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Bond Market Review
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The BMR 2017 Year–End Review and Forecasts for 2018

2017 – The Running of the Bulls

Most of the bowl games were exciting, with the outcome in question until the last snap. The stock market might as well have been the New England Patriots playing against a high school. The bulls snorted ever higher while the bears hibernated. 2017 turned out to be the year that kept on giving, and those betting that stocks were the safest play in decades were right. Week to week, numerous **BMR** issues reported and repeated the same news – new record highs!

Just how bad would the markets drop under President Trump? They were expected to be very negative, if only from a greatly–unexpected election result! From the **(BMR 11/09/16)**: *"As global traders were trying to position for just how bad a Trump victory would be, they sold Dow futures off by 861 points (or 4.71%) versus the Tuesday close. S&P futures also traded over 5% lower. As Trump was celebrating his win and acknowledging a gracious call from Hillary Clinton, traders had decided the Dow should be only 400 points lower. By the end of the day, the Dow reversed nearly 1,200 points off those panic lows to close the day 257 points higher to Tuesday's close. What a ride."*

Not only was it a wild ride, it was the last sign of any real selling! The 5.02% correction in the S&P that ended on November 4th, 2016 was the last one over 2.95% since the election. Those overnight results didn't spill over to the day session and, since Election Day, the Dow has risen 39.51%, the Nasdaq 38.86%, and the S&P is 29.35% higher. In keeping with our weekly themes, most U.S. indices kept making new highs into today!

The **BMR** market cycles were good for bonds and crude oil, but after the seasonal upmove into Labor Day – stocks went non–cyclically higher with little resistance. Despite hurricanes, North Korean threats, rate hikes, and extremely negative press for the President, it was onward and upward. Even the bitter cold failed to stall the rally which continued into the new year. When studying cycles, there's always a chance to see an impact for the 4–year cycle which was not bad – as 2013 was a good year following an election. The longer–term cycles can also come into play, and we were a bit weary of the 20–year cycle, given the 1987 October crash. The 16–year cycle is sometimes more dominant, and 2001 also had a large downmove following the end of the tech–bubble which was exacerbated by the September 11th terrorist attacks. That said, we'll continue to provide yield and price targets as well as the cyclic position of the markets. When the cycles became less effective earlier this year, we wrote a 'Cyclic Update' which is included in this year–end issue. After all, even the effectiveness and efficacy of cycles is cyclic! Heavily depending on cycles can also lead to missing the participation in runaway bull or bear markets – as it did for the end of 2017.

What could go wrong? Are stocks overbought? Yes – but they can stay that way a long time, and have! John Maynard Keynes contended: *"Markets can remain irrational for longer than you can remain solvent."* – meaning you can't fight a runaway market and/or that you can lose everything trying to short a bubble! Earlier this year, we reported that the market–safety indicator (volatility) fell to a multi–decade low indicating little chance of a major selloff. So far, it was right. World stocks are close to a record–longest streak of the most trading days without a 5% correction, and the MSCI World index is the most overbought since 1987! The S&P only needs a few more weeks of upside or stability to break the longest string of trading days without a 5% correction since 1965 and 1996. While the S&P is off to its best start in 30 years, bonds have been 'thumped' and the 2–year Treasury yield has risen above the S&P dividend yield. Bullish sentiment is the highest in over a decade at a 95% extreme. Advisor bullishness is at a 31–year high, and funds are sitting on very–low cash. What happens when there's no one else to buy? Nevertheless, a matador has only one bull to fight. However, when you're running with the bulls, the odds favor the bulls. When market optimism is 95% bullish, a bear is outnumbered 19 to 1. Without a good exit strategy, the bear is endangered.

Looking Ahead

- U.S. debt and equity markets will be closed on January 15th for the Martin Luther King, Jr. holiday.
- Equities have a trend–change low due near January 26th.
- Interest rates should be lower into January 16th, and then higher into month end.

Economic data and confidence improved throughout the year! President Trump was criticized for a lack of higher job creation – as the economy added 2.06 million workers in 2017, while 2.24 million were added in 2016. Was it a low year for jobs? It could just be diminishing returns. The economy began the year with 4.8% unemployment, and ended with 4.1%. With the Fed having contended over the years that 5% to 5.25% is a jobless level described as indicative of 'full employment', how much 'more' full are we now? Meanwhile, criticism of the new tax rates and President Trump also continued to rise. There's concern for how much the new tax rates are hurting the economy, but most of us have yet to see even a payroll check for 2018 (with or without a cut).

The minutes from the FOMC December meeting revealed the Fed thought economic activity remained strong and was improving. They expect inflation to rise from a period of sluggishness, and plan to proceed with additional hikes – though no clear plan was set forth. Chicago FRB President Charles Evans would have preferred to delay hikes until *"inflationary issues resolve themselves."* He and Minneapolis' Neel Kashkari dissented to the December increase. Evans and Kashkari have concerns that there's a perception that the Fed's 2% inflation target is a ceiling (rather than a zone the FOMC would be comfortable with). There are at least 3 other 'doves' in the mix. Atlanta's Raphael Bostic is for *"continuing a slow removal of policy accommodation."* St. Louis' James Bullard said he would prefer to leave rates on hold and Philadelphia's Patrick Harker said: *"I want to be slow and steady with any additional rate increases."* He also said 2 hikes would be appropriate.

Harker said the Fed shouldn't do anything that *"would precipitate any inversion of the yield curve."* At this point, 2 hikes would do just that – unless 10–year yields begin to move higher! Like the **BMR**, Harker doesn't see imminent danger of the economy running too hot. The Atlanta Fed GDP–Now forecast for Q4 2017 had been as high as 3.3% in mid–December, but eased back to 2.8% this week. The market–based odds for a January FOMC increase have been near 0% for the past weeks, while the March meeting chances for a hike have hovered from 70% to 82%.

Treasuries, Agencies, and MBS

Granted, bonds broke some important support this week, but 10–year yields are still holding just below their post–election highs. 30–year yields are well below their late–2016/early–2017 highs. In fact, while stocks soared ever higher, 30–year yields closed the year only 11 bps above Election Day levels and 46 bps off the 2017 highs. By our work, the 10–year yield must break 3.05% from its current 2.53% reading to signal an accelerating bear market. Otherwise, we are still sideways, backing and filling, and just had the lowest 2–to–10–year spread (on January 4th at 50 bps) since October 2007! Did we see the lowest 10–year yield in this last cycle? That's highly probable, but it doesn't mean yields are going to surge from here.

BMR (03/02/17): "There are longer–term forces in play that still have a say in the great unwinding of waves of lower lows in yields that have occurred in interest rates from a 10–year reading of 15.84% in September 1981 into the low of 1.336% last July. It was that new low, also confirmed by the 30–year bond, that kept the longer charts still 'in trend.' Coincidentally, the **BMR** was screaming 'refi' from June to August last year (2016) as our long–term yield cycles were making interim lows."

Fundamentally, wage inflation is still weak, price inflation is less transitory than the Fed would like, and U.S. debt offers a significant spread to quality global alternatives. With the U.S. Dollar dropping from 103.5 to 92 since the end of 2016, those that accepted negative yields on some foreign bonds made up nearly 11% in currency arbitrage. If that pendulum has swung all the way, we could see a reversal that would add to the bid for U.S. debt. On the other hand, it's also the case that energy prices could begin to pressure prices higher and tax cuts could allow companies to be more competitive with wages. To that end, one large retailer raised its minimum wage today!

For shorter maturities, it's a different story. This week, 2–year yields rose to their highest level (at 1.98%) since September 2008, and 5–year yields hit their highest levels (at 2.35%) since April 2011. The Fed can steer and sway short rates, but market forces dictate the yields on longer debt. There are (at least) two significant drawbacks for U.S. bonds. Besides the Fed's ongoing campaign to raise rates, they are shrinking their balance sheet by allowing increasing levels of their holdings to mature without reinvesting the proceeds. That removes a huge buyer from the Treasury and mortgage markets. The U.S. debt markets were shaken a bit this week as reports said China might be slowing or halting purchases of U.S. Treasuries. While that would take away another huge buyer of U.S. debt, officials in China said that a "wrong source" may have been quoted – and it could be just more 'fake news.'

While stocks and short rates soared higher, 10–year yields ended the year just above the center of their trading range and 30–year yields ended just below the center of their range. For the year, 2–year rates rose 69.5 bps and 5–year yields were 28 bps higher. However, yields fell 4 bps at 10–years and 32.5 bps at 30–years! Last week, yields rose 7.5, 8, 7, and 7 bps for the 2, 5, 10, and 30–year sectors. This week, after having been even 5 to 6 bps higher, yields were up by 2, 4, 6, and 5.5 bps into today. Also, all maturities are close to having the same 2% handle!

MBS spreads (FNMA 30–year 3%) narrowed by 3 bps last week. The previous two weeks saw them narrow by 3, but then widen by 2 bps. The 10 and 30–year Treasury auctions went very well this week, and bonds fought back on Wednesday and today after drifting lower into the auctions. Wednesday's $20 billion in 10–year notes brought 2.579%, which was the highest yield since July 2014. Demand was the strongest since the June 2016 auction. The group that includes foreign central banks bought a huge 71.4% of the supply versus 57.2% last month. (These are 9–year 10–month bonds as the November 2027 issue was reopened.)

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Today's $12 billion 30–year bond offering came at 2.867%. That was the highest yield since the October 2017 auction. Demand was higher versus December, and foreign buying surged to 71.5% of the issue versus a previous 61.9%. The November 2047 bond was reopened to add this supply. On Tuesday (01/09/18), the Treasury sold $24 billion 3–year notes at 2.080%. Foreign buying fell from 59% last month to 54.9% of this offering.

On December 26th, the Treasury sold $26 billion 2–year notes at 1.992%, the highest auction yield since September 2008. Demand was the lowest since the December 2016 auction. Foreign buying fell from 41.9% in November to 40% of this offering. December 27th's 5–year note auction brought 2.24% for $34 billion in supply. Demand was off to November, and foreign buying fell from 65.8% then – to 58.4% of the December offering. On December 28th, the Treasury sold $28 billion 7–year notes at 2.37%. Demand rose to November, and foreign buying was also better – increasing from 58.6% of that issue to 60.5%.

01/05/18 Treasury Yield Curve	**2-Year: 1.962%**	**5-Year: 2.289%**	**10-Year: 2.477%**	**30-Year: 2.811%**
Weekly Yield Change:	+.077%	+.082%	+.071%	+.071%
12/29/17 Treasury Yield Curve	**2-Year: 1.885%**	**5-Year: 2.207%**	**10-Year: 2.406%**	**30-Year: 2.740%**
Weekly Yield Change:	–.008%	–.043%	–.076%	–.092%
Annual Yield Change:	+.695%	+.279%	–.039%	–.326%
12/22/17 Treasury Yield Curve	**2-Year: 1.893%**	**5-Year: 2.250%**	**10-Year: 2.482%**	**30-Year: 2.832%**
Weekly Yield Change:	+.055%	+.095%	+.128%	+.144%
Support:	2.015/ 2.035/ 2.070/ 2.095	2.373/ 2.412/ 2.452/ 2.491	2.593/ 2.633/ 2.673/ 2.712	2.942/ 2.987/ 3.032/ 3.077%
Targets:	1.960/ 1.940/ 1.915/ 1.890	2.334/ 2.293/ 2.254/ 2.205	2.530/ 2.483/ 2.435/ 2.394	2.859/ 2.819/ 2.782/ 2.740%

Economics

Initial Jobless Claims rose 2K to 247K, and then were 3K higher to 250K for the last week of 2017. They rose to a 3–month high of 261K to kick off 2018 (the largest rise since the hurricanes). Continuing claims lag a week, and were up 15K to 1,951K, down 49K to 1,902K, and then 25K lower to 1,867K for the last week of 2017. Challenger Job Cuts showed 3.60% few firings versus December 2017, and ADP Employment Change surprised with a 250K private sector gains for December. The jobs reports, however, showed only a 148K gain in payrolls versus 190K expected. The earlier–reported ISM Employment number had fallen from 59.7 to 57, and was the best predictor of the actual December jobs outcome. Jobs were reported to have been held back by a drop in retail positions. 24K jobs were added to raise November's total to 252K, though the 2–month revision was 9K lower. Private payrolls grew by only 146K (versus the ADP 250K), and were 18K higher to 239K for November. Manufacturing added 25K jobs.

The U.S. Unemployment Rate remained at 4.10%, as did the Labor Force Participation Rate (at 62.70%), though the Underemployment Rate rose .10% to 8.10%. Average Weekly Hours were flat at 34.5. Average Hourly Earnings rose .30% in December, but were backed off from .20% to .10% for November. Though some were encouraged by a wage pickup from 2.40% to 2.50%, the previous month had also been revised .10% lower to 2.40% (allowing for that increase). JOLTS Job Openings fell to a 6–month low in November (dropping from 5.925M to 5.879M). It's worth noting that EU–area unemployment hit the lowest since 2009, and EU confidence rose to the highest since late 2000.

The Christmas and holiday retail season is considered to have been very good, which we will hopefully see in incoming data. In November, Personal Income rose by .30%, but Personal Spending was .60% higher. Few were saving, and many were buying on credit! Another kick for retail was evident as Consumer Credit rose by $27.951 billion (versus $18b expected). That was the largest increase since 2001, and most went on credit cards! Further evidence came from the November Trade Balance deficit which rose from $48.9 billion in October to $50.5 billion – the widest in nearly 6 years. While energy prices were rising, much of the increase came from optimistic retailers increasing inventories for the holiday selling season. December Vehicle Sales rose from 17.4M to a 17.76M annual pace. Domestic sales increased from 13.46M to 13.72M (annualized number).

Bloomberg Consumer Comfort rose from 50.8 to 52.4, fell to 51.8 last week, and then rose to 53.5 – the highest level in nearly 17 years! Other confidence data fell off a little, but it was from December. Conference Board Consumer Confidence fell from 128.6 to 122.1. Their Present Situation gauge rose from 154.9 to 156.6, but Expectations fell from 111 to 99.1. University of Michigan confidence also retreated from a recent 13–year high. Sentiment fell from 98.5 to 95.9, Current Conditions rose from 113.5 to 113.8, and Expectations eased from 88.9 to 84.3. Manufacturing had its best year since 2004 as the ISM index rose from 58.2 to 59.7. One production measure rose to the best reading since May 2010. Prices Paid rose from 65.5 to 69, and ISM New Orders rose from 64 to a near–14–year high 69.4. The Chicago Purchasing Manager's report increased from 63.9 to 67.6. Dallas Fed Manufacturing Activity also improved, rising from 19.4 to 29.7. However, Kansas City eased from 16 to 14, and Richmond fell from 30 to 20.

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NFIB Small Business Optimism dropped from 107.5 to 104.9. Orders for Durable Goods rose 1.30% in November, but fell .10% ex Transportation. Capital Goods Orders fell .20%. Factory Orders also rose 1.30%, and were .80% higher ex Transportation. Services, that make up the largest part of the U.S. economy, slipped from 57.4 to a 4–month low of 55.9 (still signaling good growth).

Some inflation indicators rose, while others showed there's no great reversal just yet. The Fed's favorite gauge, the PCE Deflator (Personal Consumption Expenditures) rose .20% in November (versus .30% expected). That accelerated the annual pace from 1.60% to 1.80% – but is still below the Fed's 2% target. Ex food & energy, the PCE Deflator rose .10%, raising the annual core pace from 1.40% to 1.50%. December Producer Prices dropped for the first time since August 2016. PPI fell .10%, decelerating the annual pace from 3.10% to 2.60%. Core PPI also fell .10%, dropping that annual pace from 2.40% to 2.30%. Import Prices rose .10%, though they fell .20% ex petroleum. The annual pace fell from 3.30% to 3.00%. November Wholesale Trade Sales rose 1.50%. Wholesale Inventories rose .80%, while Retail Inventories rose .10%.

Sales of New Homes surged 17.47% in November, from 624K to 733K (annual units). That was the largest monthly increase since January 1992. Metro home prices rose .70% (S&P Case–Shiller 20–city). The annual pace of gain quickened from 6.16% to 6.38%. The Home Price Index (annual pace) rose from 6.05% to 6.17%. Pending Home Sales contracts rose by .20% in November, and were .60% higher year–over–year. Construction Spending rose .80%. The Treasury's Monthly Budget Statement showed a December deficit of $23.2 billion. The deficit is 7.2% over fiscal 2017 at this point (3 months in).

Friday is set for with Consumer Prices (December CPI), December Retail Sales, Weekly and Hourly Earnings, and November Business Inventories. Monday (01/15) is a market holiday for Martin Luther King, Jr. Day. Next Tuesday brings Empire Manufacturing. Wednesday follows with MBA Mortgage Applications which over the past 3 weeks fell by 3.50%, dropped 1.60%, and then rose 8.30%. Also due are Industrial Production, Capacity Utilization, homebuilder confidence (NAHB Housing Market Index), the Fed's Beige Book, and International Treasury flows.

Equities

In the **BMR** (01/12/2016), we said: *"Stocks started off 2016 with their worst week since September 2011, but the more ominous message was that it was probably the worst beginning week of any year ever. We have a lot of data, and couldn't find a 6% loss for the first week (of trading) even going back to the 1930's."* What a difference we saw in 2017, and as we said earlier – early in 2018, stocks are off to their best start in 30 years!

With the exception of bank stocks, which rallied today to the highest close since September 2007, most U.S. indices rose to new record highs today! 8 trading days in, and the Dow is already up 3.46% for 2018. The S&P is 3.51% higher and the Nasdaq has risen 4.47%. Bank stocks have kicked off 2018 with a 5.09% gain and the Transports are up 6.33%! Last year saw the best stock market returns since 2013 with the Dow rising 25.08%, the S&P 19.42%, and the Nasdaq 28.24%. Bank stocks rose 16.25% and the Transports gained 17.34%.

The last 2 weeks of 2017 saw the Dow add .42% and then fall .14%. The Dow rose 576.65 points or 2.33% last week to 25,295.87, and is 1.10% higher this week. The S&P rose .28%, lost .36%, and then gained 69.54 points or 2.60% last week to 2,743.15. It's .89% higher this week. The Nasdaq gained .34%, lost .81%, and then rose 233.17 points or 3.38% last week to 7,136.56. It's up 1.05% this week. Banks stocks rose 1.60%, and then fell 1.15% to end 2017. They rose 2.05% last week, and are 2.98% higher this week. The Dow Transports gained 2.71%, and then lost .59% the last week of 2017. They added 2.82% last week, and are 3.41% higher this week (leading most indices).

	Dow:	Nasdaq:	S&P:
Resistance:	25,826/ 25,982/ 26,146/ 26,304	7,243/ 7,265/ 7,306/ 7,349	2,785/ 2,798/ 2,812/ 2,825
Support:	25,504/ 25,344/ 25,188/ 24,930	7,180/ 7,152/ 7,085/ 7,007	2,767/ 2,749/ 2,737/ 2,714

Other Markets

In the **BMR (10/30/17)**, we wrote: *"We have a $58.85 short–term target for Crude Oil, and our longer term is in the $74.90 to $76 range."* On November 24th, Crude hit $59/barrel, fulfilling the first target. In the **BMR (11/30/17)**, we said: *"We expect Crude to trade off into a low near December 14th before resuming higher prices."* In one of those cases where the cycles excel, Crude traded off into a low on the 14th and bottomed that day. It's since rallied to over $64.50/barrel! Highs are due January 24th and the 31st, before a potential pullback into mid–February.

Crude Oil rose 5.45% the last 2 weeks of 2017, and was 1.69% higher last week. It's 3.84% higher this week and up 5.59% for 2018. Commodities rose 5.06% for the last 2 weeks of 2017, lost .22% last week, but are .89% better this week. Gold gained 4.38%, added .99% last week, and is .02% ahead this week. The U.S. Dollar, in turn, was off 2.24% for the last 2 weeks of 2017, lost .17% last week, and is .07% lower this week.

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The U.S. Dollar, in turn, was off 2.24% for the last 2 weeks of 2017, lost .17% last week, and is .07% lower this week. The Euro gained 2.18%, and added .20% last week. It's .02% better this week. The Japanese Yen lost .08% to close out 2017, was .32% lower last week, but 1.58% higher this week! Corn rose .94% to close out 2017, added .14% last week, but is off .71% this week. Cotton gained 3.57% for the last 2 weeks of 2017, lost .79% last week, but has surged 5.95% higher this week.

The BMR Forecasts for 2018

- The Fed would like to hike 2 to 3 more times in 2018, and there are no early indications that the likely call is one or the other. A lot depends on jobs and GDP growth, but 2 hikes would appear minimal. It's worthy of note that there are some doves on the committee that would still like to see more hard evidence of wage inflation before taking further action.
- GDP should continue to dwell in the 3% range. We don't see a case for a rise to 4% or a drop to 2%.
- 2018 is the next 4–year cycle low for stocks, so we would picture a sizeable pullback during the year. Depending on the timing of a pullback, stocks could still return 8 to 11% this year.
- Rates should make lows near the 3rd week of March, mid–July, mid–September, and early November.
- The highest yields should come in near early May, late July, and early October.
- Trend–changes for bonds could occur near August 15th and January 8th (2019).
- We fully expect the curve to invert if (and around when) the Fed hikes a second time in 2018.
- Stocks have lows due near the end of January, the 3rd week of March, mid–May, mid–August, and late October. Highs could come in early March, mid–June, and late August.
- We don't expect the returns for stocks or bonds to rival 2017. The U.S. is tightening and removing QE, and the European Central Bank is doing so as well. There will be less 'easy money' to play with.

Reviewing the BMR Forecasts for 2017

- The Fed intends to hike at least 3 times in 2017. Confidence is infectious, and it's spilling over. Small businesses are the most optimistic since 2004, and a business–friendly environment could lead the U.S. to better growth. The markets are pricing in only 2 hikes, but 3 may happen – especially if we can see some wage improvement and GDP growth over 3%.
    - Confidence continued to the upside, and the Fed got its 3 hikes in the books. Two solid 3% GDP quarters and the possibility of a third for Q4 played a large role.
- Inflation and growth should tick higher in 2017. We expect a few setbacks from our cycle work, but foresee 2017 to be a good year economically. We don't expect the kind of stock market returns that 2016 provided, but the next timing for a larger pullback should be in 2018.
    - Inflation ticked a little higher, but remained 'stubbornly low.' 2017 was indeed a good year, and stocks outperformed 2016 with ease (and continue to do so). The next window for a 4–year low cycle could be near October 2018.
- Our cycle work on stocks suggests an important low due in early July. Other lows are due near February 24th, and early October. Highs are due near April 18th, the end of August, and mid–November.
    - Stocks moved sideways from March until early July and then took off! Stocks moved higher from those February and October dates, but pullbacks were few and marginal. Thus, the dates for highs saw minimal downturns.
- We expect bond yields to make lows near January 26th, March 21st, May 18th, August 11th, and mid–December. The longer cycles forecast that the August lows would be the most important, though mid–May also looks good. These are times to take profits or set hedges. Of course, we'll fine tune as we go!
    - The mid–May and August cycles for lows were close, especially for shorter maturities. The better low was in early September, while hedging or refinancing in August would still have been a clear winner.
- High yields (or buying opportunities) are expected near February 15th, April 4th, June 22nd, September 14th, October 5th, and November 27th. Late March and mid–September are the most important turns using longer cycles.
    - The early cycles for highs hit very well. After early September, yields traded higher with few downturns.
- Bonds have additional trend–change dates near February 3rd, June 29th, and November 23rd.
    - These were based on alternative timing methods. We didn't bring them up during the year because they weren't 'hitting' with our other cycle work.

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2017 – The Year in BMR Quips & Quotes

(The text herein may be abridged. '…' indicates skips. Full text in the form of back issues is available on request.)

BMR (01/25/17): The Trump administration wants to achieve 4% GDP growth, and for all the criticism of his expected policies, FOMC policy makers and global investors seem to be treating that goal as a foregone conclusion. The U.S. hasn't seen 3% GDP growth for a decade, so it would certainly be welcome.

The Fate of the Furious (04/20/17)

Following the November election, stocks surged to new highs, 5–year bond yields hit their highest levels since 2011, and 10–year note yields rose to their highest levels since 2014. Though stocks have fallen from recent highs, the Nasdaq reached a record close today, and yields fell back to their lowest levels since mid–November. The furious pace remained in equities, while bonds circled the track back to near the beginning of the post–election surge.

Flattening Curves and Soaring Stocks (06/01/17)

The media is replete with coverage of the supposed mistakes made by the Trump administration – including backing out of the Paris accord on climate change. That agreement was never ratified by Congress, and with a business mind, President Trump viewed it as a 'bad deal' – with the United States' responsibilities onerous in terms of cost (especially given the lack of financial support by many participants). Our point is not to debate that decision, or others, but to note that stocks and consumer confidence don't support the negative narrative.

Just the Facts (06/21/17)

On Friday, Kashkari said: *"If we base our outlook for inflation on these actual data, we shouldn't have raised rates this week."* He said the Fed should have waited to see if the recent drop was indeed transitory *"to ensure we are fulfilling our inflation mandate."*

BMR (07/20/17): When asked if Trump's 3% GDP growth goal was reachable over the next 5 years, Yellen responded: *"It would be quite challenging."* The **BMR** would ask, is this the same person, leading the same Fed, that has advocated a campaign of tightening to get ahead of the curve and prevent the economy from overheating?

Riddle Me This (10/12/17)

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?

Front End Alignment (12/06/17)

As the Fed is intent on pushing the 'front end' of the Treasury curve higher, longer rates are resisting. Since last December, the spread between 2 and 10–year Treasuries has flattened from 136 bps to 53 bps today. That's the most–narrow (flattest) curve since October 2007 – when rates were screaming a warning of impending economic troubles.

Key Economic Thoughts from the 2017 BMR

(The text herein may be abridged. '…' indicates skips. Full text in the form of back issues is available on request.)

BMR (01/16/17): The Unemployment Rate could experience a "sizable undershoot" of their estimate for full employment. Growth could actually take off, leading to an inflation "overshoot." Policy in the light of these 3 factors could present the Fed with puzzling policy problems!

Fences (02/02/17)

A major part of this past week's news was President Trump's announcement that there could be a 20% import tax on Mexican goods to finance the border wall. While media talking points said those costs would be passed on to the consumer, that's not what happens in the real world. If goods out of Mexico actually cost 20% more, retailers will seek out cheaper sources if available. Just as Japan adjusts prices to be competitive to Korea, and both do so to compete with China – or produce some of those goods in China, Mexican producers would have to drop prices to remain competitive. Rather than falling to the U.S. consumer, though that will happen to a degree, it will harm Mexico and squeeze profits on their production. We don't operate in a vacuum, and just as water seeks the lowest point – U.S. retailers will instead buy goods from Southeast Asia, Latin America, or maybe even on the home front!

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Broken Record (02/09/17)

Stocks are propelling to all–time highs – and most U.S. indices broke records today. These are also times when jobless claims and other indicators are breaking multi–decade lows and interest rates are in uncharted territory – but also to the downside! The flip side is that the news is also a broken record. It skips and jumps so much that you hear the same thing over and over. … Brady wins the Super Bowl. Alabama, Clemson, and Ohio State are in the hunt for the NCAA football championship. However, the needle has been stuck for years on the vinyl complaining about who holds the White House, Congress, or the courts! For the record, that's not a new phenomenon at all. As far back as I can recall (which means it goes back much further), the side that's in has been continuously derided by the side that's out.

Modest to Moderate Headwinds (02/22/17)

The U.S. sustained 'modest to moderate' growth over the past few years, but interest rates remained low because global risks continued to pose a clear and present danger that could thwart the Fed's plans to return to 'normal.' However, as world economies continue to emerge from the abyss of the financial crisis, those headwinds to domestic and global growth have diminished to a cool breeze. There are even a few factors that could speed things along like a welcome tailwind. Optimism has been steadily growing recently, and there's even a degree of euphoria as evidenced in the consumer confidence readings over the past few months – many the highest in years, and some are the best of the recovery. … Despite stocks smashing to new record levels into our February 21st date for a high, this past week seemed the least 'news intensive' since before the election. Is it a calm before the storm? The bullish readings on stocks rose over 90% – to their highest levels in more than 3 years. That indicates a lack of 'sellers.' Volatility is very low – which indicates the market doesn't expect that a large move is imminent. The Fed is growing confident that their job is done, that they can remove accommodation at a 'gradual pace', and that they might even begin to reduce the size of their balance sheet (by no longer reinvesting maturing assets).

Hiking a Bizarre Trail (03/08/17)

Various Fed members have voiced their concerns of risking getting 'behind the curve' – given low rates and improving growth. We've also noted the positives, and acknowledge that rates above where they are now would still be accommodative. However, it's also the case that the Fed raises rates to 'cool' the economy. So, are the overheating economy and getting 'behind the curve' just more 'fake news'? … Atlanta's projections are now forecasting Q1 GDP barely above 'stall' speed. On February 1st, they had projected a healthy 3.4%! However, the Now–cast has been steadily slipping since then – and fell to only 1.2% today. If we were served such a dish at a restaurant, we'd send it back to the kitchen to be reheated! We didn't order Sushi. … It's a fairly simple take. If you pretty much set your own borrowing costs, why would you raise them – adding $50 billion in interest burden to the Federal deficit for each 25–bps hike?

Roundabout (04/05/17)

The key wording in the March minutes released today was: *"Most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the committee's reinvestment policy would likely be appropriate later this year."* Read that as near the end of the year, the Fed will taper or cease reinvestments – though policy wise, the **BMR** thinks they'll opt to taper instead of exercising a full stop. It's also probable, and the market reaction was such, that sizing down the balance sheet is in itself tightening – and that the resulting pace of interest–rate hikes could be even more gradual.

Going in Style (05/10/17)

We recognize there's always a possibility of getting behind the curve, after all – the FOMC got ahead of it in 2006! Market participants are so convinced the Fed intends to raise rates in June, that the 'odds' rose to 100% – no matter what happens. 100% means the journey is predetermined despite incoming data, so much so that travel insurance has been deemed unnecessary! Alarmists are warning of imminent war given North Korea's repeated threats. Yet, the market's 'fear factor' is very low – with volatility trading at its lowest levels in over 23 years! How can you have both imminent war and market safety? Using that same logic, unless the Fed's crystal ball is very good, how can the U.S. economy be in danger of overheating with first–quarter GDP coming in at only .7%. It's all based on their future forecast, sort of like every young boy's dilemma – being spanked for what you were going to do!

January 27th, 2017 brought in the Chinese Year of the Fire Rooster. We said it should be a great year – especially for those that like grilled chicken! 2018 brings the Chinese Year of the Earth Dog, but we'll not be discussing a menu.

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Traction (06/01/17)

In our opinion, Fed Reserve Governor Lael Brainard was a major force in holding the FOMC back from quickening their hiking pace last year. Last week, she said the global economy *"is probably brighter today than it has been for the last few years."* Speaking to the Fed's other mandate this week, she said: *"If the soft inflation data persist, that would be concerning and, ultimately could lead me to reassess the appropriate path of policy."* She's in our camp, believing the *"neutral rate is very low"*, and that the Fed is *"not far at all from neutral"* – expecting that rates don't need to rise rapidly from where they are at present.

An Inconvenient Downturn (08/10/17)

While inflation is muted, it's speaking loudly! Though the FOMC was confident their policy had accomplished their mandates, a less–than–transitory bout of inflation has reemerged. … This week, FRB St. Louis President James Bullard said: *"I think the FOMC has been surprised by inflation coming into the downside during the spring."* The **BMR** would add: And through the summer! He said the Fed should stand on rates for now, and that recent data *"call into question the idea that U.S. inflation is reliably returning toward target."* We'd say that's true – as it's recently been turning away from their target!

The Fed Takes a Hike (09/21/17)

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.) … 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.

Flatliners (10/12/17)

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! … 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?

Thank You for Your Service (11/07/17)

Despite accolades for her service, President Trump decided against renewing Janet Yellen as Fed Chair. … CNBC's Ron Insana said Powell would be the most like Yellen – which would give the market continuity. However, earlier in October, Insana had said: *"If it ain't Yellen, I'll be sellin'"* He since backtracked from those remarks and said – *"with the exception of Jay Powell."* … On Friday, Kashkari said he thought *"Governor Powell will do a great job as chair."* He said he didn't anticipate a big change in policy, and we obviously trust his view. He did pose the question: *"Why are we tapping the brakes?"* That's our point as well. We just hit 3% GDP for 2 quarters for the first time since 2014, and haven't had annual 3% GDP growth for over a decade – so what are we trying to stop – or slow?

Apocalypse Now (11/16/17)

What could go wrong? The Fed is hiking – and the Chair is changing. Brick and mortar stores are closing at a rapid pace. Politicians and Hollywooders are under investigation for immorality. Subprime auto loans are in crisis – with delinquencies near the 2009 peak! (Subprime didn't work for housing, but surely autos would be OK?) The yield curve is the flattest its been in 10 years, and the tax cut plan has so many losses of deductions it might even lead to increases in tax obligations. Yet, the band played on. Stocks remain near (or at) all–time highs with zealous bullish outlooks – with little perception of downside risk. Consumer confidence is very high, but vitriolic news rules the day.

"It is better to sleep on things beforehand than lie awake about them afterward." Baltasar Gracian

"I'm against picketing, but I don't know how to show it." Mitch Hedberg

"I believe that professional wrestling is clean and everything else in the world is fixed." Frank Deford

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BMR (12/14/17): 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 **BMR** 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.

BMR (12/21/17): While there's always one side that is set on completely destroying the politics of the other side, we think the finally–passed GOP tax bill could lead to something that's been missing for years – wage inflation! Dropping the corporate tax rate to 21% should allow companies more room to compete for, and reward employees – and could also lead to many additional jobs as companies repatriate. Chicago's Charles Evans said he dissented to the FOMC vote last week thinking a lower funds target would help inflation reach the Fed's goals sooner. Neel Kashkari said his dissent was motivated by low inflation, continued weakness in wages, and the flatness of the yield curve. He also said undue hikes could shorten the expansion, and questioned if the FOMC was treating 2% as a ceiling – instead of a target!

Key BMR Studies and Observations from 2016

(The text herein may be abridged. '…' indicates skips. Full text in the form of back issues is available on request.)

Hidden Figures (03/29/17)

Over the years, the study of cycles has been the most dependable approach we've discovered for market forecasting. While cyclic analysis is a technical read on price activity, we of course study market fundamentals as well. The **BMR** approach is short–term technical, while we mix in fundamentals for the medium and longer–term. We openly cover the comments of various FOMC officials, but rarely get 'political.' Cycles are up and down – not left or right. Clearly the markets were disappointed with the way the new healthcare legislation was handled (or wasn't), leading many to question the expected tax reforms as well. It's evident that things are as politically divided as they've ever been.

That said, it's hard to reconcile the presidential polling numbers with consumer confidence. Some polls had President Trump's first 100–day approval ratings at the lowest of any president since Harry S. Truman. Meanwhile Consumer Confidence is skyrocketing. Given the choice, I'd certainly take the latter. … There's even more in the hidden numbers, or those not in the headlines. The percentage expecting improving business conditions rose from 23.9% to 27.1% – hitting the highest level since December 2003. Those expecting their incomes to increase over the next 6 months rose to the highest level since 2006. The numbers remind us of the election. Folks wouldn't admit they were going to vote for Trump, but they did. As a piece of satire, those reading only the polling data would think Trump's doing the worst job in decades, while the nearly all the confidence readings argue strongly to the contrary.

The Duality of Mandates (06/09/17)

It would be a great surprise at this point if the Fed chose not to hike rates this coming Wednesday (06/14). Most FOMC members view the economic negatives and faltering inflation as *"transitory."* While also in place to moderate long–term interest rates, the Fed's dual mandate is to maximize employment and stabilize prices. The **B**ond **M**arket **R**eview is of the opinion that other economic data should enter into the equation. After all, other central banks also consider economic growth (and related data) to be very important. That said, Consumer confidence has been overwhelmingly encouraging, and the stock market continues to establish new highs.

While inflation may be transitory, is it also that case that slowing job pickups, a lack of wage pressures, and a lack of robust growth are as well? As we've noted before, it's traditionally been the case that the Fed tightens to slow growth – and it's just not that great. As reported in the Fed's Beige Book, it's only been 'modest' or 'moderate' for years. Nevertheless, rates were near zero for a long time, and many Fed members feel that even after a few more hikes interest rates would still be accommodative.

Are we really at 'full employment?' May's Unemployment Rate of 4.30% was the lowest since May 2001, but at that time labor force participation was 66.7% versus last month's 62.7%. With the current population of 254.767 million, the economy would have roughly 9.7 million more folks employed at the 2001 level – so this 4.3% is somewhat tainted. It's also the case that many workers are limited to under 30 hours per week as small businesses are not able (or choose not) to pay the health care insurance costs associated with the health–care law. That effect is heavy in the service industry, which is a significant portion of the U.S. economy. That further makes this current 4.3% jobless rate far from a 'full employment' number. A bus that's 95.7% full is statistically more significant than a minivan given that same ratio.

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Despite the Fed's dual mandate, they seem to be single minded – choosing to ignore inflation and focus rather on 'full employment.' If we include growth in the equation, only one of three factors would be a positive. If the jobs data is really weaker than the 4.3% jobless rate would imply, there are three pieces of suspect data. Yet, the Fed has adopted a 'mission accomplished' posture. A scripture from Proverbs is often misquoted as 'pride comes before a fall.' With only one side of the dual mandate met – and only loosely so, it seems to be preceding a hike.

Hot or Not (06/05/17)

The **B**ond **M**arket **R**eview is of the opinion that the Fed should be more data dependent, or they risk the transparency they're trying to accomplish. Why not just say that rates are too low and hike them for that reason – rather than for what they expect to happen? Anyone that grew up watching Perry Mason or Matlock knows you have to question or object to 'facts not in evidence'! When the yield curve flattens, you get former Fed Chair Alan Greenspan's 'conundrum' – the lack of follow through of long rates when the FOMC is hiking the short end. Those are market bets that the Fed is wrong. Former FRB Philadelphia President Charles Plosser chimed in with **BMR**–like thoughts this week – challenging the FOMC's communication. He said: *"If they continue to raise rates, then you've got this conundrum. The balance sheet is large, and that's providing accommodation, but that means their funds rate target is not very informative about the true stance of policy because it's being offset – in some sense, by the balance sheet."* However, the statement did say the FOMC intended to begin *"a balance sheet normalization program this year."*

Cyclic Update (06/21/17)

With a lack of hard news, and the cycles misfiring a bit, it's a good time to talk about our forecasts. When the cycles aren't hitting, we of course recheck the work. Sometimes we become so accustomed to their veracity, that the variance to projections gets puzzling. It's then that we get questions asking if we've changed our mind on the outlook. The truth is, we never set our opinion to begin with. It's not as if we can look at a chart and interpret the next trend, turn, or strength. However, it's obvious when the cycles are out of synch. I've studied technical analysis methods and chart analysis since the late '70s, and determined a few decades ago that good cycle techniques were the best approach to timing – and had the highest percentage of accuracy. Long–time readers know that these techniques have often called nearly every turn for months at a time, and sometimes for far longer. But as we've said before, nothing even approaches 100%. Over my career, I've sought to attain incremental methods that increase success ratios well beyond 50%, and gain great satisfaction with every tweak to that effect – even if only by .1% at a time!

That said, the **BMR** provides the projections given by our work, and not (or rarely) what we think. Why craft such an elite program, and then throw darts? The dates in the **BMR** are the direct output of the program. They are based on over 2 decades of data for each market, and incorporate a nesting of short, medium, and long–term cycles – from a few days to many years. As such, short–term moves can diverge from expected paths, but the markets usually return or rejoin the projected cycles. The Fed does its 'dot plots', the Atlanta Fed forecasts GDP growth in the current quarter, and our techniques project cycle turns and the potential magnitudes of each next 'wave.' When we stick to our guns, we're really just continuing to provide the forecasts of the model. The cycles do shift, even without a newsworthy catalyst – and improving on that margin of error is akin to seeking the grail. However, the incoming data will often cause the program to alter upcoming trend–change dates. Cycles breathe and float.

BMR (08/17/17): Cycles are our passion, and an intellectual pursuit we've engaged for 38 years. Some years have provided monumental progress, while others yielded only minute gains in our formulas and processes. It's a good use of the calculus, differential mathematics, and physics that would have otherwise gone dormant. That said, work that you enjoy is the best kind! There are cycles of all different timeframes, so markets have countertrend waves along larger trends.

A Tale of Two Cities (09/04/17)

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.

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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.

BMR (09/02/17): 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."*

Doubting Dotting Doting (09/28/17) (The Underlying Inflation Gauge [UIG] is the Fed's newest price indicator) The UIG aside, until finally breaking through important support on Wednesday, yields were signaling that bond–market participants were not in concert with the Fed's projections for interest rates. Last week, the FOMC announced plans to begin reducing asset reinvestments in October (to shrink their balance sheet) and released new dot–plot projections that clearly signaled a 25–bps rate hike in December. While four members had projected a stay, one signaled a 50–bps hike, while eleven thought 25 bps was in store. At the beginning of the year, 4 hikes had been projected. Never mind that the long–term forecasts have been off for years, and that over that time bonds have been right! Still, the Fed is doubtful that markets are taking their forecasts seriously. FRB St. Louis President James Bullard said he was *"finding it pretty concerning"* that the markets were not lining up with the Fed's projections. Speaking to the reluctance of bonds and inflation to line up with recent forecasts, he said: *"It is a lack of credibility and reliance on a model that has not been working over the past five years."* Nevertheless, unlike the UIG readings, Bullard said: *"Inflation expectations are uncomfortably low at this point."* No wonder there's no love for the dots!

"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

"If you really do put a small value upon yourself, rest assured that the world will not raise your price." Anonymous

Former Treasury Secretary Jacob J. Lew said the tax cuts are leaving the country broke. Aren't we already broke?

Additional Information is Available on Request
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