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BOND MARKET REVIEW

February 22, 2017

Modest to Moderate Headwinds

The U.S. sustained 'modest to moderate' growth over the past few years, but interest rates remained low because global risks continued to pose a clear and present danger that could thwart the Fed's plans to return to 'normal.' However, as world economies continue to emerge from the abyss of the financial crisis, those headwinds to domestic and global growth have diminished to a cool breeze. There are even a few factors that could speed things along like a welcome tailwind. Optimism has been steadily growing recently, and there's even a degree of euphoria as evidenced in the consumer confidence readings over the past few months – many the highest in years, and some are the best of the recovery.

For the U.S., 2016 (and the end of 2015) were close to a recession in feel, and equity markets had one of their worst starts in recorded history. Nevertheless, the stock market and growth improved into the end of the year – and 2017 has now seen a brisk takeoff. The Dow Industrials finally punched through 20,000 on January 25th (after a month of attempts), and closed today at 20,775.60! Though 2016 GDP may change with another revision, annual growth was only 1.6%. The current Atlanta Fed GDP Now forecast is 2.4% for the first quarter (and had been over 3% near the 1st of February). Compare that to the first two quarters of 2016, which averaged only 1.0%.

Last week, the European Central Bank relaxed some of their own rules to allow asset purchases of some lower credits within the EU. Yields in Italy and Spain dropped on that news. While our Fed had changed their language from inflation "is expected to", to "will rise to 2% over the medium term", the EU has experienced more subdued wage increases and has been very concerned about low inflation. ECB officials are now viewing inflation and growth prospects as far more balanced. While some U.S. price measures are in the 2% ballpark, core inflation in the EU has not exceeded 1% for over a year. EU numbers as a whole are improving. German economic growth is nearing a 3–year high, and France's economy is growing at its best pace since 2011. (There's even talk of a French exit of the EU 'termed Frexit' if the coming elections are won by a candidate highly skeptical of the union.) Despite the 'Brexit' vote last year, a study by Bloomberg Intelligence economist Jamie Murray projected growth in the U.K. would exceed that of Germany, France, Italy, and Spain over the next decade. Growth in the U.K. and the EU greatly reduce those headwinds that had seen the FOMC far more cautious than they are at present.

Looking Ahead

- Bond yields should make a low near February 24th, rise into March 2nd, and then drop into March 20th.
- The **BMR** equity cycles show low thrusts into February 28th and March 9th.
- The next FOMC decision is scheduled for March 15th.

Despite stocks smashing to new record levels into our February 21st date for a high, this past week seemed the least 'news intensive' since before the election. Is it a calm before the storm? The bullish readings on stocks rose over 90% – to their highest levels in more than 3 years. That indicates a lack of 'sellers.' Volatility is very low – which indicates the market doesn't expect that a large move is imminent. The Fed is growing confident that their job is done, that they can remove accommodation at a 'gradual pace', and that they might even begin to reduce the size of their balance sheet (by no longer reinvesting maturing assets). The Fed's minutes from the February 1st meeting showed many officials willing to hike rates "fairly soon" if the economy stays on track. We don't see why you'd want to slow growth until it cleared 3%, but rates are low and inflation is tracking better. The odds of a March hike have been roughly 1 out of 3, while the May meeting has been over 50% for some time now – and read 61.8% today.

2017 Bank Conference & GOLF TOURNAMENT

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Treasuries, Agencies, and MBS

After yields surged higher into the **B**ond **M**arket **R**eview's February 14th/15th trend–change for a high, yields dropped into Friday – and closed with little net change for the week. Yields were flat at 2–years, and higher by 1.5, 1, and 1.5 bps for the 5, 10, and 30–year Treasury sectors. Though the 2–year was 3 bps higher into today, that was highly attributable to Tuesday's new maturity from the auction. 5–year yields were .5 bps higher, 10–year rates fell less than .5 bps, and 30–year yields rose 1 bps, for very little change. March 20th still looks to be a good target date for lower yields (to hedge portfolios and/or take profits).

02/17/17 Treasury Yield Curve	**2-Year: 1.190%**	**5-Year: 1.902%**	**10-Year: 2.416%**	**30-Year: 3.023%**
Weekly Yield Change:	–.002	+.015	+.008	+.017%
Support:	1.22/ 1.25/ 1.27/ 1.31%	1.92/ 1.95/ 1.98/ 2.02%	2.43/ 2.47/ 2.51/ 2.55%	3.04/ 3.06/ 3.09/ 3.13%
Targets:	1.19/ 1.16/ 1.14/ 1.11%	1.85/ 1.81/ 1.78/ 1.74%	2.38/ 2.36/ 2.32/ 2.28%	3.00/ 2.97/ 2.95/ 2.93%

Fed Vice Chairman Stanley Fischer maintained that Fed policy is still accommodative. Philadelphia's Patrick Harker said he could support a March hike, and 3 hikes for 2017. Cleveland's Loretta Mester and Governor Jerome Powell are among others favoring soon. The Fed soon will go 'quiet' (two Saturdays before the March 15th meeting).

MBS spreads (FNMA 30–year 3%) reversed the previous week by widening 1 bps. On Tuesday (02/21), the U.S. Treasury sold $26 billion 2–year notes at 1.23%. Demand was the highest since last August and the yield was the highest since the December offering. The foreign buying group that includes central banks accounted for 49.8% of the allocation versus 48.8% last month. Today's 5–year note auction brought 1.937% for $34 billion in supply. Demand for this sale was the lowest since July, and the yield the lowest since the November issue. Foreign buying was down from 63.3% in January to 58.2% of today's auction. The U.S. Treasury will auction $28 billion 7–year notes on Thursday (02/23).

Economics

Initial Jobless claims rose from 234K to 239K, but remained near multi–decade lows and were under 300K for a record 102st week. Continuing Claims fell 3K to 2,076K. Bloomberg Economic Expectations fell from 56 to 50, though the Philadelphia Fed Business Outlook surged from 23.6 to a 33–year high of 43.3! The Leading Index rose .60% in January, following December's .50% gain. Housing Starts were better than anticipated at 1,246K, though 2.58% lower to December data that was revised from 1,226K to 1,279K. They rose 11.25% to last January. Building Permits were also better, rising 4.64% from 1,228K to 1,285K – and 6.73% better to last year. Less inventory led to Existing Home Sales rising 3.27% in January – making up the lion's portion of a 4.02% year–over–year gain.

Thursday is set for jobless claims data, the Chicago Fed National Activity Index, Kansas City Fed Manufacturing Activity, the House Price Purchase Index for Q4 2016, the FHFA House Price Index, and Bloomberg Consumer Comfort – which last week surged from 47.2 to 48.1, a new high for the recovery and the highest level in nearly 10 years. Friday brings January New Home Sales and the University of Michigan Sentiment surveys. Next Monday (02/27) gives us Durable and Capital Goods Orders for January, Pending Home Sales, and Dallas Fed Manufacturing Activity. Tuesday closes out February trading with Q4 GDP, Personal Consumption, the GDP Price Index, and Core PCE. Also due are January Wholesale and Retail Inventories, the Advance Goods Trade Balance, and December data for S&P Case–Shiller home prices. February releases include Board Consumer Confidence, Chicago Purchasing Managers, and the Richmond Fed Manufacturing Index.

Wednesday kicks off March with MBA Mortgage Applications (which last fell by 2.00%), January Personal Income & Spending, the PCE Deflator, and Construction Spending. The Fed's Beige Book is also due along with February data for Vehicle Sales, ISM Manufacturing, Prices Paid, New Orders, and a first look into February payrolls from ISM Employment. The jobs numbers won't come until Friday, March 10th – which is unusually late for the following month, but early enough for the FOMC to review before their March 15th interest–rate policy statement.

Equities

Stocks rose nicely into our February 21st cycle. As long as the current cycle is working, we're staying with it – expecting some weakness from here. Last week, the Dow surged 354.68 points or 1.75% to 20,624.05. It's .73% higher this week. The Nasdaq gained 104.45 points or 1.82% to 5,838.58, and is .38% better this week. The S&P gained 35.06 points or 1.51% to 2,351.16, and is .50% higher since Friday. The Dow Transports rose 1.08%, but are .49% lower this week. Bank stocks were huge, gaining 3.35% last week, and adding .46% into today.

Resistance:	Dow:	20,895/ 21,041/ 21,188/ 21,336	Nasdaq:	5,848/ 5,865/ 5,904/ 5,941	S&P:	2,368/ 2,376/ 2,387/ 2,400
Support:		20,752/ 20,613/ 20,467/ 20,324		5,789/ 5,752/ 5,715/ 5,676		2,352/ 2,340/ 2,328/ 2,317

Other Markets

Commodities lost .99% last week, and are .47% lower this week. Crude Oil lost .85%, but is .36% higher this week. Gold gained .26%, but has fallen .45% this week. The U.S. Dollar rose for a second week, gaining .16%, and is .24% better this week. The Japanese Yen rose .34%, but is .42% lower this week. The Euro lost .25%, and is .55% lower since Friday. Corn fell 1.67%, and then gained .75% into today. Cotton dropped 3.09%, but is .90% better this week.

"We are confronted with insurmountable opportunities." Walt Kelly

Additional Information is Available on Request

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