macro scan

Tuesday, July 9th, 2019

- ***A painful curve flattening is occurring – is it justified?***
- ***Does the "strong" NFP print mean less Fed rate cuts are coming?***
- ***What does the curve flattening mean for equities?***
- ***Does the Dollar rally jibe with curve flattening?***
- ***Does WTI weakness mean further curve flattening?***
- ***Do the new Fed nominees speak of less rate cuts?***
- ***An attractive risk/reward entry point for steepeners is developing***

Back after some time away and the most notable price action is the pain going on in curve steepeners which has been the most crowded macro trade this year. If you look at the benchmark 2s10s curve for example, it went from a high of ~30bps just three weeks ago to half that with the vast majority of the that flattening move occurring just in the past week. Meaning it has been a swift flush lower and it's causing a great deal of angst.

US 2s10s right back into the lower end of its Q1 range. It is coming up to its first support level around 14bps …

The market has priced 2s10s right back to where it was in December/January when the Fed was only in its neutral "wait and see" stance despite seven months of data deterioration. Similarly, the EDZ0/EDZ1 spread (the Eurodollar Dec 2020/Dec 2021 spread) has gone from a high of 15bps intraday on June 6th to now completely flat. That is implying either:

1) The Fed is too tight and/or moving too slowly (a la 2018) and thus it is now as likely the Fed will still be cutting in 2021 as it will be hiking (vs. 1-month ago when the narrative was the Fed was being aggressive in its easing and which means it could be hiking by 2021), or
2) The US is becoming Europe/Japan and that the easing cycle will persist for some time and perhaps through 0% and into NIRP, and thus you can flatten curves much like we are seeing in European spreads

EDZ0/EDZ1 back to flat which essentially implies a 50/50 chance of cuts or hikes in 2021…

It is a bit early to be discussing #2 but the relentless bull flattening in the Eurozone does have folks that own steepeners in the US sufficiently freaked out so that will be a story at some point.

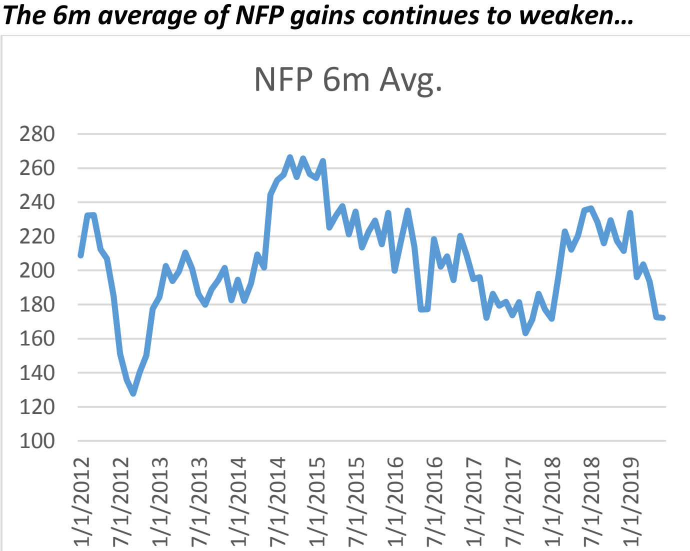
As of now, these Eurodollar spreads are more implying scenario #1 above that the Fed will now act more slowly than previous assumed, which means cuts will get pushed back later, which is acting to flatten all curves in the US. Or in other words, the market has priced out about 15bps of total cuts since we last spoke.

So what exactly is the market reacting to that is causing this painful flattening? Two things:

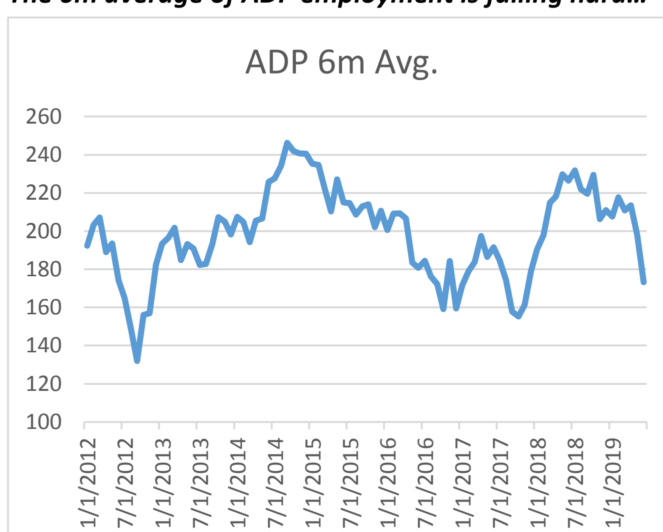
1) The Fed's walk back of a 50bp cut in July (see June 26th note with Fed comments), and
2) The "strong" NFP

Does that one NFP print change the fundamental narrative? Not at all. Let's look at big picture trends and not just once noisy data point that pops up on the ECO page:

The 6m average of NFP gains continues to weaken…



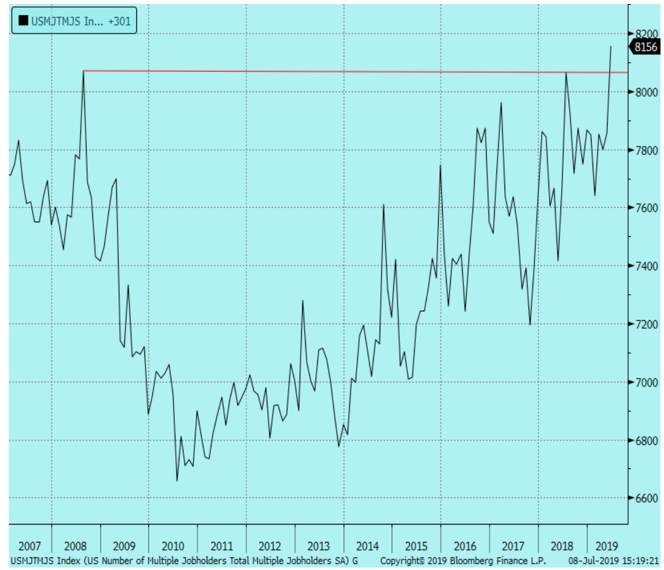
The 6m average of ADP employment is falling hard…



And do the guts of the “strong” NFP confirm the headline number? Not so much…

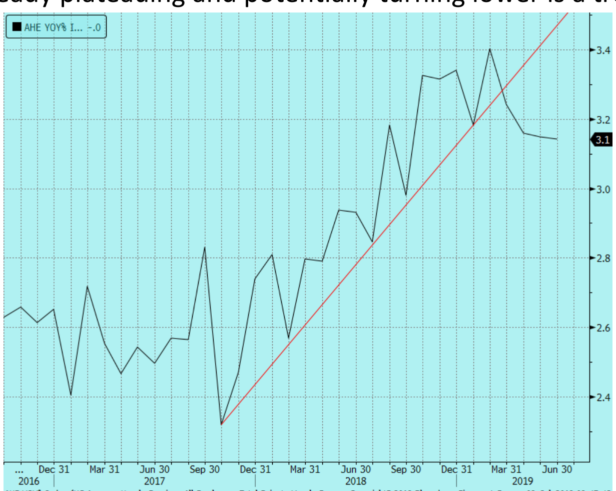
# of people unemployed more than 27 weeks…

# of people holding multiple jobs – broke 2008 highs….



I would also make a couple other quick points on the employment data:

- Although still at a decent absolute level, the fact average hourly earnings (which normally spike in late cycle) is already plateauing and potentially turning lower is a troubling signal that the US is going past late cycle



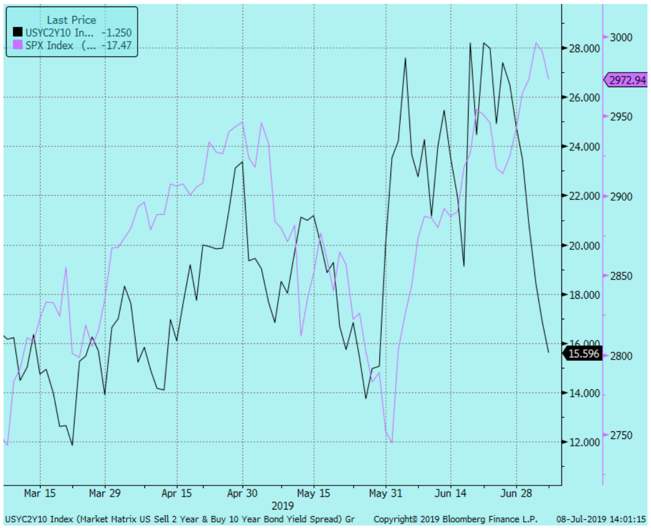
- Manufacturing jobs came in hot this month. Given the weakness in global manufacturing PMI’s, this is unlikely to persist.
- As shown above, is it positive that more people are finding it necessary to hold two jobs? <u>It’s also important to note that in the NFP data, if you hold more than one job, you get counted TWICE. So the fact that the number of people holding two jobs is rising is overstating how strong the NFP was</u>.
- And we just got another weak employment data point with JOLTS “missing” with back month revisions lower

Further on the general economic data, let’s also not forget how important the service sector is to the US. As I warned last week there was serious risk of a weak Non-Manufacturing PMI print and sure enough it missed expectations, printed almost two points lower than the prior month, and hit a 2-year low. It will be very important to watch this play out and remember that historically manufacturing weakness leads to services weakness (see chart in June 28th note).

<u>Therefore, the pricing out of cuts and the flattening in spreads like 5s30s, 2s10s, and Eurodollar spreads further out the curve like EDM2/EDM3 make little fundamental sense. The market is incorrectly assuming that the Fed will respond to that “strong” NFP, ignore 7+ months of data deterioration, and move less and more slowly. While the pricing out of a 50bp cut in July is completely reasonable, don’t lose sight of the big picture global economic weakness trend that is happening which apparently got masked by the “strong” NFP.</u>

Here is something else that does not jibe with this painful curve flattening besides the economic data. One of the most asked questions of the year is when looking at the overlay of S&P's vs. 10yr yields how there can be such a divergence. My answer has always been the dovish Fed pivot. So the better overlay since the dovish pivot is S&P's vs. 2s10s.

US 2s10s (black) vs. S&P's (purple)….



As you can see, 2s10s and S&P's were moving roughly together but now there is a large divergence. That is a problem. <u>If the market is going to price out rate cuts and assume a less aggressive Fed, then S&P's, who have benefitted from lower rate expectations, need to correct lower</u>.

However, it will be more likely that curves re-steepen to close the divergence once the Fed cuts, the data deterioration becomes apparent again, erases from our memory that noisy NFP headline print, and therefore save S&P's.

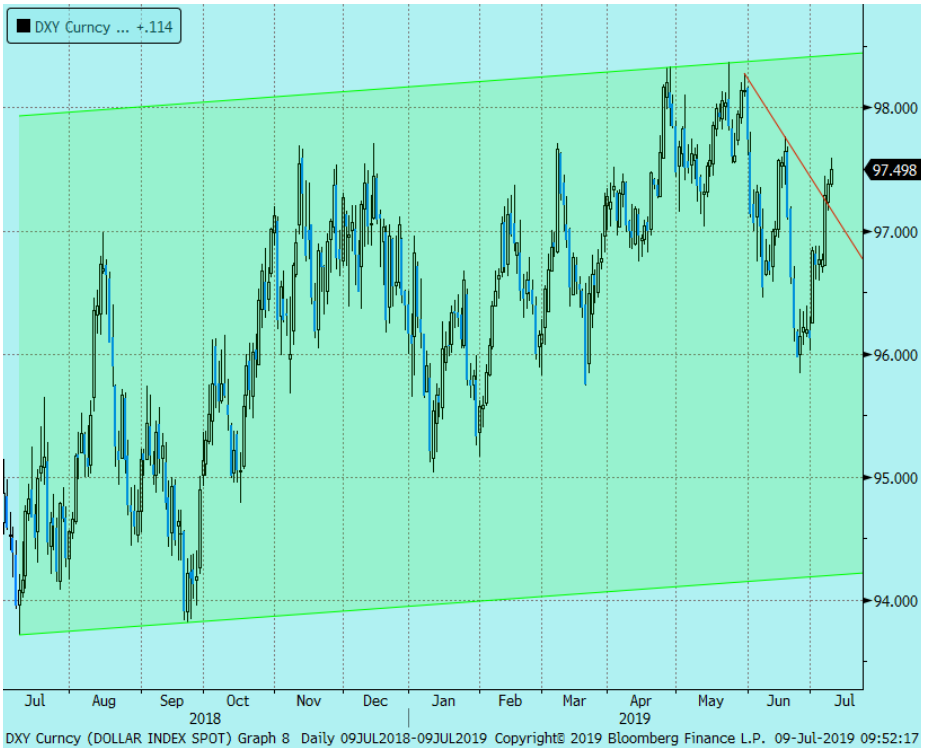
Or else equities will dive and then the market will just price in more cuts again which will ultimately re-steepen curves. You can see the conundrum here and that makes it very difficult to price out a lot more rate cuts (ie: the front end can only sell off so far before everything breaks again).

As of now, the pullback in S&P's appears to be the normal re-test of the broken resistance that will now act as support…

Here is another problem on the back of the flattening flows and “strong” NFP. The Dollar has been strengthening and broke its short-term downtrend which suggests a move to the top of the range.

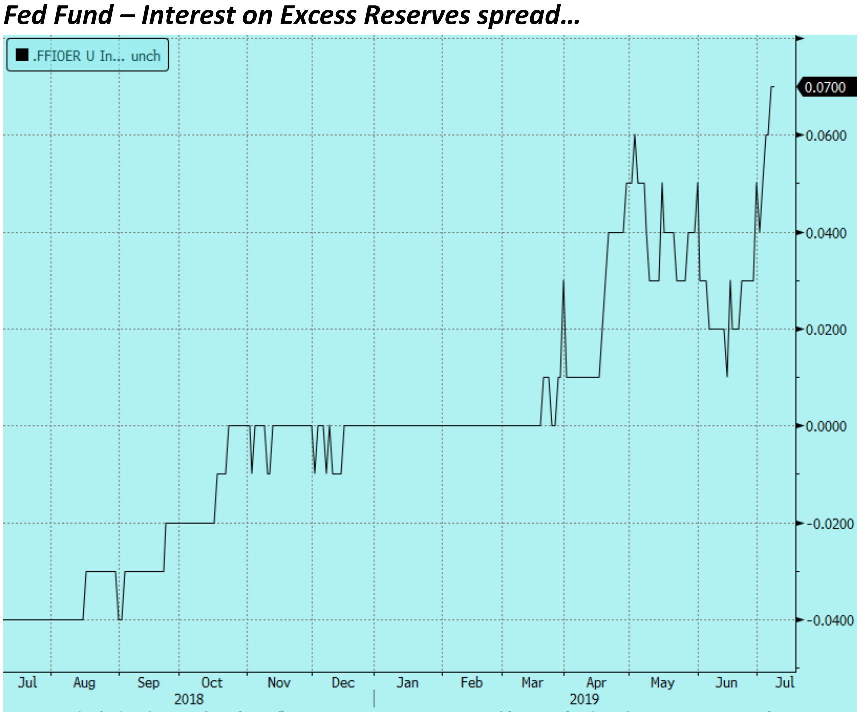
Here is the rub: when the Dollar rises, it hurts US exports which is an incremental negative for growth, and more importantly, weighs on inflation. Thus the Dollar rise will only work to cap yields.

DXY…



Another problem. The spread between Fed Funds and IOER just broke to new highs.

Fed Fund – Interest on Excess Reserves spread…



As we know, the Fed does not like "losing control" of their target rate and have previously attempted to reign in that spread widening by lowering IOER. That didn't work so now two things could happen: 1) a Fed Fund rate cut in July (obviously, 25bps almost certain), and 2) the end of its balance sheet runoff (that would be a surprise as it is supposed to end in Sept). After all, it's the glut of paper sitting on bank balance sheets that has caused this spread widening. We can see that in the continued descent of reserves so one way the Fed could alleviate the supply pressures caused by QT and rising deficits would be to end QT now. There is nothing they can do about the rising deficit other than keep rates low. Either way, it will have to be a dovish action by the Fed to solve the FF/IOER issue.

Fed Excess Reserves…

We spoke last week about WTI coming to a pivot point as it approached trend resistance. That coincided with its 4th Elliott wave which was a rally inside a downtrend. That now looks more likely as since that day I noted the resistance, WTI failed and has sold off ~4%. Lower oil leads to weaker US growth and lower inflation. Therefore, here again, it does not jibe with curve flattening/the pricing out of rate cuts.

Lastly, it should be highlighted that since we last spoke, there are two new nominees for the empty Fed seats: Christopher Waller and Judy Shelton. We can keep this succinct; both are obvious dove insertions by POTUS. Therefore, if both get through, the Fed becomes even more dovish. That also speaks of pricing in MORE rate cuts not less, and long end steepening not flattening.

Putting this all together, the sharpness of the flattening move and the pricing out of cuts has been fundamentally unwarranted given:

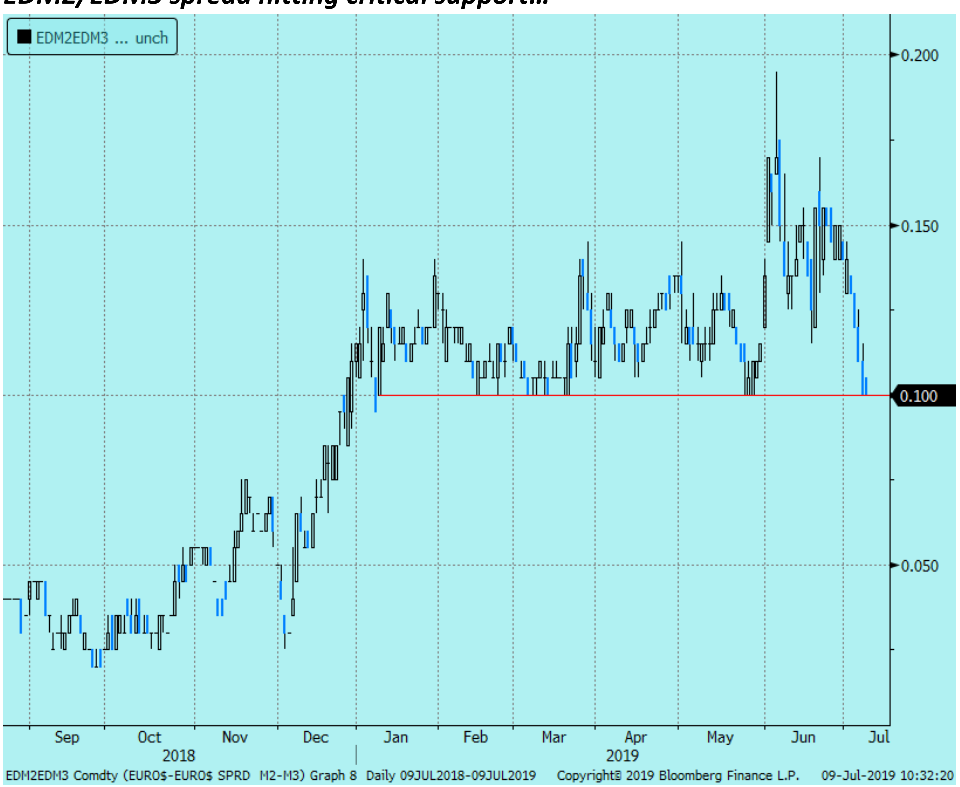
- Almost all the forward looking economic data pointing to weaker growth
- S&P's can't really have less rate cuts priced in without selling off
- The rising Dollar will only work to slow growth and weaken inflation
- Falling oil would weaken growth and inflation
- The two new Fed nominees are doves who will both be proponents of lower rates now

But technically I can understand the flattening. The steepener was a very crowded trade, and this is what happens in crowded trades especially during an illiquid holiday week. The price action suggests that some big players took profits on steepeners which led others to stop out. These kind of stop out, technical flows are usually ideal entry points as long as the narrative hasn't changed, which as explained above, it hasn't unless you truly believe the US has turned into Europe.

You are getting an attractive entry point to fade the flattening. To be clear, we are talking about Eurodollar spreads further out the curve not in the fronts where the Fed will be cutting and thus those spreads should flatten.

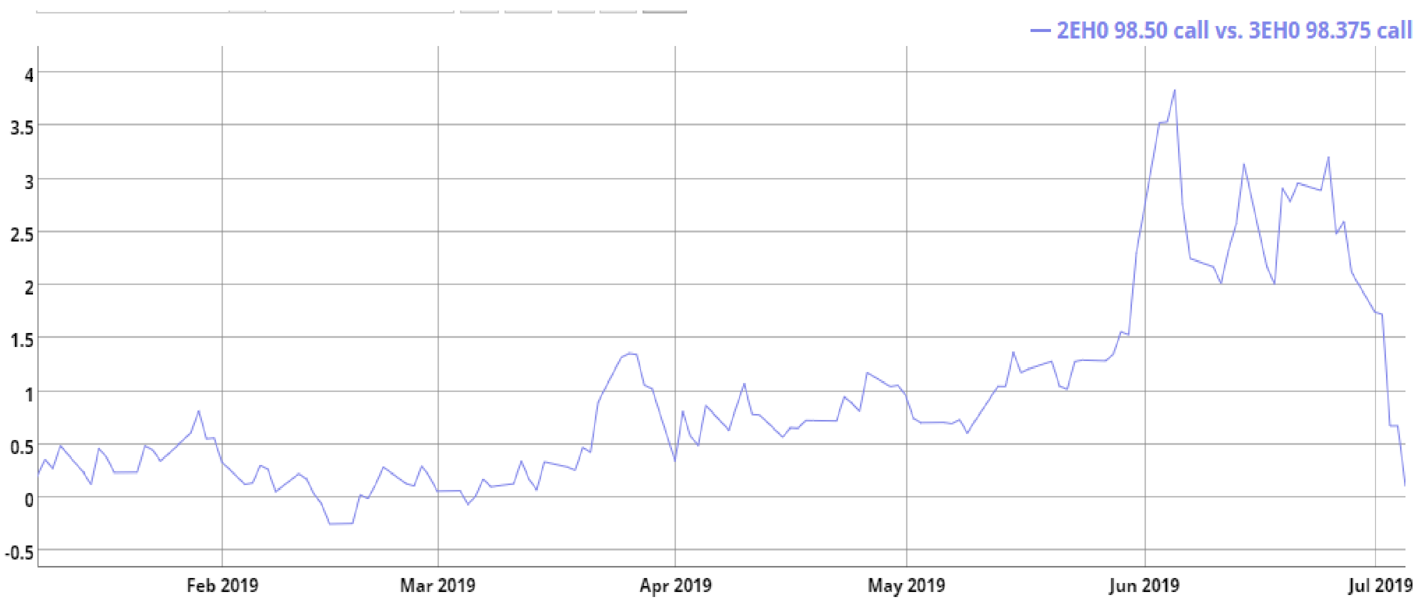
EDM2/EDM3 spread has retraced nearly 50%. Note the solid support level at 10bps which hasn't been breached since the Fed went dovish. You can buy here with a stop ~8bps for a nice risk/reward setup (risk 2bps to make 15bps). Remember this spread has the best/least onerous roll of 1-year gap spreads…

EDM2/EDM3 spread hitting critical support…



If you prefer to do it conditionally via options, these structures have cheapened substantially. A similar expression to EDM2/EDM3 would be: buying 2EH0 98.50 call vs. selling 3EH0 98.375 call for 0.0. You can now get into the conditional steepener at costless. This structure was just trading 4.0 a few weeks ago and is back near the lows (which was -0.25).

Price history of the greens/blues bull steepener shows it back to an attractive entry point…



If you are wrong and fixed income continues to sell off and flatten (you normally bear flatten not bear steepen), this structure just expires worthless which will cause no pain.

Sorry for the long note today but there was a lot to say!

Kind Regards,

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