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BOND MARKET REVIEW

December 14, 2017

Rate Wars: Return of the Dissenters

As the Fed was raising its 'Mission Accomplished' banner in hiking rates on Wednesday, there were 2 voices of dissent – which could easily have been a third, had FRB St. Louis President James Bullard been a voter. The Fed likes to have as much consensus as possible on policy moves, and this is the first time since 2008 there have been 2 dissents on an actual hike or cut. Since those 2008 votes were 8–to–2, the 7–to–2 vote this week represented the lowest approval percentage for any move going back to at least 2002. The statement said: *"Voting against the action were Charles L. Evans and Neel Kashkari, who preferred at this meeting to maintain the existing target range for the federal funds rate."* Rather than the 4 hikes anticipated for 2018, the Fed's Dot Plot showed only 3 are now expected.

While it's unclear just where 'full employment' really is, given the still–low Labor Force Participation Rate remaining at 62.70%, it's undeniable that the economy is doing much better and the repeat of 17–year–low 4.10% is a significantly–low Unemployment Rate – even if that number might be somewhat higher in reality. While the **B**ond **M**arket **R**eview doesn't see the economy as currently being in danger of overheating, the last time GDP growth was above 3% for 3 quarters was Q1 2006. The Atlanta Fed GDP–Now forecast rose back to 3.3% today – allowing for that possibility! GDP hasn't been above 3% annually since 2005, and there's at least a (long) shot at that result.

The Fed said labor market conditions *"remain strong"*, and that even after a 25–bps hike, *"monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2% inflation."* However, they also acknowledged that measures of inflation compensation remain low and that: *"On a 12–month basis, both overall inflation and inflation for items other than food and energy have declined this year and are running below 2%."*

Much of the recent economic data has been surprising to the upside, and November Payrolls and Retail Sales were no exception. Retail Sales were expected to rise .30%. In the release, October's results were revised higher by that much – from .20% to .50%, and the November number surged by .80%! Ex Autos, sales rose 1.00% (with October results revised from .10% to .40%). 11 of the 13 retail sectors had gains. A core measure of Retail Sales advanced the most in 3 years. Confirming those results, Wholesale Inventories fell .50%, while Trade Sales rose .70%. Also, October Consumer Credit rose $3.5 billion above expectations, increasing by $20.519 billion on credit–card debt. Though 195K jobs were expected to be added in November, Nonfarm Payrolls grew by 228K. October's results were revised 16K lower to 244K, but the 2–month revision was a 3K positive. Private Payrolls grew by 221K, and Manufacturing added 31K. The Underemployment Rate rose from 7.90% to 8.00%. However, wage pressures are still showing weakness. Average Hourly Earnings rose .20%, but actually fell .10% in October (revised from no gain). The annual result for earnings was .10% less to 2.30% in October, but it increased to 2.50% for November – versus 2.70% expected. Average Weekly Hours rose .1 to 34.5.

Looking Ahead

- Interest rates should be generally lower into a trend–change near December 22nd.
- The **BMR** equity cycles project a turndown into month end (near 12/28).

Treasuries, Agencies, and MBS

Rates rose last week as the 2, 5, 10, and 30–year sectors were higher by 2.5, 2.5, 1.5, and .5 bps – flattening the curve. Into today, more flattening occurred with 2–year yields higher by 1.5 bps, 5–year yields slightly lower, and the 10 and 30–year sectors dropping by 2.5 and 6 bps. The curve fell today very close to its flattest levels (just under 54 bps) since October 2007. MBS spreads (FNMA 30–year 3%) narrowed by 1 bps last week.

On Monday (12/11), the U.S. Treasury sold $24 billion 3–year notes at 1.932%. Demand was the strongest since the September 2015 auction, and the yield was the highest since the June 2009 offering. The group that includes foreign central banks bought 59.0% of the issue, versus 53.5% in November. Also coming Monday, to place the auctions ahead of Wednesday's FOMC meeting, the Treasury sold $20 billion 10–year notes at 2.384%. (The supply was added to the previous November 2027 maturity.) Demand was the lowest since September, and that yield was the highest since May. Foreign buying was 57.2%, compared to 68.0% last month. The 30–year bond also added to the previous November (2047) issue, with $12 billion coming at 2.804%. Demand was higher to last month, and the yield was the highest since October's issue. Foreign buying rose from 61.8% last month to 61.9% of this auction.

12/08/17 Treasury Yield Curve	2-Year: 1.797%	5-Year: 2.141%	10-Year: 2.377%	30-Year: 2.769%
Weekly Yield Change:	+.024%	+.027%	+.015%	+.007%
Support:	1.860/ 1.875/ 1.895/ 1.920	2.190/ 2.208/ 2.242/ 2.281	2.379/ 2.395/ 2.417/ 2.436	2.737/ 2.777/ 2.806/ 2.832%
Targets:	1.830/ 1.800/ 1.780/ 1.755	2.138/ 2.103/ 2.069/ 2.039	2.357/ 2.345/ 2.337/ 2.315	2.698/ 2.658/ 2.618/ 2.578%

Economics

Initial Jobless Claims fell 2K to 236K last week, and then dropped back very near 43–year lows to 225K this week. Continuing Claims fell from 1,960K to 1,913K, and then dropped to 1,886K this week. As we said earlier, November payrolls were very good, despite Challenger Job Cuts showing a 30.10% increase in firings versus November 2016. September job openings rose to a record 6.177M, but they eased to 5.996M in October. President Trump 'tweeted' on Tuesday that confidence and the stock market were at record highs, and unemployment was at 17–year lows. Only 2 of those were correct. He was immediately chastised by the media, which did research to show there were higher confidence levels just before the tech crash under Clinton, and some higher numbers under Nixon and Johnson as well. That said, the across–the–board results are the highest since the early 2000s, so he's on the right side of recent history. We all need to look before we leap – or tweet.

Nevertheless, the numbers are very good. NFIB Small Business Optimism increased from 103.8 to 107.5 – the best outlook since November 2004. CFO optimism just rose from 65.9 to a 13–year high 68.6 (the best since June 2004). Last week, Bloomberg Consumer Comfort rose from 51.6 to a 13–week high 52.3. It eased back to 51.3 this week. University of Michigan Sentiment dropped from 98.5 to 96.8, while their measure of Current Conditions rose from 113.5 to 115.9. Expectations fell from 88.9 to 84.6.

Producer Prices rose .40%, increasing for a third month in November. That took the annual PPI number from 2.80% to 3.10% (the highest since January 2012). Ex food & energy, PPI rose .30%, though the annual core pace remained at 2.40%. Consumer Prices rose .40%, with the annual pace increasing from 2.00% to 2.20%. Core CPI rose .10%, leading to a drop in the annual pace from 1.80% to 1.70%. Real Average Weekly Earnings rose .80% and Hourly Earnings rose .20%. Import Prices rose .70%, with the annual pace quickening from 2.30% to 3.10%. Ex petroleum, prices rose only .10%. Export Prices were .50% higher. The budget deficit for November came in at $138.5 billion. Two months in, the fiscal deficit is 10.6% higher versus last year. October Business Inventories fell .10%.

Friday is set for Empire Manufacturing, Industrial Production, Capacity Utilization, and (TIC) International Treasury Flows. Next Monday (12/18), reveals home–builder confidence (NAHB Housing Market Index). Tuesday brings November Housing Starts & Building Permits, and the Current Account Balance for Q3 2017. Wednesday gives us MBA Mortgage Applications (which were off by 2.30% last week) and Existing Home Sales for November.

Equities

The Dow made a new high today, but closed lower. While the Nasdaq's high remains back on November 28th and the Transports peaked on the 4th of December, most other U.S. indexes made highs on Wednesday before turning lower for the past 2 days. Bank stocks tied their 2017 highs on Tuesday before also turning lower for the past 2 days. Last week, the Dow gained 97.57 points or .40% to 24,329.16. It's .74% better this week. The S&P gained 9.28 points or .35% to 2,651.50, and is ahead this week – but only by .02%. The Nasdaq lost 7.51 points or .11% to 6,840.08, but is up .24% this week. The Dow Transports rose 2.12% (for a third strong week), but are .72% lower this week. Bank stocks rose 1.89%, but are 1.58% lower this week. As we said in last week's **BMR**, we continuously update our cyclic models, and they still point to a tradable low near month end (12/28).

Resistance:	Dow:	24,672/ 24,831/ 24,989/ 25,145	Nasdaq:	6,912/ 6,936/ 6,956/ 6,977	S&P:	2,678/ 2,691/ 2,704/ 2,717
Support:		24,514/ 24,362/ 24,203/ 23,915		6,874/ 6,854/ 6,834/ 6,812		2,665/ 2,653/ 2,640/ 2,627

Other Markets

Our Crude Oil cycles had a low due today, but that could extend out until the 21st – as another component of the cycle is starting to dominate. After the 21st, the cycles turn up into January. Crude lost 1.71% last week, and was .56% lower into today. Commodities reflected those losses with a 2.97% loss last week, and a .43% drop into today. Gold lost 2.63%, but was .69% higher into today. The U.S. Dollar gained 1.11% last week, but fell .42% into today as the Fed's forecast for future hikes dropped a little (indicating only 3 hikes instead of 4 for 2018). The Japanese Yen dropped 1.17% last week, but was .96% higher into today. The Euro fell 1.03%, but was only .04% higher into today. Many unknowns remain about the timing of the U.K.'s Brexit and how long the European Central Bank will maintain stimulus. Corn lost 1.38%, and another 1.10% this week. Cotton lost 2.27%, but then rose 2.18% into today.

"Duct tape is like the force. It has a light side, a dark side, and it holds the universe together ..." Carl Zwanzig

Additional Information is Available on Request

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