Interest Rate Risk Management Weekly Update

January 5, 2015

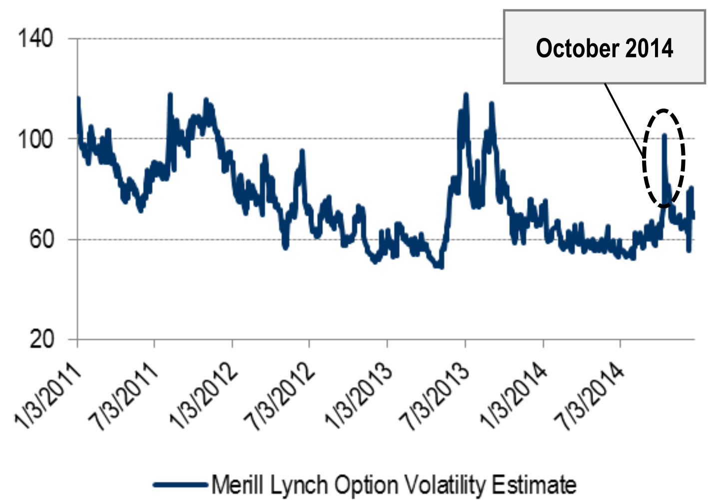
Current Rate Environment

Short Term Rates	Friday	Prior Week	Change
1-Month LIBOR	0.17%	0.17%	0.00%
3-Month LIBOR	0.26%	0.26%	0.00%
Fed Funds	0.25%	0.25%	0.00%
Fed Discount	0.75%	0.75%	0.00%
Prime	3.25%	3.25%	0.00%
US Treasury Yields			
2-year Treasury	0.67%	0.74%	(0.07%)
5-year Treasury	1.61%	1.76%	(0.15%)
10-year Treasury	2.11%	2.25%	(0.14%)
Swaps vs. 3M LIBOR			
2-year	0.94%	0.97%	(0.03%)
5-year	1.78%	1.90%	(0.12%)
10-year	2.27%	2.42%	(0.15%)

Fed Speak & Economic News:

- Government bonds were subject to an unforeseen rally throughout 2014, defying the vast majority of interest rate forecasts as the Federal Reserve ended quantitative easing and began approaching the cusp of rate normalization. Asset valuations remain rich, by most measures, and investor faith in the efficacy of monetary policy has never been higher, especially in Europe. The role of central banks has become more difficult as lower energy prices weigh on inflation expectations and global growth remains tepid. The divergence of monetary policy is accelerating, with the Federal Reserve and Bank of England tightening conditions while the European Central Bank and Bank of Japan look to carry the baton, increasing their efforts to combat disinflation. Not surprisingly, the US Treasury curve reflects the aforementioned: short-term rates have risen and long-term rates have fallen, leading to a much flatter yield curve than we saw at the start of 2014, but how high will US interest rates rise in 2015, if at all?
- While we cannot forecast where interest rates will head this year, we can provide a useful framework for guiding decision making. The US economy is on the upswing and has exhibited steady growth in employment, a moderate recovery in housing, and an increase in capital expenditures. A rise in household wealth (increased housing and equity valuation levels), coupled with a fall in oil prices, should do well for consumer spending, which accounts for about 70 percent of the US economy. According to Federal Reserve members, the fed funds rate should be around 1.4 percent by year-end; however, market participants have priced in a rate of just over 0.6 percent. If the Fed proves to be correct, short-term rates would move higher quicker than many expect. Regarding long-term rates, as we saw in 2014, Treasuries remain valuable when compared to ultra-low yielding Japanese and European sovereign bonds. That being said, German Bund yields have become a major driver of Treasury yields, which suggests that one of the biggest risks to a rise in US interest rates is growth in the eurozone. If the ECB's bond buying proves to be effective and countries in the eurozone get their fiscal houses in order, the combination would cause US Treasury yields to rise. In summary, the direction that short-term US interest rates will take depends on the development of the US economy, and hence policy decisions at the Fed, while the direction of later-dated US interest rates will be determined by investors' search for yield and hence global growth.

Will We See More Volatility in 2015?



Source: Bloomberg

The chart to the left displays the implied volatility estimate on 1-month Treasury options, weighted by volatility levels implied by 2-, 5-, 10-, and 30-year Treasuries. Remember in October 2014, when the 10-year Treasury yield fell to 1.82% during intraday trading as the market panicked on news of worsening global economic conditions, which was met with poor liquidity. The short burst of volatility was one of the few in recent memory, but as we approach rate normalization, these bursts may become more frequent as increased volatility becomes the new normal. With interest rates so low and volatility cheap, by historical standards, it will become even more imperative to have a developed interest rate hedging strategy.

U.S. Economic Data

- ISM Manufacturing disappointed, registering at 55.5 vs. 57.5 expected
- Consumer confidence in December increased from its November level from 91.0 to 92.6 but fell short of its expected reading of 93.9
- Markit US Manufacturing PMI disappointed at 53.9 vs 54.0 expected

Date	Indicator	For	Forecast	Last
6-Jan	Factory Orders	Nov	(0.5%)	(0.7%)
6-Jan	ISM Non-Manf. Composite	Dec	58.0	59.3
6-Jan	Markit US Composite PMI	Dec F	-	53.8
6-Jan	Markit US Services PMI	Dec F	53.7	53.6
7-Jan	Trade Balance	Nov	-$42.0B	-$43.4B
7-Jan	ADP Employment Change	Dec	225K	208K
9-Jan	Change in Nonfarm Payrolls	Dec	240K	321K
9-Jan	Unemployment Rate	Dec	5.7%	5.8%

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