Commerce Street Capital Management
1445 Ross Avenue
Dallas, Texas 75202
214-545-6800

# Bond Market Review

May 17, 2018

**The 2% Solution**

The U.S. economy has struggled to return to 2% inflation since the financial crisis. By the end of the day, the Dow Industrials were off for the year by a hundredth of that level! Since bottoming with our April 2nd trend–change date for a low, the Dow has risen 5.87% but is still 7.15% off its January 26th high. As of Tuesday, the Dow was down .05% for 2018. Wednesday left it .25% higher but today's close set it once again negative – albeit by a mere .02% for the year. I'm not really excited about the market's structure and for that reason remain more concerned at present about downside risk than missing upside. If the Dow can break 25,225 the bullish case will greatly improve. Breaking 24,500 and then 24,000 to the downside would be very negative for the market's structure over this coming week. That said, while most U.S. and global indices are still well off their highs, the Russell 2000 (small cap) index hit new records Wednesday and today.

While the Dow Industrials are .02% lower for the year, the Nasdaq is ahead by 6.94% – but the numbers are skewed heavily by a few tech leaders. Out of 100 stocks, Apple is 12.056% of the index or just under an 8th of the total! If you consider Amazon at 9.729%, Microsoft at 9.41%, Facebook at 5.594%, and Alphabet (Google) at 8.896%, those 5 stocks represent over 45.6% of the Nasdaq 100 – leaving under 55% for the other 95. So, as they go, so goes the Nasdaq! The S&P is 1.74% higher for the year, and as of Wednesday 4 stocks (Apple, Amazon, Microsoft, and Netflix) represented over 2/3 of the 500–stock index's year–to–date return.

**Looking Ahead**

- Equities have a cycle high due near May 22/23, and another low near May 30th.
- Yields have a cycle low due in the May 31st to June 4th window.

**Treasuries, Agencies, and MBS**

Yields sidestepped cycles and bond support levels to surge to their highest readings in nearly a decade. Once again, while recognizing the cycles get out of sync at times, we update and provide them as part of our work. 2–year yields hit highs not seen since July 2008 and 5–year notes rose to their highest levels since June 2009. The 10–year note broke cleanly through the December 2013 levels to reach the highest yields since July 2011. The 30–year is right on the highs of June 2013. While the Fed is on a tightening run, we would note 30–year bonds had greater yield increases into June 2009 and December 2013 without altering the long–term inflation cycle. The question is – will they turn it higher this time, and truly end the bull market that began in 1981 with 30–year yields peaking at 15.21%? The 10–year note peaked at 15.84% in 1981 and has endured 6 yield spikes far more substantial than the current one. 10–year yields are right on a long–term trend line, but also have critical support at 3.75% to 4.00% that must be broken before calling an end to the big bull. With March's 25–bps increase in the books, most Fed members continue to forecast 3 to 4 hikes for 2018. The market–based odds for a June 13th hike continue to remain 'locked' at 100%.

While the Fed is unlikely to check their advance, which with little resistance spills over to 2–year notes, the jury is out on whether or not the inflation battle is won. Moreover, with the EU economy seeing setbacks and the Bank of England holding rates while lowering growth and inflation forecasts – the Fed is alone in their rate campaign for major economies (Argentina's 40% rate notwithstanding). Germany's economic growth was only .3% in the first quarter – and they are the leading EU economy. The surge above 2.90% left U.S. 5–year yields higher than any other 'group of 10' leading economy's 10–year yield. The **B**ond **M**arket **R**eview remains of the opinion that the low yields and inflation rates of global alternatives combined with recent strength in the U.S. Dollar should remain tethers that check longer U.S. rates from rising much further until rates fall or the imbalance is corrected.

While German and Japanese 5–year yields are still negative, why are most less than 1% – with U.S. rates 3 times those of Italy's .975% and 10 times Spain's .273%? Besides our FOMC policy, a big reason is that the European Central Bank is still buying debt and with the recent economic slowdown and undershoots in inflation, they'll likely continue! On the other hand, San Francisco FRB President John Williams, who will take over the head job in New York talked about ending forward guidance! Williams said he wasn't worried about the yield curve but wouldn't ignore it – and said he's not that concerned about inflation because of tepid wage growth. St. Louis's James Bullard said the Fed's actions have flattened the curve and that they shouldn't be aggressive to the point of inverting it. Bullard and Williams said guidance was important with rates near zero, but the dot plots were not as important now that they are 'off zero.' The **BMR** interpreted their comments as admitting that providing inflation forecasts for 3 years was not an easy task and that they had to be careful about future changes in forecasts impacting current markets. Bullard argued for what we've called 'Greenspeak' and he called 'Greenspanian' – contending the Fed should just comment *"we have the rate about where it needs to be today"* and will monitor developments for future changes.

Mortgage rates rose to 7–year highs, but that's spurred a lot of buying before they rise even higher – sending home prices up 7.6% versus April 2017 – with sellers getting roughly 98.8% of their asking prices. Last week was rather tame – and a 'calm before the storm' as yields rose 4, 5.5, and 2 bps for the 2, 5, and 10–year sectors, but fell 2 bps at 30–years. The yield curve twisted and significantly steepened into today with rates rising 3, 10, 14, and 14 bps for the 2, 5, 10, and 30–year Treasury sectors.

Last week, MBS spreads (FNMA 30–year 3.5%) narrowed by 1 bps. As we said a few weeks ago, the U.S. Treasury recently increased the major auction sizes by $1 billion (each). That being the case, next week the Treasury will offer $33 billion 2–year notes on Tuesday (05/22), $36 billion 5–year notes on Wednesday (05/23), and $30 billion 7–year notes on Thursday (05/24).

| **05/11/18 Treasury Yield Curve** | **2-Year: 2.538%** | **5-Year: 2.839%** | **10-Year: 2.971%** | **30-Year: 3.105%** |
|---|---|---|---|---|
| Weekly Yield Change: | +.039% | +.054% | +.020% | –.018% |
| Support: | 2.560/ 2.599/ 2.640/ 2.680 | 2.914/ 2.936/ 2.958/ 2.981 | 3.091/ 3.113/ 3.135/ 3.159 | 3.240/ 3.263/ 3.284/ 3.307% |
| Targets: | 2.522/ 2.482/ 2.441/ 2.400 | 2.892/ 2.878/ 2.858/ 2.832 | 3.070/ 3.048/ 3.025/ 2.996 | 3.208/ 3.183/ 3.151/ 3.129% |

## Economics

The Atlanta Fed's GDP–now forecast began at a strong 4.1% for Q2 2018, and after a few revisions is back at 4.1%! The latest .1% rise was due to Retail Sales rising .30% in April – and being revised from a .60% increase to .80% for March. Those increases greatly improved on modest gains in January and February. Apparel sales increased the most since March 2017. Sales also increased .30% ex autos – and were doubled for March (from .20% to .40%). Initial Jobless Claims rose 11K to a still–low 222K, though Continuing Claims dropped from 1,794K to 1,707K – the lowest since 1973!

University of Michigan Sentiment was flat at 98.8 while Current Conditions fell from 114.9 to 113.3. Expectations rose from 88.4 to 89.5. Bloomberg Economic Expectations also rose – from 52.5 to 54.5, but the Consumer Comfort measure fell from 55.8 to a 14–week low of 54.6 impacted by higher gas prices. California fuel prices hit $4/gallon for the first time since mid–2014. April's Leading Index rose .40%. Industrial Production rose .70% in April and was revised from .50% to a .70% gain for March as well. Capacity Utilization was the highest since 2015 – rising from 77.60% to 78.00%. The Philadelphia Fed Business Outlook surprised to the upside – increasing from 23.2 to 34.4. Empire Manufacturing rose from 15.8 to 20.1. March Business Inventories were flat.

Homebuilder confidence rose for the first time since December as the NAHB Housing Market Index increased from 68 to 70. An 11.3% drop in the building of apartments (multi–family) led to April Housing Starts dropping 3.67% to 1,287K (annual) units. Building Permits fell 1.82%. There was good news from Q1 Mortgage Delinquencies slowing from 5.17% to 4.63% and MBA Mortgage Foreclosures falling from 1.19% to 1.16%.

April Import Prices rose .30%, quickening the annual pace from 3.30% to 3.60%. Export Prices doubled with a .60% increase. Though a net $38.5 billion flowed out of U.S. Treasury holdings in March and back into foreign coffers, China added $11 billion to hit a 5–month high. Part of that circular shuffle is – we bought stuff from them, and they used most of the incoming Dollars to buy Treasuries instead of goods from us. That happens most every month – and it's one of the reasons for the huge trade imbalance. Japan sold $16 billion, dropping their total investments to $1,043.5 billion (the lowest since October 2011). Overall, $61.8 billion flowed into longer maturities.

Next Monday (05/21) is set for the Chicago Fed National Activity Index and the Richmond Fed Manufacturing Index follows on Tuesday. Wednesday brings MBA Mortgage Applications (which fell 2.70% last week), April New Home Sales, and the minutes from the Fed's meeting that concluded on May 2nd.

## Equities

The Dow had a great surge last week to enter positive territory for the year. The 568.66–point gain sent it 2.34% higher for the week to 24,831.17 and .45% in the black for 2018. However, it's .47% lower this week – leaving it .02% lower for the year. Into Monday (05/14), the Dow had been higher 8 days in a row for the best such streak in 8 months. The Nasdaq rallied 193.26 points or 2.68% to 7,402.88 but is .28% lower this week. The S&P rose 64.30 points or 2.41% to 2,727.72 but is also .28% lower this week. The Dow Transports rallied 3.31% and are .27% better this week. Bank stocks outperformed most sectors – surging 4.07%, and they're .14% higher this week.

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|---|---|---|---|---|---|---|
| Resistance: | Dow: | 24,795/ 24,954/ 25,111/ 25,255 | Nasdaq: | 7,409/ 7,453/ 7,495/ 7,538 | S&P: | 2,728/ 2,741/ 2,754/ 2,768 |
| Support: | | 24,638/ 24,490/ 24,325/ 24,000 | | 7,326/ 7,284/ 7,241/ 7,197 | | 2,703/ 2,690/ 2,677/ 2,659 |

*"My problem lies in reconciling my gross habits with my net income." Errol Flynn*

## Other Markets

Crude Oil continued to rise into today, hitting over $72.30/barrel and closing in on the **BMR** target range of $74.90 to $76.00. Brent Crude rose over $80/barrel today for the first time since November 2014. The reasons are as old as time – concern over peace in the Middle East, and the canceling of the nuclear deal with Iran. EU nations are going out of their way to sustain the Iran deal, and have criticized the U.S. for canceling the deal. Recall they've warned on U.S. tax cuts, trade policies, the new U.S. embassy in Jerusalem, and our backing out of the onerous provisions of the Paris accord on climate change. In other words, what's new? It's likely the Iran and Middle East tensions will continue to pressure oil higher.

Crude Oil rose 1.41% last week and added 1.12% into today. Commodities were swayed by other components, gaining only .15% and continuing unchanged this week. Gold gained .46% but has lost 2.37% since Friday. The U.S. Dollar had a miniscule rise of only 3 pipettes (less than a third of a penny) but that extended its streak to 4 weeks of gains (or without a loss). It's 1.04% better this week. The Japanese Yen fell .25% last week and is 1.26% lower this week. The Euro lost .14% last week and is 1.24% lower this week. Iran's future oil dealings are rumored to be traded in Euros instead of Dollars. Corn lost 2.26% but is 1.41% higher this week. Cotton lost 2.00% but has risen .48% so far this week.

*"It was on my 5th birthday that Papa put his hand on my shoulder and said, 'Remember, my son, if you ever need a helping hand, you'll find one at the end of your arm.'" Sam Levenson*

***Additional Information is Available on Request***

Doug Ingram, Managing Director – Commerce Street Capital Management