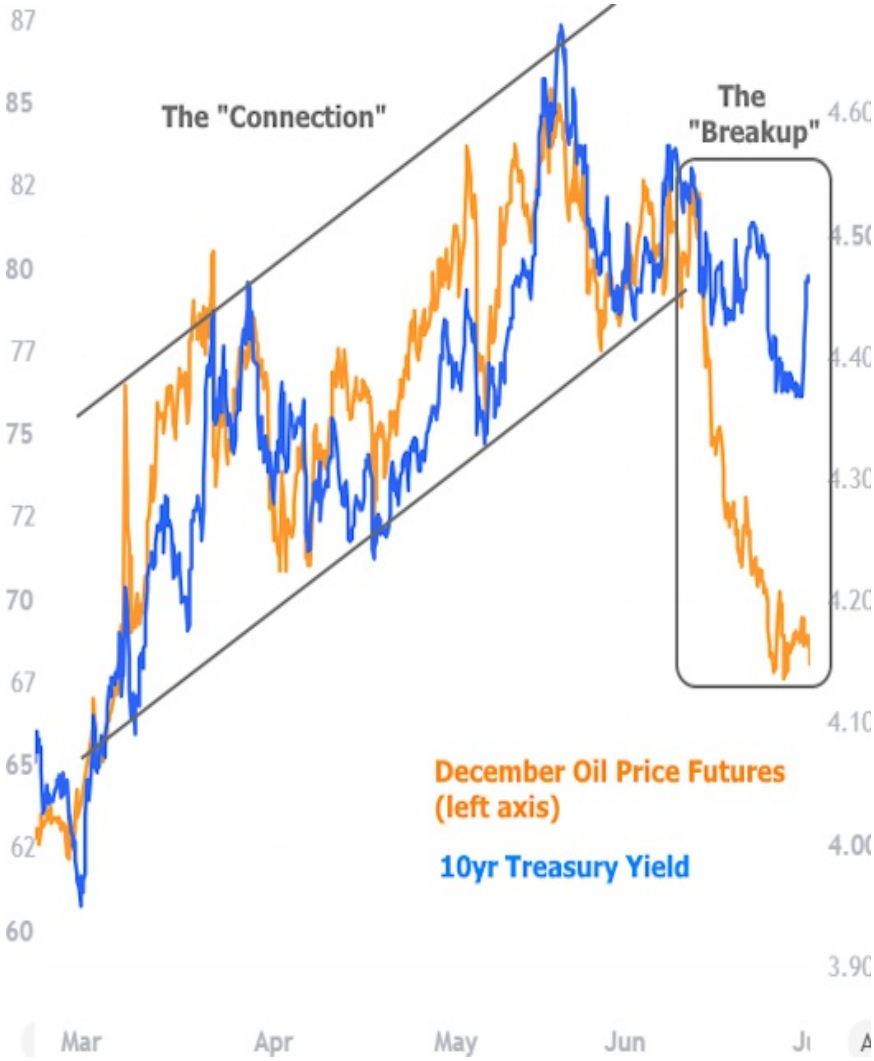
Recent Housing Data

		Value	Change
Mortgage Apps	Nov 11	199.8	-2.35%
Building Permits	Oct	1.3M	-7.5%
Housing Starts	Oct	1.31M	+7.21%
New Home Sales	Sep	676K	-1.17%
Pending Home Sales	Oct	63	-4.69%
Existing Home Sales	Oct	3.99M	+0.25%
Builder Confidence	Nov	25	-13.79%

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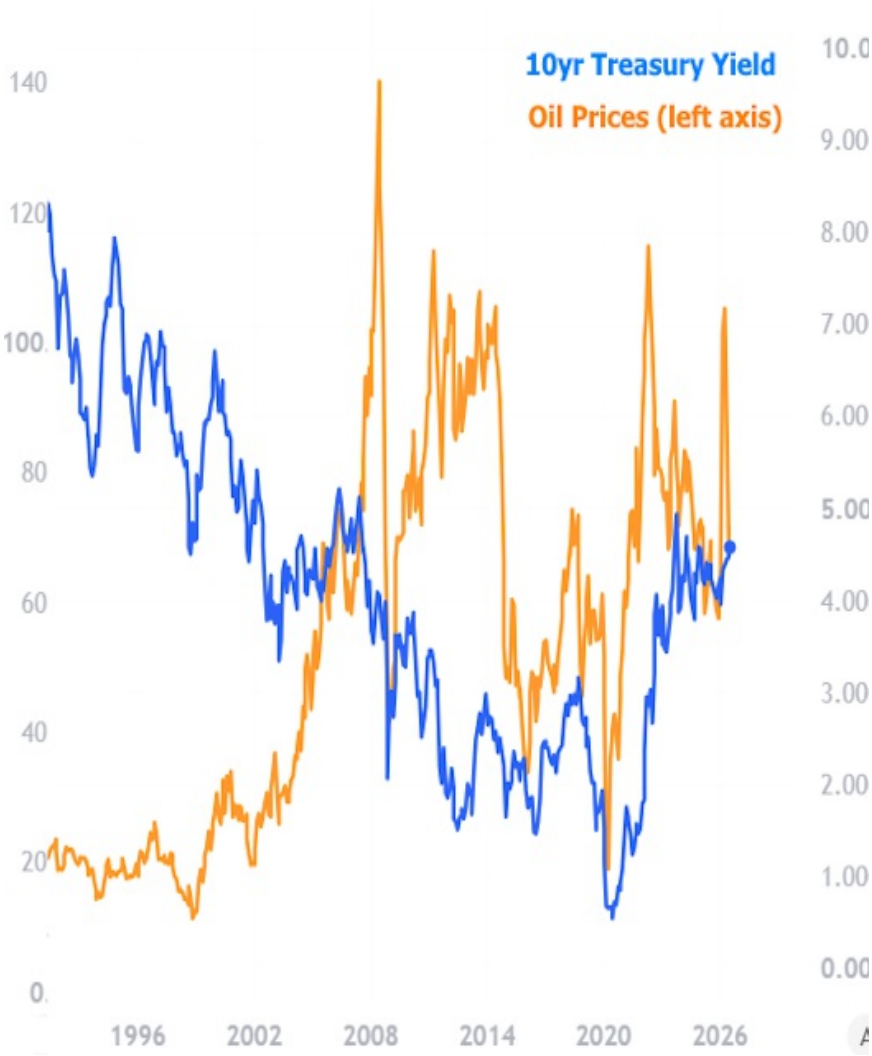


Before continuing, let's be clear on the oil/rate relationship in the bigger picture. Because fuel is so central to inflation and because inflation is so central to rates, it's tempting to conclude that oil and rates should **always** be correlating to some extent. In practice, bonds have a lot of other things on their mind besides inflation. This results in noticeable departures from the correlated trend over the years.

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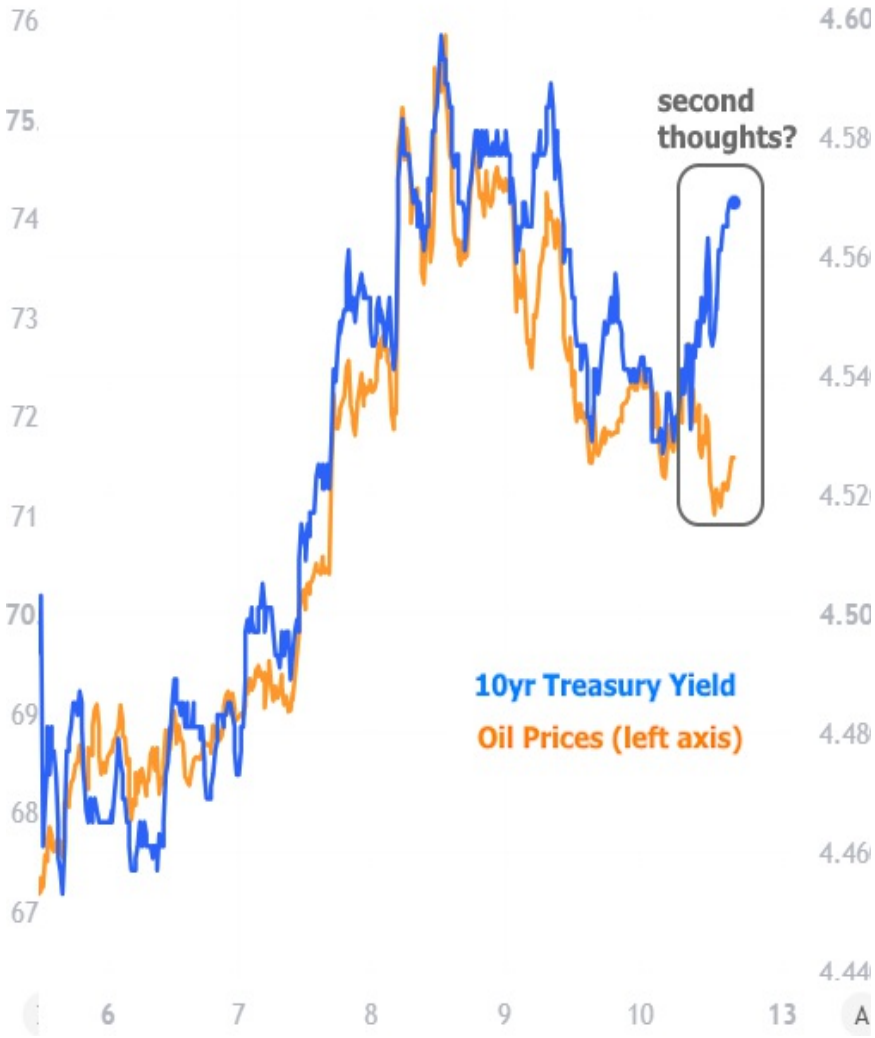
Nonetheless, recent correlation is understandable given the violence of the move in oil/fuel prices combined with an absence of other strong motivations for the bond market. This point was driven home last week when the jobs report caused a big bond-specific reaction that didn't involve oil.

The present week was a different story. Bonds/rates had very little by way of new motivation or data. Meanwhile, the end of the U.S./Iran ceasefire was big news for oil. Prices spiked and the apathetic bond market was quickly willing to be taken along for the ride.

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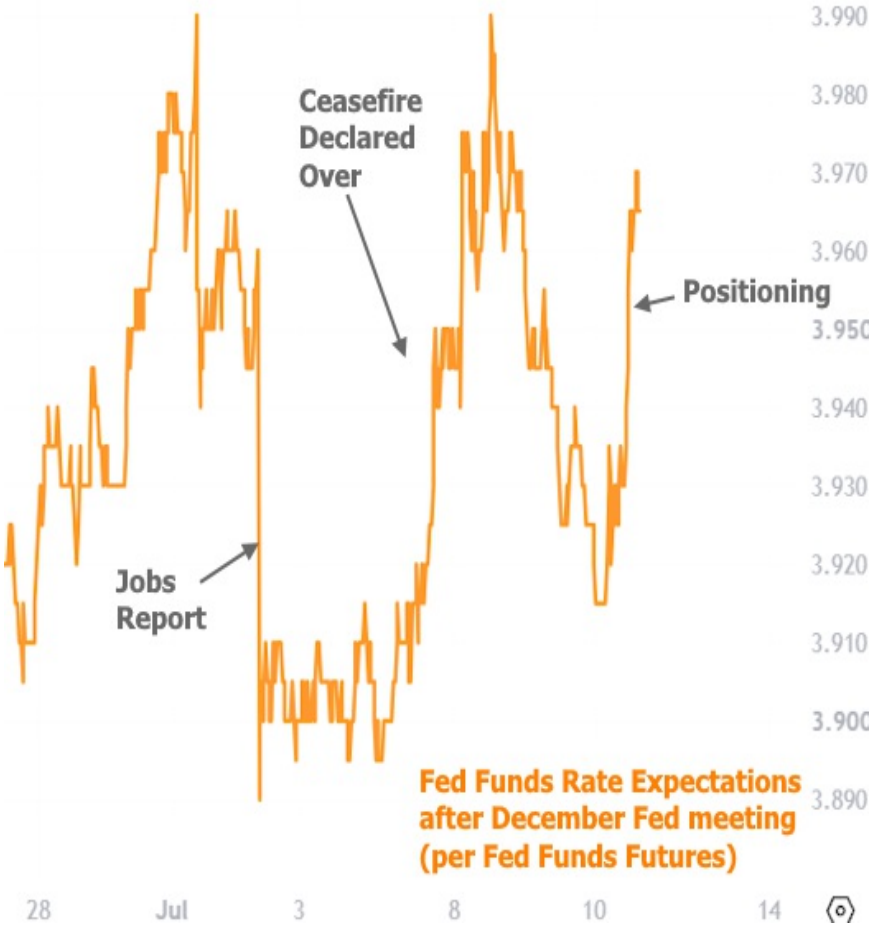


As the chart above shows, July has seen a high degree of correlation return. The only hitch was on Friday afternoon when bond yields continued to drift higher as oil prices remained lower day-over-day. There are a number of way to justify this, but the simplest would be that traders were positioning for next week's testimony from Fed Chair Warsh as well as two key inflation reports. Adding credence to this theory is the fact that Fed Funds Futures experienced an even sharper move than longer-term Treasuries.

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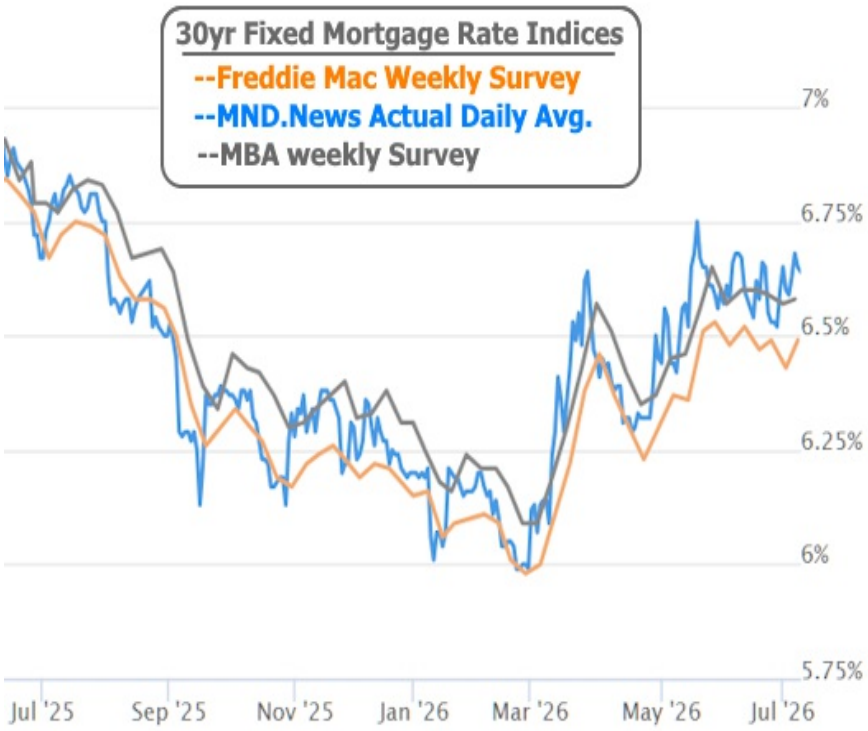


If all of the above sounds a bit dramatic, mortgage rates agree. The Treasury charts place rate volatility under a microscope. In the bigger picture, mortgage rates are merely drifting sideways in a fairly narrow range--albeit a range near the 10-month highs.

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Recent Economic Data

Date	Event	Actual	Forecast	Prior
Monday, Jul 06				
10:00AM	Jun ISM N-Mfg PMI	54.0	54	54.5
Tuesday, Jul 07				
8:30AM	May Trade Gap (bl)	$-77.6B	$-78.5B	$-55.9B
11:00AM	Jun Consumer Inflation Expectations	3.7%		3.5%
Wednesday, Jul 08				
7:00AM	Jul/03 MBA Refi Index	794.4		828.7
7:00AM	Jul/03 MBA Purchase Index	169.5		170.6
2:00PM	FOMC Minutes			
Thursday, Jul 09				
8:30AM	Jul/04 Jobless Claims (k)	215K	218K	215K
10:00AM	Jun Existing home sales (ml)	4.09M	4.20M	4.17M
Tuesday, Jul 14				
8:30AM	Jun y/y Headline CPI (%)	3.5%	3.8%	4.2%
10:00AM	Fed Chair Warsh Testimony			
Wednesday, Jul 15				
8:30AM	Jun PPI y/y	5.5%	6.2%	6.5%
10:00AM	Fed Chair Warsh Testimony			

Event Importance:

No Stars = Insignificant
☆ Low
★ Moderate
★★ Important
★★ Very Important

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Date	Event	Actual	Forecast	Prior
Thursday, Jul 16				
8:30AM	Jul/11 Jobless Claims (k)	208K	217K	215K
8:30AM	Jul Philly Fed Business Index	41.4	13	10.3
8:30AM	Jun Retail Sales (%)	0.2%	0.2%	0.9%
10:00AM	Jul NAHB housing market indx	34	35	35
10:00AM	Jun Pending Home Sales (%)	-5.4%	-0.5%	3.8%
10:00AM	May Business Inventories (%)	0.3%	0.3%	0.5%
Friday, Jul 17				
8:30AM	Jun Import prices mm (%)	0.3%	-0.7%	1.9%
9:15AM	Jun Industrial Production (%)	0.1%	0.2%	0.1%
10:00AM	Jul Consumer Sentiment (ip)	54.4	51	49.5

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