BOND MARKET REVIEW

May 24, 2017

A June Swoon?

Just a week ago, the market odds for a June FOMC rate hike were far less certain as the Dow had fallen 372.82 points – for its biggest drop of the year. Into today, stocks recovered most of that drop, and June hike odds once again rose to near certainty at 100%. In most applications, 100% is a sure thing. In markets, a rotten or robust piece of data, or a catastrophic event can change a 'sure thing.' The **BMR** cycles are forecasting falling stocks and bond prices in June. The cycles can be wrong, of course, but we wouldn't bet against them – or the chance of a June Fed hike at this point. The Fed's May 2nd–3rd minutes said: *"Overall, most participants viewed the recent softer inflation data as primarily reflecting transitory factors, but a few expressed concern that progress toward the Committee's objective may have slowed."* Mostly lacking that concern on inflation, they said: *"Most participants judged that if economic information came in about in line with their expectations, it would soon be appropriate for the Committee to take another step in removing some policy accommodation."* The market's read on that language was 'soon means June.'

Furthering the belief that the Fed is going to continue to tighten, the minutes revealed that there was a proposed approach for trimming the Fed's balance sheet with gradually increasing caps that would serve as limits to the reinvestment of maturing assets. Nearly all members thought they should begin shrinking the balance sheet in 2017.

For the counterpoint, and one with which we agree, last week St. Louis FRB President James Bullard said that *"longer–term yields have declined, inflation expectations have weakened, and market expectations of the policy rate path have declined."* Most other Fed members are still onboard with a gradual pace of rate increases that would include 3 more hikes this year – specifically in June, September, and December. However, Bullard said the before–mentioned developments *"may suggest that the FOMC's contemplated policy rate path is overly aggressive relative to actual incoming data on U.S. macroeconomic performance."* Last year, we were impressed with the reasoning of Fed Reserve Governor Lael Brainard – as she kept the Fed from being overly aggressive with tightening. She said inflation data is causing her to question *"are we there yet?"* She explained: *"The flip side of the dual mandate is we really aren't seeing much progress on core inflation. If anything, in the last few months, we've seen a bit of stalling out of core inflation."*

Though estimates for Q2 GDP are running at 3.5% or better, Q1 U.S. GDP growth was only .70%. Though the jobs market is hot, wage growth and inflation are not fulfilling FOMC expectations. Our position remains as per the **BMR** (05/10/17) and earlier, as we asked: *"Shouldn't we see GDP above 2.5%, real wage pressures, and better consumption data instead of just assuming we're heating up?"*

Looking Ahead

- Bond yields should move up from May 30th to a high due around June 20th to 22nd.
- The **BMR** equity cycles show increased price swings, with an upcoming buy opportunity in early July.

Treasuries, Agencies, and MBS

Last week, yields fell 2, 6.5, 9, and 9 bps for the 2, 5, 10, and 30–year Treasury sectors. Yields rose this week, but only by 1, .5, 1.5, and 3 bps as last week's rally held. Yields fell into the **B**ond **M**arket **R**eview's May 15th to 22 'window' for a low. The next phase should be energy for higher yields increasing from May 30th into June 20th to the 22nd. Given last week's rally, the Treasury curve has flattened with short yields rising and longer rates dropping – leaving the spread between 2 and 10–year notes at its narrowest since the end of October. While mortgage delinquencies and foreclosures declined in Q1 2017 versus the last quarter of 2016, delinquencies for auto loans have been on the rise. Banks and lenders are tightening credit by not approving would–be borrowers with lower FICO scores. In Q1 2017, new car loans made to 'subprime borrowers' fell to the lowest levels in 2 years (New York Fed report). Auto debt more than 90–days overdue rose in the first quarter to its highest level in 4 years (at 3.82%).

Last week, MBS spreads (FNMA 30–year 3%) widened by 2 bps. On Tuesday, the U.S. Treasury sold $26 billion 2–year notes at 1.316% – the highest auction yield going back to October 2008! Demand was the strongest since the May 2016 offering, and the group that includes foreign central banks bought 57.2% of the auction – versus 58.9% last month. Today's $34 billion 5–year note offering brought 1.831%, with demand the best since the December 2016 auction. Foreign buying rose from 57.3% in April to 68.7% for this auction. The U.S. Treasury will auction $28 billion 7–year notes on Thursday (05/25).

05/19/17 Treasury Yield Curve	2-Year: 1.272%	5-Year: 1.781%	10-Year: 2.235%	30-Year: 2.897%
Weekly Yield Change:	–.020%	–.067%	–.092%	–.092%
Support:	1.305/ 1.325/ 1.340/ 1.365	1.840/ 1.875/ 1.905/ 1.930	2.310/ 2.330/ 2.365/ 2.395	2.945/ 2.970/ 2.995/ 3.010%
Targets:	1.280/ 1.245/ 1.220/ 1.205	1.775/ 1.755/ 1.730/ 1.705	2.250/ 2.215/ 2.195/ 2.160	2.925/ 2.900/ 2.880/ 2.860%

Economics

Initial Jobless Claims fell 4K last week to 232K, riding the lowest levels since 1973. Continuing Claims dropped from 1,920K to 1,898K – with a 4–week average now the lowest in 43 years. Manufacturing data remains mixed. While the Chicago Fed National Activity Index rose from .07 to .49, the Richmond Fed Manufacturing Index fell from 20 to 1. (Last week, the Philadelphia Fed Index rose from 22 to a 3–month high of 38.8, while Empire Manufacturing fell for a third straight month – from +5.2 to –1.)

Home prices rose 1.4% in Q1 2017 and 6% (annually) versus Q1 2016. While job growth is feeding home prices, there is still a lag in wage increases – especially given the low U.S. Unemployment Rate (4.40%). As of March, existing homes on the market fell 6.6% versus the previous year to 1.83 million properties. In March, the FHFA House Price Index rose .60% (single–family homes financed by Fannie Mae or Freddie Mac). The median price of such homes rose 6.9% versus last year (according to realtor's data). Sales of New Homes declined by 11.37%, falling from the strongest pace since the beginning of the financial crisis (642K) to an annual pace of 569K (versus 610K expected). They were off 2.90% versus last year. The median price of a new house fell 3.8% versus last April, and the supply of new houses hit the highest level since July 2009 (268K units). Sales of Existing Home fell 2.28% in April from 5.70M to a 5.57M pace. Sales of single–family homes fell 2.40%.

Thursday is set for April Wholesale & Retail Inventories, jobless claims data, Bloomberg Consumer Comfort (which last week rose .5 to 50.2), and Kansas City Fed Manufacturing Activity. Friday updates Q1 GDP & Personal Consumption, April Durable & Capital Goods Orders, and the University of Michigan Sentiment surveys.

Next Monday (05/29) is Memorial Day. The markets will be closed. I always try to watch a movie such as 'Midway', 'Saving Private Ryan', "The Bridge on the River Kwai', or 'The Longest Day', to recall, commemorate, and appreciate the sacrifice and bravery of those that gave their lives for the cause of freedom – and the unity of all for that effort. Next Tuesday is set for April Personal Income & Spending, the PCE Deflator, S&P Case–Shiller home price data, board Consumer Confidence, and Dallas Fed Manufacturing Activity. Wednesday closes out May trading with MBA Mortgage Applications (which rose 4.40% last week), Chicago Purchasing Managers, April Pending Home Sales, and the release of the Fed's Beige Book (activity and outlook report for the 12 districts).

Equities

Though there were exceptions, by today's close, many U.S. indices had recovered all of last Wednesday's losses – recovering from the largest one–day plunge of 2017. Though this formed a retest of last week's highs, for the most part the highs made with last Tuesday's cycle have yet to be exceeded. That allows for a double–top type formation, and the cyclic forecast continues to project lows in early July – even if higher highs come first. Last week, despite improvements on Thursday and Friday, the equity markets still lost ground. The Dow lost 91.77 points or .44% to 20,804.84. It's 1.00% better this week. The Nasdaq fell 37.53 points or .61% to 6,083.70, and it's 1.30% higher this week. The S&P dropped 9.17 points or .38% to 2,381.73, but is .95% better since Friday. The Dow Transports lost 1.35% last week, but are up 1.61% this week. Bank stocks fell 1.57%, but have recovered 1.23% into today.

Resistance:	Dow:	21,140/ 21,214/ 21,288/ 21,360	Nasdaq:	6,209/ 6,248/ 6,289/ 6,329	S&P:	2,416/ 2,429/ 2,442/ 2,454
Support:		20,996/ 20,924/ 20,852/ 20,779		6,166/ 6,131/ 6,087/ 6,053		2,404/ 2,392/ 2,380/ 2,369

Other Markets

Crude Oil rose a stout 5.20% last week, and is another 2.05% higher this week – trading up to $51.36/barrel today. Saudi Arabia announced they would extend production cuts for another 9 months, and OPEC is expected to go along with that plan. With oil trading over $50/barrel, there is good incentive for U.S. production. Since early March, the U.S. oil rig count is up 127 to 901 – which is 521 rigs higher versus last year. We have a trend–change high due for Crude on May 26th. A longer–term low is due around July 25th.

Commodities rose 1.86% last week, but are .63% lower this week. Gold rose 2.11%, but is off .04% this week. The U.S. Dollar countered that move, losing 2.12%, but is .12% higher this week. That was the Dollar's worst loss since last July (2016). The Japanese Yen rose 1.87%, but is .21% lower this week. The Euro surged 2.52%, and is .12% better this week. Corn rose 2.97%, but is .34% lower this week. Cotton lost 3.32%, and is off another 2.40%.

"Reality is that which, when you stop believing in it, doesn't go away." Philip K. Dick

Additional Information is Available on Request

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