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BOND MARKET REVIEW

May 23, 2018

Roundabout

The news seemed rather 'circular' last week – with headlines just changing places. Stocks surged into our May 22/23 cycle for a high, but we still don't like the market structure. The market traded within the boundaries of levels that would cause us to get bullish or warn of more downside. (We had said: *"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."*) 10–year yields were still hovering near 3%, but we don't see an imminent danger of an upside break with the global alternatives offering little return and their economies at risk of stalling.

The Fed minutes from their May meeting showed them still desiring another hike *"soon"* and the market expectations are still locked at 100% for a June 13th rate increase. The minutes seemed a tad dovish, though members are still calling for 2 or 3 additional rate hikes in 2018. As we've run some historical data, we're inclined to believe that inflation hitting 2% may not be a breakthrough, but rather data visiting the top end of a range in a 'trading channel.' If that turns out to be the case, the battle is not yet won! We've certainly seen that pattern in the EU and Japan.

The minutes expanded on the Fed's willingness to allow inflation to rise above 2% on a temporary basis and nothing we read pointed to a divergence from the path of gradual increases. The minutes said: *"it was noted that it was premature to conclude that inflation would remain at levels around 2%, especially after several years in which inflation had persistently run below the Committee's 2% objective."*

The minutes said that some members thought that *"recent news on inflation, against a background of continued prospects for a solid pace of economic growth, supported the view that inflation on a 12–month basis would likely move slightly above the Committee's 2% objective for a time."* To the **BMR**, that sounds as though inflation was not anticipated to continue to rise. Moreover, the Fed understands the potential impacts of hiking rates and a flat yield curve. The tightening should ultimately lead to some slowdown, though the **BMR** doesn't view the U.S. as overheating (or in danger of doing so given tepid wage growth) – but certainly doing the best since the financial crisis. The minutes had a positive spin on hitting 2%. They said: *"It was also noted that a temporary period of inflation modestly above 2% would be consistent with the Committee's symmetric inflation objective and could be helpful in anchoring longer–run inflation expectations at a level consistent with that objective."* While not allowed to use the word in the definition, that certainly explains why the Fed adopted a 'symmetric' inflation objective – as that text explained their 'circling the wagons' around 2%.

The talk of tariffs that's been ruling the news turned rather tame. The U.S. backed off trade tariffs and China cut import tariffs on autos from 25% to 15%. It reminded us of the Cuban missile crisis. There was tough talk to the brink of war, and then the missiles pointing at the U.S. disappeared from Cuba. Shortly thereafter, missiles pointing at Russia similarly vanished from Turkey. Trump and North Korea may still meet, but they might not. (As we were proofing this **B**ond **M**arket **R**eview, President Trump had cancelled the June 12th Singapore summit with an official letter to the North Korean leader.) Meanwhile, the Trump investigation by Special Counsel Robert Mueller is still ongoing, but now there may be an investigation of the investigators.

Looking Ahead

- Equities have a low due near May 30th.
- Yields have a cycle low due in the May 31st to June 4th window.
- U.S. markets will close for Memorial Day (Monday 05/28). Bonds close early Friday at 2 p.m. ET.

Treasuries, Agencies, and MBS

The cycles still show bond yields lower into May 31st to June 4th. Last week, yields rose by 1, 5, 8.5, and 9.5 bps in a steepening move for the 2, 5, 10, and 30–year Treasury sectors. Into today, yields for those sectors fell by 2, 6.5, 6.5, and 4.5 bps. Last Thursday, we talked about U.S. 5–year yields at 2.926% being 3 times those of Italy's .957%. What a difference a few days can make! Political risks pushed 5–year Italian yields up to 1.17% while U.S. yields fell 10 bps – closing that spread by over 30 bps. Risks pushed Italian yields higher while our yields are trading higher because things are improving. 5–year German yields fell from –.02% to –.13% over that timeframe as growth in the EU was seen as slowing. It's hard for us to see U.S. yields trading a lot higher from current levels given their place in the global hierarchy.

05/18/18 Treasury Yield Curve	2-Year: 2.549%	5-Year: 2.889%	10-Year: 3.057%	30-Year: 3.199%
Weekly Yield Change:	+.011%	+.050%	+.086%	+.094%
Support:	2.566/ 2.595/ 2.640/ 2.680	2.829/ 2.848/ 2.872/ 2.898	2.996/ 3.025/ 3.059/ 3.077	3.137/ 3.160/ 3.181/ 3.207%
Targets:	2.522/ 2.482/ 2.443/ 2.400	2.791/ 2.769/ 2.750/ 2.730	2.962/ 2.943/ 2.920/ 2.898	3.117/ 3.097/ 3.072/ 3.050%

Last week, we reported that mortgage rates rose to 7–year highs. While MBA Mortgage Applications fell 2.60% for the week ending on May 18th, the Mortgage Banking association also said that applications to refinance existing homes just fell to the lowest levels in over 17 years (since December 2000). Last week, MBS spreads (FNMA 30–year 3.5%) narrowed by 2 bps. On Tuesday (05/22), the Treasury sold $33 billion 2–year notes at 2.59%. That was the highest auction yield since July 2008 and demand was the strongest since March. The group that includes foreign central banks accounted for 39.3% of the offering versus 41.6% in April. Today's 5–year auction brought 2.864% for $36 billion in supply. Demand was the highest since last September and the yield the highest since the September 2008 auction. Foreign buying fell to 56.2% of this issue versus 60.2% last month. The U.S. Treasury will offer $30 billion 7–year notes on Thursday (05/24).

Economics

Initial Jobless Claims rose from 211K to 222K last week – hovering above the 1969 lows. Continuing Claims fell from 1,794K to 1,707K, the lowest number on benefits since 1973. The Chicago Fed National Activity Index rose only slightly, from .32 to .34. The Richmond Fed Manufacturing Index rose from –3 to +16. New Home Sales fell 1.49% to 662K in April, but that drop was from data that was revised lower for the last 3 months.

Thursday is set for jobless claims data, the House Price Purchase Index, the FHFA House Price Index, Bloomberg Consumer Comfort, Existing Home Sales for April, and Kansas City Fed Manufacturing Activity. Friday brings Durable and Capital Goods Orders for April and the University of Michigan consumer sentiment surveys. The markets will be closed on Monday (05/28) for Memorial Day, a time to reflect on the life and blessings we have – that came at such great cost and sacrifice.

Tuesday is set for metro home prices (S&P Case–Shiller 20–City index), the Home Price Index, Conference Board Consumer Confidence, and Dallas Fed Manufacturing Activity. Wednesday's data includes the Fed's Beige Book, MBA Mortgage Applications, an update on Q1 GDP, Personal Consumption, the Advance Goods Trade Balance, and April Retail Inventories. ADP Employment Change private–payroll data is also due on Wednesday, being released before the end of the month to get out in front of Friday's (06/01) very–early May payroll numbers. On Likewise Thursday, the Challenger Job Cuts for May will be released with other clues into May payrolls from jobless claims. Other data coming Thursday includes April's PCE Deflator, April Personal Income & Spending, Chicago Purchasing Managers, Bloomberg Consumer Comfort, and Pending Home Sales for April.

Equities

Stocks appear to have peaked into our May 22/23 cycle for a high – and should trade lower into next week. The Dow Industrials lost 116.08 points or .47% last week to close at 24,715.09 but are .69% higher this week. The Nasdaq lost 48.54 points or .66% to 7,354.34 but is .97% higher this week. The S&P fell 14.75 points or .54% to 2,712.97 but is .75% better since Friday. Conversely, the Dow Transports rose .16% but are .03% lower this week. Bank stocks lost 1.19% but are .57% higher this week.

Resistance:	Dow:	24,887/ 24,979/ 25,107/ 25,255	Nasdaq:	7,422/ 7,457/ 7,507/ 7,550	S&P:	2,729/ 2,742/ 2,755/ 2,768
Support:		24,635/ 24,478/ 24,328/ 24,173		7,337/ 7,294/ 7,250/ 7,210		2,708/ 2,691/ 2,678/ 2,664

Other Markets

With a rise near $73/barrel on Tuesday, Crude Oil continued to close in on the **BMR** target range of $74.90 to $76.00. Crude rose .82% last week and another .79% into today. Commodities gained only .06% last week but were 1.32% higher into today. Gold lost 2.23% and fell another .13% this week. The U.S. Dollar countered with a 1.23% gain, rising for a 5th week, and is .40% higher this week. The Japanese Yen dropped 1.27% last week but is .63% higher this week. The Euro lost 1.43% last week and is off another .64% this week. Corn rose 3.27% and added 1.49% into today. Cotton gained 2.28% and is .47% better this week.

*The **BMR** offers our profound and utmost respect to those and their families that have paid the ultimate sacrifice in order to preserve our freedom and to protect and defend our nation. Thank you – and we do remember!*

"O beautiful for heroes proved, In liberating strife, Who more than self their country loved, And mercy more than life!" Katharine Lee Bates

Additional Information is Available on Request

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