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BOND MARKET REVIEW

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The BMR 2016 Year–End Review and Forecasts for 2017

The Greatest Show On Earth

After 146 years, Ringling Brothers Circus is pulling up stakes and closing down in 2017. Once they succumbed to pressure, and the elephants quit traveling, it was the beginning of the end. We suspect SeaWorld will have its share of challenges as well – as they announced they would phase out killer whales (orcas) over the coming years. When you lose your 'Shamu', or the big elephants, you lose your identity and the overall bigness of the experience.

What about the Grand Old Party? The United States voted in pachydermic control, and the GOP has enough elephants to stampede tax cuts and other legislation. Will they, or won't they? We've all grown skeptical of politicians, and their abilities to follow through on campaign promises. That said, the 'Make America Great Again' show is about to begin, as Donald Trump will be sworn in on Friday (01/20/2017). The incoming president has proven himself not timid when it comes to dealing with almost everyone, and while the country abounds with naysayers, confidence surveys are skyrocketing and optimism is surging – especially among small businesses.

The FOMC's concern now is that 'Trumponomics' could be expansionary! As we said in a recent article: *"If an outsider can win his party's nomination, and then edge out the political establishment to win the highest office in the land, who knows what 2017 will bring?"* There's actual concern out there that Trump tax cuts and fiscal policy could boost growth by too much. The December FOMC minutes showed that members saw upside risks to growth. It almost sounded like the concern was that America could experience great growth again, after more than a decade of sub–3% GDP. If fiscal policy is too good, will it throw the Fed off track – or behind the curve? The Unemployment Rate could experience a "sizable undershoot" of their estimate for full employment. Growth could actually take off, leading to an inflation "overshoot." Policy in the light of these 3 factors could present the Fed with puzzling policy problems!

There's concern domestically (and globally) that Trump's policies could be restrictive if he follows through on canceling or renegotiating trade agreements. He could also bring about new trade barriers with some countries. Trump embraced the 'Brexit' vote, and has said he would offer trade deals to the U.K. and Russia. He's not shy about his 'America first' plan, and has been unconcerned about a breakup of the European Union as it currently exists. The World Bank said Trump's spending plans and tax cuts could springboard the U.S. economy and lift growth around the world. However, they too have reservations about his trade policies.

There are reasons to be optimistic! 2017 has begun with the Dow knocking on the door of 20,000 (something its done for 20 trading sessions already). Stocks are up out of the gate and GDP growth is approaching 3%. Even though Labor Force Participation is poor, the Unemployment Rate is below 5%. Contrast that to early 2016. GDP was struggling to hit 1%. Stocks were selling off in a global retreat, partially in a market tantrum to the first Fed rate increase in over a decade. January 2016 was the worst start for U.S. stocks since 2009, and the worst global start on record! In the **B**ond **M**arket **R**eview (01/12/2016), we said: *"Stocks started off 2016 with their worst week since September 2011, but the more ominous message was that it was probably the worst beginning week of any year ever. We have a lot of data, and couldn't find a 6% loss for the first week (of trading) even going back to the 1930's."* The Fed's plans for a hike at every other meeting eventually turned into only one hike – instead of the planned four.

When one considers the beginning of the year, and the rough 3 quarters into Q2 2016, the finish for 2016 was prolific! The Russell 2000 index was 19.48% higher for the year, rallying 43.90% after a hard 16.97% drop into early February. Contrast that with the end of 2015. In the last **BMR** of that year, with only 2 trading sessions to go, we said it was 'too close to call' whether the S&P and Dow would end the year higher or lower. Stocks then fell for those last 2 days, and the S&P finished 2015 with a .73% loss.

Looking Ahead

- Our 10–year bond cycles show the next low–yield window near January 24th.
- Our equity cycles show the next major buying opportunity near January 26th.

The cycles and market turns were very good in 2016. It would take a lot of text to cover every cycle, and back issues are always available on request, but we consider the **BMR** trend changes and directional calls for 2016 to have been quite useful. Even the long–term forecasts were good for planning purposes (see the 2016 review herein).

The BMR Forecasts for 2017

- The Fed intends to hike at least 3 times in 2017. Confidence is infectious, and it's spilling over. Small businesses are the most optimistic since 2004, and a business–friendly environment could lead the U.S. to better growth. The markets are pricing in only 2 hikes, but 3 may happen – especially if we can see some wage improvement and GDP growth over 3%.
- Inflation and growth should tick higher in 2017. We expect a few setbacks from our cycle work, but foresee 2017 to be a good year economically. We don't expect the kind of stock market returns that 2016 provided, but the next timing for a larger pullback should be in 2018.
- Our cycle work on stocks suggests an important low due in early July. Other lows are due near February 24th, and early October. Highs are due near April 18th, the end of August, and mid–November.
- We expect bond yields to make lows near January 26th, March 21st, May 18th, August 11th, and mid–December. The longer cycles forecast that the August lows would be the most important, though mid–May also looks good. These are times to take profits or set hedges. Of course, we'll fine tune as we go!
- High yields (or buying opportunities) are expected near February 15th, April 4th, June 22nd, September 14th, October 5th, and November 27th. Late March and mid–September are the most important turns using longer cycles.
- Bonds have additional trend–change dates near February 3rd, June 29th, and November 23rd.

Treasuries, Agencies, and MBS

Following the election, the markets got a little ahead of themselves as the dollar and stocks surged – while bonds took it on the chin. The 'unwinding' of that move has seen stocks stall their advance, while the dollar and bond yields have dropped to 1–month lows. Bonds just finished their 4th week of gains. While yields have dropped from their extreme highs in mid–December, the 10–year has only retraced about 40% of its loss following Election Day.

Last week, yields were lower by 1.5, 2.5, 2.5 and 2 bps for the 2, 5, 10, and 30–year Treasury sectors. For the first week of January, 2–year yields rose 2 bps, while the longer sector yields fell by .5, 2.5, and 5.5 bps. The last week of December, yields dropped 1.5, 9.5, 9.5, and 5 bps. For all the range of 2016, yields closed the year not that much higher. For the year, they rose 14, 16.5, 17.5, and 5 bps for the 2, 5, 10, and 30–year sectors.

MBS spreads (FNMA 30–year 3%) narrowed by 5 bps the last week of December. The last 2 weeks were flat and then 2 bps wider. On Tuesday, the U.S. Treasury sold $24 billion 3–year notes at a 1.472% yield. Demand was the highest since last August, and the yield rose to the highest since the April 2010 offering. The buying group that includes foreign central banks accounted for 54.6% of the issue, versus 42.6% in December. Wednesday's 10–year note brought 2.342% for $20 billion supply. The November 2026 issue was reopened (making this a 9–year, 10–month offering). The yield was the lowest since that November issue, and demand was the highest since June. Foreign buyers stepped up to take 70.5% of the auction, versus 57.5% last month. Last Thursday's 30–year bond also saw a reopening of the November issue to add $12 billion in supply to the 2046 maturity at 2.914%. Demand was off to December, and the yield was the lowest since the November offering. Foreign buying rose from 63.9% in December to 66.7% of this auction.

Next week, the Treasury will auction 2–year notes on Tuesday (01/24), 5–year notes on Wednesday (01/25), and 7–year notes on Thursday (01/26). Detail including the size of each auction will be released this Thursday.

01/13/17 Treasury Yield Curve	**2-Year: 1.195%**	**5-Year: 1.898%**	**10-Year: 2.397%**	**30-Year: 2.989%**
Weekly Yield Change:	–.017	–.027	–.023	–.020%
01/06/17 Treasury Yield Curve	**2-Year: 1.212%**	**5-Year: 1.925%**	**10-Year: 2.420%**	**30-Year: 3.009%**
Weekly Yield Change:	+.022	–.003	–.025	–.057%
12/30/16 Treasury Yield Curve	**2-Year: 1.190%**	**5-Year: 1.928%**	**10-Year: 2.445%**	**30-Year: 3.066%**
Weekly Yield Change:	–.014	–.097	–.093	–.048%
Annual Yield Change:	+.140	+.167	+.175	+.050%
Support:	1.18/ 1.20/ 1.22/ 1.25%	1.90/ 1.93/ 1.97/ 2.04%	2.39/ 2.43/ 2.47/ 2.51%	2.97/ 3.01/ 3.06/ 3.10%
Targets:	1.14/ 1.12/ 1.10/ 1.07%	1.83/ 1.79/ 1.76/ 1.72%	2.31/ 2.27/ 2.23/ 2.20%	2.90/ 2.86/ 2.82/ 2.78%

Said U.S. notes to Japan, Germany, and a few other EU countries: "Our yields are better than yours!" 'Are you sure they asked?' "We're 'positive!'" – came the Treasury's reply! ***BMR***

Reviewing the BMR Forecasts for 2016

- The Fed intends to hike 4 times in 2016. At this juncture, our cycle work leads us to believe we won't see 4 hikes in 2016. The data just may not cooperate.
    - The early data for 2016 was very disappointing. The Fed hiked in December 2015 even though GDP for the last quarter of the year would later show only .90% annualized growth. The first 2 quarters of 2016 had growth of only .80% and 1.40%, and May had only a 24K job pickup.
- We still have a major economic trough due in 2016. For that reason, the global GDP recovery should remain elusive with inflation remaining on the low side. Any real upturn nearer or beyond the Fed's long–run inflation target above 2% should be delayed until after 2016.
    - The trough occurred early in the year with 3 quarters of GDP below 1.50%, and the worst start for U.S. stocks since 2009. It's been over a decade since GDP topped 3% annually! CPI continued to rise since bottoming out in April 2015, but was still below 2% with a 1.70% annual rise into November 2016.
- Emerging markets (beyond China) should experience debt–driven crises with their currencies. The spill over could be the catalyst for some of the turbulence we expect and might also serve to give U.S. bonds a boost.
    - The chief catalyst turned out to be the 'Brexit' vote, sending the 10–year note below 1.35% in early July as leading EU nations and Japan debt traded to negative yields.
- The added costs of security in the EU combined with continued challenges with low inflation levels will probably lead to additional stimulus measures by the European Central Bank.
    - Challenges continued in the EU. Inflation remained fairly low. The 'Brexit' vote was followed later in the year by a no–confidence vote on a referendum in Italy to allow the government more power to streamline policies. Each caused concern of a breakup or at least a few nations leaving the European Union. Eurozone inflation rose to only 1.10% by year end. In early December, the ECB announced a 9–month extension of their asset–purchase program.
- Our cycle work on stocks suggests a high near April 13th and a low near June 8th. Another important low is due in early October.
    - Stocks made a nice high near on April 20th that was followed by an important drop following the 'Brexit' vote. The Dow made a low on October 13th, but drifted to a lower low into November 4th. We forecast a rally from November 8th, and it turned out to be legendary.
- We expect bond yields to make lows near April 1st, highs in early June, and a more important low in mid–July. The best buy opportunity could be near the end of November.
    - Bonds yields made a low on April 7th, and fell hard from a high on May 31st to a 'more–important' low on July 6th. Yields surged higher from that area, where we also said the best chance to refinance would be then, or by late August. Rates held relatively low until September 7th. If you waited to buy until late November, you saw the highest yields of the year – at that point. Yields rose another 20 bps higher into mid–December, but they have since come back to the late–November levels.

Economics

Initial Jobless Claims fell 30K to an 8–week low of 237K to close out 2016, in data often skewed by the holidays. They then rose 10K to 247K last week – remaining near the lower end of recent data. Continuing Claims were 11K higher to 2,116K, and then fell to 2,087K last week. The private payroll data from ADP Employment Change came in below estimates at 153K, and that trend carried over with the release of December payrolls. Nonfarm payrolls rose 156K in December. That was nearly 20K below forecasts and the 4th lowest reading of 2016 – around 100K below the best results from June and July. The 2–month revision was an increase of 19K. Private Payrolls rose 144K, but were revised from 156K up to 198K for November. Manufacturing added 17K jobs, the most since last January, but there was a net 45K loss from that sector in 2016. The U.S. Unemployment Rate rose .10% to 4.70%. That was in part due to Labor Force Participation rising to 62.70% from November data that had been revised .10% lower to 62.60%. The Underemployment Rate fell from 9.30% to 9.20%. Average Hourly Earnings rose .40%, leading to the fastest annual wage growth since 2009 – as there was a 2.90% improvement versus December 2015! Average Weekly Hours were unchanged at 34.3, but only because the November data was revised .1 lower to that reading. November showed some promise for opportunities as JOLTs Job Openings rose from 5.451M to 5.522M. Government agency jobs increased the most since 2007 in 2016, while Private Payrolls rose the least in 6 years.

NFIB Small Business Optimism soared higher, rising the most since 1980 – from 98.4 to 105.8. ISM Manufacturing rose from 53.2 to 54.7 – showing expansion at the best pace since mid–2015. New Orders rose from 53 to 60.2 for the largest pickup since August 2009.

The ISM Employment gauge rose .8 to 53.1 and Prices Paid rose 11 points to 65.5. The Service Sector outlook (ISM Non–Manufacturing Composite) held at the best reading since October 2015, maintaining a 57.2 result (versus 56.8 expected).

Bloomberg Consumer Comfort fell for a third week, but the drops from 46 to 45.5, and then to 45.1 were still near the highs of recent data – and the best measurements since 2007. Chicago Purchasing Managers data fell from 57.6 to a still–positive outlook of 54.6. The University of Michigan surveys also slipped marginally. Sentiment dropped from 98.2 to 98.1, and Expectations fell from 89.5 to 88.9. However, Current Conditions rose from 111.9 to 112.5.

Retail Sales rose .60% in December and were revised from .10% to .20% for November. Ex auto and gas, sales rose .20% (as did the control group). November orders were challenged as Factory Orders fell 2.40%, and were only up .10% ex transportation. Orders for Durable Goods fell 4.50%, but were .60% higher ex transportation. Orders for Capital Goods rose .90%. Wholesale Inventories rose 1.00%, and Wholesale Trade Sales rose .40%. Business Inventories rose by .70%. Construction Spending rose .90%. Import Prices rose .40% in December, hiking the annual pace from .10% to 1.80%. Producer Prices rose .30%, and the annual pace also increased .30% to 1.60%. Core PPI (ex food & energy) rose .20%, leaving the annual pace unchanged (and also at 1.60%).

Vehicle Sales rose from 17.75M to an 18.29M annual pace. Domestic Vehicle Sales rose from 13.85M to a 14.19M annual pace. Those results, though annualized, were new cycle highs. The Trade Balance deficit rose 6.8% to $45.2 billion in November, reaching a 9–month high. Imports were the highest since August 2015, and exports fell by .2%. Consumer Credit surged from $16.174 billion in October to $24.532 billion in November. Credit card debt rose the most in 8 months. The Monthly Treasury Budget Statement showed a $27.5 billion deficit, with fiscal 2017 running a little under 2016 at this point (with a total of $208.4 billion versus $215.5 billion for last year).

Tuesday is set for Empire Manufacturing. Wednesday follows with Hourly & Weekly Earnings, Consumer Prices (December CPI), Industrial Production, Capacity Utilization, Treasury International Capital flows, home builder outlook (the NAHB Housing Market Index), and MBA Mortgage Applications (which fell 12.10%, rose .10%, and then rose 5.80% over the past 3 weeks). Thursday brings December Housing Starts & Building Permits, jobless claims data, the Philadelphia Fed Business Outlook, and Bloomberg Comfort & Economic Expectations. Next Tuesday (01/24) is set for the Richmond Fed Manufacturing Index and Existing Home Sales for December.

Equities

Stocks overcame a significant handicap in 2016, as the S&P lost 11.44% into February 11th. The S&P reversed 23.69% higher to close out 2016 with a 9.54% gain – blowing out the January effect and barometer in the process. The Nasdaq had fallen 15.93% into February, but then surged 27.87% to a 7.50% gain. The Dow Industrials fell 11.33% into January 20th, but then rose 27.91% to end the year 13.42% higher. Bank stocks plunged 23.39%, but then surged 63.94% to end the year with a 25.60% gain!

The Dow hit a brick wall just under 20,000 and has yet to break through – despite 20 sessions over 19,900, and one that missed it by only .37 points! It's like an old car that someone keeps driving backwards half the time to keep the odometer from going over 20,000. (Those old odometers would actually do that!) The Dow fell .86% the last week of 2016, rose 201.20 points or 1.02% to 19,963.80 the first week of 2017, and then lost 78.07 points or .39% to close Friday at 19,885.73. The Nasdaq lost 1.46% to close out 2016, gained 2.56% the first week of 2017, and then rose 53.06 points or .96% to 5,574.12 – pretty much alone reaching a new record high and close on Friday. The S&P 100 (OEX), Russell 1000, and Russell 3000 indexes made record highs on January 6th. The S&P lost 1.10%, gained 1.70%, and then lost 2.34 points or .10% to 2,274.64 to close out last week. The Dow Transports lost 1.60%, gained .67% to kick off 2017, and then rose 1.08% last week. Bank stocks lost 1.45% the last week of the year, gained 1.07% for the first week of 2017, and then rose .37% last week – to reach the best levels since February 2008.

Resistance:	Dow:	19,928/ 19,999/ 20,070/ 20,140	Nasdaq:	5,582/ 5,619/ 5,657/ 5,695	S&P:	2,278/ 2,284/ 2,291/ 2,297
Support:		19,787/ 19,718/ 19,648/ 19,577		5,509/ 5,470/ 5,428/ 5,387		2,267/ 2,261/ 2,255/ 2,249

Other Markets

Commodities rose for the past 3 weeks, gaining 1.04%, .53%, and then .52% last week. Crude Oil had risen 1.32% the last week of 2016, and then started 2017 with a .50% gain. However, Crude dropped 3.00% last week. The upcoming cycle turns for Crude are for a February 3rd low, a March 23rd high, a May 3rd low, and a high near June 30th. (All projected cycle turns are plus or minus a day.) Gold rallied for 3 weeks as the U.S. dollar declined for a third week. Gold rose 1.75%, 1.88%, and 1.94% last week. The Dollar fell .70%, .08%, and 1.00%. The Japanese Yen gained .32%, lost .05%, and then rallied 2.16%. The Euro rose .58%, .14%, and then 1.05% over the past 3 weeks. Corn gained 1.81%, 1.70%, and then .14% last week. Cotton rose 1.12% and 4.73%, but then fell 2.32%.

2016 – The Year in BMR Quips & Quotes

(The text herein may be abridged. '…' indicates skips. Full text in the form of back issues is available on request.)

BMR (01/11/16): Germany's inflation rate went negative and their 5–year note traded to negative yields for the first time.

BMR (01/11/16): (One reason for the Trump revolution) Like the frog that doesn't realize he's in slowing boiling water, America is populated with people that are settling for less. Less money, less work hours, less benefits. The U.S. is changing from a manufacturing economy to a service–based one. Making pizzas and sandwiches – as long as you don't put in more than 28 hours a week (per job). Likewise, the financial jobs diminished and service jobs increased.

Ride Along 2 (01/21/16)

The Chinese year of the Red Fire Monkey begins February 8th, but what we've seen so far is more like a Black Clawing Bear. It's the outgoing year of the Sheep – in bear's clothing! Overall, 2016 is now off to the worst global start on record! The markets have been riding along with the record stimulus provided by central banks since emerging from the financial crisis. They seem to have overshot the reversal! Could a 25–bps hike really lead to such a 'market tantrum?'

The Break Up (01/27/16)

… To paraphrase a book title, the FOMC said to global stocks: 'I'm O.K., you're not!' The Fed was dissing foreign markets with a reversal of the classic break–up line: 'It's not me – it's you!'

Less than Zero (02/03/16)

The groundhog, Punxsutawney Phil, saw no shadow on Tuesday and forecast an early spring. However, the Fed's hiking forecast has been cooling. We're thinking 6 more weeks of low rates – and then some! When the FOMC began their liftoff in December, 4 hikes in 2016 were a 'lock' and the first was intended for March 16th, 2016. Back in December, and in our subsequent 2016 forecast issue, the **B**ond **M**arket **R**eview was skeptical of those 4 hikes – given our outlook for an economic trough in 2016. The odds of a hike at that March meeting have fallen from a coin toss in December to only 12% today! Additionally, given the global equity selloff and slowing growth data worldwide, the market–driven chances for even one more hike in 2016 now stand at less than 50%.

January turned out to be the worst month for global stocks since last August, and the worst yearly start since 2009. The global selloff erased well over $7 trillion in market value – but it could have been much worse. The Dow gained over 500 points on last two days of January to trim what through last Wednesday was the worst monthly loss for the Dow since February 2009, and the worst for most indices since May 2010.

BMR (02/17/16): Oil stockpiles were reported near an 86–year high, and drilling rigs across the U.S. continued to be shut down from being unprofitable. Over 1,000 rigs have ceased operations over the past year and a half. This domestic capability could serve as a 'cap', as rigs and other oil producing methods would come back on line and increase supply when and if higher prices allow.

Red Card (02/25/16)

The Dow fell deeply into the red to kick off 2016, plunging 11.33% into January 20th. However, just like a soccer player that went to the ground writhing in agony and pain, it suddenly rose just before the stretchers were brought onto the field. … How many times can the bull cry wolf – or the bear cry bull? … After all, sometimes those soccer players really do get hurt.

'Modestly–Moderate' Ado About Nothing (04/20/16)

Growth being less than 'much', expectations for a hike at next week's FOMC meeting are so low, an increase would lead to a 'man bites dog' type of headline. Other than stocks rising to 4–month highs, the best story we saw last week was about a Memphis FedEx employee that fell asleep around 4 a.m. – only to awake as the plane neared the airport in Lubbock. Kansas City's WDAF–TV quipped: *"No word yet on if the man splurged to have himself shipped FedEx Same Day back to Memphis, or if he waited the 5 business days for FedEx ground."*

Treasuries, Agencies, and MBS (07/28/16)

In last week's **B**ond **M**arket **R**eview, we said *"our bond cycles still call for another bullish move into the end of August, though our primary 10–year yield target has been achieved."* The August target was 1.38% to 1.41%, and the 10–year traded in that zone from July 5th to July 11th – while dipping to 1.34% on the 6th.

Yields should still drop into a trend–change near August 25th, and then trade higher into the end of September. For now, the timing for the next low for interest rates is Monday, November 7th – one day before the elections!

BMR (08/11/16): A study of long cycles projects larger recessions every 8 to 10 years – with smaller business–cycles troughs due every 3 1/2 to 4 years. We had projected 2016 as the next larger trough, though that could extend out to 2018. Even though we've had a couple months where jobs seem back on track, falling productivity and sluggish GDP growth are ominous signs. In the **B**ond **M**arket **R**eview (11/23/2003), we said there was an obvious desire for *"the good ship 'Economy' to sail north, but it's been diverted through the straights of recession and the shallows of low inflation."* It turned out that the 3rd–quarter 2003 GDP growth of 6.9% was the highest now in 13 years. It zig–zagged its way from that point into an 8.2% loss for the 4th quarter of 2008 – marking the lowest point of growth since early 1980. Annual GDP growth has been under 3% for every year now since 2005 (which saw 3.3%). Even if the Fed does want to 'normalize' rates, will they tighten while other global central banks are seeking to promote growth?

BMR (09/01/16): When we hear of a few Fed members still advocating not one, but even two hikes for 2016, we think of that as 'personal consumption' redefined, or at least an 'individual obsession' with an agenda that in our view has a lot of hope built into expectations for future data – rather than in the reality of recent results.

BMR (09/21/16): In her post–statement press conference, Janet Yellen said: *"Our decision does not reflect a lack of confidence in the economy."* She curiously contended that: *"Since monetary policy is only modestly accommodative, there appears little risk of falling behind the curve in the near future."* If that's the case, why are they placing such pressures on themselves to time a hike?

Masterminds (10/06/16)

You'd think there was nothing else to write about, but the weekly stories continue to abound with individual Fed members making their case for raising rates or exercising caution. It's like a broken record. However, there's a whole generation now that has no concept of a damaged record playing the same phrase over and over – as the needle skips over the grooves. Do you bump it to make it continue, hope that it will move forward without doing anything, or remove the disc and clean it? FOMC members are weighing similar options as rates relate to the economy.

BMR (11/21/16): Speaking to the bigger picture, we followed our own advice and locked our refinance rate in July. In our 2016 forecast issue **(BMR 01/11/2016)**, we wrote: *"We expect bond yields to make lows near April 1st, highs in early June, and a more important low in mid–July. The best buy opportunity could be near the end of November."* In the **BMR (05/17/16)**, we said: *"Missed the chance to refi? We don't think so. Late August could be the best opportunity!"* The 10–year note (mortgage benchmark) yielded 1.55% near the end of August, and hit 2.34% today. While no one knows what to really expect, the combination of cycles can at least give us an 'improved guess.' If the long cycles said the best buy was near the end of November, bonds are oversold, and spreads are historically high, they could be right!

BMR (12/01/16): GDP growth is also improving. Q4 2015 came in at .90%, and Q1 2016 GDP growth was only .80%. Q2 2016 rose to 1.4%, but the second revision for Q3 2016 was just bumped .3% higher to 3.2%. Consumer spending continues to be solid, and some measures of consumer confidence are the highest in 9 years. Readings that were already improving into the election are continuing higher.

Key Economic Thoughts from the 2016 BMR

Gradual Patience (02/11/16)

While the Fed might not bear the responsibility of causing the global selloff in stocks, they're almost certainly perceived as a catalyst. So far, whatever the cause, the 'event' brought about a global loss of over $8 trillion. However, it also bought a Fed (that was out of ammunition) one accommodative 25–bps caliber bullet (for what that may be worth). It's interesting that Fed Chair Janet Yellen's talking points have been to deny FOMC policy had anything to do with the ensuing global market turmoil. As in, (please), don't blame us! She said the first hike had to have been widely anticipated by investors. It's only the evidence that speaks otherwise. The Fed wouldn't be the first to use bad timing, but it is the case they were determined to hike in 2015, and since pulling away the punch bowl on 'liftoff day', the S&P has lost 12.84% and the Nasdaq is down over 17%. The Fed tried to prepare markets by assuring the coming hikes would be gradual instead of campaign like (given their history). Last week, the **B**ond **M**arket **R**eview recalled the Fed's buzzword following the financial crisis. They said they could be 'patient' in removing stimulus! It would now appear they intend to also be 'considerably patient' with the gradualness of the hikes.

Downshifting (02/17/16)

Though not saying the economy had reversed, the Fed's January minutes showed their hiking foot was off the accelerator and their forecasted expectations had downshifted. The most obvious headwind has been the global selloff in equities that had erased over $8 trillion in market value through last week. Fed Chair Janet Yellen said the Fed was not to blame for what they've termed 'market turmoil.' …

The downshifting in the economy has the Fed tapping the brakes on tightening (what members have termed as 'normalization'). Clearly the FOMC's collective December forecast had been good enough to allow the Fed to hike rates for the first time in a decade – and layout a plan to continue hikes at every other meeting in 2016. The **B**ond **M**arket **R**eview doubted that campaign would unfold in that manner at that time, and we still do. A major difference is that we now have company – even on the committee.

The Walking Dead (03/03/16)

When one is seeking to elude a zombie, they're thankful that the 'walkers' don't seem to be able to move or change direction very fast. The fright results from the sheer numbers, the relentless pursuit, and the lack of resources to fight off the hoard. The G20 finance ministers (Group of 20) met and sought ways to increase growth and revive the global economy. The International Monetary Fund just reelected French–born Christine Lagarde to another term as its head. She has a record of pressuring central banks to provide more global stimulus, and has many times asked the Fed to keep rates low or delay removal of stimulus. Her latest idea: *"We need a tax system where multinational companies and wealthy individuals contribute a fair share to the public purse."* More global taxes added to federal, state, health care, Medicare, unemployment, sales, property, fuel, etc.? The U.S. already gives plenty to the IMF, but along with the Chinese agreed that increased government spending would be in order. While the kind of reasoning one would normally expect from the Brits, Germany made the case that bumping up debt in order to fund growth only leads to 'Zombifying' economies.

While 'not quite dead yet' in Pythonesque terms, many global economies have been limping along more like the 'walking wounded' for a decade now. It seems that every year the Fed forecasts GDP growth of 3% or above, only to miss those forecasts. Final U.S. GDP was only 2.4% in 2015, matching the GDP growth for 2014. In fact, U.S. GDP hasn't been able to grow above 3% for 10 straight years now.

Crossroads (03/16/16)

As much as the Fed and global central banks want to see numbers pointing to a pickup in inflation, some of the data just won't cooperate. … Given our read on economic cycles, the **B**ond **M**arket **R**eview thought it unlikely the Fed would hike rates at a *"gradual pace"* their planned 4 times in 2016 – following the first increase in nearly a decade during their December 2015 meeting. The 'Dot Plot' forecasts of members of the committee now project only 2 more hikes in 2016. As the oft–quoted poem goes, their 'get up and go has got up and went!' Fed chair Janet Yellen said the participant's shift in forecasted assessments of rate policy *"largely reflects a somewhat slower path for global growth, for growth in the global economy outside the United States, and for some tightening in credit conditions in the form of an increase in spreads."* With fewer hikes expected, and the European Central Bank's position that it will not cut any further, the Dollar's premium versus the Euro has been eroding (unwinding the strength based on the reverse of those assumptions).

Un–Lonesome Dove (03/31/16)

While the Fed had its share of members arguing to stay the course on rate increases – even if only gradually, Fed Chair Janet Yellen was not the 'lone stranger' in the dove camp. One of the quotes from 'Lonesome Dove' was: *"Yesterday's gone on down the river, and you can't get it back."* GDP growth over 3% vanished 10 years ago and any tangible inflation hasn't returned since the financial crisis. Living off bond interest has become a thing of the past, and a number of global rates are still negative – some out to 10 years! A few Fed members spoke against relying on the 'dot plot' chart (reflecting the member's collective forecasts of where rates might be over the next 3 years). While those dot plots are traditionally a bit optimistic (at least to us), the markets believed the March numbers which indicated only 2 more hikes for 2016. Whether or not the intent, that's what the markets read into them! St. Louis FRB President James Bullard said he'd even considered *"dropping out unilaterally from the whole exercise,"* believing that the projections lead to uncertainty.

Against all Odds (05/04/16)

Bond traders are positioned against the Fed's wishes for further tightening. Despite warnings from a few FOMC members that a June hike is still 'on the table', the odds for that move dropped into today. … Regardless of all these shifts in market sentiment, the first month with odds above 50% for the next Fed hike has consistently been December. Even then – that's only a coin toss!

In last week's **B**ond **M**arket **R**eview, we noted that the last two quarters of U.S. GDP growth were only 1.40% and then .50%. We asked: *"How would the Fed see enough evidence of a pickup by June – especially after a first quarter GDP just plodding along in low gear?"* Given the low odds for a June move, Atlanta FRB President Dennis Lockhart said: *"I would put more probability on it being a real option."* While that might just mean he thinks the chance should be above 12% – even if by only a few percentage points, it doesn't mean he thinks June will happen. He said he wasn't leaning to June, but that 2 more increases this year were "certainly possible." San Francisco's Williams said June was *"appropriate"* if the economy stayed on track, but said *"a lot can happen between now and June."* Williams is not a voter this year. Dallas' Robert Kaplan said the possibility of the United Kingdom's exit from the EU (termed Br–exit) could be the one core issue that would make a June policy move *"unclear."*

Reversal of Fortune (06/08/16)

In the **BMR** (04/28/16), we asked: *"How would the Fed see enough evidence of a pickup by June – especially after a first quarter GDP just plodding along in low gear?"* We followed that skepticism in the **BMR (05/04/16)**, making our case: *"By June, we'll know the results for April and May payrolls. … However, it will be too early to get a really good read on 2nd–quarter GDP, and through today there hasn't been enough promising data to push us into the June–hike camp."* …

It was like a scene from 'Peanuts!' As bond traders were about to kick the football, Lucy (in the form of Janet Yellen) pulled it away – tripping them up. Yet, as Yellen went to kick the other way, Snoopy (in the form of May payroll numbers) left her also kicking air. Until last week, December was the next month with market–driven odds over 50% for the next Fed hike. After Yellen's comments last week, the July odds soared from near 20% to over 50%, and June's rose from single digits to 30%. With May's lowest payroll additions since 2010, June quickly dropped to near 0% and July fell below 30%.

Dropping the Baton (06/16/16)

On your mark, get set, wait! On Wednesday, the FOMC decided to leave interest rates unchanged. While that was widely expected since May's weak job gains, the Fed had previously desired to hike at this meeting. As the Fed left the starting blocks in December, it was clear that their intent was to hike rates at every other meeting going forward in a 'gradual pace.' The baton was bobbled in the March meeting as global stocks plummeted into early February and growth was challenged. …

When the May jobs data came in with only 38K gains compared to around 160K expected, the baton was dropped again – and fell into a grate. Nevertheless, the Fed could still win this one. With other leading economies running backwards – with negative rates, they can contend while standing still. For the first time in history, Germany's 10–year rates fell to zero – and then went negative. Japanese, Australian, and South Korean debt fell to record lows as well. U.S. 10–year yields fell back to August 2012 levels – near record lows, but were still at a healthy spread versus those global alternatives.

Euro Cup (07/15/16)

We've all seen it. Two soccer players challenge for the ball and at least one goes down to the ground – writhing in pain in an Oscar–winning fashion that rivals even the best acting of professional wrestlers. In most cases, after the referee has either been swayed by their agony (or not) and determined whether or not to 'card' a player, the 'injured' player not only makes a miraculous instant recovery, but is back in the game – at full speed! After the 'Brexit' vote, the markets feigned such a fall – only to recover in like manner.

The No–Rush 49er's (08/04/16)

The latest GDP data confirmed that the U.S. economy is growing at its slowest pace since 1949. When June payrolls rose the most in 8 months with a 287K increase, the markets and some Fed members revived the chances for another FOMC hike in 2016. The 'Brexit' vote put a damper on those expectations, and continues to provide more headwinds to global growth. The Bank of England just cut their rates to a record low .25%, and said more stimulus could be on the way. It was their first cut since 2009. Last week's **B**ond **M**arket **R**eview addressed the G–20's intention to use 'all tools' to promote growth, and the continuous pressure by the International Monetary Fund on the ECB and the FOMC to remain accommodative. Earlier in the year, investors assumed September still held possibility for a hike, while December drew the higher odds. With last week's announcement that the first two quarters of GDP growth for 2016 averaged only 1.00%, the market odds for the next likely hike were shifted instead to September of 2017!

While there has been some promising data to drive optimism in the U.S. economy and recovery, it is worth noting that it's been 7 years since the trough of the economic crisis – and the word 'recovery' is still widely employed! The Fed is noting improvement, and wants to continue to normalize interest rates, but the conditions are not yet present to allow them to move forward with what was already intended to be only a 'gradual pace' approach. The U.S. economy has already experienced a record 10 straight years without growing above 3% – which is generally agreed to be the benchmark for good growth. Below that level simply gives us the 'modest' to 'moderate' label which we've seen in the Beige Book regional district reports now for a decade.

The Disappointments Room (09/15/16)
As much as the FOMC has signaled intent to at least heavily weigh in on raising rates in September, some of the data has given us cause to step back from those hawkish comments and consider the bigger picture. Sure, the committee wants to continue its gradual pace of normalization, but with only one hike since June 2006 it's hard to envision any kind of trend or pace to that end. The Fed had considered some promises for better growth and improving jobs data in deciding to begin to lift off of zero. The obvious headwinds and lack of broad–based economic gains led them to propose a 'gradual pace' of hikes which were intended to lessen negative impacts on global markets by assuring investors that they would not enter one of their 'campaigns' of tightening – where they made moves at every meeting until they achieved their targets. … One has to wonder with the national debt pushing $20 trillion, what is the hurry to raise rates? The added debt service could send the deficit skyrocketing. It also makes you wonder why anyone would seek office – other than for the fact that they all seem to leave far richer than when they swore the oath!

Cool Hand Luke (10/13/16)
While the September FOMC minutes were more hawkish than dovish in tone, Chicago FRB President Charles Evans said we shouldn't infer the economy is at full employment and that *"prematurely tightening policy would carry particularly high social costs."* Though Evans said *"One move isn't that big a deal either way,"* the **BMR** thinks it's all about those zeros. For instance, even though all the debt won't reprice at once, a 25–bps hike in rates will add around $50 billion annually to our $20 trillion deficit. If normalization is around 2%, $400 billion would be added to the annual debt service – further accelerating the deficit and destroying any thought of holding a ceiling in check. So, if you hike to cool the economy, shouldn't there be at least a modicum of fire before you pull the trigger?

A Brighter Shade of Beige (10/20/16)
As we expected, the Beige Book (FOMC district outlook report) consensus was that: *"Most districts indicated a modest or moderate pace of expansion."* Again, nothing stellar … The report said: *"Outlooks were mostly positive, with growth expected to continue at a slight to moderate pace in several districts."* We would guess when the economy is cruising along just over 1% for the first 2 quarters, it's (maybe) OK to view a 'slight' increase in growth in the *"mostly positive"* category. However, that doesn't seem to line up with the recently–hawkish tone near of many FOMC members that are ready to cool the economy solely on the basis of reaching 'full employment.'

Things that go Bump in the Night (11/09/16)
Ghoulies and ghosties may cause lack of sleep, but we discovered that things that go 'Trump' in the night can roil world markets. As global traders were trying to position for just how bad a Trump victory would be, they sold Dow futures off by 861 points (or 4.71%) versus the Tuesday close. S&P futures also traded over 5% lower. As Trump was celebrating his win and acknowledging a gracious call from Hillary Clinton, traders had decided the Dow should be only 400 points lower. By the end of the day, the Dow reversed nearly 1,200 points off those panic lows to close the day 257 points higher to Tuesday's close. What a ride. The selloff mirrored the 2–day loss of 947 points following the Brexit vote, but in this case happened over a few hours – and U.S. markets were closed! Some foreign markets were not so fortunate. … It turns out the markets were as wrong as the polls! Stocks gained. The Dollar rallied, and Gold eased. If there was a surprise, it was the magnitude of the selloff in bonds.

Rules Don't Apply (12/07/16)
As the U.S. Unemployment Rate approached 5.5% near the end of 2014, many Fed members started moving their full–employment targets below that threshold. In an economy confronted with slow wage gains, a high number of part–time workers, and the lowest labor force participation in decades, 5.5% just wasn't quite the 'sweet spot' previously presumed. The Fed's dual mandate of promoting 'both stable prices and full employment' (a 1977 amendment to the Federal Reserve Act) was suddenly subject to some 'fuzzy math.' The economy hasn't seen GPD growth over 3% for a decade and though inflation has tightened nearer the Fed's 2% target, it's not quite there – and has taken far longer than expected.

"Make the most of yourself, for that is all there is of you." Ralph Waldo Emerson

High and Outside (12/15/16)

Fed Chair Janet Yellen and the FOMC managed to throw the market a curveball on Wednesday. Though their 25–bps hike was widely anticipated, the Fed signaled there could be 3 more hikes in 2017 instead of only 1 or 2. While that pace is still on a slope that is only modestly gradual, bond traders are currently pricing in only 2 hikes for 2017 – and they were right in 2016! (The original 'gradual pace' was an every–other–meeting track.)

Key BMR Studies and Observations from 2016

(The text herein may be abridged. '…' indicates skips. Full text in the form of back issues is available on request.)

Memorial Day (05/30/16)

As we were in final preparation for this issue just ahead of the Memorial Day weekend, I got the call that my mother–in–law's second husband (of nearly 10 years) had passed away. William 'Buster' Hagood was a part of what has been termed the Greatest Generation – having lived during the Great Depression and then gone on to fight and prevail in World War II. The numbers in that elite group of WWII veterans are fading quickly now 7 decades later. Buster was a radar engineer aboard the Navy Destroyer USS Aulick. On November 29th, 1944, while the fleet was in the Leyte Gulf, he spotted and warned of six enemy planes approaching on radar. However, this was near the end of the war when those planes themselves had become weapons – as Kamikaze pilots would guide them to targets on suicide missions. Though damaged, one plane skipped across the ship and hit the bridge causing an explosion that reached the #2 gun and the handling room. The other radar operator was killed instantly by shrapnel right next to Buster. That day, in that one attack, 31 sailors lost their lives, and over 60 were wounded. Who knows why one 22–year old escapes injury and lives past the age of 93, while others step into eternity? The **B**ond **M**arket **R**eview salutes Buster Hagood – a positive influence to so many, and all those that selflessly served our country for the cause of freedom.

State of Fear (06/23/16)

Despite the way the polls appeared to be leaning, voters in the U.K. elected to exit the European Union. While we last week listed a 'who's who' of global central bankers and others warning about the consequences of an exit vote, we're again reminded of the power of collective individual voters. As we said last week, open borders are heavy on the minds of voters both here in the U.S. and abroad. The dozens of stories we read leading into the vote contended that the British exit (termed 'Brexit') from the EU would be disastrous for the U.K., the EU, and the rest of the globe.

Our early read is that this may be one of those 'buy the rumor sell the fact' events. In this case the rumor was that the 'stays' would have it – so after a much–anticipated market shakeout, the markets could recover better than anticipated. In the U.S., we know that polls are often misleading. However, no one knows whether or not the U.K. exit from the European Union will be near as negative as feared. We do know the early ramifications, as futures on the Dow traded off more than 800 points, the U.S. Dollar had its largest one–day gain since 1978, and the British Pound fell to a 31–year low.

Independence Day: Resurgence (06/30/16)

As we come into the long holiday weekend for July 4th, we'd note the largest 'Brexit' was not necessarily last week's vote by the United Kingdom to leave the European Union, but rather the Declaration of Independence of the 13 colonies to leave the British Empire in 1776. A state of war had existed since 1775, and the colonists were tired of heavy taxes levied on them by British Parliament – in which they had no representation. 40 years of war followed that 'Brexit'. An increasing number of tax acts were implemented in the interest of having the colonies pay their 'fair share' of the costs to keep them in the British Empire. It's interesting that even then, higher taxes were viewed as a 'fair share' by the government that sought to raise them. These collective tax laws were known as the 'Coercive Acts' by Parliament, but became known as the 'Intolerable Acts' in the Colonies. In November 1775, Thomas Jefferson said: *"Believe me, dear Sir: there is not in the British empire a man who more cordially loves a union with Great Britain than I do. But, by the God that made me, I will cease to exist before I yield to a connection on such terms as the British Parliament propose; and in this, I think I speak the sentiments of America."* It was obvious last week that modern Britain saw the 'levy' required to be in the EU as a burden, and was weary of the ability to protect its borders.

"Sometimes I lie awake at night, and I ask, 'Where have I gone wrong?' Then a voice says to me, 'This is going to take more than one night.'" Charles M. Schulz

Peace eluded the new United States and Great Britain for years, and wasn't settled until the War of 1812 (which also involved Britain's conflict with Napoleon Bonaparte in France – and his conquests within Europe and into Russia). Solomon Short said: *"The only winner of the War of 1812 was Tchaikovsky."* – as that musical overture celebrated Russia's defense against Napoleon's forces in 1812. In the Atlantic, American sailors were being captured from merchant vessels and impressed into the British Navy which ruled the waters in that day – and was restricting our abilities to trade. America declared war against Britain in 1812, though fighting had been going on since 1811. The early stages didn't go well for the states. Following their defeat of Napoleon in April 1814, they were able to focus on America. Britain managed to capture and burn much of Washington D.C. in August. When their attack on Baltimore failed, Britain devised a major campaign against New Orleans. The attack commenced in 1815, with British forces not knowing a peace treaty had already been reached – establishing the modern Canadian borders. They were defeated by American forces led by General Andrew Jackson – who is scheduled shortly to lose his place on the $20 bill. The War of 1812 was viewed as a second revolutionary war, but it took from 1775 to 1815 to achieve peace.

Trumponomics (11/09/16)

… The odds for Trump winning seemed very remote – if you believed the polls. However, the Chicago Cubs were down 3 games to 1 in the World Series against the Cleveland Indians and beat heavy odds to come back and win 4 straight games and take the championship. Was it the year to beat the odds?

We strive to be non–political, but will try to render an opinion on the expected effects of the many campaign promises made by President Elect Trump that could be positives for the economy. Changing the health care law should allow those that have their hours limited by its mandates to be more productive and increase their earnings (and government and sales tax receipts). Allowing health care insurance companies to compete, and offer select or targeted plans should greatly reduce premiums – as not everyone needs the same coverage. Health insurance will once again be an incentive or benefit to used attract workers, and employers will see reduced premiums.

Better border controls should spill over into wage gains for those already in America, regardless of whatever amnesty plans come to pass. The U.S. has one of the highest corporate tax rates in the world. Reducing those rates should help companies to prosper, spend, and hire. That could also lead to repatriation of many companies that left the U.S. or moved their headquarters abroad. Loosening restraints on domestic energy resources, whether coal, oil, gas or pipelines and their production will greatly help those industries, hiring, and lessen dependence on foreign sources. The U.S. spends a lot of money on defense for other nations – some of which could bear some of the burden. There are expenses related to climate change – some of which may be questionable. Though there are other plans that could also help, bringing jobs back to America and renegotiating some of the one–sided trade deals couldn't hurt. Lower personal tax rates could spur growth, but could also reduce receipts – and without spending cuts would expand the national debt at a higher pace.

"Dance like no one is watching! Email like it may one day be read aloud in a deposition!!!"

"When you reach for the stars you may not quite get one, but you won't come up with a handful of mud either."
Leo Burnett

"As long as judges tinker with the Constitution to 'do what the people want,' instead of what the document actually commands, politicians who pick and confirm new federal judges will naturally want only those who agree with them politically." Antonin Scalia

"A Bill of Rights that means what the majority wants it to mean is worthless." Antonin Scalia

"Give a man a fish, and he'll eat for a day. Give a fish a man, and he'll eat for weeks!"
Takayuki Ikkaku, Arisa Hosaka and Toshihiro Kawabata

Additional Information is Available on Request
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