Interest Rate Risk Management Weekly Update

November 24, 2014

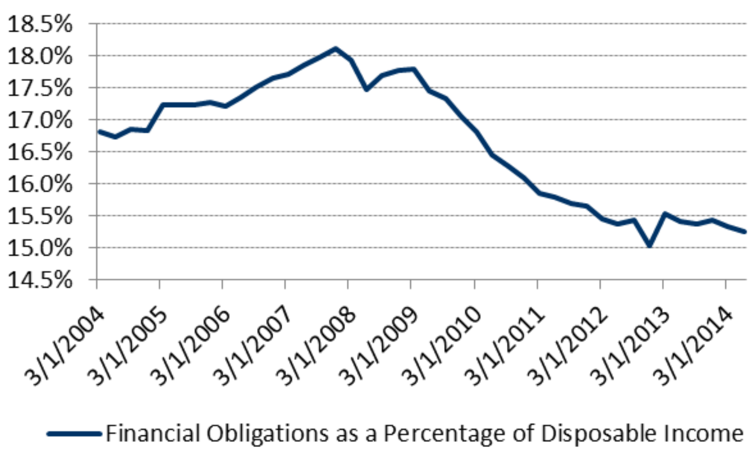
Current Rate Environment

Short Term Rates	Friday	Prior Week	Change
1-Month LIBOR	0.16%	0.15%	0.01%
3-Month LIBOR	0.23%	0.23%	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	0.50%	0.51%	(0.01%)
5-year Treasury	1.61%	1.61%	0.00%
10-year Treasury	2.31%	2.32%	(0.01%)
Swaps vs. 3M LIBOR			
2-year	0.77%	0.78%	(0.01%)
5-year	1.79%	1.79%	0.00%
10-year	2.48%	2.50%	(0.02%)

Fed Speak & Economic News:

- Economic theory tells us that higher expected economic growth should increase the level of natural interest rates, and vice versa for lower expected growth. If corporate entities expect increased growth in the future, they are likely to borrow and invest via capital expenditures in anticipation of greater demand. This behavior will increase the demand for capital, which should lead to higher interest rates. Therefore, it is reasonable to suggest that understanding the connection between economic growth and interest rates is important for forecasting the future level of interest rates.
- Earlier this year, the Congressional Budget Office and some committee members of the Federal Open Market Committee lowered their projections of US Treasury yields and estimates of interest rates, respectively, citing the expectation of slower growth in the time to come. But does slower economic growth lead to lower interest rates? According to economists Sylvain Leduc and Glenn D. Rudebusch at the San Francisco Federal Reserve, private forecasters do not share this view. [1]
- While Mr. Leduc and Rudebusch note that although the CBO's and FOMC's projections have fallen together, the private sector does not anticipate such a drop. Their research suggests that over the past three decades, private forecasters have incorporated no link between potential growth and the natural rate of interest. However, this does not necessarily suggest that private forecasters are correct; they could be missing the link between growth and interest rates. But on the other hand, they might have a better understanding of other factors that affect investment and saving. The findings suggest that if private forecasters are correct, FOMC participants and the CBO may have overstated the effect that weaker potential growth has on interest rates.
- Last week, the FOMC released the minutes to its Oct. 28-29 meeting. The notable takeaway was the increased concern surrounding the downward shift in inflation expectations. The committee cited that this was likely to be only temporary, but if participants begin to embed this into their long-term views, expected inflation could head even lower, possibly delaying any rate increase by the Fed. Across the pond, the surprise negative GDP report from Japan and surprise rate cuts by China's central bank weighed on the market. If the BoJ decides to ease policy further, the value of the yen could decline, which could weigh on the US dollar.

Can Consumers Weather an Interest Rate Increase?



Interest burdens have improved considerably since the mid-2000s and the Great Recession. Financial obligations, including mandatory financial payments made by a household, as a percentage of disposable income, have fallen quite precipitously. This should help the Fed in determining the impact that higher interest rates will have on the economy. The figures show that the private sector has reduced its interest-rate exposure, which comes with impeccable timing given that the Fed is expected to hike rates in the near term.

U.S. Economic Data

- Consumer inflation MoM for October registered at 0.0%, instead of -0.1% expected by market participants. Inflation continues to be pinned down by declining commodity prices.
- Industrial production declined by 0.1% vs. an increase of 0.2% expected. Manufacturing output increased but was offset by the utilities and mining industries.
- Housing starts disappointed but existing home sales improved.

Date	Indicator	For	Forecast	Last
25-Nov	GDP Annualized QoQ	3Q S	3.3%	3.5%
25-Nov	Consumer Confidence Index	Nov	96.0	94.5
26-Nov	Univ. of Michigan Confidence	Nov F	90.0	89.4
26-Nov	Durable Goods Orders	Oct	(0.6%)	(1.1%)
26-Nov	New Home Sales	Oct	471K	467K
26-Nov	Personal Income	Oct	0.4%	0.2%
26-Nov	Personal Spending	Oct	0.3%	(0.2%)

Source: Bloomberg [1] http://www.frbsf.org/economic-research/publications/economic-letter/2014/november/interest-rates-economic-growth-monetary-policy/

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