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

BOND MARKET REVIEW

June 09, 2017

The Duality of Mandates

It would be a great surprise at this point if the Fed chose not to hike rates this coming Wednesday (06/14). Most FOMC members view the economic negatives and faltering inflation as *"transitory."* While also in place to moderate long–term interest rates, the Fed's dual mandate is to maximize employment and stabilize prices. The **B**ond **M**arket **R**eview is of the opinion that other economic data should enter into the equation. After all, other central banks also consider economic growth (and related data) to be very important. That said, Consumer confidence has been overwhelmingly encouraging, and the stock market continues to establish new highs.

While inflation may be transitory, is it also that case that slowing job pickups, a lack of wage pressures, and a lack of robust growth are as well? As we've noted before, it's traditionally been the case that the Fed tightens to slow growth – and it's just not that great. As reported in the Fed's Beige Book, it's only been 'modest' or 'moderate' for years. Nevertheless, rates were near zero for a long time, and many Fed members feel that even after a few more hikes interest rates would still be accommodative.

Are we really at 'full employment?' May's Unemployment Rate of 4.30% was the lowest since May 2001, but at that time labor force participation was 66.7% versus last month's 62.7%. With the current population of 254.767 million, the economy would have roughly 9.7 million more folks employed at the 2001 level – so this 4.3% is somewhat tainted. It's also the case that many workers are limited to under 30 hours per week as small businesses are not able (or choose not) to pay the health care insurance costs associated with the health–care law. That effect is heavy in the service industry, which is a significant portion of the U.S. economy. That further makes this current 4.3% jobless rate far from a 'full employment' number. A bus that's 95.7% full is statistically more significant than a minivan given that same ratio.

Despite the Fed's dual mandate, they seem to be single minded – choosing to ignore inflation and focus rather on 'full employment.' If we include growth in the equation, only one of three factors would be a positive. If the jobs data is really weaker than the 4.3% jobless rate would imply, there are three pieces of suspect data. Yet, the Fed has adopted a 'mission accomplished' posture. A scripture from Proverbs is often misquoted as 'pride comes before a fall.' With only one side of the dual mandate met – and only loosely so, it seems to be preceding a hike.

Looking Ahead

- Bond yields should move higher into a trend–change top due around June 19th to 22nd.
- The **BMR** equity cycles show increased price swings, with an upcoming buy opportunity in early July.
- The FOMC will most likely hike rates 25 bps following their Wednesday meeting (06/14) at 2:00 ET.

Treasuries, Agencies, and MBS

The market–based odds for a Fed hike next Wednesday rose steadily from 88.4% last Thursday to 97.8% by the end of this week – basically an assumed 'done deal.' While expectations over recent months had been for hikes in June, September, and December (for 3 more moves this year), bondtraders began to lower the odds for a following September move after the recently weaker inflation and employment releases. As of Friday, the December meeting had gained favor over September as the likely timing for the next hike.

Into June 2nd, the curve flattened ahead of the Fed's expected hike with yields falling .5, 7, 8.5, and 10 bps for the 2, 5, 10, and 30–year Treasury sectors. Part of that rally was given back through Friday with yields rising 4.5, 4.5, 4, and 4.5 bps – a uniform rise maintaining the shape of the curve. The Treasury curve is the most flat it's been since early October. The 10 to 2–year spread was 136 bps on December 22nd. It fell below 1% last week, and then to 85 bps earlier this week. Bonds continue to signal caution, while stocks press on as if there were few reasons for worry. Flat or inverted yield curves often precede economic slowdowns and recessions.

Last week, MBS spreads (FNMA 30–year 3%) widened by 1 bps. They narrowed by 2 bps this week. The U.S. Treasury will hold auctions earlier in the week to get ahead of the FOMC announcement on Wednesday the 14th. They will 'double up' on Monday (06/12) with $24 billion 3–year notes and $20 billion 10–year notes. The $12 billion supply of 30–year bonds will follow on Tuesday (06/13).

06/09/17 Treasury Yield Curve	**2-Year: 1.337%**	**5-Year: 1.767%**	**10-Year: 2.201%**	**30-Year: 2.856%**
Weekly Yield Change:	+.047%	+.047%	+.041%	+.046%
06/02/17 Treasury Yield Curve	**2-Year: 1.290%**	**5-Year: 1.720%**	**10-Year: 2.160%**	**30-Year: 2.810%**
Weekly Yield Change:	–.006%	–.070%	–.087%	–.102%
Support:	1.345/ 1.365/ 1.385/ 1.405	1.790/ 1.810/ 1.840/ 1.875	2.230/ 2.265/ 2.285/ 2.330	2.860/ 2.880/ 2.900/ 2.920%
Targets:	1.330/ 1.305/ 1.290/ 1.270	1.735/ 1.705/ 1.670/ 1.640	2.190/ 2.155/ 2.130/ 2.090	2.840/ 2.820/ 2.800/ 2.780%

Economics

Initial Jobless Claims fell 10K last week to 245K and Continuing Claims fell 2K to 1,917K. While firings have been the lowest since the early '70s, job pickups are slowing. Though expected to rise around 182K, only 138K Nonfarm jobs were added in May, and April's increase was reduced from 211K to 174K. Over the past 2 months, there was a revision of 66K fewer jobs than previously reported. That set the job pace for the first 5 months of 2017 as 216K, 232K, 50K, 174K, and 138K. Last Thursday, ADP Employment Change data showed that 253K private sector jobs were added in May. The bureau's release showed only 147K for May, and a revision from 194K to 173K for April. While only down by 1K, Manufacturing lost jobs for the first time since October.

Expectations had been for 182K jobs to be added and the Unemployment Rate to maintain 4.40%. Instead, the jobless rate fell to 4.30% on fewer hires. Unfortunately, the contributing factor was in the labor Force Participation Rate falling from 62.90% to 62.70% – the lowest since December. Less workforce with more jobs added means the unemployed ratio is reduced. The Underemployment Rate fell from 8.60% to 8.40%. Average Hourly Earnings rose .20%, and were revised .10% lower to .20% for April. Average Hourly Earnings maintained a 2.50% pace of gain, though expected to rise 2.60%. Average Weekly Hours were flat at 34.4. JOLTS Job Openings rose in April from 5.785 million to a record 6.044 million.

Consumer Credit expanded by $8.197 billion in April (versus $15 billion expected), and was revised just over $3.1 billion higher to $19.536 billion for March. Bloomberg Consumer Comfort fell from 51.2 (the 2nd–highest level since 2001) to a still–strong 49.9. Sentiment of company CEOs rose to a 3–year high. Capital spending was expected to increase and the sales outlook also rose. The U.S. Trade Balance deficit was revised higher for March (from $43.7 billion to $45.3 billion), and expanded to $47.6 billion in April. The merchandise trade deficit was the second largest in 2 years, and exports fell by .3%.

Nonfarm Productivity was flat in the first quarter, and Unit Labor Costs rose 2.20% (versus a previous 3.00% pace). The service sector continued to expand at a good pace, though the ISM Non–Manufacturing Composite fell from 57.5 to 56.9. Factory Orders fell .20% in April. Ex transportation, they rose .10%. Orders for Durable Goods were off by .80%. Ex transportation, they fell .50%. Orders for Capital Goods rose .10%. With interest rates dropping, MBA Mortgage Applications rose sharply last week (up 7.10%). Wholesale Inventories fell .50% in April, and Trade Sales dropped .40%. In the 1st quarter, household net worth grew by $2.347 trillion.

Monday (06/12) gives us the Monthly Budget Statement for May. Tuesday follows with NFIB Small Business Optimism and Producer Prices (May PPI). Wednesday provides more inflation readings with Consumer Prices (May CPI) and Real Average Earnings. Also due are May Retail Sales, April Business Inventories, and the FOMC's June interest–rate policy decision.

Equities

Most U.S. stock indexes made new highs on Friday, but a selloff in tech stocks left the session mixed – and the Nasdaq lower for the week. The Dow Industrials rose .60% into June 2nd, and rose 65.68 points or .31% this week to 21,271.97. The S&P gained .96% last week, but fell 7.30 points or .30% to 2,431.77 this week. The Nasdaq gained 1.54%, but after making a new high Friday then plunged 1.55% to 6,207.92 – to wipe out almost all of June's gains. The Dow Transports gained 1.69%, but were .04% lower this week. Bank stocks lost 1.60%, but surged 4.93% this week. The cycles still point to a buying opportunity in early July.

Resistance:	Dow:	21,223/ 21,297/ 21,370/ 21,443	Nasdaq:	6,182/ 6,222/ 6,261/ 6,301	S&P:	2,428/ 2,441/ 2,446/ 2,453
Support:		21,136/ 21,078/ 21,004/ 20,944		6,104/ 6,066/ 6,027/ 5,988		2,428/ 2,416/ 2,404/ 2,391

Other Markets

Crude Oil lost 4.30% last week, and then fell 3.84% this week for a 3rd weekly loss. Correspondingly, Commodities dropped 2.22% and then .67%. Gold gained .69%, but lost .65% last week. The U.S. Dollar fell .71%, but gained .59% this week. The Japanese Yen rose .84%, and added .07% this week. The Euro gained .86%, but fell .74% by Friday's close. Corn fell .40%, and then surged 4.02%. Cotton fell .52%, and lost another 1.30% this week.

"In prosperity our friends know us; in adversity we know our friends." John Churton Collins

Additional Information is Available on Request

Doug Ingram, Managing Director – Commerce Street Capital Management