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Bond Market Review

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The Fed Takes a Hike

The FOMC left interest rates unchanged, but decided to 'walk away' from reinvesting maturing assets. We would contend that the great unwind of the Fed's $4.47 trillion balance sheet is far more significant in the removal of accommodation than a few rate hikes. However, at their initially–intended pace of $10 billion per month, it would take over 37 years to unwind their gargantuan balance sheet! (Note: Their plan is to increase the pace by $10 billion each quarter until reaching $50 billion a month.) Only two weeks ago, yields on 10–year notes were just above 2% as North Korea was threatening the U.S. and its allies, hurricane Harvey had done its damage, and Irma was approaching Florida. Hurricane Irma did less damage than was feared, relieving some market angst. However, yields are now sharply higher, and traders seem convinced that the Fed will not only begin to unwind asset purchases in October, but also hike rates again in December. Last week, the **B**ond **M**arket **R**eview reported that at least two Fed officials were wary of more hikes without further evidence of wage gains, economic growth, and inflation hitting nearer FOMC targets. There was no dissent to this vote, but voting–members Lael Brainard and Neel Kashkari had been quite vocal in saying the Fed should be on hold until incoming data provided further evidence that it was time to move forward. Kashkari had commented that the existing hikes might be *"doing real harm"* to economic growth. That said, Fed Chair Janet Yellen still holds the bully pulpit and turned very hawkish in tone this week.

Thus, the largest buyer of U.S. bonds is going to be backing away. Make no mistake, the loss of the Fed as a buyer of U.S. Treasuries and mortgage–backed securities should lead to higher rates and increasing interest–burden costs. The removal of this Quantitative Easing tool is a form of tightening in itself – as it removes stimulus. Even with surging stocks and higher yields, the problems that existed a few weeks ago are still with us. North Korea is threatening to test more–potent nuclear weapons and missiles with greater range. Hurricane Maria knocked out power to Puerto Rico and caused severe structural damage, and Jose and Maria still threaten the mainland. The Fed was careful to note that: *"Hurricanes Harvey, Irma, and Maria have devastated many communities, inflicting severe hardship. Storm–related disruptions and rebuilding will affect economic activity in the near term, but past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term."*

Yellen said she couldn't say that the FOMC clearly understood the causes of the shortfall in inflation, calling it *"more of a mystery."* She then said the shortfall was *"due to transitory factors that are likely to disappear over the course of this year."* The **BMR** found the puzzlement and the conclusion to be at odds. In their statement, the Fed said: *"Higher prices for gasoline and some other items in the aftermath of the hurricanes will likely boost inflation temporarily."* That made it sound like a bump up in inflation would also be considered transitory – so which is it?

Though the Dow closed lower today after making its 6th record high in a row, Wednesday marked the 7th record close for the Dow – and its 9th straight gain. While that's most promising, in our opinion some of the incoming data and the remaining unknowns concerning the storm damage (and what may still come) should have caused more concern to the FOMC. Instead, Yellen said they wanted to be sure the economy didn't overheat! Industrial Production showed that factory output declined by .90% in August, and that Capacity Utilization fell by .80% to 76.10%. We were more concerned with Retail Sales. Not only was the pre–storm .60% gain for July cut in half to .30%, but sales declined by .20% in August! Ex autos, sales rose .20%. The Atlanta Fed's third–quarter 'GDP now' forecast dropped from 4.0% in early August to 2.2% – far from overheating.

Looking Ahead

- Bond yields should move higher into a peak near October 4th, and top from another peak near the 20th.
- The **BMR** equity cycles project a low near September 28th, and a selloff from October 12th to the 20th.

Treasuries, Agencies, and MBS

Last week, yields rose a stout 12, 17, 15, and 10 bps for the 2, 5, 10, and 30–year sectors. Into today, they were again higher by 6, 8, 7.5, and 3.5 bps. That put the 10–year at 2.28%, 23 bps higher than the 2.05% from just two weeks ago. 2–year yields soared from 1.26% to 1.44%. The market expectations for the next rate hike had moved out to next September only a few weeks ago – given North Korean threats and disastrous weather scenarios. They pulled into June on the 11th, to March by the 13th, and then to this December this week (as the Fed's dot plots indicated by an 11 to 5 margin), pushing that month above 63%. Last week, MBS spreads (FNMA 30–year 3%) fell by 6 bps.

09/15/17 Treasury Yield Curve	2-Year: 1.382%	5-Year: 1.806%	10-Year: 2.203%	30-Year: 2.770%
Weekly Yield Change:	+.118%	+.172%	+.151%	+.100%
Support:	1.450/ 1.475/ 1.500/ 1.530	1.886/ 1.923/ 1.957/ 1.992	2.288/ 2.327/ 2.367/ 2.408	2.835/ 2.875/ 2.918/ 2.963%
Targets:	1.400/ 1.375/ 1.350/ 1.320	1.853/ 1.819/ 1.783/ 1.748	2.249/ 2.213/ 2.184/ 2.144	2.760/ 2.716/ 2.687/ 2.652%

Next week, the U.S. Treasury will auction $26 billion 2–year notes on Tuesday (09/26), $34 billion 5–year notes on Wednesday (09/27), and $28 billion 7–year notes on Thursday (09/28).

Economics

While we know there will be many challenges – mostly in Texas, Florida, and U.S. territories in the Caribbean, the last few weeks of jobless claims data have been encouraging. Initial Jobless Claims decreased from the almost–300K level of 298K last week to 282K. Today's data (reflecting numbers into September 16th) fell to 259K – showing more resilience in labor than most would have anticipated. Continuing Claims fell from 1,951K to 1,936K, but then rose to 1,980K (in data that trails a week for September 9th). Bloomberg Consumer Comfort fell for a third straight week, dropping from 52.6 to 51.9, and then to 50.6 with today's release. Bloomberg Economic Expectations dropped from 54 to 51.5. The Leading Index rose .40% in August. Empire Manufacturing slipped from 25.2 to 24.4, but the Philadelphia Fed Business Outlook rose from 18.9 to 23.8. Business Inventories rose .20% in July.

The Fed finally got some higher reads on inflation from August Consumer Prices, which rose by .40%. It was the first month to meet expectations after five misses. The annual CPI pace quickened from 1.70% to 1.90%. The core result (ex food & energy) rose .20%, though the annual core pace remained at 1.70%. However, the pace of annual wage increases dropped a little. Average Weekly Earnings fell from 1.10% to .90% (year–over–year), and Average Hourly Earnings rose .60% versus .70% in July. Import Prices rose .60%, but were revised from a .10% gain to a .10% drop for July. Nevertheless, the annual pace jumped from 1.20% to 2.10%! Foreign entities withdrew a net $7.3 billion in Treasury transactions for July, though longer–term holdings increased by $1.3 billion. The U.S. Current Account Balance deficit for the 2nd quarter was about $7 billion more than expected at $123.1 billion.

Homebuilder optimism fell from 67 to 64. The current sales component dropped 4 points to 70 for the largest drop in 3 years. The 6–month sales outlook declined by 4 points as well (the most since November 2015). Construction costs have been steadily increasing since mid–2015, and the FHFA House Price Index rose .20% in July. Housing Starts fell .84% in August to 1,180K units, because July numbers were revised from 1,155K to 1,190K. Building Permits rose 5.69% to 1,300K units. Existing Home Sales fell 1.65% to a one–year–low 5.35M–unit annual pace.

Friday is set for the PMI manufacturing and services outlooks. Next Monday (09/25), brings the Chicago Fed National Activity Index and Dallas Fed Manufacturing Activity. Tuesday gives us S&P Case–Shiller home price data, August New Home Sales, Conference Board Consumer Confidence, and Richmond Fed Manufacturing. Wednesday updates MBA Mortgage Applications (which fell 9.70% last week after rising 9.90% the week before), Durable and Capital Orders for August, and Pending Home Sales (also for August).

Equities

The Dow powered 470.55 points or 2.16% higher last week to 22,268.34. We expected a rally from the 11th to the 15th, but stocks also continued higher this week – despite a cycle that still shows weakness into October 20th, followed by another drop into the end of December. The Dow was .41% higher into today. The S&P gained 38.80 points or 1.58% to 2,500.23, and is .01% better this week. The Nasdaq rose 88.28 points or 1.39% to 6,448.47, but is .40% lower after today's drop. The Dow Transports gained 1.73% and then added 1.29% into today. Bank stocks rose 4.04% and are 3.56% better this week – returning to the highs of early August.

	Dow:	Nasdaq:	S&P:
Resistance:	22,412/ 22,479/ 22,553/ 22,629	6,437/ 6,457/ 6,478/ 6,497	2,508/ 2,521/ 2,533/ 2,546
Support:	22,275/ 22,181/ 22,104/ 22,033	6,398/ 6,378/ 6,358/ 6,338	2,497/ 2,484/ 2,465/ 2,447

Other Markets

Crude Oil's recent rally has taken it once again above the $50/barrel level. We expect another wave up from around September 25th into a more important high due near October 17th. Crude rose 5.08% last week, and is 1.32% higher this week. Commodities gained 1.59% last week, but are .36% lower this week with Gold losing 1.93% last week and then falling 2.32% this week. After a large 1.56% loss 2 weeks ago, the U.S. Dollar rose .59% last week and is .20% better this week – given higher rates. The recently–volatile Japanese Yen gained 2.19% 2 weeks ago and then tumbled 2.77% last week. It's fallen 1.49% this week. The Euro lost .76% last week, and is off .03% this week. Corn rose 3.05%, but is 1.27% lower this week. Cotton dropped 7.22%, and was off another 1.55% into today.

"Don't fall before you're pushed." English Proverb

Additional Information is Available on Request

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