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

Bond Market Review

July 20, 2017

Spider–Man: Homecoming

One of the slogans or themes from Spider–Man has been that – 'with great power comes great responsibility.' That's likely a paraphrase of the biblical parable, 'to whom much is given, much is required.' With regards to next week's almost–invisible FOMC meeting – to whom much is given, little is expected! When Congress doesn't do anything, they get criticized – and rightly so. For most meetings since 2008, the FOMC has done nothing – and it was expected! When the Fed began tightening in late 2015, they wanted to make sure the markets didn't expect one of the unchecked campaigns of hikes such as the last that led to 17 straight increases into June 2006. They adopted a 'gradual pace' approach which meant (at least to date) that there would be no back–to–back hikes – leaving all such meetings and next week's July 26th policy decision as 'non events.' Gradual or not, bond investors have heavily moved away from the expectations for any imminent hikes. The July meeting has had a 0% chance, while the next most likely hike (better than 50% odds) has moved from September to March of 2018, and then back to December 2017 over the past few months. The next move is now perceived by the market as being shifted again out to March 2018.

What's a consumer to believe? The Fed keeps telling us the economy is solid, but the data isn't overwhelmingly supportive. With Congress failing at nearly every turn, and the constant drum of negative news stories, consumer confidence is waning. The University of Michigan Expectations survey just fell to a 9–month low (from 83.9 to 80.2). Sentiment dropped from 95.1 to 93.1, though Current Conditions rose from 112.5 to 113.2. Last week, Bloomberg Consumer Comfort fell from 48.5 to 47 – the lowest level since January. It rose to 47.6 today. Their survey of Expectations also dropped (from 52 to an 8–month low of 47). The Fed's Beige Book said the economy was expanding across all 12 districts, though only at a *"slight to moderate"* pace. Nothing new there! The Atlanta Fed's GDP–Now forecast has fallen from an initial (and highest) 4.3% for Q2 2017 to only 2.5%. Price increases were also only modest, with a few districts reporting easing inflation. Data showed Weekly Earnings were only 1.10% higher to last year, and Hourly Earnings only .80% higher. Consumer Prices were flat, with the annual pace falling from 1.90% to 1.60%! Core CPI (ex food & energy) rose .10%, which left the annual core pace at (a non–transitory) 1.70%.

Nevertheless, last week Fed Chair Janet Yellen stuck to her guns – telling Congress that the economy's growth would lead to *"gradual increases in the federal funds rate over time."* She allowed that there was uncertainty about when *"inflation will respond to tightening resource utilization."* That uncertainty has puzzled Japan since the late '80s, and the EU and other economies since the financial crisis! European Central Bank President Mario Draghi sounded a lot like Yellen, contending this week: *"We are finally experiencing a robust recovery where we only have to wait for wages and prices to follow course." 'Anticipation'* is not reserved solely for ketchup commercials!

When asked if Trump's 3% GDP growth goal was reachable over the next 5 years, Yellen responded: *"It would be quite challenging."* The **B**ond **M**arket **R**eview would ask, is this the same person, leading the same Fed, that has advocated a campaign of tightening to get ahead of the curve and prevent the economy from overheating? Yellen said opioid use might be a cause of the *"declining labor force participation among prime–age workers."* In the Beige Book, the St. Louis Fed reported problems with workers not consistently reporting to work and/or passing drug tests.

Looking Ahead

- Bond yields should lower into July 25th and August 9th.
- The **BMR** equity cycles show better positive energy from July 18th into August 1st.
- The FOMC is widely expected to hold rates steady with their Wednesday (07/26) statement at 2 pm ET.

Treasuries, Agencies, and MBS

While we expected a yield high in the 14th to 19th timeframe, that window proved too large. Longer yields have fallen since the 14th after making a push higher on the 13th. Yields should make lows near July 25th and August 9th – the 9th possibly being the better for taking profits and adding hedges. Yields dropped last week, falling 4.5, 8, 5.5, and 1 bps for the 2, 5, 10, and 30–year Treasury sectors. Yields continued to drop into today, twisting flatter by .5, 5, 7.5, and 9.5 bps (for those sectors).

Last week, MBS spreads (FNMA 30–year 3%) narrowed by 1 bps. Last Tuesday (07/11), the Treasury auctioned $24 billion 3–year notes at 1.573%. Demand fell versus the June offering, and foreign accounts (including central banks) bought only 52.6% of the issue compared to 65.6% during that previous auction. On Wednesday (07/12), the Treasury sold $20 billion 10–year notes at 2.325%. Demand fell to June, and foreign buying was also lower – dropping from 66.1% then to 64.8% for this month. On Thursday (07/13), $12 billion 30–year bonds brought 2.936%. Demand also fell versus the June auction, and foreign buying slipped from 63.7% last month to 61.7%. This coming week, the U.S. Treasury will auction $26 billion 2–year notes on Tuesday (07/25), $34 billion 5–year notes on Wednesday (07/26), and $28 billion 7–year notes on Thursday (07/27).

07/14/17 Treasury Yield Curve	2-Year: 1.358%	5-Year: 1.867%	10-Year: 2.333%	30-Year: 2.920%
Weekly Yield Change:	–.043%	–.081%	–.053%	–.009%
Support:	1.360/ 1.380/ 1.405/ 1.430	1.850/ 1.885/ 1.920/ 1.955	2.270/ 2.290/ 2.305/ 2.325	2.845/ 2.860/ 2.880/ 2.905%
Targets:	1.340/ 1.320/ 1.305/ 1.280	1.780/ 1.745/ 1.715/ 1.680	2.230/ 2.215/ 2.195/ 2.175	2.805/ 2.785/ 2.765/ 2.745%

Economics

Retail Sales disappointed with a .20% drop in June (though May data was revised .20% higher to a lesser .10% drop). Ex autos, sales were also .20% lower. The Fed's read on the jobs markets improved from 2.3 to 3.3 for May, but despite a 4–month best 222K pickup for June – the Labor Market Conditions Index rose only 1.5 (versus 2.5 expected). Initial Jobless Claims fell 2K to 248K last week, and then to a 9–week low of 233K this week – hovering just above 43–year lows. Continuing Claims fell from 1,965K to 1,949K, but then rose to 1,977K with today's release. The number of available jobs fell in May (JOLTS Job Openings) dropped from 5.967M to 5.666M. The 'quit rate' rose from 2.1% to 2.2% (includes those finding other or better jobs). NFIB Small Business Optimism fell from 104.5 to 103.6. In turn, the Philadelphia Fed Business Outlook dropped from 27.6 to 19.5 and Empire Manufacturing fell from 19.8 to 9.8. Industrial Production rose .40% and Capacity Utilization improved from 76.40% to 76.60%. The Leading Index for June came in at .60%. Wholesale Inventories rose .40% in May, while Trade Sales fell by .50%. Business Inventories rose .30%.

Producer Prices rose .10% in June, but the annual pace fell from 2.40% to 2.00% – challenging the Fed's view that recent drops in inflation measures have been only 'transitory.' Ex food & energy, PPI also rose .10%, with the annual core pace falling from 2.10% to 1.90%. Import Prices fell .20% in June, leading to the annual pace dropping from 2.30% to 1.50%. Home builder sentiment followed others in dropping 2 points to an 8–month low of 64 (NAHB Housing Market Index). June Housing Starts rose 8.29% to 1,215K and Building Permits were 7.36% higher to 1,254K. June's Monthly Budget Statement deficit was $90.2 billion, leaving the fiscal deficit running 31% more to 2016. Consumer Credit expanded by $18.410 billion in May (and was increased from $8.197B to $12.929B for April). Foreign accounts added $57.3 billion to Treasury investments in May, and shifted $91.9 billion into longer maturities.

Monday (07/24) is set for the Markit PMI reports and Existing Home Sales for June. Tuesday brings Conference Board Consumer Conference, the FHFA House Price Index, S&P Case–Shiller home price data, and the Richmond Fed Manufacturing Index. Wednesday gives us MBA Mortgage Applications (which fell by 7.4% and then rose 6.30% over the past 2 weeks), New Home Sales for June, and the FOMC interest–rate policy decision for July.

Equities

Our stock cycles forecasted a low near July 5th, and improving upside energy from a low on July 18th. So far, equities shot higher from a low on July 6th, and then got another boost from a mild pullback into July 18th. These are not classic cycle swings, as there's a clear bias to the upside. The Nasdaq had fallen 4.10% from its June 9th high into that July 6th low, but has closed higher every day since then – hitting new highs since Tuesday. Even though the Dow Transports have fallen since their record high on Friday (07/14), within the past week most indices finally joined up in making new highs in concert. Trading volatility continues to demonstrate that investors have very little concern of any imminent or sizable down move. The next trend–change high is due August 1st. Last week, the Dow rallied 223.40 points or 1.04% to 21,637.74. It's .12% lower this week. The S&P gained 34.09 points or 1.41% to 2,459.27, and is .58% higher this week. The Nasdaq was the clear winner with a 159.39–point gain of 2.59% to 6,312.47, and it's followed through with 1.23% more upside this week. The Dow Transports rose .49%, but have tumbled 2.67% this week. Bank stocks lost .86%, and are 1.32% lower this week.

Resistance:	Dow:	21,587/ 21,661/ 21,736/ 21,808	Nasdaq:	6,398/ 6,438/ 6,478/ 6,518	S&P:	2,475/ 2,487/ 2,500/ 2,513
Support:		21,514/ 21,441/ 21,369/ 21,296		6,366/ 6,343/ 6,292/ 6,199		2,463/ 2,451/ 2,438/ 2,426

Other Markets

Crude Oil enjoyed another good week, rising 5.22%. It's .54% better this week. Commodities mirrored the move with gains of 2.16% and then 1.20% into today. Gold rose 1.47% and is up so far this week by that same percentage. The U.S. Dollar lost .90% last week, and is .86% lower this week to the lowest levels since August 2016. It's quite oversold at this point. The Japanese Yen rose 1.22% last week, and was .55% higher into today. The Euro gained .61%, and has risen 1.40% this week. Corn lost 4.45% last week, but has risen 7.05% this week. Cotton plunged 10.77% last week, but has recovered 3.53% this week.

"I am looking for a lot of men who have an infinite capacity to not know what can't be done." Henry Ford

Additional Information is Available on Request

Doug Ingram, Managing Director – Commerce Street Capital Management