<u>Monday, June 10th, 2019</u>

- ***Last week was watershed: Fed lays groundwork for cuts + first signs of labor market weakness***
- ***There are other signs of a turning labor market besides ADP and NFP***
- ***Update on Fed pricing: 2019 is full, whereas in 2020 there is potential for additional cuts to be priced***
- ***2H 2020 is particularly cheap point to play for more cuts – yes the Fed can cut during a presidential cycle***

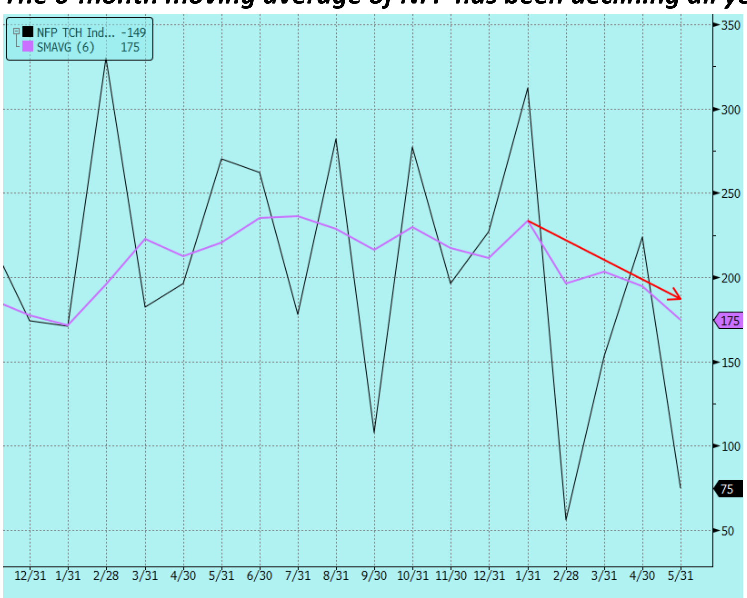
Down the road, we will all look back at the first week of June 2019 as watershed.

First, the Fed gave us all the groundwork for rate cuts the market had started to price in. From a tactical perspective, you had Evans and other using trade wars to open the door to what he labeled "insurance reasons" to talk about policy adjustments. From a more fundamental perspective, you had the AIT clan of Brainard ("we haven't hit 2% inflation goal on a sustainable basis) and Williams ("too low inflation is a more pressing problem today') using persistently disappointing inflation as their cover to cut. Interestingly, you are now even getting social justifications (too many people left behind during the recovery) as reasons for the Fed to cut. All that was enough to sustain Fed rate cut pricing, and sooth risk asset fears.

We also saw another downtick and disappointment in the Manufacturing PMI. We have spoken about this a few times that as a China/US trade war persists along with lower oil prices and flooded farm lands; a Manufacturing PMI contraction is a matter of months away. Last week was another step in that direction. It should be noted the ISM Service PMI, which in all fairness is most of the US economy, came in fine so this isn't an economic disaster yet. However also note the Markit PMI (why do we ignore Markit in the US but nowhere else in the world?) remains precipitously close to contraction at 50.9.

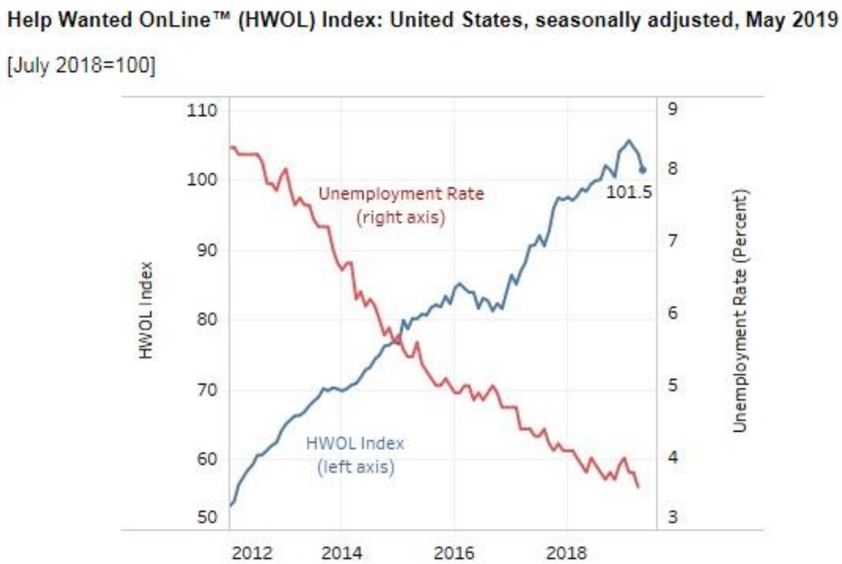
Most importantly last week, we saw very initial signs the labor market is cooling/rolling over/turning whatever you want to call it. <u>This is significant because anybody who has fought the Fed cut mentality has used the labor market as their cover. Your cover is getting pulled</u>. ADP and NFP both were pretty disastrous. About the only positive thing you can say is at least they didn't print negative.

The 6-month moving average of NFP has been declining all year…



Furthermore, the initial turning of the labor market was not only seen in the lagging indicators of ADP and NFP but also in some more forward looking indicators.

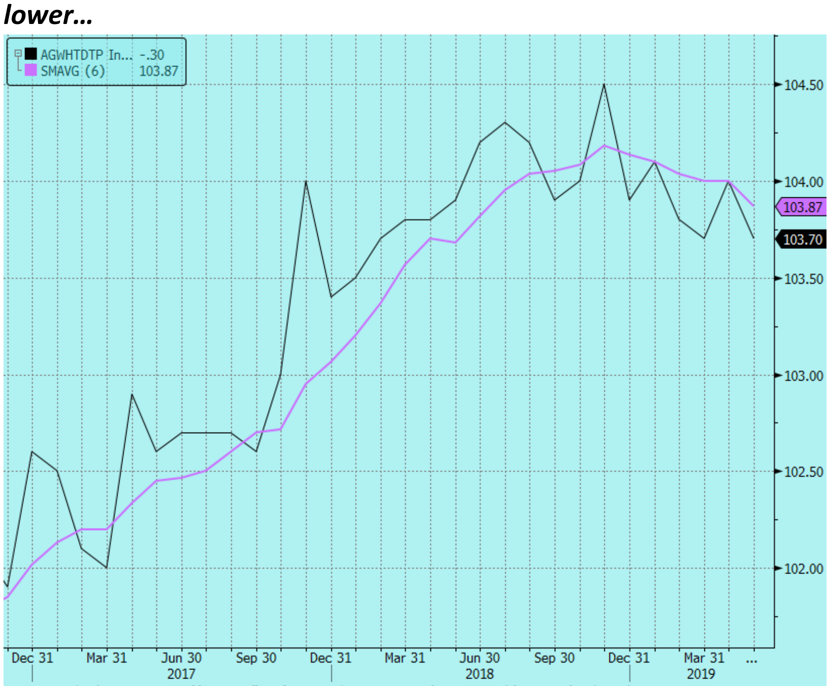
Help Wanted OnLine Index is turning over…



Sources: The Conference Board, Bureau of Labor Statistics

Truckers and transport jobs are not only an important part of the economy (especially for the center of the country), but more importantly it's a read through to the overall health of the economy. Meaning if truckers and other transport jobs are hot, then the economy is cooking. Last year you couldn't find enough truckers. This year is another story.

Aggregate Weekly Hours - All Employees Trade & Transport – also seeing the 6-month moving average turning lower…



Therefore, you are seeing plenty of signs the labor market is, to say it conservatively, weakening on a rate of change basis.

If we look at where Fed pricing stands now compared to May 6th when I first showed this table in my note *"40bps of cuts is not enough for the end of cycle,"* the market has rightfully caught up and priced in more cuts. Even the "Johnny come lately" banks and academic economist have finally shifted their views.

May 4th…

	Ticker	Last	Change 1m	3m	6m	1y	2y
	FFK9 Comdty	97.6025					
Jun-19	FFM9 Comdty	97.615	0.01				
	FFN9 Comdty	97.625	0.01				
	FFQ9 Comdty	97.65	0.03	0.05			
Sep-19	FFU9 Comdty	97.675	0.02	0.06			
	FFV9 Comdty	97.705	0.03	0.08			
	FFX9 Comdty	97.725	0.02	0.07	0.12		
Dec-19	FFZ9 Comdty	97.77	0.05	0.09	0.16		
	FFF0 Comdty	97.795	0.03	0.09	0.17		
	FFG0 Comdty	97.825	0.03	0.10	0.17		
Mar-20	FFH0 Comdty	97.835	0.01	0.06	0.16		
	FFJ0 Comdty	97.86	0.03	0.06	0.16		
	FFK0 Comdty	97.885	0.03	0.06	0.16	0.28	
Jun-20	FFM0 Comdty	97.905	0.02	0.07	0.14	0.29	
	FFN0 Comdty	97.935	0.03	0.08	0.14	0.31	
	FFQ0 Comdty	97.965	0.03	0.08	0.14	0.31	
Sep-20	FFU0 Comdty	97.985	0.02	0.08	0.15	0.31	
	FFV0 Comdty	98	0.02	0.06	0.14	0.30	
	FFX0 Comdty	97.975	(0.03)	0.01	0.09	0.25	
Dec-20	FFZ0 Comdty	97.985	0.01	-	0.08	0.22	
	FFF1 Comdty	97.99	0.00	(0.01)	0.05	0.19	
	FFG1 Comdty	98	0.01	0.03	0.03	0.17	
Mar-21	FFH1 Comdty	98.005	0.00	0.02	0.02	0.17	
	FFJ1 Comdty	98.01	0.01	0.02	0.01	0.15	
	FFK1 Comdty	98.01	-	0.01	0.04	0.13	0.41
Jun-21	FFM1 Comdty	98.01	-	0.01	0.03	0.11	0.40
	FFN1 Comdty	98.005	(0.01)	(0.01)	0.02	0.07	0.38
	FFQ1 Comdty	98.005	-	(0.01)	0.00	0.04	0.35
Sep-21	FFU1 Comdty	98.005	-	(0.01)	-	0.02	0.33
	FFV1 Comdty	98.005	-	-	(0.01)	0.00	0.30
	FFX1 Comdty	98.005	-	-	(0.01)	0.03	0.28
Dec-21	FFZ1 Comdty	98.005	-	-	(0.01)	0.02	0.23
	FFF2 Comdty	98.005	-	-	-	0.02	0.21
	FFG2 Comdty	98.005	-	-	-	0.00	0.18
Mar-21	FFH2 Comdty	98.005	-	-	-	-	0.17
	FFJ2 Comdty	98.005	-	-	-	(0.01)	0.14

16bps of cuts priced into 2019

Various micro "cuts" or inaction periods

A total of 41bps total of cuts for the whole cycle

Now…

	Ticker	Last	Change 1m	3m	6m	1y	2y
Jun-19	FFM9 Comdty	97.64					
	FFN9 Comdty	97.67	0.03				
	FFQ9 Comdty	97.865	0.19				
Sep-19	FFU9 Comdty	97.93	0.07	0.29			
	FFV9 Comdty	98.045	0.11	0.38			
	FFX9 Comdty	98.12	0.08	0.26			
Dec-19	FFZ9 Comdty	98.21	0.09	0.28	0.57		
	FFF0 Comdty	98.27	0.06	0.22	0.60		
	FFG0 Comdty	98.33	0.06	0.21	0.47		
Mar-20	FFH0 Comdty	98.35	0.02	0.14	0.42		
	FFJ0 Comdty	98.38	0.03	0.11	0.33		
	FFK0 Comdty	98.405	0.03	0.08	0.28		
Jun-20	FFM0 Comdty	98.42	0.02	0.07	0.21	0.78	
	FFN0 Comdty	98.435	0.02	0.06	0.17	0.77	
	FFQ0 Comdty	98.46	0.02	0.05	0.13	0.59	
Sep-20	FFU0 Comdty	98.475	0.02	0.05	0.13	0.54	
	FFV0 Comdty	98.485	0.01	0.05	0.11	0.44	
	FFX0 Comdty	98.485	-	0.03	0.08	0.36	
Dec-20	FFZ0 Comdty	98.485	-	0.01	0.06	0.28	
	FFF1 Comdty	98.49	0.00	0.00	0.05	0.22	
	FFG1 Comdty	98.575	0.09	0.09	0.12	0.25	
Mar-21	FFH1 Comdty	98.57	(0.01)	0.08	0.09	0.22	
	FFJ1 Comdty	98.56	(0.01)	0.07	0.08	0.18	
	FFK1 Comdty	98.56	-	(0.02)	0.08	0.16	0.92
Jun-21	FFM1 Comdty	98.55	(0.01)	(0.02)	0.06	0.13	0.91
	FFN1 Comdty	98.53	(0.02)	(0.03)	0.04	0.09	0.86
	FFQ1 Comdty	98.53	-	(0.03)	(0.05)	0.07	0.67
Sep-21	FFU1 Comdty	98.525	(0.00)	(0.02)	(0.04)	0.05	0.59
	FFV1 Comdty	98.505	(0.02)	(0.03)	(0.06)	0.02	0.46
	FFX1 Comdty	98.505	-	(0.03)	(0.06)	0.02	0.38
Dec-21	FFZ1 Comdty	98.505	-	(0.02)	(0.05)	0.02	0.30
	FFF2 Comdty	98.505	-	-	(0.03)	0.02	0.23
	FFG2 Comdty	98.505	-	-	(0.03)	(0.07)	0.17
Mar-21	FFH2 Comdty	98.505	-	-	(0.02)	(0.06)	0.16
	FFJ2 Comdty	98.505	-	-	-	(0.06)	0.13

More than two cuts now priced

The various micro "hikes" have been completely flipped to cuts

A total of 92bps total of cuts for the whole cycle, +52bps since May 6th note

As we can see, a lot more has been priced in and positioning generally has gotten long. So what's my beef today? There is 92bps of cuts priced for the whole cycle. The bulk of that comes this year with ~65bps priced. That is the market partying like its 1995 or perhaps using the Evans narrative of insurance cuts. That's fully priced now and perhaps overpriced if anything.

The 2020 pricing is what I want to point to. <u>If you believe the narrative that the economy is not in a tailspin but in what looks to me like the most classic end of cycle, and you are paying attention to Fed rhetoric; then the one cut only priced into 2020 seems too little</u> (~27bps of cuts priced past 2019). In other words, the risk reward is now to play for more cuts in 2020.

So as the market starts to price out rate cuts in the past few sessions, you are getting your opportunity to play for more cuts past 2019. That means you can make specific 2020 plays like selling EDH0/EDH1 spread as it approaches key resistance levels.

EDH0/EDH1 is coming up on pivot and trend resistance at -10bps…

Or you can go back to my old friend the EDM1/EDM2 steepener which remains a classic end of cycle trade and coming back down to levels we want to reengage. I am watching for a pullback down to 10bps.

EDM1/EDM2 is falling to trend and pivot support at 10bps…

To be clear, flatteners in 2020 and steepeners there on out with the thought being that more cuts will come in 2020, and those cuts lead to a better economic backdrop in the future which steepens out time spreads further out the curve.

I would also point out that there is a mindset that exists where the Fed will not cut during the presidential election cycle in 2020. Let's be logical for a minute. If the US economy, which consensus economist expectations are for slower growth already in 2020 not even taking into account a potential labor market turn, slows sharply in 2020, do you really think the Fed will not cut?? It would be political if they DID NOT respond to a slowdown. The Fed will be data dependent as they always are. So if inflation is sub 1.5% and UER is ticking higher you think the Fed is going to say oh we are holding off because of the election?

The market is therefore giving you an almost free option with 2H 2020 Fed pricing. The FFM0/FFF1 spread (June 2020/Jan 2021) is 8bps. If the Fed doesn't cut at all from July to December, you lose 8bps. If the Fed cuts once you make 17bps. If the Fed cuts twice you make 42bps. That's call asymmetry folks.

Kind Regards,

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