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BOND MARKET REVIEW

March 22, 2018

Final Four

As the NCAA playoffs work their way from the Sweet–16 to the Final Four this weekend, bond traders are focused on the Fed's plans for 2018. As widely expected, the FOMC raised their benchmark funds target by 25 bps this week, given that most members have been signaling 3 or 4 hikes this year at a 'gradual pace'. Which will it be, and would a 'final 4' hikes bring us to the 'new normal?' The Fed's new dot–plot projections (of future interest rates) are suggesting there will be a total of 3 hikes in 2018. A few Fed members have been expressing concern that rates are too low, and that the committee was risking getting behind the curve. However, the Fed has been very good about telegraphing their intentions in recent years and there have been no surprises for a long while. It was also highly doubtful that incoming Fed Chairman Jerome Powell would choose to jolt the markets with an unexpected policy move during his first meeting as head of the FOMC – and there was no dissent. Wednesday marked the 6th hike of this campaign, bringing the target range to 1.50% to 1.75%. Most of the changes versus the January FOMC statement were rewording, while other parts were a bit more upbeat. They added: *"The economic outlook has strengthened in recent months."* The FOMC also held that inflation would move up *"in the coming months"* instead of *"this year."*

Looking Ahead

- Equities have a low due near March 23rd, and another down–leg from March 27th to April 2nd.
- Interest rates should have a low around March 23rd, and another low near the 29th.

Treasuries, Agencies, and MBS

With the Fed sticking to their nominal rate increases at a supposed–to–continue 'gradual pace', the market–based odds for a hike at the May meeting were only 27.8% today – while the June and August meetings hovered near 79%. Obviously, a lot can happen between now and the upcoming meetings, but the Fed has been outspoken in their intentions to not be swayed by market turbulence. The **B**ond **M**arket **R**eview would expect them to maintain their course unless equities were to weaken appreciably, or the economy seemed in danger of stalling. For now, most market participants are probably viewing weakness in the stock market as a long–due correction. Our bond cycles had yields falling into March 23rd, and the 10–year note fell to 2.80% today for the first time since March 1st. We expect another drop in yields into March 29th, before they advance again. A lot depends on stocks. If equities continue lower into April 2nd, that should keep longer yields in check until any developing market panic begins to dissipate.

The Treasury curve flattened last week, with 2–year yields rising by 3.5 bps, while rates for the 5, 10, and 30–year sectors fell by 1, 5, and 8 bps. In a Greenspan–like conundrum, short rates are rising with Fed policy, but longer rates are still reflecting slow growth, only modest inflation, and a good relative value versus quality foreign alternatives. We may view 2.80% as a low rate, but the German 10–year yields only .52% and Japan's a mere .011%. Germany and Japan still have modestly negative 5–year yields, and many EU nations and Japan have 2–year notes that range from –.167% (Japan), to –.31% (Italy and Spain), to lower than .62% (Germany and the Netherlands), to –.98% in Switzerland. Clearly there are still some longer–term dynamics that will take years to unwind. On Wednesday 2–year yields were the highest since August 2008, and the yield on the 5–year note was the highest since April 2010. On the other side, partly driven by today's 724–point loss in the Dow Industrials, the yield on the 30–year bond fell to the lowest level since February 6th. Into today, yields were 1.5 to 2 bps lower across the curve (since last Friday).

MBS spreads (FNMA 30–year 3%) were flat last week. Last Tuesday (03/13), the U.S. Treasury sold $13 billion 30–year bonds at 3.109%. The February 2048 maturity was reopened to add this supply, and the yield was the lowest since January. Demand rose versus the February offering, and the group that includes foreign central banks bought 57.9% of this issue – down from 61.2% in that prior auction. Next week, the Treasury will offer $30 billion 2–year notes on Monday (03/26), $35 billion 5–year notes on Tuesday, and $29 billion 7–year notes on Wednesday. With rates rising, Mortgage Refinancing dropped to a 9-year low (representing only 38.5% of total mortgage activity).

China's Treasury holdings fell to the lowest reading since last July – dropping to $1.17 trillion in January from $1.18 trillion in December. Japan, the second largest holder of U.S. debt, increased holdings from $1.06T to $1.07 trillion.

03/16/18 Treasury Yield Curve	2-Year: 2.293%	5-Year: 2.643%	10-Year: 2.845%	30-Year: 3.078%
Weekly Yield Change:	+.033%	–.008%	–.050%	–.080%
Support:	2.280/ 2.315/ 2.360/ 2.375	2.638/ 2.652/ 2.672/ 2.691	2.850/ 2.869/ 2.888/ 2.912	3.101/ 3.133/ 3.156/ 3.178%
Targets:	2.255/ 2.240/ 2.220/ 2.195	2.612/ 2.592/ 2.573/ 2.552	2.810/ 2.795/ 2.770/ 2.751	3.067/ 3.045/ 3.022/ 3.000%

Foreign holdings of U.S. debt fell from a record $6.32 trillion in October to $6.26 trillion. Foreign equity purchases were a decade–high $34.5 in January. (As of today, most equity gains for 2018 were gone.)

Economics

Initial Jobless Claims fell 4K to 226K, and then rose to 229K last week – but are still hovering just above the lowest levels since the '60s. Continuing Claims rose 4K to 1,879K, and then dropped to 1,828K. JOLTs Job Openings rose from 5.667M in December to a robust 6.312M in January. NFIB Small Business Optimism rose from 106.9 to 107.6 – the highest since 1983! Optimism for America's CEOs hit a record high, rising from 96.8 to 118.6. Bloomberg Economic Expectations rose from 54.5 to 56 – matching the highest level since March 2002. Bloomberg Consumer Comfort had fallen from 56.8 to 56.2 but rose once again to 56.8 this week – near the highest levels since 2001. University of Michigan Sentiment rose from 99.7 to 102, surging to a 14–year high. Current Conditions rose from 114.9 to 122.8, the highest reading since 1946 (post WWII). Unlike the Bloomberg data, Expectations fell from 90 to 88.6. The Philadelphia Fed Business Outlook fell from 25.8 to 22.3. Kansas City Fed Manufacturing Activity was flat at 17, though Empire Manufacturing rose from 13.1 to 22.5. The Leading Index rose .60% in February but was revised .20% lower to .80% for January. Industrial Production rose 1.10% in February, following a .30% drop in January. Capacity Utilization rose from 77.40% to 78.10%. Business Inventories rose .60% in January.

Retail Sales came in under estimates, falling in February for a 3rd month. The .10% decrease followed a .10% decline in January – that was revised from a .30% drop. Ex autos, sales were .20% higher. Auto sales were the overall reason for the decline as they again fell .90% – matching January's drop. Consumer Prices rose .20%, quickening the annual pace from 2.10% to 2.20% (supporting the Fed's hiking mode). Ex food & energy, core CPI also rose .20%, though the annual core pace was flat at 1.80%. Real Average Weekly Earnings rose .60% (year over year), and Hourly Earnings were up .40% (but had slowed from .70%). Producer Prices rose .20% to hike the annual pace from 2.70% to 2.80%. Core PPI also rose .20%, increasing that year–over–year rate from 2.20% to 2.50%. Import Prices rose .40%, following a .80% increase in January.

Home–builder optimism fell from 71 to 70 (NAHB Housing Market Index) but remained near an 18–year high. The FHFA House Price Index rose .80% in January. Housing Starts fell by 7% from January's torrid (annual) pace of 1,326K units to 1,236K. February Building Permits dropped 5.74% to 1,298K units. Though inventories are still the lowest going back to data records from the late '90s, Existing Home Sales rose 2.97% in February – from 5.38M to 5.54M (annual) units. The Current Account Balance for Q4 2017 was a $128.2 billion deficit.

Friday is set for February New Home Sales, and Orders for Capital and Durable Goods. Next Monday (03/26), brings the Chicago Fed National Activity Index and Dallas Fed Manufacturing Activity. Tuesday follows with Metro–home prices (the S&P Case–Shiller 20–City index), the S&P–CS Home Price Index, Richmond Fed Manufacturing, and Conference Board Consumer Confidence. Wednesday updates MBA Mortgage Applications (which rose .90% and then fell 1.10% over the past 2 weeks), Q4 GDP (which is expected to be .2% better to 2.70%), Personal Consumption, Retail & Wholesale Inventories, and Pending Home Sales for February.

Equities

The Dow Industrials lost 389.23 points last week, falling 1.54% to 24,946.51. We expected a drop into March 23rd, and today's 724–point drop put the Dow, S&P, and numerous other indices in the red for the year – joining many global markets which were already much lower. The Dow was off 3.96% into today. The S&P lost 34.56 points or 1.24% last week to 2,752.01, and it's 3.94% lower this week. The Nasdaq dropped 78.82 points or 1.04% to 7,481.99, and it's 4.21% lower this week (but still 3.81% to the good for 2018). The Dow Transports lost .52% and tumbled 3.09% this week. Banks stocks fell 2.74% and were only .78% higher for 2018 after a 4.76% drop this week.

Resistance:	Dow:	24,236/ 24,526/ 24,863/ 25,173	Nasdaq:	7,206/ 7,294/ 7,380/ 7,465	S&P:	2,660/ 2,685/ 2,711/ 2,738
Support:		23,911/ 23,621/ 23,308/ 23,006		7,095/ 7,040/ 6,960/ 6,873		2,631/ 2,608/ 2,583/ 2,559

Other Markets

Crude should be trending higher with our cycle into April 25th. Crude Oil rose .48% last week and is 3.14% higher this week. Commodities fell .36%, but they are .40% higher this week. Gold lost .88% but is 1.15% better this week. The U.S. Dollar gained .16% last week but has fallen .82% this week. The Japanese Yen rose .76% and is .69% higher this week. The Euro lost .14% but is .10% higher this week. Corn lost .07% and is off another 1.76% since Friday. Cotton fell 1.98% and is down another .84% this week.

"Small opportunities are often the beginning of great enterprises." Demosthenes (384 BC - 322 BC)

Additional Information is Available on Request

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