Monthly Review & Outlook

DECEMBER 2016

The Federal Reserve (Fed) raised interest rates 25 basis points this month, which is the second time in more than 10 years. The first increase was December 2015. Leading economic growth indicators remain stable and inflation measures have moved higher. We expect these trends to continue. Unemployment reached a new cyclical low, a level historically considered full employment.

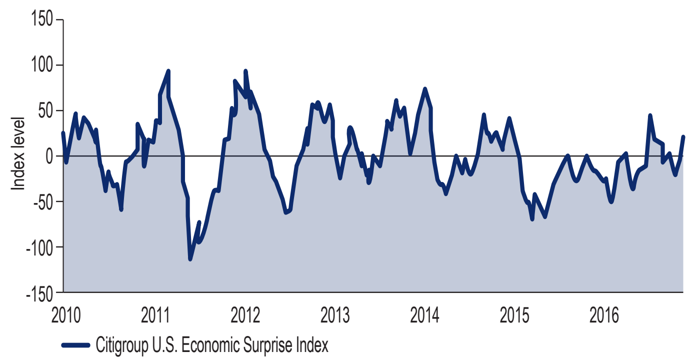
MULTIPLE FACTORS ARE DRIVING TREASURY YIELDS UPWARD

Longer-term U.S. Treasury yields have increased as expectations for Fed action firmed in recent weeks. Yields on 10-year Treasuries rose from a midyear low of 1.36 percent to 2.45 percent in early December. This movement reflects several factors.

Near-term economic growth indicators are improving. Gross domestic product (GDP) accelerated in the third quarter. High frequency current activity indicators, such as the Institute for Supply Management's (ISM) manufacturing and non-manufacturing indices, improved through November. We see this acceleration trend reflected in the Citigroup U.S. Economic Surprise Index.

Fiscal policy may boost the economy. Financial market expectations have risen for fiscal policy that will increase growth under a Trump administration. The magnitude of any fiscal stimulus remains unknown and it is difficult to predict when it may begin influencing economic performance.

Economic Surprise Index reflects improving indicators



Data source: Citigroup, 1/01/10-11/30/16. The Citi Economic Surprise Index tracks how economic data are faring relative to expectations. The index rises when economic data exceed economists' consensus estimates and falls when data come in below estimates.

Inflation expectations are increasing. The PCE (personal consumption expenditures) deflator, the Fed's preferred inflation measure, rose 1.4 percent in October. This is the largest annual increase since October 2014 and further increases are likely in the months ahead. The 10-year inflation breakeven rate is approaching the Fed's 2 percent objective.

Fed expectations are shifting. The forward path of expected Fed policy rates has adjusted modestly higher, with unemployment at a new cyclical low, inflation approaching the Fed's target and growth expectations improving. Policy rates are anticipated to end 2017 and 2018 at approximately 1 percent and 1.5 percent, respectively, based on futures market pricing.

TREASURY YIELDS HAVE RISEN SHARPLY BEFORE

We have seen dramatic increases in long-term U.S. Treasury yields before. A similar sharp move occurred during the second half of 2013, in anticipation of the Fed tapering its third quantitative easing (QE) program. A roughly equivalent move occurred in 2010, before the Fed implemented its second round of QE.

During these two periods, yields increased 135 basis points and 140 basis points trough to peak, respectively, over five to seven months. These comparisons suggest yields could increase another 25 basis points to 30 basis points over the next few months, but most of the adjustment has likely occurred. After both episodes, yields gradually declined to new historic lows.

The shift in policy associated with the Trump administration, depending upon implementation and effectiveness, could represent a turning point in the ongoing decline in bond yields since the early 1980s. Global bond yields had never been lower prior to the recent jump. For all borrowers, except Switzerland, 10-year government bond yields have now returned to positive territory.

10-year Treasuries have a history of increases

Data source: Bloomberg L.P., 1/01/10-11/30/16.

WILL LONGER-TERM YIELDS KEEP RISING?

We don't anticipate these influences pushing yields materially higher in the near term.

U.S. economic growth accelerated from an average of 1.1 percent in the first half of 2016 to 3.2 percent in the third quarter. Other indicators have also improved, but the Atlanta Fed's GDPNow model estimates fourth quarter growth decelerating to 2.6 percent.

Employment growth has also slowed to average job gains of 176,000 per month over the past three months, with further slowing likely in 2017. Thus, the economic growth environment is unlikely to materially put further upward pressure on long-term yields.

Inflation has trended higher recently as the effect of earlier energy and import price declines fades and service price inflation trends slowly higher. While still below the Fed's 2 percent objective, we should see readings near 2 percent in early 2017. This will be a nearly 2 percentage point increase from the 2015 lows, but further increases will likely be limited. With longer-term inflation compensation rising to near 2 percent, inflation is also unlikely to push long-term bond yields significantly higher.

Fed monetary policy, while related to growth and inflation, also independently influences long-term interest rates. Policy tightens as unemployment and inflation approach desired levels. With modest tightening anticipated in 2017, monetary policy should be an incremental source of upward pressure on bond yields.

However, the yield curve typically flattens between 10-year yields and the level of policy rates during the tightening cycle. The curve is typically flat when the cycle concludes. The primary upside risk to long-term bond yields currently would be a more aggressive Fed tightening path than futures markets currently envision.

Fiscal policy initiatives involving greater deficit spending could also increase yields. However, debt levels and Congressional constraints seem likely to limit the extent of deficit increases.

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