Commerce Street Capital Management
1445 Ross Avenue
Dallas, Texas 75202
214-545-6800

Bond Market Review

May 03, 2017

Blinders

The 143rd Kentucky Derby is set for Saturday, and there's a fan favorite named 'Patch' that only has one eye. While he's a longshot, the FOMC adopted a single–vision approach to their June meeting and the odds for a hike rose to 90% after today's policy statement. That's nearly a lock, despite U.S. GDP growth of only .7% in the first quarter! Over the past few years, the first–quarter results have been rather weak – with a few due to cold winters, but the weakness in Q1 2017 was instead partially attributed to warm weather. The .7% growth was the weakest in 3 years, going back to the –1.2% that kicked off a very–cold early 2014. Whichever horse might be your choice, the supposed smart money is on higher rates and a June hike. In the past, the Fed would not have chosen to remove accommodation (or tighten) with such low growth, and would instead be seeking forms of stimulus. After all, tightening is a tool intended to thwart growth. Nevertheless, the Fed has made a choice to look past the negatives in the data, and believes that rates even 25 to 50 bps higher would still be accommodative. Fed Vice Chairman Stanley Fischer recently said the FOMC hadn't seen anything to change plans for 2 more hikes in 2017. There's your trifecta!

Another 'good bet' has been the Atlanta Fed's GDP–Now Forecast, which was pointing to weakness over the past few weeks – and even sank as low as .2% coming into the forecast. Their read considers all the incoming data and the potential weight or effect it should have on the end result. Just as their Q1 started much higher (3.4% on February 1st), the first read on Q2 out of the gates is 4.3%! There's been a mix of slow and weak data to go along with some that is instead promising. However, after today's meeting, it seemed clear the Fed had 'blinders' to anything except their 'mission accomplished' view on inflation and employment. The FOMC considered *"the slowing in growth during the first quarter as likely to be transitory"* and expected that *"with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will stabilize around 2% over the medium term."* The committee said labor had strengthened *"even as growth in economic activity slowed."* Despite some data to the contrary, they said *"the fundamentals underpinning the continued growth of consumption remained solid."* The vote for a 'stay' was unanimous.

Looking Ahead

- Bond yields should make an important low near May 15th/19th.
- The **B**ond **M**arket **R**eview equity cycles show topping action due in the May 12th–to–16th window.

Treasuries, Agencies, and MBS

Ever get the urge to lock in a low–rate investment for 50 years? While there's a better chance that rates have turned the corner than at any other time over the past decade, the charts don't yet confirm that conclusion. However, if the long cycle has begun its upward trek, imagine the potential price drop to the initial holders of a new 50–year Treasury bond! Treasury Secretary Steven Mnuchin has said ultra–long maturities *"could absolutely make sense."* I guess I hate the idea of a bond fairly sure to outlive me, and one that could be underwater for the next two decades (or more).

Into April 21st, yields fell 2.5 bps at 2–years, were flat at 5–years, and 1 bps higher at 10 and 30–years. Last week, Treasury yields rose by 8, 4.5, 3, and 5 bps for those sectors. Into today, yields were higher by 3, 3.5, 3.5, and 1.5 bps. MBS spreads (FNMA 30–year 3%) were flat into the 21st, but pulled in by 2 bps last week. Last Tuesday (04/25), the Treasury sold \$26 billion 2–year notes at 1.28%. The yield was the highest since December, and demand was the best since the May 2016 offering. The group that includes foreign central banks accounted for 58.9%, rising from 53.6% for the March auction. Last Wednesday's \$34 billion 5–year note offering brought 1.875%. The yield was the lowest since November, and demand was off versus last month. Foreign buying fell to 57.3% from 68.9% in March. Last Thursday's \$24 billion in 7–year notes came at 2.084%, the lowest yield since October – with the best demand since the November 2012 auction! Foreign buying rose from 71.1% last month to 81.7%!

Next week, the Treasury will auction \$24 billion 3–year notes on Tuesday (05/09), \$23 billion 10–year notes on Wednesday, and \$15 billion 30–year bonds on Thursday. Puerto Rico is seeking relief under a special bankruptcy law to reduce \$122 billion in debt to bondholders and retired employees. (Under U.S. code, states and territories can't file Chapter 9.)

04/28/17 Treasury Yield Curve	2-Year: 1.264%	5-Year: 1.815%	10-Year: 2.281%	30-Year: 2.952%
Weekly Yield Change:	+.082%	+.044%	+.032%	+.050%
04/21/17 Treasury Yield Curve	**2-Year: 1.182%**	**5-Year: 1.771%**	**10-Year: 2.249%**	**30-Year: 2.902%**
Weekly Yield Change:	–.025%	+.001%	+.011%	+.009%
Support:	1.320/ 1.340/ 1.363/ 1.385	1.895/ 1.930/ 1.965/ 2.000	2.385/ 2.425/ 2.465/ 2.505	3.020/ 3.065/ 3.110/ 3.155%
Targets:	1.270/ 1.250/ 1.225/ 1.180	1.855/ 1.825/ 1.800/ 1.765	2.320/ 2.280/ 2.235/ 2.195	2.975/ 2.940/ 2.895/ 2.850%

Economics

The ADP Employment Change showed 177K private–sector jobs created in April. There were 255K last month, but only 98K overall jobs were gained in March. This month 190K additions are expected. Initial Jobless Claims rose from 243K to a 4–week high of 257K, but that is still a very low and non–threatening result. Continuing Claims rose from 1,978K to 1,988K. Board Consumer Confidence fell from 124.9, the highest since December 2000, to a second–place 120.3. The Present Situation survey fell from 143.9 to 140.6, and Expectations dropped from 112.3 to 106.7. The University of Michigan surveys were similar. Sentiment fell from 98 to 97, and Current Conditions dropped from 115.2 to 112.7. Expectations, however, rose .1 to 87.

The Chicago Purchasing Managers data rose from 57.7 to 58.3. The others declined a bit. The Chicago Fed National Activity Index fell from .34 to .08. Kansas City Fed Manufacturing Activity dropped from 20 to 7, Richmond fell from 22 to 20, and Dallas was .1 lower to 16.8. Bloomberg expectations rose from 48 to 49.6 reaching the highest level since August 2001. Personal finances rose from 58.8 to 59.7, and the comfort measure rose from 49.9 to 50.8.

ISM Manufacturing fell from 57.2 to 54.8, slowing but still expanding. ISM Prices Paid dropped from 70.5 to 68.5. ISM New Orders fell from 64.5 to 57.5. The ISM (factory) Employment outlook fell from 58.9 to 52. Services had a better outlook, as the ISM Non–Manufacturing Composite improved from 55.2 to 57.5 – the 2nd best since October 2015. Wholesale Inventories fell .10%, though Retail Inventories rose .40%. March Orders for Durable Goods rose .70%, but fell .20% ex Transportation. Capital Goods Orders rose by .20%. Q1 GDP was .7%, and was greatly challenged by Personal Consumption only a third of expectations at .30% (the lowest reading since Q4 2009).

Personal Spending was flat in February and March. March Personal Income rose by .20%. The PCE Deflator fell .20% in March, reducing the annual Personal Consumption Expenditures inflation reading from 2.10% to 1.80% (back below the Fed's 2% target). Ex food & energy, PCE fell .10%, reducing the annual pace from 1.80% to 1.60%. The Employment Cost Index for Q1 2017 rose .80%. The GDP Price Index accelerated from 2.10% to 2.30%, and Core PCE rose from 1.30% to 2.00%.

In March, Existing Home Sales rose 4.39% to a 5.71M pace – the best since February 2007! New Home Sales rose 5.79% to 621K, beating expectations (of 584K), and hitting the best pace since July 2016. However, Pending Home Sales fell .80%. The FHFA House Price Index rose .80% in February. Metro home prices rose for their 5th month. The S&P CaseShiller 20–City index rose by .69%, quickening the annual pace from 5.66% to 5.85%. The annual house price index rose from 5.64% to 5.76%. Construction Spending fell .20% in March. April Vehicle Sales rose from 16.53M to a 16.81M annual pace. Domestic sales rose from 12.97M to a 13.12M pace.

As the Star Wars crowd says, May the 4th be with you! Thursday is set for two more clues into Friday's April payroll numbers from Challenger Job Cuts and jobless claims data. Also due are the March Trade Balance (deficit), Q1 Nonfarm Productivity & Unit Labor Costs, Bloomberg Consumer Comfort, Factory Orders, and Durable & Capital Goods Orders. Friday reveals April payrolls and related data, and March Consumer Credit.

Next Monday (05/08) gives us the Fed's read on April jobs with the Labor Market Conditions Index Change. Tuesday is set for NFIB Small Business Optimism, JOLTS Job Openings, and March Wholesale Inventories & Trade Sales. Wednesday brings MBA Mortgage Applications (which rose 2.70%, and then fell .10% over the past 2 weeks), April Import Prices, and the Monthly Budget Statement (for April).

Equities

The Nasdaq rose to a record high on Tuesday. While other indices came close to making new highs, the Russell 2000 index was the only other one we follow making significant new highs (with the Nasdaq). The Dow rose .46% into the 21st, and 392.75 points or 1.91% to 20,940.51 last week. It's .08% higher this week. The Nasdaq gained 1.82% and then 2.32% to 6,047.61 last week. It's up .41% this week. The S&P gained .85% and 1.51% to 2,384.20, and is .16% higher since Friday. The Dow Transports gained 2.92%, and then lost .40% last week. They are .39% higher this week. Bank stocks gained 1.83% and then 1.80%. They are 1.59% better this week.

We expected another push higher from April 27th, but the markets got ahead of the cycles with the global rally stemming from the French elections which were interpreted as avoiding a 'Frexit' – a French exit from the EU. The Euro, in turn, rose to a 5–month high. The stock cycles indicate topping action due in the May 12th–to–16th window – so take care.

Resistance:	Dow:	20,989/ 21,070/ 21,144/ 21,217	Nasdaq:	6,101/ 6,140/ 6,179/ 6,218	S&P:	2,397/ 2,409/ 2,422/ 2,434
Support:		20,853/ 20,781/ 20,712/ 20,597		6,051/ 6,023/ 5,989/ 5,915		2,376/ 2,361/ 2,349/ 2,339

Other Markets

Speaking to the Crude Oil cycles, back in the **BMR** (03/08/17) we said we expected *"a better–quality low due near the end of April."* That trend–change for a low is now May 5th, and oil has plunged into this cycle. The next high should occur May 24th–26th. Crude Oil fell 6.69% into the 21st, another .58% last week, and is 3.06% lower this week. Commodities lost 3.14%, .08%, and are .73% lower this week. Gold rose .12%, lost 1.48% last week, and is 1.56% lower this week. The U.S. Dollar lost .58%, and then another .98% last week. It's .19% higher this week. The Japanese Yen lost .41%, and then fell 2.20% last week. It's off 1.13% this week. The Euro gained 1.04%, and added 1.56% last week. It's off .08% this week. Corn lost 3.77%, rose .28%, and then added 2.30% into today. Cotton gained 4.46%, and then another 1.57% last week. It's .57% better this week as well.

"Drama is life with the dull bits cut out." Alfred Hitchcock

Additional Information is Available on Request

Doug Ingram, Managing Director – Commerce Street Capital Management