Interest Rate Risk Management Weekly Update

December 21, 2015

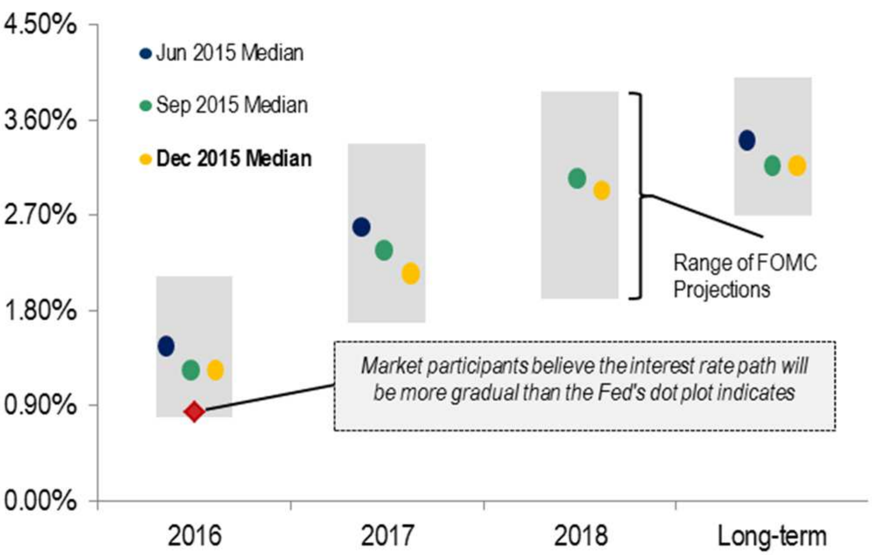
Current Rate Environment

Short Term Rates	Friday	Prior Week	Change	
1-Month LIBOR	0.41%	0.33%	0.08%	↑
3-Month LIBOR	0.59%	0.51%	0.08%	↑
Fed Funds	0.50%	0.25%	0.25%	↑
Fed Discount	0.75%	0.75%	0.00%	○
Prime	3.50%	3.25%	0.25%	↑
US Treasury Yields				
2-year Treasury	0.95%	0.88%	0.07%	↑
5-year Treasury	1.68%	1.55%	0.13%	↑
10-year Treasury	2.21%	2.13%	0.08%	↑
Swaps vs. 3M LIBOR				
2-year	1.14%	1.04%	0.10%	↑
5-year	1.72%	1.60%	0.12%	↑
10-year	2.20%	2.13%	0.07%	↑

Fedspeak & Economic News:

- The world survived the unanimous decision to hike rates last Thursday: After seven years to the day of lowering interest rates to the zero bound, the Federal Reserve raised the federal funds target rate by 25bps, to the 25-50bp range. The move was widely anticipated and the market was well prepared in advance as the Fed was very calculated in its approach to begin interest rate normalization. That being said, market participants paid greater attention to the economic schematics provided by the Staff Economic Projections (SEPs) and the rhetoric offered in the post-statement meeting given by Chairwoman Janet Yellen.
- FOMC officials felt the decision was justified based on the "considerable improvement in labor market conditions this year"; however, the Fed will remain accommodative: "The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run." Going forward, we could see a rate hike at any meeting (meetings will be "live".)
- The top of the 25-50 federal funds basis point range will be governed by the interest rate offered on reserves while the bottom of the band will be determined by the overnight reverse repurchase agreement rate, or overnight "repo" for short; both rates became effective on Thursday. Repo and reverse repo transactions function as collateralized loans: One party buys a security from another (the collateral) and then sells it back at a higher price (usually a day later); the price differential is equivalent to the interest rate on the loan, known as the repo rate. The Fed will make available its portfolio of securities that it has accumulated over the years through open market purchases and since the central bank is the party initiating the transaction (rather than the investor who is looking to make use of his or her cash), the transaction is known as a reverse repo. Repo transactions allow market participants to make use of idle cash and banks and broker dealers to put their securities to work. Since all other short-term rate products involve a minor amount of credit risk (the Fed has a printing press in its back pocket), they should all trade above the repo rate. The top of the band is governed by the interest rate that the Fed chooses to pay banks that have deposits with it (~$2.6 trillion): the Interest on Excess Reserves rate (IOER). By raising this rate 25bps, the Fed reduces a bank's willingness to lend elsewhere at any rate lower.

The Revised Dot Plot



The "dot plot" gives us a feel for where FOMC officials believe interest rates will head. Per the most recent meeting, the 2016 federal funds median remained the same, while 2017 and 2018 estimates showed that the median tightened. Again, this reiterates the message that the Fed has communicated well before its most recent meeting: Interest rate normalization will be a gradual process. Despite all of the chatter about equilibrium real fed funds rates, the long-term estimate was unchanged. For now, the market sees a more gradual tightening than the Fed does.

Sources: Bloomberg

The Week Ahead

- It is likely we will see some volatility this week given year-end balance sheet pressures, fund duration extension, and reduced liquidity.
- Tuesday and Wednesday will see the release of important economic indicators, including the final estimate of third quarter GDP (Tuesday)
- US Stock markets will close at 3 p.m. EST and the bond market will shut down early at 2 p.m. EST on Christmas Eve
- Keep in mind, as we approach Christmas, liquidity will become scarcer

Date	Indicator	For	Forecast	Last
22-Dec	GDP Annualized QoQ	3Q T	1.9%	2.1%
22-Dec	Existing Home Sales	Nov	5.34m	5.36m
22-Dec	Personal Spending	Nov	0.3%	0.1%
23-Dec	U. of Mich. Sentiment	Dec F	92.0	91.8
23-Dec	Durable Goods Orders	Nov P	(0.7%)	2.9%
23-Dec	New Home Sales	Nov	505k	495k
23-Dec	Personal Income	Nov	0.2%	0.4%

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