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Bond Market Review

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Hot or Not?

As widely expected, the Fed hiked interest rates 25 bps on Wednesday – even though recent data has been less than supportive of their cause. The data hasn't been cold, but it's certainly not hot. Inflation has cooled, and the latest jobs results have been more tepid than hot. At 4.3%, the U.S. Unemployment Rate is low, but America is far from 'full employment' – no matter the statistic. Skeptics would question why the Fed would tighten without supportive data, but it was clear they intended to do so – so much so that the market–based odds had been at or near 100% for weeks coming into this meeting. After the hike, Fed Chair Janet Yellen downplayed recently weaker inflation. Though the statement said *"inflation on a 12–month basis"* was expected to remain below the Fed's target, she contended that despite the data, the Fed was going to see its 2% inflation goal hit as the job market heated up. Yellen said: *"It's important not to overreact to a few readings, and data on inflation can be noisy."* While she may be right, what if it's the FOMC that has overreacted with expectations that defy the data? Jerry Reed wrote a song about being aware of things going your way – or not. It went: *"When you're hot, you're hot – and when you're not, you're not."*

Yellen said: *"We continue to feel that with a strong labor market, and with a labor market that's continuing to strengthen, the conditions are in place for inflation to move up."* However, it doesn't always work out that way – ask Japan or the EU! Bond spreads are pulling in, with the long end of the curve not believing the picture is quite as 'rosy' as the Fed has painted it. With 2 hikes now done for 2017, and the Fed having projected a total of 4 – bonds are currently pricing in the chance of a 3rd hike at less than 50% (with December reading only 44.4% as of today).

The **B**ond **M**arket **R**eview is of the opinion that the Fed should be more data dependent, or they risk the transparency they're trying to accomplish. Why not just say that rates are too low and hike them for that reason – rather than for what they expect to happen? Anyone that grew up watching Perry Mason or Matlock knows you have to question or object to 'facts not in evidence'! When the yield curve flattens, you get former Fed Chair Alan Greenspan's 'conundrum' – the lack of follow through of long rates when the FOMC is hiking the short end. Those are market bets that the Fed is wrong. Former FRB Philadelphia President Charles Plosser chimed in with **BMR**–like thoughts this week – challenging the FOMC's communication. He said: *"If they continue to raise rates, then you've got this conundrum. The balance sheet is large, and that's providing accommodation, but that means their funds rate target is not very informative about the true stance of policy because it's being offset – in some sense, by the balance sheet."* However, the statement did say the FOMC intended to begin *"a balance sheet normalization program this year."*

Looking Ahead

- Bond yields should move lower from the 22nd to the 27th. A low in rates is expected around August 9th.
- The **BMR** equity cycles show increased price swings, with an upcoming buy opportunity in early July.

Treasuries, Agencies, and MBS

Since Friday, 2–year yields have risen 1.5 bps, while the 5, 10, and 30–year sectors have seen yields fall by .5, 3.5, and 7 bps. Thus, the U.S. Treasury yield curve continued to flatten this week. We noted that the 2 to 10–year spread fell below 1% two weeks ago, and to 85 bps (.85%) last week. With the Fed's hike on Wednesday, that part of the curve flattened below .80%. The Fed is seeking to assure markets that inflation will return as hiring heats up, but medium to long–term bonds are skeptical. As the curve flattens, bonds are signaling an economic slowdown. This is especially true if the curve inverts (the long–short spread goes negative as short rates rise above those of longer horizons). Recent inflation data has been dropping and, in May, Retail Sales just fell the most since early 2016.

Last week, MBS spreads (FNMA 30–year 3%) narrowed by 2 bps. On Monday (06/12), the U.S. Treasury sold $24 billion 3–year notes at 1.50%. Demand was the best since the December 2015 auction. The group that includes foreign central banks accounted for 65.6% of the sale, versus 50.8% last month. The 10–year note auction was also held on Monday – to get ahead of 'FOMC Wednesday.' $20 billion notes brought 2.195% with the best demand since March. The May 2027 issue was reopened to add this supply, and foreign accounts bought 66.1% of the issue compared to 60.7% in May. On Tuesday (06/13), the Treasury sold $12 billion 30–year bonds at 2.87%. The yield was the lowest since October, and demand rose versus May. The May 2047 issue was reopened for this supply, and foreign accounts bought 63.7% of the offering versus 59.1% in May.

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%
Support:	1.340/ 1.360/ 1.385/ 1.405	1.770/ 1.795/ 1.840/ 1.875	2.175/ 2.215/ 2.250/ 2.290	2.800/ 2.845/ 2.885/ 2.925%
Targets:	1.305/ 1.285/ 1.270/ 1.250	1.735/ 1.705/ 1.675/ 1.640	2.145/ 2.110/ 2.075/ 2.040	2.765/ 2.725/ 2.685/ 2.645%

Economics

Initial Jobless Claims fell from 245K to a 3–week low of 237K. (The 43–year low is 227K.) Continuing Claims were higher by 6K to 1,935K. NFIB Small Business Optimism was flat at 104.5. Bloomberg Consumer Comfort edged a tenth higher from 49.9 to 50. Though the Philadelphia Fed Business Outlook fell from 38.8 to 27.6, Empire Manufacturing rose from –1 to 19.8. Factory output fell by .40%, following the biggest jump (1.10% for April) since February 2014. Industrial Production was flat, and Capacity Utilization dropped .10% to 76.60%. Despite record tax collections for the month of May at $240.418 billion, the federal government still ran a deficit of $88.4 billion due to $328.844 billion in spending. To date, the federal deficit is running 6.8% higher than fiscal 2016.

The inflation data has been a little mixed, but recently skewed more to the downside. In May, Import Prices fell .30%, and were revised .30% lower to a .20% gain for April – though the annual pace quickened from 3.60% to 4.10%. Ex petroleum, prices were flat. Export prices fell .70%, and the year–over–year pace dropped from 3.20% to 3.00%. Consumer Prices decelerated even more than forecast. May CPI fell by .10%, slowing the annual pace from 2.20% to 1.90%. Ex food & energy, CPI rose .10%, though the annual pace of core CPI fell from 1.90% to 1.70%. Wholesale price pressures also diminished. May Producer Prices were flat, reducing the annual pace from 2.50% to 2.40%. Core PPI rose .30%, raising the annual pace from 1.90% to 2.10%. Real Average Weekly Earnings rose .60%, and Real Average Hourly Earnings matched that pace.

In May, Retail Sales fell .30% – the most since early 2016. They dropped by .30% ex autos as well. Home–builder optimism is falling off, but still relatively strong. The NAHB Housing Market Index fell from 69 to 67. The March reading of 71 had been the best since mid–2005. The 6–month outlook and current sales gauges also dropped 2 points. Business Inventories fell by .20% in April. Foreign entities moved a net $65.8 billion into U.S. Treasury assets in April. China's holdings of Treasuries rose to a 6–month high with a net $4.6 billion increase to $1.09 trillion – still only enough for second place behind Japan. Overall, foreign accounts moved a net $1.8 billion into longer maturities.

Friday is set for May Housing Starts & Building Permits, and the University of Michigan sentiment surveys. The Fed's jobs dashboard is also due on Friday (Labor Market Conditions Index Change). The FOMC read on May payrolls was delayed due to the blackout preceding the Fed's announcement. Tuesday brings the Current Account Balance for Q1 2017. Wednesday gives us MBA Mortgage Applications (which rose 2.80% last week) and Existing Home Sales for May.

Equities

Stocks are beginning to diverge. While the Dow Industrials and NYSE index made new highs on Wednesday, most other indices made their highs last week – and the Nasdaq today broke to its lowest level since May 22nd. The Dow rose .31% last week and is .41% higher this week. The S&P lost .30% last week, and is a slight .03% higher this week. The Nasdaq lost 1.55% last week and is off another .68% so far this week. The Dow Transports fell .04%, but are out–performing other sectors this week with a .87% gain. Bank stocks gained 4.93%, and are .16% higher this week. The **BMR** equity cycles are projecting lows around July 3rd to the 5th.

Resistance:	Dow:	21,379/ 21,527/ 21,672/ 21,820	Nasdaq:	6,168/ 6,207/ 6,238/ 6,269	S&P:	2,434/ 2,442/ 2,454/ 2,467
Support:		21,234/ 21,115/ 20,945/ 20,802		6,129/ 6,109/ 6,090/ 6,051		2,419/ 2,404/ 2,392/ 2,380

Other Markets

Our last high for Crude Oil was due near May 26th, though Crude started trading lower on the 25th. Crude made a new low into today, and our next expected downwave should be from a high near June 27th/28th into a low in the first week of August. Crude Oil lost 3.84% last week, and was off another 2.99% into today. Commodities traded .67% lower last week, and continued 2.25% lower this week. Gold lost .65%, and is 1.28% lower this week. The U.S. Dollar rose .59% last week, and has added .20% this week. The Japanese Yen rose .07%, but was .55% lower into today. The Euro lost .74%, and is off .45% so far this week. Corn rose 4.02%, but has lost 2.13% this week. Cotton lost 1.30%, and has tumbled 4.99% this week.

"Never hold discussions with the monkey when the organ grinder is in the room." Sir Winston Churchill

Additional Information is Available on Request

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