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BOND MARKET REVIEW

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Valentines on Capitol Hill

Fed Chair Janet Yellen testified before the Senate Banking Committee on February 14th, and made the case that the economy had continued to make progress toward the Fed's *"dual–mandate objectives of maximum employment and price stability."* The Fed had romanced bonds as the financial crisis unfolded – assuring markets that yields would remain near zero for an extended period. Then things went negative! As global bond yields dropped below zero, the U.S. began a 'modest to moderate' improvement that allowed the Fed to begin to taper asset purchases and begin talks of hikes. Slow growth, sovereign debt problems, and very–low inflation continued to plague other leading economies, while the talk of higher rates made the U.S. Dollar more attractive to global investors – and even though U.S. yields were higher versus alternatives, bonds had run their course. While the European Central Bank continued (and continues) to purchase assets, Yellen's stance that the Fed's goals are basically met, and that more rate hikes are on the way if the economy stays on course, left bonds jilted for stocks as the most appealing U.S. asset.

The big news was on the inflation front. The FOMC has contended that employment has been near the 'full' level since falling near (and under) 5% – even though labor force participation remains historically low. The last FOMC statement voiced confidence that inflation was going to reach the long–term goal of 2%. Surveys were already leaning to the Fed side, as last week's University of Michigan results rose from 2.60% to 2.80% for 1–year inflation, though falling .10% to 2.50% for 5–to–10 years out. A survey by the New York Fed showed expectations for inflation rising from 2.8% to 2.9% January – hitting the highest levels since mid–2015. The CPI report followed suit as Consumer Prices jumped .60% in January, rising the most since 2013. The annual pace quickened from 2.10% to 2.50%. Ex food & energy, CPI rose .30%, hiking the core annual pace from 2.20% to 2.30%. Any way you read it, the numbers were above the Fed's 2% benchmark. It's obvious they were getting a good read on incoming data. The **BMR** noted in their February statement: *"They changed 'expected to rise' to 'inflation will rise to 2% over the medium term.'"* Wholesale (or producer) prices increased by the most since September of 2012. They rose .60%, though the year–over–year pace was flat at 1.60%. The core rose .40%, though the annual pace dropped from 1.60% to 1.20%.

Looking Ahead

- Bond yields should make a low near February 24th, rise into March 2nd, and then drop into March 20th.
- The **B**ond **M**arket **R**eview's equity cycles weaken following a secondary push into February 21st.
- The markets will be closed for Washington's Birthday/Presidents' Day on Monday, February 20th.

Treasuries, Agencies, and MBS

A jump in inflation certainly raises more red flags for the bond market. Bond yields and inflation rates may not move pari passu, but they are to some extent 'joined at the hip.' Thus, a jump in import, producer (wholesale), and consumer prices – some of which just rose the most in years, represents a reversal from the low–rate arena – and has Fed members raising the 'mission accomplished' banner. We learned in the mid–2000s that that notion might be in error.

Last week, yields fell 1, 2.5, 6, and 8.5 bps for the 2, 5, 10, and 30–year sectors. However, given incoming inflation data and Yellen's comments this week on the likelihood of additional interest–rate hikes, the market–based odds for a May hike rose above 50% on Tuesday. Rates were higher into today – with 2–year yields hitting their highest mark for 2017. Yields rose 5.5, 10.5, 8.5, and 7 bps – wiping out last week's gains for all maturities below 30–years, while also peaking into our February 14th/15th cycle.

Foreign entities reduced long–term Treasury debt holdings by $12.9 billion in December, and withdrew a net $42.8 billion out of U.S. bond markets. China's holdings of Treasuries recorded their largest drop as they reduced their portfolio by $188 billion in 2016 to still hold second place at $1.06 trillion. China did have an increase of $9.1 billion in December, but it was their first since May. Japan's larger (and first place) holdings fell for a 5th month – down $17.8 billion to $1.09 trillion, and lower by $31.6 billion for the year.

MBS spreads (FNMA 30–year 3%) narrowed by 1 bps for the 4th straight time last week. The debt and equity markets will be closed on Monday. The U.S. Treasury will auction $26 billion 2–year notes on Tuesday (02/21), $34 billion 5–year notes on Wednesday (02/22), and $28 billion 7–year notes on Thursday (02/23).

02/10/17 Treasury Yield Curve	2-Year: 1.192%	5-Year: 1.887%	10-Year: 2.408%	30-Year: 3.006%
Weekly Yield Change:	–.007	–.023	–.058	–.085%
Support:	1.26/ 1.29/ 1.31/ 1.34%	2.00/ 2.04/ 2.06/ 2.11%	2.47/ 2.51/ 2.55/ 2.58%	3.08/ 3.13/ 3.16/ 3.22%
Targets:	1.23/ 1.20/ 1.17/ 1.14%	1.94/ 1.91/ 1.87/ 1.83%	2.43/ 2.39/ 2.35/ 2.31%	3.03/ 2.99/ 2.95/ 2.91%

Economics

Dampening the inflation outlook, Real Average Weekly Earnings fell by .60%. The December data was revised to show a .40% increase compared to the previously–reported .20%. However, confirming the CPI and PPI numbers, Import Prices rose by .40% in January – leading to the largest surge in almost 5 years (from 2.00% to 3.70%)! The results ex Petroleum were flat. The imported fuel component rose 57.6% over the past year for the largest increase since March 2010. As noted last week, Initial Jobless Claims for February 4th dropped from 246K to 234K – one of the lowest readings going back to the early '70s, and below 300K for a 101st week. Wholesale Trade Sales rose 2.60% in December. Inventories rose 1.00%. Business Inventories rose .40%. University of Michigan Sentiment dropped from 98.5 to 95.7. While that was a 3–month low, the index is coming off a 13–year high. Current Conditions were nearly unchanged with a .1 drop to 111.2, but Expectations also fell from 90.3 to a 3–month low of 85.7. NFIB Small Business Optimism rose .1 to 105.9. Empire Manufacturing jumped from 6.5 to 18.7. However, Industrial Production fell .30%, and was revised .20% lower to a .60% rise for December. Capacity Utilization dropped from 75.60% to 75.30%. Retail Sales rose .40% in January, but were revised from a .60% rise to 1.00% for December. Ex autos, sales rose .80%, and the control group rose .40%. The Monthly Budget Statement revealed a surplus of $51.3 billion in January, beating expectations of $45 billion. The fiscal deficit is running just under 2016 at $156.9 billion vs $160.4 billion. In the 4th quarter, Mortgage Delinquencies rose from 4.52% to 4.80% – increasing for the first time since 2013. 4.52% had been the lowest level since 2006. MBA Mortgage Foreclosures fell from 1.55% to 1.52% in the 4th quarter. Foreclosure actions taken in Q4 2016 fell to only .28% – the lowest level since 1988.

Home–builder optimism (the NAHB Housing Market Index) cooled from its 67 January reading to 65 for February. Thursday's data for January Housing Starts and Building Permits will give us some hard data to see if things are indeed slowing. Also due are jobless claims data, the Philadelphia Fed Business Outlook, Bloomberg Consumer Comfort (which last week rose .6 to 47.2 – the highest level since April 2015), and Economic Expectations. Friday's main release is the Leading Index (LEI) for January. On Monday (02/20), the debt and equity markets will be closed for the Presidents' Day Federal holiday. Tuesday (02/21) kicks off the trading week with data on the outlooks for manufacturing and services. Wednesday gives us MBA Mortgage Applications (which last week fell 3.70%), Existing Home Sales for January, and the minutes from the February 1st FOMC meeting.

Equities

The cycles have been doing their job. After projecting higher prices into February 14th, the past two **BMR** issues have expressed that *"stocks should be strong from February 9th to the 14th."* In the **BMR** (01/25), we said: *"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."* After 25 sessions of trading just under 20,000, in 3 weeks the Dow has tacked on over 600 points to close at yet another record high today. Over 550 points of that gain has happened since the 8th, emphasizing the efficacy of that projected surge. The **BMR** equity cycles weaken from February 21st, so we would think it prudent to take some profits or become defensive by that time. Just be careful out there …

Last week, the Dow Industrials gained 197.91 points or .99% to 20,269.37, and they've surged 1.69% this week. The S&P gained 18.68 points or .81% to 2,316.10, and are 1.43% higher this week. The Nasdaq rallied 67.36 points or 1.19% to 5,734.13, and is up another 1.49% since Friday. The Dow Transports rose 1.65%, and added 1.71% into today – joining most other U.S. indices in reaching new record highs. Bank stocks were flat last week, but up 4.03% so far this week, reaching the highest levels since December 11th, 2007.

Resistance:	Dow:	20,640/ 20,785/ 20,928/ 21,075	Nasdaq:	5,848/ 5,885/ 5,924/ 5,962	S&P:	2,351/ 2,358/ 2,371/ 2,382
Support:		20,496/ 20,372/ 20,282/ 20,210		5,772/ 5,735/ 5,696/ 5,651		2,334/ 2,322/ 2,311/ 2,299

Other Markets

Commodities gained .43% last week, but are .40% lower this week. Crude Oil was .06% higher, but has fallen 1.39% this week. Gold gained 1.30%, but dropped .22% into today. Part of the reason is the U.S. Dollar – having regained strength after falling for 6 straight weeks. The Dollar rose .95% last week, and is .37% higher this week as the odds remain high for at least two more FOMC hikes this year. The Japanese Yen dropped .54% last week, and is .83% lower this week. The Euro plunged 1.30%, and is off another .39% this week. Corn gained 2.53%, and is 1.13% higher this week. Cotton was .77% lower, and has fallen another .15% this week.

"Why not go out on a limb? Isn't that where the fruit is?" Frank Scully

Additional Information is Available on Request

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