COMMERCE STREET Capital Management
1445 ROSS AVENUE
DALLAS, TEXAS 75202
214-545-6800

BOND MARKET REVIEW

March 15, 2017

Fed Up

Those that have read the **B**ond **M**arket **R**eview since 2000 know that our cycle work has kept us very much in tune with a good read on expectations for each Fed meeting over those years. Sometimes it was also because the FOMC was very predictable, while others were universally known as the Fed clearly signaled their upcoming actions. We've also been critical of some of their moves – as they at times seemed far more academic than real–world in implementation. This was especially true when the FOMC went on a campaign of tightening moves – feeling like they had to raise rates at each meeting until their goals were met. In February 2004, then Fed Chair Alan Greenspan advocated the use of adjustable–rate mortgages back when anyone with a heartbeat could get a home loan. The Fed then raised rates at every meeting from June 2004 through June 2006 as Ben Bernanke had just taken over as the new chair (in March 2006). We ironically referred to Bernanke as the *"new quarterback"* in December 2005, and just before his final hiking move in June 2006 he said: *"It could take anywhere from 3 to 4 months, to as long as 18 months before the full effects of the policy action are felt by the economy."* At that point we wondered why the Fed needed to make a move at each meeting – a lesson that probably led to the gradual pace we're seeing today.

Bernanke explained his thoughts with this football analogy: *"I like to think of it as the way a quarterback has to lead a receiver going down the football field. You have to throw where the receiver is going to be, not where he is at the current moment. It's the same with the economy."* That sounded good on paper – but there was only textbook experience to play this important game. We all had a 50–yard–line seat to see what those higher rates did to the holders of subprime and other adjustable–rate loans – and the resulting massive defaults. Within *"18 months"* we saw the major part they would play in the worst financial crisis since the Great Depression.

Last Tuesday (March 7th), I was most fortunate to attend the Commerce–Street sponsored book–signing event in Dallas for 'Fed Up' (an insider's take on why the Federal Reserve is bad for America). The author, Danielle DiMartino Booth, talked about the book and her experiences as an analyst with the Federal Reserve Bank of Dallas, serving alongside President Richard Fisher – who was there to introduce her. It's an excellent and candid read on the Fed, its history, its mission, and what's gone on 'behind the scenes' – especially during the financial crisis. Danielle pulls no punches – and it's an adventurous read. I'm sure if you like the **BMR**, you'll love 'Fed Up!'

Looking Ahead

- Bonds should rally into March 20th, when a low–yield trend–change is expected.
- The **BMR** equity cycles show a low near March 16th, and a trend–change high near March 21st.

Death, Taxes, and Rate Hikes

We all know that some things are sure – others inevitable. H.L. Mencken once said: *"Unquestionably, there is progress. The average American now pays out twice as much in taxes as he formerly got in wages."* That was true if you have a few years on you, and you can remember the mid–60s – when the average income was $4,600, a car was $3,500, and a new home averaged $20,000. However, in recent years, inflation just hasn't been a huge issue – but your income, property, purchases, phones, utilities, and most other things are taxed. U.S. corporate tax rates are among the highest in the world, with the top rate nearly double that of EU countries. Though there's a biblical loophole to death, it's unfortunately also very dependable. Nevertheless, I don't ever recall seeing market–based odds for a rate hike at 100% across the board – until last week. They went to 100% last Wednesday and held until the Fed hiked 25 bps today. The odds placed no chance for a stay, much less a cut. There was no allowance whatsoever for some surprise action by North Korea, or any other impactive event. The Fed was in its own bubble, and a rate hike was inevitable. Another 25–bps increase could not have been more baked in! Yet, even with a 100% virtual lock on the assumptive move, there was actually a dissenting vote! The statement said Neel Kashkari would have preferred to maintain the existing target range.

The Fed's Dot Plot chart was not quite as hawkish as anticipated, projecting 'only' 3 hikes for 2017 instead of the 4 that had been widely assumed. With that read on the statement, the U.S. Dollar retreated and bonds rallied. Speaking of 'only', it was noticeably absent from the February text. That previous statement said the committee expected that *"economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate."*

Our read was that warrant 'only' gradual implied that hikes would be staggered – never at two subsequent meetings. With 'only' gone, I read *"warrant gradual"* as a still staggered approach, but leaving every meeting on the table – even if the Fed hiked at the one just previous. That said, the May odds for a hike kicked off at 'only' 13.3% today.

The FOMC also changed their inflation language to say it would *"stabilize around"* instead of *"rise to"* 2%. Given that thought, they added expectations for a *"sustained return to 2% inflation"* instead of just a *"return."* They emphasized a desire to monitor a *"symmetric inflation goal"* instead of *"progress toward"* that goal – no doubt to appease those that are also concerned with an overshoot. Many will welcome higher rates – especially those that are 'cash heavy.' However, those with adjustable loans and credit card debt will feel the effect – as will the Government in terms of rising debt service. Free and almost–free money still please equities, as investors perceive at least a little more time with inexpensive funds. For the longer term, another cyclic recession is due in a few years, so we don't expect the funds rate to exceed 3% in this campaign. We're also considering slow GDP growth and modest inflation. (Compare those possible 11 staggered and gradual hikes to 17 straight hikes into June 2006.)

Treasuries, Agencies, and MBS

Bonds responded to the Fed hike with a 'sell the rumor, buy the fact' rally – as 25 bps seemed to evaporate from the Fed's agenda (down from 4 hikes in 2017 to possibly only 3?). Today alone, 2, 5, 10, and 30–year yields fell by 7.5, 10.5, 8.5, and 6.5 bps. Yields were much higher into March 3rd, and then rose 5, 9, 9.5, and 9.5 bps last week. Today's rally left rates 5.5, 9.5, 8, and 5.5 bps lower for the week.

MBS spreads (FNMA 30–year 3%) narrowed by 1 bps last week. Last Thursday (03/09), the U.S. Treasury sold $12 billion 30–year bonds at 3.17%. The February 2047 maturity was reopened to add this supply, and the yield was the highest since the auction held in September 2014. Demand rose to last month, and the foreign buying group accounted for 61.1% of the offering versus 66.2% during that original February issue.

03/10/17 Treasury Yield Curve	**2-Year: 1.355%**	**5-Year: 2.102%**	**10-Year: 2.575%**	**30-Year: 3.165%**
Weekly Yield Change:	+.048	+.092	+.096	+.093%
Support:	1.34/ 1.37/ 1.39/ 1.42%	2.06/ 2.10/ 2.13/ 2.17%	2.53/ 2.57/ 2.61/ 2.65%	3.15/ 3.18/ 3.20/ 3.24%
Targets:	1.28/ 1.25/ 1.21/ 1.18%	2.00/ 1.96/ 1.93/ 1.89%	2.50/ 2.47/ 2.44/ 2.37%	3.11/ 3.07/ 3.03/ 2.98%

Economics

Last week, we said: *"If the private payroll data is a harbinger of things to come, the February employment numbers should be very good – and the last dagger into those hoping for the FOMC to hold rates steady."* February job gains were indeed solid and the Fed hiked rates as planned. Initial Jobless Claims rose 20K to 243K, but remained near multi–decade lows. Continuing Claims fell 6K to 2,058K. Challenger Job Cuts fell 40% versus last February (less cuts). Nonfarm Payrolls rose 235K, with a 2–month revision that was 9K higher. Private Payrolls rose 227K, and Manufacturing put together a nice 3–month run of +18K, +11K, and then +28K for February. In perspective, from mid–2015 to November there'd been a net loss of 13K manufacturing jobs!

We were naysayers as unemployment was falling due to a drop in labor force participation, and thought it fine that the jobless rate rose in January due to more entrants. February was the best of both. Labor force participation rose from 62.90% to 63% and the U.S. Unemployment Rate fell from 4.80% to 4.70%. 63% tied March 2016 for the highest level since March 2014. Average Hourly Earnings rose .20%, accelerating the annual pace from 2.60% (previously reported at 2.50%) to 2.80%! Average Weekly Hours remained at 34.4 and the Underemployment Rate fell from 9.40% to 9.20%. Further fuel for the Fed came from Bloomberg Consumer Comfort, which rose from 49.8 to 50.6 – the highest level since March 2007. The buying climate was the best since April 2002 and the economic gauge the highest since August 2001. U.S. Household net worth rose by $2.043 trillion in Q4 2016 to a record $92.18 trillion (wealth to income also rising to a record). NFIB Small Business Optimism slipped from 105.9 to 105.3. However, the Business Roundtable's CEO Economic Outlook Index surged the most since the 4th quarter of 2009. Empire Manufacturing fell from 18.7 to 16.4 and January Business Inventories rose .30%.

On the inflation front, February Import Prices rose .20%, quickening the annual pace from 3.80% to 4.60%. Producer Prices rose .30%, taking the annual pace up to 2.20% from 1.60%. Ex food & energy, prices also rose .30% – raising the core annual pace from 1.20% to 1.50%. Consumer Prices rose .10%, quickening the annual pace from 2.50% to 2.70% – the most since March 2012. Core CPI rose .20%, yielding a .10% drop in the annual pace to 2.20%.

Real Average Weekly Earnings fell .30% on an annual basis, though Hourly Earnings were flat. Retail Sales rose .10% in February, but that was the least gain since last August. Ex autos, sales rose .20%.

Homebuilder sentiment rose to the highest since June 2005 as the NAHB Housing Market Index increased from 65 to 71. The 6–month sales outlook matched the highest level since 2005, while current sales rose to the highest level since December 2004. Buyer traffic rose 8 points to 54.

In January, a net $110.4 billion in foreign funds flowed into U.S. assets. Longer–term Treasury holdings increased by $6.3 billion. The February Monthly Budget Statement revealed a $192 billion deficit that is moving at a similar pace to fiscal 2016.

Thursday is set for jobless claims data, February Housing Starts & Building Permits, the Philadelphia Fed Business Outlook, Bloomberg Consumer Comfort & Economic Expectations, and JOLTS Job Openings. Friday brings February Industrial Production & Capacity Utilization, the University of Michigan sentiment surveys, the Leading Index (February LEI), and the delayed Labor Market Conditions Index Change (Fed's job dashboard). Next Monday (03/20) provides the Chicago Fed National Activity Index. Tuesday follows with the Current Account Balance for Q4 2016. Wednesday brings MBA Mortgage Applications (up 3.10% last week), the FHFA House Price Index for January, and Existing Home Sales for February.

Equities

Stocks lost ground last week, but are a little higher this week – due to today's rally. The Dow Industrials fell 102.73 points or .49% last week to 20,902.98, but are .23% better this week. The Nasdaq lost 9.03 points or .15% to 5,861.73, but is .65% higher this week. The S&P lost 10.52 points or .44% to 2,372.60, but is .53% higher since Friday. The Dow Transports dropped 2.13% last week, and have fallen another .65% this week. Bank stocks lost 1.00%, and are .87% lower this week.

Resistance:	Dow:	20,993/ 21,065/ 21,138/ 21,210	Nasdaq:	5,910/ 5,930/ 5,949/ 5,968	S&P:	2,384/ 2,390/ 2,395/ 2,401
Support:		20,922/ 20,849/ 20,777/ 20,707		5,873/ 5,853/ 5,835/ 5,816		2,378/ 2,372/ 2,366/ 2,360

Other Markets

Commodities lost 3.72% last week, but are .63% higher this week. Crude Oil fell 9.08% contributing to that loss, but is .76% better this week. Gold lost 2.05%, and is .06% lower this week. The U.S. Dollar lost .30% last week, and was .66% lower through today as the Fed was perceived to have only 2 more hikes in store for 2017. The Japanese Yen fell .66%, but rallied 1.23% into today. The Euro gained .48% last week, and is .57% higher this week. Corn lost 4.47%, but is 1.54% higher this week. Cotton rose .01%, and is 1.02% better this week. European Central Bank President Mario Draghi said they've been successful in raising headline inflation and that risks, though still tilted to the downside, have lessened. Though not facing their previous sense of urgency, the ECB elected to continue stimulus through year end. EU rates have been moving higher in recent months – most near 3–month highs.

"I believe that professional wrestling is clean and everything else in the world is fixed." Frank Deford

Additional Information is Available on Request
Doug Ingram, Managing Director – Commerce Street Capital Management