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The Day Ahead: 2 Charts That Help Explain the Big Picture

There's nothing significant on the econ calendar today, and bonds are starting out by retreating (in a good way) back into the center of the ongoing uptrend. On days like today, bond analysis has to look to the bigger picture (because there's not much to say about today). If you didn't catch the last big-picture explanation on why things are the way they are, the best recent example is probably THIS ONE about short-term rates driving long term rates. I revisited that topic in yesterday's Day Ahead to some extent (here) as well.

Today's first chart speaks to the same sort of phenomenon whereby the shorter end of the yield curve is pushing longer-term rates **reluctantly** higher. I say "reluctantly" because long term rates really want to see more evidence of rising core inflation, and especially of rising inflation-adjusted wages (the thing that would logically precede meaningful price inflation). The reluctance is evident in the rampant yield curve flattening of 2017 (10 and 2yr yields getting closer to each other).

Flattening was mainly a factor of rising 2yr yields in 2017, and 2yr yields' upward trajectory was mainly a factor of Fed rate hike expectations (though there are other factors we will discuss). The following chart shows the Fed Funds Rate versus OIS (overnight-indexed swaps, which are essentially non-speculative assumptions about where the Fed Funds Rate will be in the near future and thus the most accurate peek into the real market's rate hike expectations). OIS don't get a lot of publicity because they're **never** going to react to the rate hike outlook more than a month or two in the future. But in the month or two preceding a potential hike, they **tell us a lot** about the degree to which markets are expecting a hike. As you can see, there was some indecision in the middle of 2017 that's now been resolved. The 2 most recent rate hikes have seen the strongest, most linear front-running by OIS to date.

MBS & Treasury Market Data

	Price / Yield	Change
MBS UMBS 5.0	99.37	+0.02
MBS GNMA 5.0	99.93	+0.02
10 YR Treasury	3.9068	+0.0029
30 YR Treasury	4.1960	+0.0028

Pricing as of: 9/1 7:34PM EST

Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	6.43%	+0.02	0.00
15 Yr. Fixed	5.95%	0.00	0.00
30 Yr. FHA	5.82%	+0.02	0.00
30 Yr. Jumbo	6.62%	0.00	0.00
5/1 ARM	6.28%	-0.01	0.00
Freddie Mac			
30 Yr. Fixed	6.35%	-0.51	0.00
15 Yr. Fixed	5.51%	-0.65	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	6.44%	-0.06	0.54
15 Yr. Fixed	5.88%	-0.16	0.68
30 Yr. FHA	6.36%	-0.06	0.85

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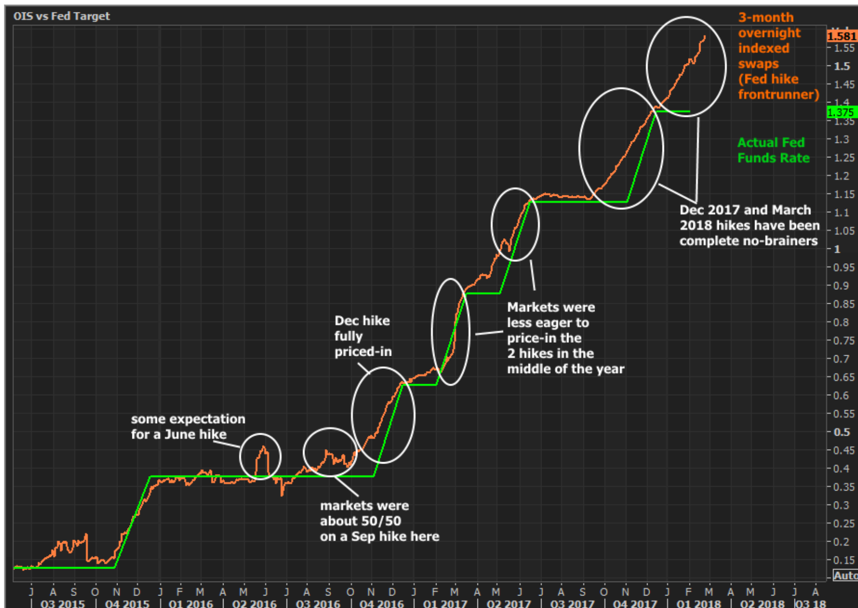
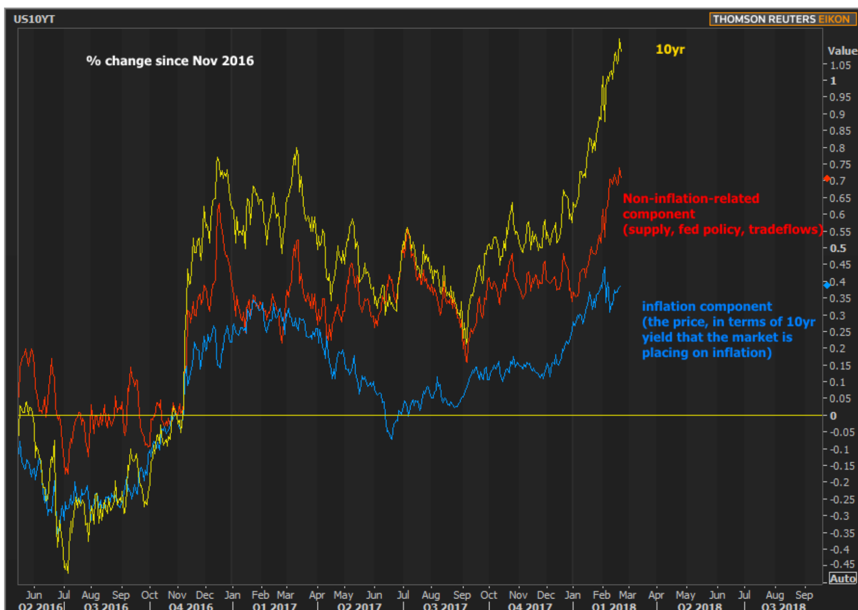
	Rate	Change	Points
30 Yr. Jumbo	6.75%	+0.07	0.39
5/1 ARM	5.98%	-0.27	0.65

Rates as of: 8/30



Notably, OIS started the most recent trend in September when we had the double whammy of more revised Fed rate hike expectations (via the Fed's dots) and the soft launch of the now-passed tax bill. That was all well and good for the short end of the yield curve. It would logically need to rise fairly quickly (and indeed it has, as seen in the link in the first paragraph), but 10yr yields would **need more convincing**.

Clearly, 10yr yields have been acting more convinced so far in 2018. When we break 10yr yields out into their inflation and non-inflation-related components, it's easier to understand why this is happening. While we've seen instances of each spiking individually, we're now in an environment where **BOTH** have been moving higher **together**. In other words, the market's inflation expectations have managed to edge to post-election highs at the same time that other interest rate considerations are surging to post-election highs.



Although not pictured on the chart, the highest recent levels in the 2 components (red and blue lines) seen above would suggest major technical support for bonds in the 3.15%-3.20% area. Anything above that would require a sea change for economic growth, inflation, and longer-duration bond issuance. In other words, every step into more painful territory brings us **closer to reprieve**.

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