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Bond Market Review

October 30, 2017

Ghost of a Chance

There were a number of sure things in store for this week. For instance, Alabama wouldn't lose and the Fed would skip a chance at a rate hike on November 1st – despite heavy expectations for actions in December. You couldn't bet on Alabama – as the Crimson Tide had a bye, and this Wednesday – the Fed is widely expected to take one as well! The market–based odds for a November move have been consistently below 1%, while the expectations for a hike in December have been oscillating between 80% and 87% for the past 2 weeks. Of course, they'll meet into Wednesday, but much like Congress – decide to do nothing, and wait until later. The larger concern continues to be the naming of the next Fed Chair. While stocks fear for nothing, bonds seem fearful of every event – especially if the tone of the Fed might change. The three finalists for the Fed Chair are considered to be the current holder, Janet Yellen, Stanford University economist John Taylor, and Fed Governor Jerome Powell. Taylor is considered the most hawkish.

President Trump quipped that he and Yellen are *"obviously doing very well together if you look at the markets."* However, he also said you'd *"like to make your own mark"* which implied he wanted to choose his own person. It's widely expected that Trump will make his choice known on Thursday, and that Powell will receive the nod. Even if Janet Yellen is not chosen as the Chair, she can remain a Fed Governor to serve out her 10–year term.

It's a scary week for bonds, as the Fed is set to announce policy and address the continued unwinding of their balance sheet! However, the biggest worry is probably a change in the Fed Chair – as that ushers in a major unknown. With rates rising to 7–month highs (or in the case of short rates to 9–year highs), bonds were already spooked! Other concerns are from special counsel Robert Mueller bringing charges in dealings with Russia, the October payroll reports due on Friday, recent flatness in the Treasury curve, and an increase in trading volatility.

A Double Dose of a Half–full Glass

While we all know bonds love uncertainty, they at times hate it! The thought of replacing the Fed Chair in the midst of a tightening phase is shaking the debt markets. However, stocks just don't care. They don't see things as 'half full' or 'half empty', but rather as filled to the brim with no chance of a spill. Equity volatility has been very low, and stock bullishness is at a 30–year high! The cup of the equity investor indeed 'runneth over'. We don't see things as half anything – we'll just add ice to the existing amount and go with it. That's our 'cold and calculating' way to deal with a cyclic picture that calls for an important stock–market low in late December. We would lighten stock holdings!

Looking Ahead

- Our bond cycles show yields generally lower into November 15th.
- The **BMR** equity cycles project a major low near December 28th, and a minor low on November 2nd.
- The FOMC will announce their November interest–rate policy on Wednesday (11/01) at 2 p.m. ET.
- Roll those clocks back an hour early Sunday morning (at 2 a.m.)!

Treasuries, Agencies, and MBS

The U.S. Dollar just had its best week since last November with a 1.33% gain, given the Fed unwinding their balance sheet and the thoughts that the next Fed Chair might be even more aggressive in raising rates. EU (and Japanese) bonds continue to trade at negative yields – making recently–higher yielding U.S. debt even more attractive. The U.S. Treasury yield curve reached a very flat 2–to–10–year spread of a mere 75.2 bps on Tuesday, October 17th. That was the most–narrow reading since mid–2016, but it was really tied with those levels in reaching the flattest curve since November 2007. The **B**ond **M**arket **R**eview believes longer U.S. rates won't rise in tandem with shorter rates because of the value versus foreign alternatives. It's also the case that flat and/or inverted curves often precede recessions.

The Fed's Beige Book saw the labor market as tight, but with only modest wage gains. There were many challenges in Florida due to the length of time to restore services (leading to downtime for businesses). Richmond, Atlanta, and Dallas noted disruptions from the storms. All districts reported growth, though at the now–familiar 'modest to moderate' rate. The Monthly Budget Statement for September showed an $8 billion surplus, but fiscal 2017's deficit rose to $665.7 billion versus the $585.6 billion shortfall for 2016. That made fiscal 2017 the largest deficit since 2013. Keep in mind that each 25 bps rise in rates eventually adds about $50 billion in debt service to the nation's $20 trillion plus deficit. The Fed's earlier 4 presumptive 25– bps hikes (which now looks to be 3) would add roughly $200 billion of debt burden (eventually) to each coming year's budget shortfall.

10/27/17 Treasury Yield Curve	**2-Year: 1.590%**	**5-Year: 2.029%**	**10-Year: 2.407%**	**30-Year: 2.918%**
Weekly Yield Change:	+.012%	+.008%	+.022%	+.020%
10/20/17 Treasury Yield Curve	**2-Year: 1.578%**	**5-Year: 2.021%**	**10-Year: 2.385%**	**30-Year: 2.898%**
Weekly Yield Change:	+.083%	+.120%	+.111%	+.092%

Yields kicked off this week with a little improvement as traders perceived a little less trouble in coming events. Yields for the 2–year sector fell by 1.5 bps while longer yields dropped roughly 3.5 bps. Yields had fallen by 1, 5.5, 8.5, and 9 bps for the 2, 5, 10, and 30–year Treasury sectors into October 13th, and then reversed 8.5, 12, 11, and 9 bps higher into the 20th – which was when the cyclic energy for higher yields peaked. This past week, yields for those sectors were modestly higher by 1 bps out to 5–years, and 2 bps for longer maturities. 2–year notes hit their highest levels (1.62% last Thursday) since October 2008, while 5 and 10–year yields rose back to highs not seen since March – when it was widely expected that the Fed would hike rates 4 times in 2017. In August, overall a net $125 billion flowed into Treasuries from foreign operations. $67.2 billion was invested in longer term issues.

MBS spreads (FNMA 30–year 3%) narrowed by 2 and 1 bps over the past 2 weeks. Last Tuesday (10/24), the U.S. Treasury sold $26 billion 2–year notes at 1.596% – which was the highest auction yield since October 2008! Demand was the lowest since March, and the group that includes foreign central banks bought 48.2% of the issue versus 44.2% in September. Incidentally, while U.K. 2–year yields are around .47%, most EU yields continue to be negative. Swedish, Dutch and German yields are roughly –.76%, and Japan's are –.015%. Most of the leading EU 5–year yields (as well as Japan's) are also still negative. Over the past decade, the wide spread between U.S. and EU debt has prevented a larger selloff in U.S. bonds. On Wednesday (10/25), $34 billion 5–year notes came at 2.058%. Demand was off to last month, and foreign buying dropped from 69.6% of September's issuance to 61.6%. Thursday's (10/26) 7–year note sale brought 2.28% for $28 billion in supply. The awarded yield was the highest since January, and demand fell to the lowest since August 2016! Foreign buying dropped from 70.6% last month to 63.4% for Thursday's auction. Next week, the Treasury will auction 3–year notes on Tuesday (11/07), 10–year notes on Wednesday (11/08), and 30–year bonds on Thursday (11/09).

10/13/17 Treasury Yield Curve	**2-Year: 1.495%**	**5-Year: 1.901%**	**10-Year: 2.274%**	**30-Year: 2.806%**
Weekly Yield Change:	–.011%	–.056%	–.086%	–.088%
Support:	1.590/ 1.615/ 1.632/ 1.655	2.030/ 2.066/ 2.098/ 2.134	2.406/ 2.425/ 2.450/ 2.490	2.895/ 2.927/ 2.947/ 2.972%
Targets:	1.555/ 1.530/ 1.500/ 1.480	1.995/ 1.960/ 1.925/ 1.890	2.370/ 2.330/ 2.300/ 2.274	2.860/ 2.834/ 2.804/ 2.788%

Economics

The preliminary read on third–quarter GDP came in at a better–than–expected 3.0%! With Q2 reading 3.10%, the consecutive quarters were the best since 2014. Consumer spending was also .30% more than anticipated as Personal Consumption grew by 2.40%. The GDP Price Index rose 2.20% and the core increase for PCE (Personal Consumption Expenditures) rose 1.30%. The jobs front continued to look good, and to move beyond the weather–related setbacks beginning in late August. A week ago, Initial Jobless Claims fell from 244K to 223K – the lowest since March 1973. They rose only 10K above that level to 233K this week. Continuing Claims had fallen from 1,904K to 1, 896K, and then 3K lower to 1,893K this week (for the first 2 weeks of October). That was the lowest level since December 1973.

Personal Spending rose 1.00% in September, as the storms led to a surge in auto purchases. That was the largest jump since August 2009. Incomes rose only .40%, leaving the savings rate at 3.1% – the lowest since December 2007. September Retail Sales surged by 1.6%, following August's .10% drop. That was the largest gain since March 2015 and largely attributed to the storms. Auto purchases surged by 3.6% (also rising the most since March 2015). Ex autos, Retail Sales rose 1.00%, and were revised from a .20% increase for August up to .50%. After a 3–week decline, Bloomberg Consumer Comfort rose from 49.5 to 51.1, and then fell a modest .1 to 51. Economic Expectations fell from 51.5 to a 3–month low 47.5. The University of Michigan surveys showed sentiment rising from 95.1 to 100.7. Their gauge of current conditions rose from 111.7 to 116.5, the best level since November 2000. Expectations were the best since January 2015, rising from 84.4 to 90.5.

Inflation indicators undershot estimates, but were higher, as September Consumer Prices rose .50% – and the annual pace quickened from 1.90% to 2.20%. Ex food & energy, CPI rose .10%, leaving the core annual pace unchanged at 1.70%. Real Average Weekly Earnings slowed from 1.00% annually to .60%, and Real Average Hourly Earnings were unchanged at a .70% annual pace. Import Prices rose .70%, taking the annual pace from 2.10% to 2.70%. Ex Petroleum, prices rose only .30%. The PCE Deflator rose .40% in September, hiking the annual pace from 1.40% to 1.60%. However, the core pace rose only .10%, (like CPI) leaving the annual pace unchanged at 1.30%.

Business Inventories rose .70%, Wholesale Inventories rose .30%, and Retail Inventories fell 1.00%. The preliminary results for September showed Durable Goods Orders rising by 2.20% – easily beating expectations of only 1.00%. Ex transportation, they rose .70%. Orders for Capital Goods rose 1.30% (versus only .30% expected). The nation's merchandise trade deficit rose from $63.3 billion to a 4–month high $64.1 billion. In September, factories saw their first production increases since June. Industrial Production rose .3% after a .7% drop in August). Capacity Utilization rose .20% (from 75.8% to 76.0%). The Leading Index fell .20% in September, and Richmond Manufacturing dropped from 19 to 12. However, most other production gauges improved.

The Chicago Fed National Activity Index rose from –.37 to .17, the Philadelphia Fed Outlook rose from 23.8 to 27.9, Empire Manufacturing rose from 24.4 to 30.2, Kansas City gained 6 points to 23, and Dallas rose from 21.3 to 27.6.

Homebuilder optimism rose from 64 to a 5–month high of 68 (NAHB Housing Market Index). The 6–month sales outlook was the best since 2005. The FHFA House Price Index rose .70% in August. Sales of New Homes surged 18.89% in September (from 561K to a 667K annual pace). That was the best result since October 2007, with sales in the South up 25.8%. Existing Home Sales rose a modest, but still steady .75% to 5.39M units. However, Pending Home Sales showed no improvement, and were down 5.40% versus last year for the largest annual drop since April (which was attributed to the storms hampering sales). Housing Starts were also affected by the storms. They fell 4.73% in September to 1,127K. Building Permits were off by 4.48% to 1,215K.

Tuesday (10/31) closes out October trading with the Q3 Employment Cost Index, S&P Case–Shiller home price data, Chicago Purchasing Managers, and the Conference Board confidence surveys. Wednesday kicks off November with MBA Mortgage Applications (which were up 3.60% and then down 4.60% over the past 2 weeks), October Vehicle Sales, September Construction Spending, and ISM Manufacturing data. Wednesday's ISM Employment and ADP Employment Change releases will provide the first clues into Friday's reports on October payrolls. The November FOMC Rate Decision is due at 2 p.m. ET. No changes are expected. More input into October payrolls follows on Thursday with additional jobless claims data and Challenger Job Cuts. Other data includes Nonfarm Productivity and Unit Labor Costs for the third quarter, and Bloomberg Consumer Comfort. Friday gives us the breakdown on October payrolls with the Unemployment Rate and other related data. Other scheduled releases for Friday include the September Trade Balance (deficit), the service–sector outlook (ISM Non–Manufacturing Composite), and September Factory, Durable Goods, and Capital Goods Orders.

Equities

Our equity cycles expected a low on the 20th, but stocks instead surged into that date. It's always troubling when the bond and stock cycles are not synching well, and with yields expected higher into the 20th – it was difficult to view a selloff in stocks as also likely. However, we've done way too much work on the cycle models that took us decades to create to attempt to second guess them! So, we always print the projections of that process – and not our personal opinion. The cycle low we expect near December 28th is far more important, and still very much a possibility.

The Dow broke through 23,000 on Tuesday (10/17), and then gapped above that watermark. Though the Dow made its high to date on Tuesday (10/24), many indexes stretched to new highs on Friday. Stocks are becoming a bit mixed though, as the Dow Transports and some smaller–cap indexes are lagging. Into October 20th, the Dow gained 2.00%, and it was 105.56 points or .45% higher to 23,434.19 by the end of the week. The S&P gained .86%, and then added 5.86 points or .23% to 2,581.07 by Friday's close. The Nasdaq rose .35% and then was buoyed by a 2.20% gain on Friday to end the week 72.21 points or 1.09% higher to 6,701.26. Before that Friday rally, the Nasdaq appeared to be leading other indexes to the downside. The Dow Transports gained .36%, but lost that this past week in falling .41%. Bank stocks gained 2.32% and then another 1.05% last week. That rally left bank stocks at their highest levels since November 2007, and after plunging 85.24% into their March 2009 low, they were within 15.5% of their all–time highs. Stocks were generally lower today with the Nasdaq falling only .03%, but the S&P dropping .32% and the Dow losing .36%. The Transports took a 1.30% plunge, and bank stocks lost .46%.

Resistance:	Dow:	23,481/ 23,556/ 23,636/ 23,787	Nasdaq:	6,724/ 6,743/ 6,765/ 6,806	S&P:	2,576/ 2,583/ 2,589/ 2,595
Support:		23,328/ 23,249/ 23,175/ 23,050		6,681/ 6,642/ 6,601/ 6,572		2,571/ 2,565/ 2,558/ 2,552

Other Markets

The markets seem convinced that the next Fed Chair will continue to tighten, and with the EU continuing their asset purchases while our Fed is beginning to unwind their balance sheet, the U.S. Dollar has been the beneficiary of a continued bid – until today (it fell .39%). Into October 20th, the Dollar rose .69%, and it gained 1.33% this past week for its strongest showing since last November. The Japanese Yen lost 1.52% and then .13%, but was .43% higher today. The Euro had lost .30% and then 1.49%, but also rose .37% today. Commodities lost .39%, but then rose 1.51% this week as Crude Oil gained 4.72% after having risen only .04% the week of the 20th. Commodities were .34% higher today as Crude rose .46% to $54.15. We have a $58.85 short–term target for Crude Oil, and our longer term is in the $74.90 to $76 range. Gold lost 1.85% and .70% reflecting the strength of the Dollar, but was .73% higher today. Corn lost 2.34%, but then gained 1.23% last week. Corn was unchanged today. Cotton had also sold off into the 20th, losing 2.54%, but was 1.97% higher this week, and up .65% today.

"Nobody believes the official spokesman ... but everybody trusts an unidentified source." Ron Nesen

Additional Information is Available on Request

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