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

# BOND MARKET REVIEW

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## The Emoji Economy

Equity markets may be getting a big–smile emoji, but economic growth has only a small grin. However, inflation expectations have emoted a puzzled look that's spilled over to a number of FOMC participants as well! (Add a head–scratch to that emoji.) The Atlanta Fed's GDP–Now forecast had finalized at 2.7% for Q2 2017, and it once again proved most prescient with Friday's Q2 release of 2.60%. Q1 was downgraded from 1.40% to 1.20%, so the average annual result for the first half of 2017 was only 1.90% – still in the moderate range. Personal Consumption looked better, having been revised from 1.10% to 1.90% for Q1, and hitting 2.80% for Q2. The GDP Price Index fell from 2.00% to 1.00%, and the core rate (ex food & energy) dropped from 1.80% to .90%. The Employment Cost Index fell from .80% to .50%. Another challenge to the Fed's contention that recently–lower prices were transitory came from the PCE Deflator being flat in June. The left the Personal Consumption Expenditures inflation measure .10% lower to an annual pace of only 1.40%. Moreover, core PCE rose .10%, but the annual pace remained at 1.50% – each well below the Fed's 2% target. Personal Incomes were flat in June, with spending rising only .10%. Real Personal Spending was deemed flat. The personal savings rate was adjusted to 3.6% for Q4 2016 – reaching the lowest level in 9 years (since Q4 2007). This expansion remains the slowest of any following World War II.

The service sector is the largest part of the U.S. economy, and it was pulling back in July – actually showing a weaker outlook than manufacturing. Though still positive (above 50), the ISM Non–Manufacturing gauge dropped from 57.4 to 53.9. That marked the weakest outlook for services since last August, and the largest decline since November 2008. The service–sector employment measure fell from 55.8 to 53.6, while manufacturing fell 2 points to 55.2. The early indicators for July payrolls were suggesting less strength than for June. The positives came from Challenger Job Cuts indicating 37.60% less cuts versus July 2016 and jobless claims which remained just above 43–year lows.

Recently weaker inflation data has caused the Fed (and other central banks) to rethink rate projections. There are a number of die–hard Fed members still contending that the situation is transitory, but bonds are once again siding with those that believe it to be entrenched for a longer period. (A few weeks ago, European Central Bank President Mario Draghi said the EU recovery was robust, and they would *"only have to wait for wages and prices to follow course."*) Now and then, the textbooks don't have all the answers. The **B**ond **M**arket **R**eview would say: 'There are hard facts of science, and then there's economic theory.' Though many Fed members still expect to begin to unwind their $4.5 trillion balance sheet 'relatively soon', they are coming to grips with the slower pace of inflation. This week, San Francisco FRB President John Williams said: *"We still have a ways to go in terms of inflation."* Williams still expects inflation to approach the Fed's 2% target over the next year or two, but that puts a damper on the gradual rate–hike plans of the FOMC. Loretta Mester (Cleveland) said she wanted to see more data, granting that there could be *"something more"* to recently–weaker results. The market–based odds are continuing to offer the Fed plenty of time to view incoming data, with the next meeting given any serious consideration for another rate hike still March 2018.

Incomes made little progress in June, and spending rose only .1%. That marked the 3rd month of slowing in spending. Disposable income dropped (for the first time in 2017) by .1%, after being adjusted for inflation. FRB St. Louis President James Bullard was siding more with bonds. He said: *"Given the inflation outlook, which has deteriorated in 2017, I would not support further moves in the near term."* So much for 'transitory!' Bullard said: *"We would do better to admit that we're in a low–interest rate, low–growth, low–inflation regime. We've got the right policy for that regime."* That said, Mr. Bullard won't be an active voter until 2019. Inflation may hold out for his term!

## Looking Ahead

- Bond yields should be lower into August 9th and August 15th. We expect yields to rise out of that window.
- The **BMR** equity cycles are mixed in August, with a late–month push to a high due near August 31st.

## Treasuries, Agencies, and MBS

The Treasury curve steepened last week, with yields rising by 1, 3, 5, and 8.5 bps for the 2, 5, 10, and 30–year sectors. Yields fell into today, with those sectors dropping by 1, 4.5, 7, and 10 bps. That larger improvement left the curve the flattest it's been since the end of June – with yields across the curve also the lowest since then. The 2 to 10–year Treasury spread declined from a 99–bps high on July 10th to only 88 bps today. Last week, MBS spreads (FNMA 30–year 3%) narrowed by 3 bps. Next week, the U.S. Treasury will auction $24 billion 3–year notes on Tuesday (08/08), $23 billion 10–year notes on Wednesday (08/09), and $15 billion 30–year bonds on Thursday (08/10).

| 07/28/17 Treasury Yield Curve | 2-Year: 1.349% | 5-Year: 1.835% | 10-Year: 2.290% | 30-Year: 2.896% |
|---|---|---|---|---|
| Weekly Yield Change: | +.007% | +.031% | +.052% | +.087% |
| Support: | 1.370/ 1.390/ 1.430/ 1.455 | 1.830/ 1.850/ 1.870/ 1.885 | 2.285/ 2.305/ 2.320/ 2.335 | 2.855/ 2.875/ 2.895/ 2.915% |
| Targets: | 1.345/ 1.330/ 1.310/ 1.290 | 1.800/ 1.780/ 1.765/ 1.745 | 2.245/ 2.225/ 2.210/ 2.195 | 2.835/ 2.815/ 2.795/ 2.775% |

## Economics

Initial Jobless Claims fell from 245K to 240K, and Continuing Claims rose only 3K to 1,968K. ISM Employment fell from 57.2 to 55.2, and ADP Employment Change came in 12K below expectations at 178K (though June data was revised 33K higher to 191K). Consumer confidence continued to improve modestly – following a pullback that had removed most of the surge following the election. Bloomberg Consumer Confidence rose 1 point to 49.6, its best reading since June. The University of Michigan Sentiment survey rose from 93.1 to 93.4. Current Conditions rose .2 to 113.4, and Expectations rose .3 to 80.5. ISM Manufacturing pared back 1.5 points to 56.3. Prices Paid rose from 55 to 62 and New Orders fell from 63.5 to 60.4. Kansas City Fed Manufacturing Activity dropped 1 point to 10, and the Chicago Purchasing Manager's report fell from 65.7 to a still–respectable 58.9. The Chicago Fed National Activity Index rose from –.3 to +.13, and Dallas Fed Manufacturing Activity was 1.8 points better to 16.8.

Pending Home Sales had fallen .70% in May, but were up 1.50% in June (and .70% higher to June 2016). Construction Spending fell 1.30% in June. Global Vehicle Sales did better in July, expanding from a 16.59M pace to 16.69M annual units. However, Domestic Vehicle Sales were flat at a 12.96M unit annual pace. Factory Orders rose 3.00% on a nice increase in aircraft demand, but were .20% lower ex transportation. Likewise, Orders for Durable Goods rose 6.40%, but only .10% ex transportation. Orders for Capital Goods were flat.

Friday is set for July payrolls with the associated earnings and unemployment data. Also due is the U.S. Trade Balance (deficit) for June. Next Monday (08/07) gives us the Fed's read on the July payroll numbers (Labor Market Conditions Index Change) and June Consumer Credit. Tuesday follows with NFIB Small Business Optimism and JOLTS Job Openings. Wednesday is set for MBA Mortgage Applications (which last week fell 2.80%), Q2 Nonfarm Productivity & Unit Labor Costs, and Wholesale Inventories and Trade Sales for June. Mortgage Delinquencies and MBA Mortgage Foreclosures for the second quarter are also due next week.

## Equities

Blue chips continued to lead the way with the Dow Industrials rising to new highs today – clearing 22,000 for the first time on Wednesday. The projected strength from July 18th through August 1st was evident in the Dow and the NYSE – which also made a new high on the Tuesday, August 1st. Though the Dow has risen for the past 8 trading sessions, overall momentum appears to be slowing. The S&P100 made a new high on Wednesday, but the Nasdaq and S&P made their highs last Thursday (07/27). The Dow Transports are lagging, having joined other indexes in making new highs into July 14th, but subsequently losing 6.68% into yesterday's low. The cycles turn more sideways from here, but shouldn't turn down with any significant energy (or follow through) until a high near August 31st. Into that expected high, there is another positive–energy push due from the 25th through the 31st.

Last Wednesday, volatility was the lowest in decades – indicating nearly all participants believed that stocks were in little danger of a significant selloff. The Dow gained 250.24 points or 1.16% to close at 21,830.31 last week, and it's .90% better this week. We have a nominal upside target of 22,138. The S&P lost .44 points or .02% to 2,472.10, and it's only 6 cents better this week (statistically flat). The Nasdaq lost 13.08 points or .20% to 6,374.68, and is .54% lower this week. The Dow Transports lost 2.58% (after dropping 2.79% the week before), and are .27% lower this week. Bank stocks rose .49%, and are outperforming most other sectors this week with a 1.13% gain.

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|---|---|---|---|---|---|---|
| Resistance: | Dow: | 22,078/ 22,138/ 22,227/ 22,302 | Nasdaq: | 6,362/ 6,393/ 6,421/ 6,461 | S&P: | 2,474/ 2,477/ 2,480/ 2,483 |
| Support: | | 22,004/ 21,930/ 21,840/ 21,784 | | 6,321/ 6,301/ 6,281/ 6,261 | | 2,468/ 2,465/ 2,462/ 2,459 |

## Other Markets

While the Dow was soaring to new heights, the Dollar was tumbling to the lowest levels since early May of 2016, and Crude Oil hit 2–month highs – rising on a nice trajectory from its June 21st low. Crude once again cleared $50/barrel this week – a level generally conceded to encourage new drilling and investment in the U.S. Crude surged 8.61% higher last week, but gave back 1.37% into today. Commodities rose 3.09%, but are off by .81% since Friday. Gold rose 1.08%, but fell .05% through today. The U.S. Dollar lost .60%, and appears headed for a 4th weekly loss with a .44% drop since Friday. The Japanese Yen rallied for a 3rd week, adding .40%, and is .57% better this week. The Euro gained .75%, and is 1.01 better this week – well on its way to a 4th weekly gain. Corn fell 1.45%, and is 2.87% lower this week. Cotton rose 1.56%, and is 1.89% better this week.

*"There's an old saying about those who forget history. I don't remember it, but it's good." Stephen Colbert*

***Additional Information is Available on Request***

Doug Ingram, Managing Director – Commerce Street Capital Management