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BOND MARKET REVIEW

January 25, 2017

Passengers

While possibly not 'behind the curve', are we getting ahead of ourselves? For some reason, members of the Fed are focused on how many hikes they expect to take place in 2017 and 2018 as if the 'dot plots' are finally set in stone. The Trump administration wants to achieve 4% GDP growth, and for all the criticism of his expected policies, FOMC policy makers and global investors seem to be treating that goal as a foregone conclusion. The U.S. hasn't seen 3% GDP growth for a decade, so it would certainly be welcome. As 2016 was winding down, inflation began approaching the Fed's 2% target and the gap between annual consumer prices and the core reading (ex food & energy) finally closed the gap that lingered from the plunge in oil prices. The FOMC continues to view U.S. employment as full (or close), though critics heavily consider the rather large number of Americans not participating in the labor force.

Though the end of 2016 closed out with quarters that at least approached 3%, the Beige Book has for years been stuck on 'modest' to 'moderate' growth outlooks for the 12 Fed districts. The latest report said the U.S. economy continued to expand modestly to close out 2016. The report said *"wage pressures had increased"* in most districts. It also cited tightening in the labor market with *"widespread difficulties in finding workers for skilled positions."*

Investors have enjoyed the ride so far. After knocking on the door for over a month, the Dow Industrials finally broke through 20,000 today – as most U.S. indices rose to record highs. Since the election, the stock market has added roughly $2 trillion in value! With the new journey underway, the International Monetary Fund joined earlier conclusions by the World Bank – expecting that the U.S. and global economies would experience a modest boost from the Trump administration's tax cuts and fiscal policies. Even then, their GDP forecasts for U.S. growth were only notched up by .1% – to 2.3% in 2017 and 2.5% for 2018.

That takes us back to question the obsession with hikes! Those projections for U.S. GDP growth aren't much (if any) better than results over the past decade – excepting of course the depths of the financial crisis. Employment is better, inflation is a little higher, and wage pressures are rising, so maybe the Fed is content with continuing to get off of near zero with GDP at a modest new normal. The market–based expectations for the next hike finally rose above 50% for the May meeting, spurred forward by surging stocks and non–threatening economic data. That said, the probabilities for any tightening for the February 1st or March 15th meeting are still fairly low, so we don't expect any surprises next Wednesday.

Looking Ahead

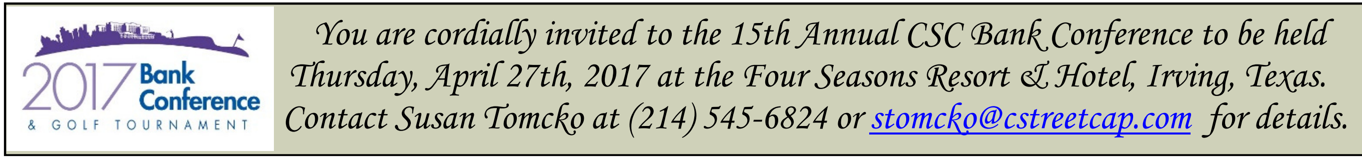
- Our 10–year bond cycles have a low–yield window near January 31st, with higher yields into mid–February.
- Our equity cycles show positive forces into a high near February 14th.
- The FOMC will update their rate–policy stance Wednesday (02/01) at 2:00 ET. Expect a stay.

Treasuries, Agencies, and MBS

Bond yields began to rise out of our January 24th low–yield window, with 10–year rates rising to their highest levels (2.535%) since December 28th. Even though stocks are very overbought, a positive cycle into mid–February leads the **B**ond **M**arket **R**eview to conclude that rates will also trek higher into that timeframe – though we first expect a rally (lower yields) into month end. Fed Chair Janet Yellen is in favor of gradual hikes, and said the Fed may also reduce its balance sheet and shorten maturities – which would also remove stimulus and pressure rates higher.

Last week, yields fell .5 bps at 2–years, but rose by 4, 7, and 6 bps for the 5, 10, and 30–year Treasury sectors. Into today the 2 to 30–year curve rose 4 to 4.5 bps. MBS spreads (FNMA 30–year 3%) narrowed by 1 bps last week. On Tuesday (01/24), the U.S. Treasury sold $26 billion 2–year notes at 1.21%. Demand was the best, and the yield the lowest, since the November auction. Foreign buying rose to 48.8% from 32.7% in December. Today's $34 billion 5–year note auction brought 1.988% (also the lowest since November). Demand was the lowest since the July 2016 offering, and foreign buyers fell to 63.3% of the allotment versus 71.4% last month. The Treasury will auction $28 billion 7–year notes on Thursday (01/26).

01/20/17 Treasury Yield Curve	2-Year: 1.191%	5-Year: 1.937%	10-Year: 2.468%	30-Year: 3.049%
Weekly Yield Change:	–.004	+.039	+.071	+.060%
Support:	1.25/ 1.27/ 1.30/ 1.32%	2.02/ 2.05/ 2.09/ 2.12%	2.55/ 2.59/ 2.63/ 2.67%	3.13/ 3.15/ 3.17/ 3.19%
Targets:	1.21/ 1.19/ 1.16/ 1.14%	1.99/ 1.95/ 1.92/ 1.88%	2.51/ 2.47/ 2.43/ 2.41%	3.09/ 3.06/ 3.04/ 3.00%



Economics

Initial Jobless Claims fell from 249K to 234K – once again riding the lowest levels since the early '70s, and under 300K for a 98th week. Continuing Claims fell from 2,093K to 2,046K. Bloomberg Economic Expectations rose from 53.5 to 56. The Philadelphia Fed Business Outlook rose from 19.7 to 23.6, and the Richmond Fed Manufacturing Index rose from 8 to 12. Empire Manufacturing fell from 7.6 to 6.5. Industrial Production rose .80%, and Capacity Utilization rose from 74.90% to 75.50%. Consumer Prices rose for a 5th month in December with a .30% increase that hiked the annual pace from 1.70% to 2.10% – finally closing the gap with core prices that has existed since the plunge in oil prices. The core (ex food & energy) rose .20%, taking the annual rate .10% higher to 2.20%. Real Average Weekly Earnings rose .20%. Foreign entities moved $23.7 billion into Treasury investments in November, while $30.8 billion was bought or channeled into longer maturities. China's holdings fell by $66.4 billion – for a 6th straight decline. That was the largest drop since the end of 2011. Japan also sold $23.3 billion, but remained the largest holder of U.S. debt.

Home builder confidence (NAHB Housing Market Index) fell 2 points to 67 from the highest level in 11 years. The FHFA House Price Index rose .50% in November. Housing Starts rose 11.25% to a 1,226K pace, mostly due to a 57% jump in multifamily construction. Building Permits (for future starts) fell .17% to a 1,210K annual pace. Existing Home Sales fell by 2.83% to a 5.49M pace, though 2016 was still the best sales year since 2006.

Thursday is set for December Retail and Wholesale Inventories, jobless claims data, Bloomberg Consumer Comfort (which last week rose .1 to 45.2), December New Home Sales, the Leading Index, the Chicago Fed National Activity Index, and Kansas City Fed Manufacturing Activity. Friday follows with an update on Q4 GDP and Personal Consumption, December Durable & Capital Goods Orders, and the University of Michigan sentiment surveys. Next Monday (01/30) brings December Personal Income & Spending, the PCE Deflator, Pending Home Sales, and Dallas Fed Manufacturing Activity. Tuesday closes out January trading with the Employment Cost Index for Q4 2016, S&P Case–Shiller home price data, Chicago Purchasing Managers, and Board Consumer Confidence. Wednesday kicks off February with MBA Mortgage Applications (which rose .80% and 4.00% the past 2 weeks), ISM Manufacturing, December Construction Spending, Q4 Mortgage Delinquencies, January Vehicle Sales, and a first look from Friday's January jobs from ADP Employment Change (private payrolls) and ISM Employment. On Wednesday, the FOMC will announce their interest–rate policy from the first meeting in 2017, but is expected to hold rates steady.

Equities

This appears to be one of those times that stocks bottomed early ahead of an expected cycle date. Our forecast for a trend–change low was near January 26th, but stocks began their current rally instead on Tuesday the 24th. While the Dow Transports and the Russell 2000 have yet to make new highs, Dow Theory enthusiasts would like the fact that most major U.S. indexes made new highs today – so the others will probably come along for the ride. Unless the cycles are out of synch, stocks should have a positive trajectory into a high near February 14th.

Stocks were modestly lower last week, with the Dow losing 58.48 points or .29% to 19,827.25. The Dow cleanly broke 20,000 today and is 1.22% higher this week. The S&P lost 3.33 points or .15% to 2,271.31, but is 1.19% better this week. The Nasdaq lost 18.78 points or .34% to 5,555.33 last week, but has surged 1.82% higher this week. The Dow Transports were .24% higher last week, and have rallied 2.13% this week – attempting to catch up to the other record–setting indices. Bank stocks lost 2.82% last week, but made most of it back with a 2.74% rally into today.

	Dow:	Nasdaq:	S&P:
Resistance:	20,137/ 20,173/ 20,208/ 20,245	5,671/ 5,710/ 5,748/ 5,786	2,299/ 2,306/ 2,312/ 2,318
Support:	20,067/ 19,995/ 19,948/ 19,890	5,634/ 5,597/ 5,560/ 5,523	2,284/ 2,276/ 2,270/ 2,258

Other Markets

Commodities lost .27% last week, and are a slight .02% lower this week. Crude Oil rose .10% last week, and was .63% higher into today. Gold rose .73% last week, but was .59% lower into today. The U.S. Dollar lost .49% and was .67% lower into today – potentially headed for a 5th weekly loss. The Japanese Yen lost .11%, but is 1.17% higher this week. The Euro gained .56%, and has risen .42% this week. Corn rose 3.14%, but is .95% lower this week. Cotton rose 1.07%, and added another 1.15% into today.

"When you are in any contest you should work as if there were – to the very last minute – a chance to lose it."
Dwight D. Eisenhower

Additional Information is Available on Request
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