BOND MARKET REVIEW

October 12, 2017

Flatliners

As the Unemployment Rate began to fall following the financial crisis, Fed members told us that 5% to 5.25% represented a level they deemed as 'full!' It obviously got more so, and had been flatlining much lower at 4.3%–to–4.4% over the past 5 months. However, the September level reached a new 'full' in falling to 4.2% – despite a loss in jobs! Economists are now attempting to quantify the effects of the storms, and what jobs and their trajectory would have been without them. 4.2% is the lowest reading since February 2001. The low for this era occurred in April 2000 at 3.8%, a month after stocks had surged to new highs – as they're doing now. The Nasdaq high made that March wouldn't be exceeded until June 2015! Additionally, that 3.8% in April 2000 was the lowest since 1969.

FRB San Francisco President John Williams said the 4.2% meant *"we've not only reached the full employment mark, we've exceeded it!"* How do you do that? If we are really at 'full employment' – how can I know folks without a job, or struggling with income? Sure, one may always get a job flipping hamburgers, but even then – that may not be 'full employment' at a personal level. To get 40 hours or more with those kind of jobs, you may need multiple employers. The opportunity for hours may be limited due to the still–existing health–care–act employer mandates, and your income won't be what you expected – but the nation will be even 'more' fully employed by 'plus one.' The data may look to be improving, but you won't be replacing previously–better income, and you may not even be able to meet your monthly obligations. The 'quality' of jobs doesn't appear to be anywhere near as good as those of the 3 decades coming into the financial crisis. For that reason, the **B**ond **M**arket **R**eview will not be all too impressed with low unemployment data until the limit on hours is removed and we really see some sustained wage increases.

The economy lost 33,000 jobs in September. Though highly due to the storms – something that should indeed be transitory – that was the weakest job performance since the 52K loss of September 2010. Despite that slowdown, the Fed is still determined to hike rates in December. In fact, the odds for a December move remained in the high 70%–range, even after the drop in payrolls. Those are the kind of odds you'd see for Oklahoma over Iowa State, Michigan over Michigan State, or LSU over Troy, but things don't always come off as planned! This past weekend, Hurricane Nate hit the gulf states, and there was a lot of damage, but the effects compared to Harvey, Irma, and Maria left it 'shorted' in the news cycle – like O.J. Simpson being released from prison. Local leaders in Texas, Florida, Puerto Rico, and the gulf coast have surely altered their forecasts – and some Fed members have as well. Early last week, the Atlanta Fed GDP–Now forecast for Q3 had risen from a low of 2.1% to 2.9% on manufacturing and services data. However, their projection fell back to a still–respectable 2.5% following the weak September payroll report. Are we to believe the Fed won't consider that and other incoming data? We've seen evidence that coaches that don't adjust to their opponents, or to injuries on their own team, can fail to make good decisions. Arrogance doesn't win games, nor will a Fed predisposed to policy moves – despite natural disasters and questionable data.

Looking Ahead

- Our bond cycles show yields falling from a high near October 20th.
- The **BMR** equity cycles project a downtrend from October 12th to the 20th.

Riddle Me This

I'm always in front of you, but you can never see me! What am I? The answer is the future! The Fed is continually bewildered by things that their textbooks don't explain or solve. While none of us know what will be, the brain trust expects certain actions to bring about expected results. For instance, lower inflation numbers are not just temporary because you say they are! The Fed wondering why inflation won't go up is a little like the rationalization we might use for staying in an alternative or losing investment. We can vehemently argue that the price of our venture should be rising, but if we had an analyst – they'd term it denial! The Fed instead calls it a mystery – as if UFOs were at fault. If not the Twilight Zone or Outer Limits, maybe it's Russian tampering? Mystery is just another word for something we don't understand. We'd say: If you don't understand it, how do you make the case that it's temporary?

The Fed's September minutes said they expect a fourth–quarter rebound. However, FRB St. Louis' John Bullard said the jobs report was clearly weaker than expected and it caused him *"some concern."* He was also taken aback by the market's *"little bit too nonchalant"* reaction to the payroll report. He's one of the members that would not raise rates with inflation not meeting goals. He said: *"I'm getting more concerned that we might make a policy mistake."* Though the FOMC meeting, statement, and dot–plot projections seemed more hawkish, the minutes had a dovish twist that was a little unexpected. The Fed acknowledged that employment may be *"temporarily depressed"* by the storms, but said the effects of the weather was *"unlikely to materially alter"* the economy's course.

The minutes said: *"Many participants expressed concern that the low inflation readings this year might reflect not only transitory factors, but also the influence of developments that could prove more persistent."* The 'persistence' we see is on the part of the Fed – insisting certain data is transitory, when that belief might be more opinion than fact. If not, why has the temporary transitory period been with us for so long? To that end, FRB Chicago's Charles Evans said the inflation data has *"been disappointing."* Numerous members have made the case that inflation should rise as a result of full employment. Once again, because the textbooks say so! Evans said *"low inflation is a global environment, so the whole world is dealing with transitory effects."* It may be the case that it's transitory, but we can't just 'assume facts not in evidence.' He said he was really nervous that inflation expectations are low. At least Evans thinks *"it's too early to say"* if the FOMC should hike in December. We do know that, given the Feds dot plots, most are in the hike camp – assuming the numbers and data will catch up by then.

Treasuries, Agencies, and MBS

Our shorter–term yield cycles have already peaked, though the longer–term ones show a downturn from October 20th. Last week, yields rose by 2, 2, 2.5, and 3.5 bps for the 2, 5, 10, and 30–year Treasury sectors. Yields were mixed into today with 2–year rates 1 bps higher, while the longer sector yields dropped 2, 4, and 4.5 bps.

Last week, MBS spreads (FNMA 30–year 3%) were flat. The U.S. Treasury auctioned 3 and 10–year notes on Wednesday. $24 billion 3–year notes came at 1.657% – the highest yield since the April 2010 auction, as the front end of the curve continued to price in additional Fed rate hikes. Demand was the best since August, and the group that includes foreign central banks stepped up to take 54.3% of the issue (versus 46.2% in September). For the 10–year notes, $20 billion was added to the August 2027 maturity at 2.346%, with foreign interesting growing from 55.3% last month to 69.1%. Demand was better versus last month. Today's 30–year note auction saw $12 billion also added to the August maturity (though 2047) at 2.87%. Demand rose to last month, and the yield was the highest since July. Foreign buying rose from 58.8% last month to 62.8% of this offering. The Treasury will auction 2–year notes on Tuesday (10/24), 5–year notes on Wednesday (10/25), and 7–year notes on Thursday (10/26).

10/06/17 Treasury Yield Curve	2-Year: 1.506%	5-Year: 1.957%	10-Year: 2.360%	30-Year: 2.894%
Weekly Yield Change:	+.020%	+.020%	+.026%	+.034%
Support:	1.530/ 1.545/ 1.565/ 1.580	1.960/ 1.995/ 2.021/ 2.056	2.357/ 2.395/ 2.435/ 2.475	2.885/ 2.950/ 2.945/ 2.968%
Targets:	1.495/ 1.470/ 1.455/ 1.435	1.925/ 1.900/ 1.867/ 1.840	2.318/ 2.275/ 2.243/ 2.202	2.845/ 2.820/ 2.788/ 2.765%

Economics

September payrolls disappointed, but Initial Jobless Claims fell from 258K to 243K – the lowest result going back to the weeks preceding the series of devastating storms. Continuing Claims fell from 1,921K to 1,889K, marking the least on benefits since December 1973! Payrolls fell by 33K for the first (and worst) drop since September 2010. Restaurants and bars suffered a 105K decline. Though 13K were added to August numbers, the 2–month revision was a 38K loss. Private Payrolls fell 40K versus an expected 75K gain! Manufacturing, which had been growing nicely, dropped by 1K. The U.S. Unemployment Rate fell from 4.40% to 4.20%. Average Hourly Earnings rose .50% and the annual pace showed some promise, quickening from 2.70% to 2.90%. Average Weekly Hours remained at 34.4, and the Labor Force Participation Rate rose from 62.90% to 63.10% (another good sign). The Underemployment Rate fell from 8.60% to 8.30%. JOLTS Job Openings had fallen from 6,140K to 6,082K in August as less positions were waiting to be filled. NFIB Small Business Optimism fell from 105.3 to a 10–month low of 103 as the storms also took their toll on that outlook. Bloomberg Consumer Comfort fell .4 to 49.5 – the lowest since late July.

August Consumer Credit fell from a revised $800M–lower $17.717 billion in July to an increase of $13.065 billion (versus $15.54 billion expected). Wholesale Inventories rose .90% in August, and Trade Sales were 1.70% higher. Producer Prices rose .40% in September, giving the Fed a little ammo for their cause. The annual PPI pace quickened from 2.40% to 2.60%. PPI ex food & energy also rose .40%, with the annual core pace rising from 2.00% to 2.20%.

The Monthly Budget Statement is due over the next few days. Friday gives us more inflation reads from Consumer Prices (September CPI) and Weekly Earnings. We'll also get September Retail Sales, the University of Michigan surveys, and August Business Inventories. Next Monday (10/16) brings Empire Manufacturing, and Tuesday follows with September Import Prices, Industrial Production, Capacity Utilization, home–builder outlook (NAHB Housing Market Index), and Treasury International Capital Flows. Wednesday is set for MBA Mortgage Applications (which fell by 2.10% last week), September Housing Starts & Building Permits, and the Fed's Beige Book. Thursday is set for September's Leading Index and Friday brings Existing Home Sales for September. The following Wednesday (10/25) is set for September New Home Sales and the next **B**ond **M**arket **R**eview.

Equities

Prices were due to turn down today, and they were lower, but only modestly. Our equity cycles show weakness into October 20th, though we're more keyed into a very important low expected near December 28th. We'd feel content to stand on the sidelines until then, and if prices are indeed lower into that date – use that window to accumulate. The Dow Industrials surged 1.65% or 368.58 points higher to 22,773.67 last week, and are .30% better this week. Many U.S. and global indices made new highs today (or yesterday), though most U.S. indexes closed lower today. However, the Dow Transports continued to surge higher, losing .28% last week, but rising 1.53% this week to a new record today. The S&P added 29.97 points or 1.19% last week to 2,549.33, and was still ahead by .06% through today. The Nasdaq gained 94.22 points or 1.45% to 6,590.18, and was .02% ahead for the week after today's trading. Bank stocks rose 1.50% last week, but were lower by 1.38% so far this week.

Resistance:	Dow:	22,885/ 22,961/ 23,037/ 23,113	Nasdaq:	6,608/ 6,628/ 6,649/ 6,670	S&P:	2,555/ 2,568/ 2,580/ 2,593
Support:		22,809/ 22,734/ 22,652/ 22,584		6,587/ 6,566/ 6,548/ 6,513		2,543/ 2,531/ 2,518/ 2,505

Other Markets

Commodities lost 1.17% last week, but erased the loss with a 1.28% gain into today. Crude Oil had fallen 4.61%, but is 2.66% higher since Friday. Gold lost .77%, but was 1.71% better into today. Many of those changes were counter the U.S. Dollar, which rose .82% last week, but lost .79% through today. The Japanese Yen lost .12%, but was .33% higher so far this week. The Euro was also counter the Dollar, losing .71% and then gaining .85% this week. Corn fell 1.48%, and is .29% lower this week. Cotton rose .56%, but then lost 2.35% through today.

"We must not allow the clock and the calendar to blind us to the fact that each moment of life is a miracle and mystery." H. G. Wells

"If it weren't for my lawyer, I'd still be in prison. It went a lot faster with two people digging!"
Joe Martin, Mister Boffo

Additional Information is Available on Request

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