Interest Rate Risk Management Weekly Update

July 21, 2014

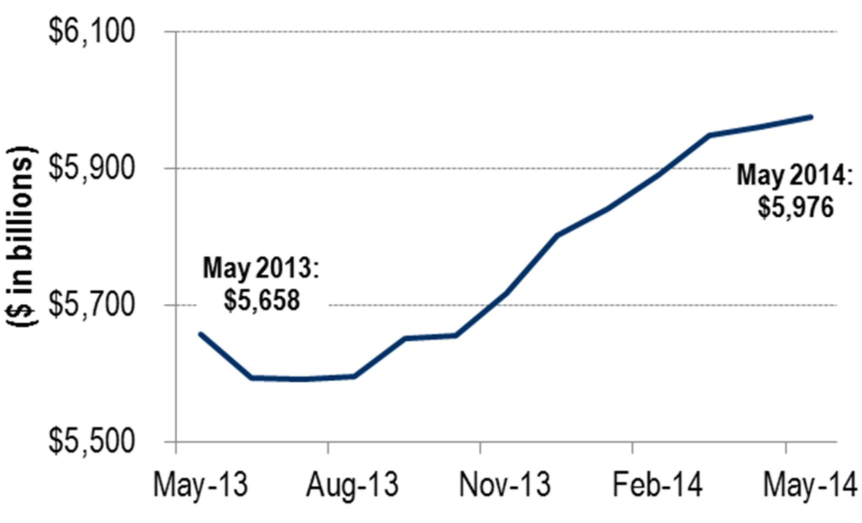
Current Rate Environment

Short Term Rates	Friday	Prior Week	Change	
1-Month LIBOR	0.15%	0.15%	0.00%	○
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	0.48%	0.45%	0.03%	↑
5-year Treasury	1.67%	1.64%	0.03%	↑
10-year Treasury	2.48%	2.52%	(0.04%)	↓
Swaps vs. 3M LIBOR				
2-year	0.72%	0.67%	0.05%	↑
5-year	1.84%	1.79%	0.05%	↑
10-year	2.65%	2.68%	(0.03%)	↓

Fed Speak & Economic News:

- The triumvirate comprising the downing of Malaysian Airlines Flight 17 in the geopolitical hotbed of Ukraine; the Israeli invasion of Gaza; and Fed Chair Yellen's testimony to Congress weighed on the term structure last week. That being said, we are witnessing a tug-of-war between geopolitical stresses and improving economic fundamentals. Both have influenced the flattening of the curve, with market participants pulling forward their hiking timelines – steepening the front-end – while the geopolitical environment thickens with concern – flattening the back-end.
- The prospect of stability and peace in the Ukraine and Middle East seems to become more distant by the day, further clouding the geopolitical environment. On Thursday, the downing of Malaysian Airlines Flight 17 by a surface-to-air missile in Eastern Ukraine at a conflict site between pro-Russian separatists and the Ukrainian government roiled global markets. In the Middle East, Israel launched a ground offensive, sending Israeli infantry into the Gaza's most densely populated city, Shajaiyeh. The foregoing kept later-dated Treasuries well bid, leading to an underperformance of most risk assets. Failed attempts at a cease fire between Israel and Hamas suggest that the end of conflict is out of sight for the time being. In addition, investigations related to the downing of the Malaysian airline are underway, with allegations that pro-separatists are to blame and Russia may be involved. A day earlier, President Obama slapped sanctions on Russia, prohibiting American banks from issuing loans with maturities longer than 90 days to four Russian companies: Rosneft, Novatek, Gazprombank, and VEB. One should expect later-dated Treasury rates to stay at similar levels amid the geopolitical environment, perhaps with the Treasury curve flattening even more so if stresses worsen.
- As a result of improving economic fundamentals in the United States and Fed Chair Yellen's testimony to Congress last week, shorter-dated Treasury rates increased. Retail sales improved in June while inflationary pressures edged higher. In addition, the industrial sector improved, ending the quarter higher. Yellen's comments were interpreted holistically as hawkish, despite mentioning that slack in the labor market remains a concern. Given the backdrop of improving economic fundamentals, the market has priced in more aggressive policy expectations, ergo we have seen shorter-dated Treasury rates trend higher.

Foreign Demand for Treasuries has Increased



Source: Bloomberg

On Wednesday, the Treasury released its May TIC report, which highlights foreign investor demand for Treasuries. The report gave clues as to why later-dated Treasury rates remain so low despite improving economic fundamentals. The reason lies partly with foreign demand, with foreign holdings having increased by $318 billion over the past twelve months. Not only have holdings increased, but foreign holders have extended the duration of their purchases.

U.S. Economic Data

- US retail sales disappointed in June, increasing only 0.2% but the previous two months' figures were revised higher.
- The PPI Final Demand reading for June beat expectations, printing at 0.4% (1.9% annualized) vs. 0.2% expected.
- Housing starts disappointed in June, registering a 893k gain vs. 1020k expected.
- The Fed's Beige Book had a more upbeat tone. In short, anecdotal evidence suggest that the economy is picking up across the United States.

Date	Indicator	For	Forecast	Last
22-Jul	CPI MoM	Jun	0.3%	0.4%
22-Jul	Existing Home Sales	Jun	4.99M	4.89M
22-Jul	Richmond Fed Manufact. Index	Jul	5	3
24-Jul	New Home Sales	Jun	476K	504K
24-Jul	Markit US Manufacturing PMI	Jul P	57.5	57.3
25-Jul	Durable Goods Orders	Jun	0.4%	(0.9%)

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