Interest Rate Risk Management Weekly Update

August 11, 2014

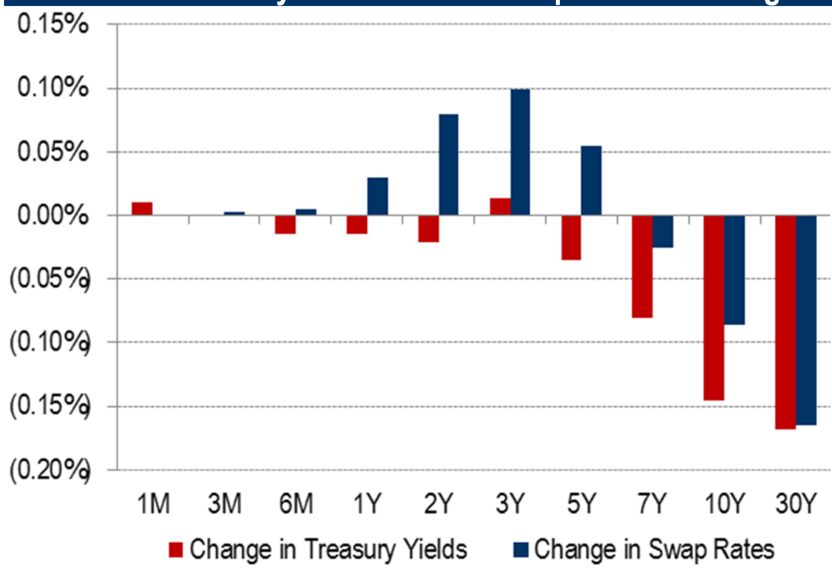
Current Rate Environment

Short Term Rates	Friday	Prior Week	Change
1-Month LIBOR	0.16%	0.16%	0.00%
3-Month LIBOR	0.24%	0.24%	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	0.45%	0.47%	(0.02%)
5-year Treasury	1.62%	1.66%	(0.04%)
10-year Treasury	2.42%	2.49%	(0.07%)
Swaps vs. 3M LIBOR			
2-year	0.73%	0.73%	0.00%
5-year	1.84%	1.86%	(0.02%)
10-year	2.63%	2.68%	(0.05%)

Fed Speak & Economic News:

- Here we are, eight months into the year, with an ample amount of economic measures that signal a rebounding economy, yet we find ourselves in a similar situation to what we have been in since 2008: an economic environment with slower-than-expected growth and low inflation despite the Fed throwing everything but the kitchen sink in an effort to get things back in order. Economists have constantly revised their forecasts lower, blaming unanticipated circumstances such as, severe weather in the United States and, more recently, geopolitical tensions in eastern Europe and the Middle East. The movement in interest rates reflects these concerns; for example, the 10-year Treasury Note reached a new 52-week low last week.
- Over the past month, risk assets have underperformed, falling victim to escalating conflict worldwide. Broad equity markets have sold off and spread products have disappointed. Market participants' desire to hold Treasuries has flattened the back-end of the curve quite noticeably. The front-end of the curve – which typically does not elicit a response to geopolitics like the back-end – remains very steep, and it should. At its previous meeting, the Fed has said that its monthly easing purchases will end in October, unless unforeseen circumstances dictate otherwise. The question market participants are trying to answer is when will the Fed increase its benchmark rate, the fed funds rate? Heightened geopolitical risks and slower economic growth in Europe should limit the rate at which Treasury yields rise. But the bottom line is that the US economy is doing well and once geopolitical events calm down or subside, economic growth worldwide should pick up and Treasury rates should move higher.
- But just how well is the US economy doing? Recent economic data have told us that it is doing fairly well. The jobs market is continuing its improvement, with the July jobs report showing a solid payroll gain and initial jobless claims plummeting through the beginning of August. The ISM non-manufacturing index hit 58.7, the highest level seen since early 2006. Judging by a handful of economic measures, some of them not mentioned here, the economy is doing better. Therein lies the reason for the steepness in the front-end of the curve: market participants believe the economy is doing better than the Fed does; hence, when the fed funds rate moves higher, it should do so very quickly.

Treasury Yields Versus Swap Rates – Change Since July 1, 2014



Source: Bloomberg

LIBO rates and Treasury yields are widely-used proxies for risk-free interest rates. However, LIBO rates are the interest rates at which AA-rated banks lend to one another, hence, they contain a small amount of credit risk. Swap rates, which are a function of LIBO rates, have actually increased over the past month, which is the result of spillover effects stemming from economic woes in the euro zone and Russia's intransigent attitude towards the situation in Ukraine. Other spread products have felt the effects as well, especially 5-year investment grade and high yield CDS spreads. We often see this behavior in rates during times of stress.

U.S. Economic Data

- Initial jobless claims decreased to 289k from 304k
- Factory orders surprised to upside, printing at 1.1% versus 0.6% expected
- The US trade balance showed improvement, with the balance narrowing in June to -$41.5 billion from -$44.7 billion in May
- Markit US services printed at 60.8, right on level with expectations
- ISM non-manufacturing composite registered at the highest level since early 2006.

Date	Indicator	For	Forecast	Last
13-Aug	Retail Sales Advance MoM	Jul	0.2%	0.2%
14-Aug	Initial Jobless Claims	9-Aug	295K	289K
15-Aug	Univ. of Michigan Confidence	Aug P	82.5	81.8
15-Aug	Industrial Production MoM	Jul	0.3%	0.2%
15-Aug	PPI Final Demand MoM	Jul	0.1%	0.4%
15-Aug	Empire Manufacturing	Aug	20.00	25.60

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