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BOND MARKET REVIEW

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Broken Record

Stocks are propelling to all–time highs – and most U.S. indices broke records today. These are also times when jobless claims and other indicators are breaking multi–decade lows and interest rates are in uncharted territory – but also to the downside! The flip side is that the news is also a broken record. It skips and jumps so much that you hear the same thing over and over. How many times will the Fed hike this year? Have interest rates bottomed? Brady wins the Super Bowl. Alabama, Clemson, and Ohio State are in the hunt for the NCAA football championship. However, the needle has been stuck for years on the vinyl complaining about who holds the White House, Congress, or the courts! For the record, that's not a new phenomenon at all. As far back as I can recall (which means it goes back much further), the side that's in has been continuously derided by the side that's out.

We remember that if the A side won't play, the B side might night either. If it was in more than one piece, nothing would happen, so in the long run we learn to work together. However, a Japanese proverb says: *"The reverse side also has a reverse side."* So, the flip side might have its own considerations – and there are still plenty. The market–based odds that were leaning to 3 more hikes in 2017 are now edging closer to only 2. Over the past week, March fell from 32% to 26%, May fell from near 50% to under 41%, and June dropped from 71.4% to 67.5%. Over the past week, a number of FOMC members have urged patience or going slow with plans to tighten. Others have said even the March meeting should be in play, and that 3 hikes are still possible for 2017. The Atlanta Fed's 'GDP Now' is forecasting that Q1 GDP could be near 3.40%. For the past decade, a continuously–painful 'thorn in the side' for the FOMC has been that U.S. growth has been meandering with only 'moderate or modest' annual gains of less than 3.00%. As we've asked before, stock market aside, is this really an economy that needs to have the brakes applied?

Looking Ahead

- Bond yields should turn lower again after a high due near February 14th–15th.
- Our equity cycles show positive forces into a high near February 14th.

An Update on the Bond Supercycle

The FOMC didn't have a handbook or a textbook for very–low to negative rates, or how best to get off of zero after the descent. At present, the Fed may be inclined to believe inflation will hit their 2% goal, but it's yet to happen. Even after rates rose sharply into December, there hasn't yet been a break of the last major range of 3.04% on the 10–year that would argue technically that the 36–year bull market has come to an end. That key high of 3.04% came in early 2014 following the 1.39% low made in July 2012 – a move of 165–bps to the upside. The 10–year then made a lower low of 1.34% in July 2016 that was followed by a 128–bps rise into the recent December 15th high of 2.62%. For the 30–year bond, the numbers are somewhat easier to reach. Breaking 3.26% would be a warning, as the chart is a little cleaner – and the 30–year hit a very–close 3.197% on December 16th. However, the **B**ond **M**arket **R**eview favors a break of the December 6th, 2013 high of 3.98% as a better confirmation of the larger change in trend. We continue to believe that lower inflation or even negative rates could still pose a threat to global economies.

That said, the bond market does have the feel of interest rates having bottomed out, but stocks are so overvalued that a hard correction is increasingly possible – leading to another flight–to–quality run. We must also point out that the 5–year note has already broken the 1.88% upside to establish its chart reversal. While the argument could be made that global economies are doing better, there is still wariness of falling inflation, another slowdown, or conflict. Wage gains are not only stagnant in the U.S., but Germany and other leading economies are still experiencing some slack in their labor markets as well. U.S Productivity rose only .20% in 2016, for the smallest increase in 5 years. Speaking of Germany, their Industrial Output just fell the most in 8 years!

Since 2007 the Fed's balance sheet has grown from $870 billion to $4.454 trillion, and the national debt has mushroomed from around $5.8 trillion (at the end of 2008) to $19.97 trillion. It makes one wonder if we simply financed our way into a recovery – with a huge bill yet to pay! Though FRB San Francisco President John Williams said he thought there wouldn't be market disruptions from the Fed ending reinvestments, they could be substantial! He said the Fed's balance sheet could fall to around $1.5 trillion – giving the Fed the ability to maintain currency holdings.

To date, even though the Fed quit purchasing new assets, they've been reinvesting funds as holdings matured. However, following logic, it would mean that the Fed would be allowing nearly $3 trillion to roll off the books without further purchases. Though not the same as a sale, $3 trillion that doesn't reenter the bond or mortgage–backed security markets could be the straw that finally breaks the 36–year bull market in bonds.

We have to start taking this shrinking of the Fed balance sheet more seriously because it's a large reversal of policy, more FOMC members are now talking about it, and it could even lead to the dumping of securities. We know that Mario Draghi and the European Central Bank just extended their asset–purchase program. However, when central banks stop buying, it will be the same as when any business loses its largest customer. Moreover, when they start selling – the clearance sale could be brutal. FRB St. Louis President James Bullard said: *"Now that the policy rate has been increased, the FOMC may be in a better position to allow reinvestment to end or to otherwise reduce the size of the balance sheet."* He contended that low rates are a global issue and, that being the case, *"a relatively low policy rate will remain appropriate."* Bullard said: *"Ending balance sheet reinvestment may allow for a more natural adjustment of rates across the yield curve as normalization proceeds"* Maybe. Maybe not!

Treasuries, Agencies, and MBS

The U.S. Treasury yield curve has been generally flattening since the 3rd week of December. Last week, yields were lower by 2, 3.5, and 2 bps at 2, 5, and 10–years, while 3 bps higher at 30–years. Into today, yields dropped 2, 4, 7, and 8.5 bps for those sectors – though the 10–year had been 16 bps better on Wednesday. Fed Chair Janet Yellen will spend Valentine's Day (02/14) testifying before the Senate Banking Panel. Hopefully, you have better plans!

MBS spreads (FNMA 30–year 3%) narrowed by 1 bps yet again last week. On Tuesday, the Treasury sold $24 billion 3–year notes at a 1.423% yield. That was the lowest since the November auction, and demand fell to a 2–month low. The group that includes foreign central banks bought 57.2% of the issue versus 54.6% last month. Wednesday's 10–year note auction brought 2.333% for $23 billion in supply. Demand was the lowest since the November 2016 offering, and so was the yield. Foreign bidders won 65.1% of this auction versus 70.5% in January. Today's 30-year bond brought 3.005% for $15 billion. Demand was off to January, and foreign buying was .5% lower to 66.2%.

02/03/17 Treasury Yield Curve	2-Year: 1.199%	5-Year: 1.910%	10-Year: 2.466%	30-Year: 3.091%
Weekly Yield Change:	–.021	–.037	–.019	+.032%
Support:	1.20/ 1.22/ 1.26/ 1.29%	1.90/ 1.93/ 1.97/ 2.00%	2.43/ 2.47/ 2.51/ 2.55%	3.04/ 3.09/ 3.13/ 3.18%
Targets:	1.17/ 1.14/ 1.11/ 1.09%	1.86/ 1.83/ 1.79/ 1.76%	2.39/ 2.35/ 2.32/ 2.27%	3.00/ 2.96/ 2.91/ 2.87%

Economics

The early reads on January employment turned out to be spot on. Last week, we said: *"Data leading into Friday's payroll numbers has been very good. ADP Employment Change showed a best–in–7–months 246K jobs created in the private sector versus 168K expected."* Private payrolls rose 237K and Nonfarm Payrolls rose by 227K – the most in 4 months, beating estimates of 180K by nearly 50K. While Manufacturing added 5K jobs, government jobs fell by 10K. One of the stated reasons for the FOMC removing accommodation has been because the labor market is perceived as tightening. Another is that the Fed now believes that inflation will rise to their 2% target. However, stagnant wage gains challenge both those assumptions to a degree. They show a lack of wage pressures and reveal that there is still slack in the labor market. Initial Jobless Claims fell from 246K back to 234K and to the lowest levels since the early '70s – and under 300K for the 101st week. Continuing Claims rose from 2,063K to 2,078K.

The U.S. Unemployment Rate rose from 4.70% to 4.80%, but for a good reason. The Labor Force Participation Rate rose from 62.70% to a 4–month high of 62.90% as 736K workers joined (or re–joined) the jobs market in seeking or finding work. That's .50% above the 38–year low of 62.40% reached in September 2015. The Fed's jobs dashboard (Labor Market Conditions Index) rose by 1.3 – reflecting mostly positives from the report. The index last peaked in December 2015, as the economy experienced a pullback in late 2015 and early 2016 that was not measured as a recession.

While Average Hourly Earnings rose .10%, they were expected to increase by .30%. In fact, December's gain was cut in half to .20%. That changed the annual gain from 2.90% to 2.80%, and the result fell to 2.50% in January – showing far more slack than estimated, and the slowest wage growth since August. Average Weekly Hours were flat at 34.4. Though the result would be much higher by methods that consider all workers that could be working and/or may have quit looking, the Underemployment Rate rose from 9.20% to 9.40%. That was the highest level since October. JOLTS Job Openings showed little change in available work and still good demand for labor with a slight drop from 5.505M to 5.501M. The service–sector outlook was steady, falling only .1 to 56.5.

Bloomberg Consumer Comfort rose from 46.6 to 47.2 – reaching the highest sentiment reading since April 2015. December Factory Orders rose by 1.30%, and were 2.10% higher ex transportation. Durable Goods Orders fell by .50%, but were .50% higher ex transportation. Orders for Capital Goods rose by .70%. In December, Consumer Credit rose by only $14.160 billion compared to November's $25.205 billion increase. For the year, household borrowing increased the least since 2013. Wholesale Trade Sales rose 2.6% and Inventories rose 1.0%.

The December Trade Balance deficit fell from $45.7 billion the previous month to $44.3 billion. However, for all of 2016 the trade gap was the widest since 2012 – with exports dropping more than imports. That's little surprise given the considerable strength of the U.S. Dollar over the past year.

Friday brings January data for Import Prices for January, the Monthly Budget Statement, and University of Michigan Sentiment surveys. Don't forget your Valentine on Tuesday (02/14). Scheduled releases are NFIB Small Business Optimism and Producer Prices (January PPI). Wednesday reveals MBA Mortgage Applications (which last week rose 2.30%), and January data for Consumer Prices (CPI), Retail Sales, Industrial Production, and Capacity Utilization. Other releases include home–builder optimism (NAHB Housing Market Index), Empire Manufacturing, and December data for Business Inventories and TIC (Treasury International Capital) Flows.

Equities

Going into last Friday, stocks were lower for the week with the Dow off roughly 1.04%. Though there were a few blemishes, a good January jobs report contributed to the Dow's best gain of 2017 on Friday. Despite that 186.55–point gain, stocks were mixed with the Dow still off .11% for the week. However, on that day the Nasdaq hit a new closing high, and today most major U.S. indices hit new record highs!

For the week, the Dow ended 22.32 points or .11% lower to 20,071.46. It's .50% better this week. The Nasdaq was 5.98 points or .11% higher to 5,666.77, and is up .85% this week. The S&P gained 2.73 points or .12% to 2,297.42, and is .45% higher this week. The Dow Transports lost 2.15%, but have risen .97% this week. Bank stocks rose .31%, and after being down 2.36% this week are now off only .24%. Our thoughts remain that *"stocks should be strong from February 9th to the 14th."*

Resistance:	Dow:	20,263/ 20,334/ 20,405/ 20,476	Nasdaq:	5,729/ 5,647/ 5,765/ 5,803	S&P:	2,317/ 2,323/ 2,329/ 2,335
Support:		20,187/ 20,118/ 20,018/ 19,890		5,689/ 5,651/ 5,617/ 5,577		2,309/ 2,300/ 2,288/ 2,282

Other Markets

Commodities lost .12% last week, and were .23% lower into today. Crude Oil gained 1.24%, but was off by 1.54% by today. Gold rose 2.53%, and has added another 1.36% this week. The U.S. Dollar fell .68% for a 6th week of losses, but is up .81% this week. The Japanese Yen surged 2.16%, but is .57% lower so far this week. The Euro gained .79% last week, but is down by 1.19% this week. Corn gained .76%, and is up another 1.16% this week. Cotton gained 2.08%, but is 1.09% lower this week.

(Just for fun)
"The trouble with quotes on the Internet is that you can never know if they are genuine." Abraham Lincoln.

Additional Information is Available on Request
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