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# Bond Market Review

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## Convergence

As widely expected, the FOMC hiked rates 25 bps on Wednesday. The **B**ond **M**arket **R**eview's position has been that continuing to hike without the global resolution of low–inflation pressures and challenged growth would lead to further flattening in the U.S. Treasury curve. The short end believes the Fed and domestic data, while the long end is more tuned to global forces. The spread between the 2 and 10–year Treasury notes fell to 37 bps today – the lowest difference since August 2007, closing in on inversion.

There were other highs and lows, mostly positives for the economy. According to the JOLTs survey, in April job openings rose to 6.698 million – meaning for the first time in nearly near 5 decades, there are more positions open than there are unemployed prospects for those jobs! Americans on unemployment benefits fell below 1.7 million for the first time since November 1973, the U.S. Unemployment Rate fell to only 3.8%, and food–stamp usage just fell to the lowest level since February 2010. President Trump may have even paved the way to open a MacDonald's in North Korea! On the downside, the tariff wars are just beginning – and the outcome is highly speculative.

While the FOMC raised rates with another unanimous vote, their statement was greatly downsized. While they moved words around a little, they kept their *"symmetric 2% inflation objective"* – again using the adjective twice! They changed economic activity rising at a *"moderate"* rate to *"solid"* – which you would think necessary to merit tightening. The statement was viewed as more hawkish with 8 officials now expecting 4 hikes in 2018 (versus 7 as of the March dot–plots). Fed Chairman Jerome Powell said the *"main takeaway is that the economy is doing very well"* and the growth outlook is *"favorable."* The statement was slimmed down – removing the language of *"gradual increases"* of rates, the plan to *"carefully monitor"* inflation, and their dependence on *"incoming data."* The Fed announced they would begin holding pressers after every meeting starting next January.

Nevertheless, unless the economy actually overheats and inflation really overshoots 2% on a sustained basis, the FOMC is causing a large part of the deficit. The national debt is still rising and each 25–bps hike adds a huge burden to its cost (over $50 billion per year for <u>each</u> 25 bps). That means 4 hikes would eventually lead to over $200 billion more in deficit spending each year just to service debt. It's also stifling home buyers and emerging markets. Physicians in the past would apply leeches as a type of bloodletting therapy. If the economy isn't really overheating and inflation is not exceeding the Fed's target on a sustained basis, how is this much different?

## Looking Ahead

- Equity cycles show trend–change highs due near June 18th and the 25th, followed by weakness into August.
- Yields should peak near June 14th and reverse lower into June 22nd and July 11th.

## Thank You for Smoking

The U.S. Dollar is on fire – and so is the economy. With solid economic growth and higher rates, the Dollar continued its rally as the 'place to be' to position American assets and outpace global alternatives. Today, the Atlanta Fed's GDP–Now forecast tied its early–month high of 4.8% for Q2 2018. As we've said before, any growth near that pace would place running year–over–year GDP over 3% for the first time since 2005.

The European Central Bank tried to say 'me too' by announcing they would taper asset purchases by the end of 2018 and hold rates unchanged until the summer of 2019. While ECB President Mario Draghi may have intended the announcement to stop the ascent of the Dollar, it was read as overly dovish and backfired – sending the Dollar ever higher. Announcing the intentions to taper purchases into 2019 but with no clear plan to shrink their balance sheet, and no hikes until later next year, led to the market's perception of the quitter's dilemma: 'I've made a decision to go on a diet and/or to quit smoking, and I'm going to start – in a little over a year!' The Bank of Japan also decided to taper asset purchases, but left rate policy unchanged and downgraded their assessment of inflation.

## Looney Tunes

While the FOMC was in their 'blackout period' coming into Wednesday's statement, former Fed Chair Ben Bernanke decided he'd add his 2¢ saying the Trump stimulus was *"at the very wrong moment"* and would fade after 2 years – hitting the economy in such a way that it would be like Wile E. Coyote going off a cliff (and then dropping hard).

If the economy ever fell off a cliff, it was in the financial crisis debacle partially caused by Bernanke's Fed as they continued to raise rates at every meeting – even 7 months after the yield curve had inverted, causing subprime debt to be recast at payments that simply couldn't be handled by debtors. That after no or low–doc loans at high LTVs were so easy to obtain that professionals in other occupations were scrambling to get real–estate licenses.

This was only a few years after Bernanke's predecessor, Alan Greenspan, advised the masses to get adjustable rate mortgages because rates were so low. It only goes to show that, despite the best textbooks and economic degrees out there, the FOMC can be very wrong with their policies and timing. Though implying he had the financial foresight to use hikes to act as a quarterback that passes the ball to where his receiver is going to be (Bernanke speaking of the Fed's hikes and their ultimate economic effect), the persistence of 17 consecutive hikes led to a blitz that almost took the entire financial system down. Evaluations were out of control, but we think defaults were unduly exacerbated by onerous payment resets. The Fed must know there's an entirely new generation of homebuyers beginning to feel the pain of upward–payment creep.

## Treasuries, Agencies, and MBS

We had expected yields to *"peak near June 14th"* and then *"reverse lower into June 22nd and July 11th."* Those cycles seem to be in play, so lightening hedges is in order. Last week, yields rose 2.5, 3.5, 4.5, and 4 bps for the 2, 5, 10, and 30–year sectors as the U.S. Treasury curve steepened. The long end had begun to rally today as the curve reached its flattest level since August 2007. 2 and 5–year rates rose 6.5 and 2 bps into today, while 10 and 30–year yields were lower by 1 and 3.5 bps. After the FOMC action, the market odds for an August hike were only 18.6% but September rose to 84.9%. It was clear the Fed intended to hike 2 more times – probably September and December.

MBS spreads (FNMA 30–year 3.5%) widened by 1 bps last week. This week's auctions were held earlier in the week to conclude before 'Fed day.' On Monday, the U.S. Treasury sold $32 billion 3–year notes at 2.664% – the same yield result for May's offering. Demand was stronger versus that auction and the group that includes foreign central banks accounted for 51.4% of this issue versus 45.6% last month. Also on Monday, the May 2028 issue was reopened to add $22 billion 10–year notes which brought 2.962%. Demand was the best since January and the yield was the lowest since April. Foreign buyers took 56% of the offering versus 63% in May. The 30–year bond auction took place on Tuesday, again reopening the May (2048) maturity. $14 billion supply was sold at 3.10%, also the lowest yield since April. Demand was unchanged to May, and foreign buying fell to 62.2% versus 62.7% of that auction.

| 06/08/18 Treasury Yield Curve | 2-Year: 2.500% | 5-Year: 2.785% | 10-Year: 2.947% | 30-Year: 3.090% |
|---|---|---|---|---|
| Weekly Yield Change: | +.027% | +.036% | +.044% | +.039% |
| Support: | 2.595/ 2.635/ 2.675/ 2.715 | 2.802/ 2.822/ 2.843/ 2.863 | 2.845/ 2.967/ 2.990/ 3.012 | 3.049/ 3.071/ 3.094/ 3.116% |
| Targets: | 2.516/ 2.477/ 2.436/ 2.397 | 2.764/ 2.744/ 2.727/ 2.695 | 2.902/ 2.881/ 2.849/ 2.823 | 3.027/ 3.004/ 2.986/ 2.960% |

## Economics

Initial Jobless Claims continue to ride near the lowest levels since the early '70s. They fell 1K to 222K last week and then dropped 4K to 218K this week. Continuing Claims rose from 1,720K to 1,741K, but then fell to 1,697K (under 1.7 million for the first time since November 1973). Bloomberg Consumer Comfort fell .4 to 54.8 last week but rose to a 6–week high 55.8 this week. NFIB Small Business Optimism rose from 104.8 to 107.8 – the second highest level ever and just under the record 108 from 1983. The service sector expanded beyond forecasts, rising from 56.8 to 58.6 (ISM Non–Manufacturing Composite). Business activity rose from 59.1 to 61.3 and the employment index improved from 53.6 to 54.1. April Business Inventories rose .30% and Wholesale Inventories rose .10%. Wholesale Trade Sales rose a nice .80%. Nonfarm Productivity rose .40% for Q1 2018. Unit Labor Costs rose 2.90%.

In May, Retail Sales rose by .80% (the most since September). Ex autos, sales rose .90%. The control group, that includes select retail (less food, autos, and fuel, etc.), rose .50%. Though we would expect a much higher result for May, in April Consumer Credit rose by the smallest amount in 7 months – rising only $9.262 billion. Consumer Prices rose the most (annually) since December 2011 as CPI was .20% higher in May leading to the annual pace increasing from 2.50% to 2.80%! The core pace (ex food & energy) also rose .20%, though the annual pace increased only .10% to 2.20%. Though Average Weekly Earnings rose .30% year–over–year, Average Hourly Earnings were unchanged. Producer Prices rose .50%, quickening the annual pace from 2.60% to 3.10%. Core PPI rose .30% taking that annual pace .10% higher to 2.40%. Inflation was closer to Fed targets but wages are lagging. Import Prices rose .60% in May, with the annual pace increasing from 3.60% to 4.30%.

The Treasury's Monthly Budget Statement revealed a deficit of $146.8 billion in May (the most for May since 2009). At $530 billion 8 months in, the fiscal deficit for 2018 is running 11.9% deeper than for 2017. Debt service rose to $32 billion. As trade wars were being considered, the U.S. trade deficit narrowed to the lowest level since September – dropping to $46.2 billion in April (from $47.2 billion in March). Exports rose to a record. Whether or not you think tariffs are a good idea, the U.S. has been running huge trade deficits for years. Clearly our trade partners are far more interested in selling to us – than buying from us.

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Friday is set for Treasury International Capital (foreign flows and net Treasury operations), the University of Michigan sentiment surveys, Empire Manufacturing, and Industrial Production & Capacity Utilization. Next Monday (06/18) gives us the NAHB Housing Market Index (home builder's optimism & outlook). Tuesday provides Housing Starts and Building Permits for May. Wednesday brings MBA Mortgage Applications (which rose 4.10% and then fell 1.50% over the past two weeks), the Current Account Balance for Q1 2018, and Existing Home Sales for May.

## Equities

The Nasdaq again surged to new highs while most other indexes remain below their January highs. Investor optimism is once again approaching the levels of that January high as traders seem unconcerned about another wave down being imminent. The cycles show trend–change highs due near June 18th and the 25th, followed by weakness into mid–August. The Nasdaq gained 91.18 points or 1.21% to 7,645.51 and is 1.51% higher this week. Other indices traded up with the cycle we expected into June 8th, and then fell a bit. The Dow Industrials surged 681.32 points or 2.77% last week to 25,316.53 but are .56% lower this week. The S&P gained 44.41 points or 1.62% to 2,779.03 last week and is .12% higher this week. The Dow Transports gained .41% and are .65% better this week. Bank stocks rose 2.34% (after 3 weekly losses) but are 2.18% lower this week.

| | Dow: | Nasdaq: | S&P: |
|---|---|---|---|
| Resistance: | 25,165/ 25,342/ 25,506/ 25,665 | 7,731/ 7,767/ 7,819/ 7,863 | 2,778/ 2,791/ 2,804/ 2,817 |
| Support: | 24,871/ 24,714/ 24,557/ 24,400 | 7,688/ 7,644/ 7,600/ 7,544 | 2,766/ 2,753/ 2,740/ 2,727 |

## Other Markets

Crude Oil started to rally this week, up 1.75% after a .11% drop last week. We expect a high near *"June 20th to be followed by a drop into July 2nd."* Commodities lost .83% and were .51% lower into today. Gold gained .25% and is up .45% this week despite the strong U.S. Dollar, which was off .67% last week for the first drop in 8 weeks, but up a stout 1.32% this week following a hawkish Fed and the dovish ECB and Bank of Japan moves. The Japanese Yen lost .01% last week and is .99% lower this week. The Euro gained .94% last week but has plunged 1.71% lower this week – as for now the Dollar is king. Corn lost 3.51% and is 3.90% lower this week. Cotton gained 1.76% last week but has since fallen 1.61%.

*"I love being a writer. What I can't stand is the paperwork!" Peter De Vries*

*"Most people rust out due to lack of challenge. Few people rust out due to overuse."*

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

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