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BOND MARKET REVIEW

April 26, 2018

Draft Day

The 'Bulls' drafted Crude Oil and the 'Broncos' took stocks. The 'Bears' have bonds – and the 'trade mill' has them trading the dollar to the 'Bulls' for equities and a market to be determined later. We see a case for bonds 'holding out' as higher U.S. rates are extending their value versus global alternatives. It's been the case that holders of negative–yielding foreign bonds outperformed U.S. debt since early 2017 – with the Dollar losing nearly 15% into February 2018. Of course, that was after a prolific gain of over 30 percentage points from 2011 into 2017! With our 10–year note near 3%, most EU debt roughly half that yield, Germany's at .56%, and Japan's at .05%, we still see a 'tether' constraining any significant rise in U.S. rates. It's actually humorous to those of us that dealt with 10–year yields of 6% to 15% over the past 4 decades to consider 3% a great threat! While our 5–year is 'on the heels' of 10–year yields, Germany's 5–year bunds are yielding –.05% – a spread of nearly 2.90%! We think a bullish turn to the Dollar is on the way and would unwind the attraction of global alternatives – sending a bid back to U.S. debt markets.

Trading Places

On April 17th, the U.S. Treasury yield curve reached its flattest level (at just over 43 bps) since September 2007. In only 6 trading days that 2 to 10–year spread rose 10 bps to 53.5 bps. Longer yields finally gave way to the Fed's intentions – and the 10–year note capitulated to trade above 3% for the first time since January 2014. With the curve basically flat but now moving higher, shorter maturities were trading at yields that their longer counterparts were holding only a short time ago. Yields on the 2–year note rose to the highest levels since August 2008, and to the zone held by the 5–year note in early February (02/06/18). The 5–year traded to its highest levels since August 2009, trading places with the yields held by the 10–year only a week ago (on April 18th). 10–year yields likewise traded to the zone held by the 30–year bond on April 18th.

The FOMC meets next Wednesday to decide the fate of 'short' interest rates. Though the chances of a May 2nd hike have steadily risen to reach a high of 34.2% today, that's still only a 1 in 3 shot for further tightening next week. The chances for 2 hikes by September rose over 50% over the past 2 weeks, but a move in May by the FOMC would bypass the 'gradual pace' that's been held out as policy. Outgoing New York FRB President William Dudley said that even though the unemployment rate is low, inflation is holding below the Fed's 2% objective. He said: *"As long as that is true, the case for tightening policy more aggressively does not seem compelling."* While there are Fed members wary of the economy overheating, Cleveland's Loretta Mester said she didn't expect inflation to *"pick up sharply"* which would argue *"against a steep path"* for interest rates. While one of the more 'hawkish' members, she said the Fed should *"give inflation time to move back to (their) goal"*, reinforcing the case for the current 'gradual pace' of hikes. That said, a recently–improving upward trajectory for inflation allowed the 10–year note to break 3% and reach a 4–year high. Chicago's Charles Evans said: *"Sometimes I wonder if I risk having my Ph.D. reduced for being seduced into amnesia about the great inflation of the '70s."* However, he contended: *"We have the opportunity to more patiently read, and react to, the incoming data."* Though the Fed is making moves to ease lending constraints, the ongoing hikes are making borrowing less attractive. They're easing and tightening at the same time!

The Fed certainly had tariffs on their minds. The Beige Book said the economy was expanding at the same old *"modest to moderate pace"* (as it has for years). The **B**ond **M**arket **R**eview would think 'robust' or a similar adjective would be needed to describe growth before any 'overheating' could really take hold. Most districts reported wage growth as only modest. If anything, President Trump's trade tariffs had Fed members warning of economic speedbumps. The word 'tariff' appeared 3 dozen times in last Wednesday's report, though not present at all in the previous Beige Book. Most mentioned concerns over higher costs of steel. Last week, some Fed economists argued that tariffs would likely lead to a net loss of U.S. jobs, concluding the steel tariff would *"cost more jobs than it saves."*

Looking Ahead

- Equities should make cycle lows into April 30th, May 7th, and May 16th.
- Yields should peak by May 4th and drop most of May. We would remove hedges and/or buy bonds on dips.
- The FOMC will announce their updated rate–policy stance next Wednesday (05/02) at 2 p.m. ET.

Treasuries, Agencies, and MBS

Yields rose sharply and broadly last week with the 2, 5, 10, and 30–year Treasury sectors rising 10, 13, 13.5, and 12 bps. Into today, those sectors were higher by 2.5, 1, 2, and 2 bps. Our bond cycles were mirroring stocks but translated further in time than we expected – and could hold higher into May 4th before a material rally ensues. After then, the cycles argue for lower yields throughout May. MBS spreads (FNMA 30–year 3.5%) narrowed by 5 bps last week.

On Tuesday, the U.S Treasury sold $32 billion 2–year notes at 2.498% – the highest auction yield since July 2008. Demand was the lowest since December, and the group that includes foreign central banks bought 41.6% of the issue (versus 44.5% last month). Wednesday's $35 billion in 5–year notes brought 2.837% – the highest since September 2008. Demand was the weakest since February and foreign allocations fell from 63.5% last month to 60.2% of this offering. Today's $29 billion 7–year note came at 2.952%. That was the highest yield since April 2010 and demand rose versus last month. Foreign buying improved from 55.8% last month to 65.8% of this auction.

04/20/18 Treasury Yield Curve	2-Year: 2.459%	5-Year: 2.801%	10-Year: 2.961%	30-Year: 3.146%
Weekly Yield Change:	+.100%	+.128%	+.133%	+.118%
Support:	2.495/ 2.510/ 2.550/ 2.590	2.826/ 2.845/ 2.866/ 2.886	2.990/ 3.006/ 3.032/ 3.055	3.157/ 3.180/ 3.203/ 3.224%
Targets:	2.475/ 2.432/ 2.392/ 2.353	2.788/ 2.768/ 2.749/ 2.731	2.951/ 2.922/ 2.900/ 2.868	3.116/ 3.091/ 3.069/ 3.052%

Economics

Initial Jobless Claims were steady at 233K last week but fell to 209K in today's release – the lowest level since 1969! Continuing Claims, which lag a week, fell from 1,878K to 1,866K, and then dropped to 1,837K. Bloomberg Economic Expectations eased from 56 to 52.5, while Consumer Comfort rose .1 to a new 17–year high of 58.1 last week. That survey fell to 57.5 this week on higher gas prices, and the buying climate dropped for the first time in 6 weeks. Conference Board Consumer Confidence rose from 127 to 128.7. The Present Situation rose from 158.1 to 159.6 and Expectations improved from 106.2 to 108.1. Investor Confidence rose from 111.5 to 114.5. The Leading Index for March rose .30%, and February's was revised .10% higher to .70%. The Philadelphia Fed Business Outlook rose from 22.3 to 23.3 and Kansas City Fed Manufacturing Activity rose from 17 to 26. However, Richmond fell from 15 to –3 and the Chicago Fed National Activity Index fell from .98 to .10.

New Home Sales rose 4.05% in March – from 667K to a 4–month–high 694K annual pace. Existing Home Sales improved by 1.08% from 5.54M to 5.60M (annually). The FHFA House Price Index rose .60% in February and Metro home prices were .83% better – taking the S&P Case–Shiller 20–City annual increase from 6.43% to 6.80%! The Home Price Index rose from 6.11% to 6.34% (year–over–year). In March, Durable Goods Orders rose 2.60% but were flat ex transportation. Orders for Capital Goods fell .10%. Retail Inventories fell .40% while Wholesale Inventories rose .50%. The merchandise trade deficit fell from $75.9 billion to a 6–month low $68.0 billion (with imports dropping the most in 2 years).

Friday is set for the long–awaited preliminary Q1 GDP estimate. The final Atlanta Fed forecast was 2.0%. Also due are the Q1 Employment Cost Index, Personal Consumption, the GDP Price Index, Core PCE, and the University of Michigan sentiment surveys. Next Monday (04/30) closes out April trading with the March Personal Income & Spending, the PCE Deflator, Pending Home Sales, the Chicago Purchasing Manager's report, and Dallas Fed Manufacturing Activity. May Day (Tuesday 05/01) kicks off May trading in what is traditionally a negative month for equities. Releases scheduled are March Construction Spending, Vehicle Sales, and ISM data for Manufacturing, Prices Paid, New Orders, and Employment – the first look into next Friday's report on April payrolls. Wednesday is set for MBA Mortgage Applications (which rose by 4.90% the week of April 13th and then slipped by .20% last week), ADP Employment Change (the second look into April jobs), and the May rate decision by the FOMC.

Equities

Equities dropped into April 24th, keeping the cycles very much 'in play'. Last week, the Dow rose 102.80 points or .42% to 24,462.94 (after having been over 2% higher). The Dow is .57% lower this week. The Nasdaq gained 39.48 points or .56% to 7,146.13 but is .38% lower this week. The S&P gained 13.84 points or .52% to 2,670.14 but is .12% lower this week. The Dow Transports gained 2.02% but are 1.56% lower this week. Bank stocks rose .95% and then added .11% into today.

	Dow:	Nasdaq:	S&P:
Resistance:	24,289/ 24,368/ 24,446/ 24,528	7,150/ 7,191/ 7,233/ 7,276	2,671/ 2,682/ 2,696/ 2,708
Support:	24,210/ 24,134/ 24,057/ 23,978	7,065/ 7,016/ 6,984/ 6,940	2,658/ 2,643/ 2,633/ 2,619

Other Markets

Crude Oil rose 1.47% last week and topped $69.35/barrel for the first time since November 2014. It's off .28% this week. In turn, Commodities rose 1.11% but were .35% lower into today. Gold lost .60% and has fallen 1.53% this week. It's 'in sync' inversely with the U.S. Dollar which rose .64% and was 1.43% better into today. The Japanese Yen fell .29% and dropped another 1.52% this week, and the Euro dropped .35% and 1.51% – also confirming the currency play. Corn lost 2.52% and then rose 2.52% this week. Cotton rose 2.47% but dropped .56% into today.

"A little government and a little luck are necessary in life, but only a fool trusts either of them." P. J. O'Rourke

Additional Information is Available on Request

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