BOND MARKET REVIEW

September 04, 2017

A Tale of Two Cities

It was the worst of times for both Houston and Mumbai. We visited India and missed the eclipse, but not the flooding. It was the worst to hit Mumbai since 2005 and it hampered our return. Coincidentally, it was in 2005 that Hurricane Katrina struck our Gulf Coast (on August 29th). On Thursday night, we flew into Memphis into the much–weakened eye of Harvey. Power outages and debris were widespread – even though the winds had diminished below 40 mph. Compared to Houston though, it was a mere nuisance. Before the storm, the Houston economy was progressing nicely, as oil production had rebounded. It's probably the case that the higher storm–driven fuel prices will lead to some inflation over the next few months, but there are also forces that continue to work against higher prices. Last week, Amazon began to cut prices at Whole Foods by as much as 43%. The damage from hurricane Harvey will be a setback to the economy and a great hardship to many Americans. However, we saw the American spirit at work as people came together for comfort and rescue efforts. Within a few months, the rebuilding efforts should provide a boost to the economy. Though the path can change, hurricane Irma is now a category 5 on track to threaten Florida by the end of the week with winds already reading 180 mph.

We're a little suspect of payroll data that comes very early in the month, so with the release coming on the 1st we expect numerous revisions next month. One of the first effects we expect to see from Harvey is an almost–unavoidable increase in jobless claims. That will probably linger for a number of months. August jobs had some early promise as the ADP Employment Change showed private payrolls rising by 237K versus 185K forecast – though Challenger Job Cuts rose 5.10% (more cuts) versus last year. Nevertheless, August payrolls disappointed with a 156K increase versus 180K expected. Additionally, 41K jobs were removed from the totals for June and July. Private payrolls countered the ADP data by coming in at 165K, 7K less than forecast. A bright spot came from manufacturing. The ISM factory index rose from 56.3 to 58.8 – showing growth at the fastest pace since 2011. New Orders fell only .1, but the Employment measure rose from 55.2 to 59.9 – the highest reading since June 2011. Friday's payroll reports confirmed that recent strength with a pickup of 36K manufacturing jobs versus only 8K expected, and an upward 10K revision to July's numbers! The Unemployment Rate ticked up from 4.30% to 4.40%. The Labor Force Participation Rate was steady at 62.90% and the Underemployment Rate was unchanged at 8.60%. Unfortunately, Average Hourly Earnings were also flat at 2.50% annually, and only .10% higher in August. Average Weekly Hours fell by .1 to 34.4.

Looking Ahead

- Bond yields should be higher into September 7th, and then peak near October 4th.
- The **BMR** equity cycles show a possible rise from 9/11 to 9/15, but extreme weakness into October 19th.

Treasuries, Agencies, and MBS

Not only did Texas sustain major hurricane damage with another major hurricane now threatening Florida, but North Korea continues to test missiles and develop more potent warheads – with threats to use them. With their firing of a missile over Japan, the threat to the entire region and U.S. allies has escalated. Our bond cycles remain the same, though a safe–haven bid has kept yields from rising. If stocks fall from here, that should also serve to keep yields relatively low. On Tuesday, 10–year yields dropped to the lowest levels since the election.

Speaking to the larger picture, the **B**ond **M**arket **R**eview said: *"Our bond cycles lead us to conclude that higher inflation targets will continue to elude the Fed! After a peak near October 4th, the cycles project that yields could be lower into February 2018."* Though it's far too early to make a call, since August 28th the market–based odds for the next Fed hike shifted from March out to June 2018. Though volatile, the net yield changes have been within 3 bps from week to week since August 18th. Into Friday, yields rose 1 and 3 bps at 2 and 30–years, fell 2 bps at 5–years, and were flat at 10–years. MBS spreads (FNMA 30–year 3%) were flat the previous two weeks, but narrowed 1 bps last week.

Last Monday (08/28), the Treasury sold $26 billion 2–year notes at 1.345%. Demand was the lowest since the April auction, and the yield was the lowest since the May offering. Foreign participation (including central banks) fell to 45.8% from 58.5% in July. On that same day, $34 billion 5–year notes were sold at 1.742%. Demand was the same as in July, and the yield was the lowest since last October's (2016) offering. Foreign buying remained very high, falling only .7% to 69.1% of the issue. On Tuesday, $28 billion 7–year notes drew a bid of 1.941% – also the lowest yield since October. Demand was off versus July, but foreign buying rose from 67.7% then to 68.8% of this offering. Next week, the U.S. Treasury will auction 3–year notes on Monday (09/11), 10–year notes on Tuesday (09/12), and 30–year bonds on Wednesday (09/13).

09/01/17 Treasury Yield Curve	**2-Year: 1.344%**	**5-Year: 1.739%**	**10-Year: 2.167%**	**30-Year: 2.778%**
Weekly Yield Change:	+.009%	–.019%	–.000%	–.031%
08/25/17 Treasury Yield Curve	**2-Year: 1.335%**	**5-Year: 1.758%**	**10-Year: 2.167%**	**30-Year: 2.747%**
Weekly Yield Change:	+.028%	–.003%	–.028%	–.030%
08/18/17 Treasury Yield Curve	**2-Year: 1.307%**	**5-Year: 1.761%**	**10-Year: 2.195%**	**30-Year: 2.777%**
Weekly Yield Change:	+.011%	+.017%	+.005%	–.009%
Support:	1.320/ 1.355/ 1.370/ 1.395	1.705/ 1.740/ 1.775/ 1.810	2.125/ 2.165/ 2.195/ 2.235	2.735/ 2.775/ 2.815/ 2.860%
Targets:	1.285/ 1.275/ 1.260/ 1.245	1.645/ 1.615/ 1.585/ 1.555	2.075/ 2.060/ 2.025/ 1.999	2.700/ 2.655/ 2.615/ 2.580%

Economics

Q2 GDP was revised .40% higher to 3.00% as Personal Consumption was revised from a 2.80% increase to 3.30%. The effects from hurricane Harvey (and potentially Irma) could reduce GDP for Q3, but rebuilding should step up the 4th quarter. (We expect a North Korea–driven arms race to have an impact as well.) The GDP Price Index remained at 1.00% for Q2 and core PCE rose .90%. Inflation remained in check in July as the PCE (Personal Consumption Expenditures) Deflator rose .10%, leaving the annual pace at 1.40%. The core (ex food & energy) also rose .10%, but the annual core pace fell from 1.50% to 1.40%. In Jackson Hole, European Central Bank President Mario Draghi signaled that their QE exit would be very slow. German Finance Minister Wolfgang Schaeuble said: *"We hope that interest rates will rise again."* Of course, they will – but maybe not just yet. (Is hope a strategy?)

In July, Personal Income rose .40% and Personal Spending rose .30%. American's savings rate fell .1% to 3.5% – the lowest this year. Over the past 2 weeks, Initial Jobless Claims rose 3K to 235K, and then 1K to 236K. The coming results should begin to show the effects of the hurricane's aftermath. Continuing Claims were flat at 1,954K, and then 12K lower to 1,942K.

Two weeks ago, Bloomberg Consumer Comfort rose .7 to a 16–year high of 52.8. Current views of the economy were also the highest since April 2001. This index then rose for a 7th straight week to hit another 16–year high (53.3) in last Thursday's release. The 7–week gain was the strongest in nearly 11 years. The Conference Board Consumer Confidence measure rose from 120 to 122.9. The Present Situation index rose from 145.4 to 151.2 – the highest level since July 2001. Expectations rose from 103 to 104. University of Michigan Sentiment rose from 93.4 to 96.8, and Expectations rose from 80.5 to 87.7. However, their survey of Current Conditions saw a drop from 113.4 to 110.9. The Richmond Fed Manufacturing Index was flat at 14 and Chicago Purchasing Managers was unchanged at 58.9. The Chicago Fed National Activity Index dropped from .16 to –.01. However, Kansas City Fed Manufacturing Activity rose 6 points to 16, and Dallas was .2 better to 17.

After good results for the first half of 2017, New Home Sales dropped 9.37% in July to a 571K annual pace (and the lowest this year). That was also 13.35% lower to last year's results. Slimming inventories were leading to price gains. The FHFA House Price Index rose .10% in June, and overall home prices accelerated from 5.69% to 5.77%. Metro home prices (S&P Case–Shiller 20–city) rose by .11% in June, but the annual pace of gains slowed from 5.74% to 5.65%. Those results are of course outpacing wages and other inflation indicators. Higher prices and low inventories are squeezing the housing industry. Pending Home Sales fell by .80%, and were .50% lower versus last year. Sales of Existing Homes fell to an 11–month low with a 1.27% decline to 5.44M (annual) units. Inventories of homes for sale fell 9% versus last year for the 26th annual decline. The House Price Purchase Index rose 1.60% in the second quarter. On a more positive note, in the second quarter, MBA Foreclosures fell from 1.39% to 1.29%, and Mortgage Delinquencies declined from 4.71% to 4.24%. Construction Spending fell .60% in July.

In July, orders for Durable Goods fell 6.80% – the most since August 2014. (Note they had surged 6.40% in June on aircraft orders.) Ex transportation, orders rose .50%. Capital Goods Orders rose .40%. July Retail Inventories fell .20% while Wholesale Inventories rose .40%. August Vehicle Sales fell from a 16.69M pace to 16.03M. Domestic sales dropped from a 12.96M pace to 12.48M.

Tuesday is set for July Factory, Capital, and Durable Goods Orders. Wednesday brings MBA Mortgage Applications (which fell by .50% and 2.30% for the past 2 weeks), the July Trade Balance (deficit), the Fed's Beige Book, and the service–sector outlook (ISM Non–Manufacturing). Thursday gives us jobless claims data, Q2 Nonfarm Productivity and Unit Labor Costs, and Bloomberg Consumer Comfort. Friday is set for July Wholesale Inventories and Consumer Credit. Next Tuesday (09/12) brings NFIB Small Business Optimism and JOLTS Job Openings for July.

Equities

Once again, the Labor Day seasonal cycle worked as stocks rose to 3–week highs into the long weekend – with some indices rising close to record highs. Our cycles are now turning very negative for stocks, so in our estimation increasing caution is warranted! The Dow Industrials fell .84% into the 18th, but rose .64% and then .80% (or 173.89 points) last week to 21,987.56. The Nasdaq gained .79% into August 25th, and then rose 169.69 points or 2.71% to 6,435.33. The S&P gained .72% and then added 33.50 points or 1.37% to 2,476.55. The Dow Transports rose .42% and then surged 2.43% last week. Bank stocks rose 1.03% into the 25th, but were .55% lower last week.

Resistance:	Dow:	21,889/ 21,965/ 22,038/ 22,082	Nasdaq:	6,414/ 6,448/ 6,493/ 6,534	S&P:	2,472/ 2,479/ 2,490/ 2,498
Support:		21,772/ 21,674/ 21,608/ 21,549		6,374/ 6,334/ 6,294/ 6,246		2,461/ 2,454/ 2,441/ 2,430

Other Markets

Commodities rose .19% into the 25th, and then added 1.75% last week. Crude Oil dropped 1.32%, and then fell 1.21% last week for a 5th drop. Gold gained .53% and 2.64% over the past 2 weeks. Exchange rates on the U.S. Dollar fell to 2–year lows as the currency fell .73% into the 25th. The Dollar rose .10% last week. The Euro surged 1.39% into the 25th, but fell .54% last week. The Japanese Yen fell .16%, and then dropped another .81% last week. Corn fell 3.76%, and then rose .37% last week. Cotton gained 1.21%, and then surged 5.74% last week.

"Keep five yards from a carriage, ten yards from a horse, and a hundred yards from an elephant; but the distance one should keep from a wicked man cannot be measured." Indian Proverb

Floods from the worst monsoon since 2005 caused over 1,200 deaths around Mumbai, and headlines said that hurricane Harvey dumped around 50 inches of rain on Texas with a volume of roughly 11 trillion gallons of water – enough to fill the Great Salt Lake more than twice!

The Washington Post noted that Harvey had possibly caused a 1000–year flood event. This was an excerpt:
"Just how unprecedented is this? Well, remember the flooding that New Orleans experienced with Hurricane Katrina? Most places saw about 10 to 20 feet of water thanks to levee failure, inundating about 80% of the city. Now, if we took the amount of rainfall that Texas has seen and spread it over the city limits of New Orleans, it would tower to 128 feet in height — roughly reaching as high as a 12–story office building."

Our thoughts and prayers are with Texas and all those affected. With hurricane Irma already reaching a monster category 5 with winds around 180 mph, we're concerned about Florida and another Gulf Coast event as well. We never know which way these storms will go. Hopefully, given the chance, more residents will evacuate the path.

Additional Information is Available on Request
Doug Ingram, Managing Director – Commerce Street Capital Management