Bond Market Review

August 10, 2017

An Inconvenient Downturn

While inflation is muted, it's speaking loudly! Though the FOMC was confident their policy had accomplished their mandates, a less–than–transitory bout of inflation has reemerged. Data through today continued to follow that pattern as Producer Prices fell .10% in July. Though it had been expected to rise by 2.20%, the drop reduced the annual pace from 2.00% to 1.90% (and .30% off trajectory). Those wholesale–price measures also fell .10% ex food & energy, dropping the core pace down from 1.90% to 1.80%. For asset appreciation and investment, low inflation is an unwelcome force – but for buying power it's to the advantage of the consumer (especially given weakness in wages).

This week, FRB St. Louis President James Bullard said: *"I think the FOMC has been surprised by inflation coming into the downside during the spring."* The **BMR** would add: And through the summer! He said the Fed should stand on rates for now, and that recent data *"call into question the idea that U.S. inflation is reliably returning toward target."* We'd say that's true – as it's recently been turning away from their target! Bullard said the Fed's expected balance sheet reduction plan would be so slow as to be *"almost nothing"* or have little effect on the markets. The market expectations for the next hike remain below 50% out to March 2018, but today dropped to 0% (or extremely remote) for the September meeting! Minneapolis' Neel Kashkari said inflation coming up short *"actually matters"*, and that people need to be able to believe in the Fed's credibility in achieving their goals.

The July payroll report was very good, though the Atlanta Fed's GDP–Now forecast for the 3rd quarter dropped from an initial 4.0% down to 3.7% after last Friday's data. They dropped the forecast again (to 3.5%) after Wednesday's data – specifically on slightly higher wholesale inventories. While 3.5% would still be great growth, we wonder if this quarter's projections will continue to diminish (as new data rolls in) on a similar trajectory to the falling estimates of those made for the 1st and 2nd quarters!

The assets that have seen appreciation have been global equities. However, a slowing in momentum left money chasing 'blue chips' while larger baskets of stocks and emerging markets failed to follow. There were days when some indexes were higher due to only 10% of their component stocks. While other indices began to trail, the Dow made new highs for 10 days in a row through Tuesday, having closed higher for 10 days in a row through Monday. Diverging away, the Dow Transports closed at their lowest levels since May 24th today, having peaked on July 14th. The Nasdaq retreated to its lowest level since July 12th. New York stocks and the S&P had their lowest closing levels since July 11th. The market–safety indicator (volatility), made a multi–decade low (indicating little chance of a major selloff) on July 26th – but today rose to the highest level since November 10th, rising over 44% today alone. On Tuesday, the day of the high, the Dow hit one of our longer–term targets of 22,138 – which we included in last week's **B**ond **M**arket **R**eview.

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

When we spoke of the Fed's determination to hike and the market's perception that stocks were the safest place to be in decades, we said: *"There was no allowance whatsoever for some surprise action by North Korea, or any other impactive event."* Despite improving economic numbers, bonds are siding with inflation. However, the safe–haven buy for U.S. Treasuries has now reappeared, with bonds receiving a 'flight to quality' bid. Last week, yields were .5 bps higher at 2–years, but the curve flattened with yields dropping 2, 2.5, and 5.5 bps for the 5, 10, and 30–year sectors. The curve continued to flatten into today and ended with the lowest 2 to 10–year spread since June 27th at .8708% (or 87 bps). Through today, yields had fallen 2.5, 4.5, 6.5, and 7 bps for the 2, 5, 10, and 30–year Treasury sectors. Our cyclic projections had called for yields to drop into the August 9th to 15th window. They've responded to that forecast, which would also argue for taking profits and/or hedging inventories (or portfolios) in this timeframe.

Last week, MBS spreads (FNMA 30–year 3%) narrowed by 1 bps. On Tuesday (08/08), the U.S. Treasury sold $24 bill 3–year notes at 1.52%. Demand was the highest since the October 2015 offering and the yield was the lowest since the June auction. The group that includes foreign central banks accounted for 64.1% of the issue versus 52.6% last month. Wednesday's 10–year note auction brought 2.25% for $23 billion in supply. Demand was the weakest since the November 2016 offering, and the yield was also the lowest since the June auction. Foreign buying dropped to 57.9% of the issue versus 64.8% in July. Today's offering of $15 billion 30–year bonds brought 2.818%. Demand was slightly higher to July, and the yield was the lowest since the 2016 elections.

30–year bond yields had soared from 2.626% on November 8th to 3.201% on March 10th. Yields then dropped to 2.68% into June 26th, and closed at 2.787% today.

08/04/17 Treasury Yield Curve	**2-Year: 1.353%**	**5-Year: 1.816%**	**10-Year: 2.263%**	**30-Year: 2.843%**
Weekly Yield Change:	+.004%	–.019%	–.027%	–.053%
Support:	1.340/ 1.365/ 1.395/ 1.430	1.790/ 1.805/ 1.825/ 1.845	2.225/ 2.265/ 2.290/ 2.320	2.815/ 2.835/ 2.855/ 2.875%
Targets:	1.310/ 1.290/ 1.275/ 1.260	1.755/ 1.735/ 1.720/ 1.700	2.185/ 2.160/ 2.140/ 2.105	2.775/ 2.755/ 2.735/ 2.715%

Economics

The data for jobless claims has been so stable that it's almost a non–story. Initial Jobless Claims rose 3K to 244K and Continuing Claims fell 16K to 1,951K. Over the past year, food stamp usage has dropped in 46 of the 50 states. Moreover, food stamp use just fell to the lowest levels in 7 years. July payrolls beat expectations of adding 180K jobs with a 209K increase (and 9K added to June for a 231K result). Private sector payrolls increased by 205K. Manufacturing surprised with a 16K pickup and a revision from only 1K to 12K for June! The U.S. Unemployment Rate fell from 4.40% to 4.30%, and with the Labor Force Participation Rate rising from 62.80% to 62.90%, the result was statistically more sound. The Underemployment Rate remained at 8.60%. Average Hourly Earnings rose .30%, though the annual pace remained at 2.50%. Average Weekly Hours were steady at 34.5. JOLTS Job Openings was a big positive as the June numbers rose by 461K (the most in nearly 2 years) to a record 6.163 million positions waiting to be filled. NFIB Small Business Optimism rose from 103.6 to 105.2, and Bloomberg Consumer Comfort jumped 1.8 points to 51.4. Nonfarm Productivity rose .90% in the second quarter, and Unit Labor Costs increased by .60%.

Household debt expanded to a record $12.7 trillion in the first quarter, having finally risen above the 2008 level (from before the financial crisis). However, in June, Consumer Credit rose only $12.397 billion (versus $15.75b expected) – due to a slower rise in non–revolving debt. Wholesale Inventories rose .70% in June, and Trade Sales matched that increase. The Trade Balance deficit narrowed in June to $43.6 billion from May's $46.4 billion shortfall, as U.S. exports increased by the most since the end of 2014. The Monthly Budget Statement's July deficit was around $9 billion less than anticipated at $42.9 billion. However, fiscal 2017's deficit is running 10.6% above 2016.

Friday is set for Consumer Prices (July CPI), along with data on Weekly and Hourly Earnings. More inflation data comes next Tuesday (08/15) with July Import Prices. Other releases for Tuesday include Empire Manufacturing, Retail Sales, home–builder outlook (NAHB Housing Market Index), June Business Inventories, and foreign Treasury flows and operations (also for June). Wednesday brings MBA Mortgage Applications (which rose 3.00% last week), July Housing Starts & Building Permits, and the minutes from June's FOMC meeting.

Equities

The Dow Industrials rose 262.50 points or 1.20% last week to 22,092.81 – leading most markets. Despite hitting new highs on Tuesday, and fulfilling our upside target of 22,138, the Dow is 1.13% lower this week. The S&P has risen only 4.73 points or .19% to 2,476.83, but is 1.56% lower now since Friday. The Nasdaq had fallen 23.11 points or .36% to 6,351.56, and is off another 2.12% this week. While the Dow Transports had risen .55%, they are 1.70% lower this week. Bank stocks rallied 2.09% last week, but gave it all back through today with a 2.92% loss so far this week. As we said last week, *"there is another positive–energy push due from the 25th through the 31st."* After August 31st, the cycles are significantly weaker.

Resistance:	Dow: 21,907/ 21,981/ 22,055/ 22,128	Nasdaq: 6,273/ 6,338/ 6,393/ 6,434	S&P: 2,452/ 2,465/ 2,474/ 2,484
Support:	21,831/ 21,757/ 21,684/ 21,608	6,195/ 6,156/ 6,117/ 6,078	2,434/ 2,423/ 2,415/ 2,403

Other Markets

Commodities dropped .79% last week, and fell another .98% into today. Following some nice gains, Crude Oil fell .26% last week, and was off 2.00% into today. Gold dropped .80% last week, but rallied 2.02% into today – along with bonds also seeing a safe–haven bid on North Korea's continued threats against the U.S. and its territories. The U.S. Dollar rose .32% last week, but was .12% lower into today. The Japanese Yen slipped .01% last week, but is 1.35% higher this week. The Euro gained .19%, but is .01% lower this week. Corn fell 2.07%, and is off another 2.52% this week. Cotton gained 1.10%, but has fallen 2.44% this week.

"I have always felt that a politician is to be judged by the animosities he excites among his opponents."
Sir Winston Churchill

Additional Information is Available on Request
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