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Bond Market Review

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World Cup

Forget the Tonys, some of the best acting you will ever see is during the FIFA World Cup – and of course there's as much or more kicking than on Broadway. Players tumble to the ground writhing in pain – seemingly whether touched or untouched in an effort to win a free (or penalty) kick and to sway the referees with their act. Unless the blow is to the head, the players almost always hold their shin or foot and have mastered the art of wincing! While it's not always easy to discern the cause or extent of each injury – in nearly every case (and we've watched a lot), the players revive from the dead, limp for a few steps, and then are again elite athletes at full speed – until the next brush with a foot, elbow, knee, head, or in some cases thin air. It occasionally reminds us of Monty Python's bit when one of their 'players' is wounded: *"I'm not quite dead yet."*

Since the January top, stocks have swooned like soccer players – only to come back to life, and in the case of the Nasdaq, make new highs. While the Nasdaq hit a new record high on Wednesday, on Tuesday the Dow Industrials traded into the red for 2018. When we've discussed not liking the market's structure, we've been referring to the Dow, and we're still suspect. Despite the Nasdaq's defiant rise, the Dow just traded lower for its 8th straight session – tying a record going back 40 years! It hasn't lost for 9 sessions since 1978. Nevertheless, the loss for these 8 days was only 3.40% – and the Dow's had many single sessions with a far greater loss, including two of over 4% back in February. So, will the Dow again rise up and deliver a blow for the bulls? Of course that's possible, but the cycles argue for lows near August 13th followed by a 3–week rally, and then for a hard low into October.

European Central Bank President Mario Draghi sounded as though he held the FOMC's talking points. He said: *"We will remain patient in determining the timing of the first rate rise and will take a gradual approach to adjusting policy thereafter."* Sound vaguely familiar? The **B**ond **M**arket **R**eview noted that U.S. rates had outpaced their global counterparts into mid–May. Before the ECB announced intentions to taper asset purchases, debts for some EU nations seemed very out of place. While the 5–year notes of France, Germany, and a few other EU nations are still negative, in the **BMR** (05/17/18) we noted that U.S. 5–year rates were *"3 times those of Italy's .975% and 10 times Spain's .273%?"* Recall also those were two of the EU nations highly challenged in the sovereign debt crisis! Since then, U.S. yields have fallen from over 2.90% to 2.78%, and Italy's bonds have crashed sending yields from .975% to 1.72% in only a month. (Spain's rose to .386%.) With a strong Dollar, these spreads still seem way too high.

Looking Ahead

- Equity cycles show stocks weakening from June 25th into July 18th and then mid–August.
- Yields should trade lower from a high near July 2nd into a low near July 11th.

Treasuries, Agencies, and MBS

We still expect yields to trade lower into July 11th, but there is a trend–change high due near July 2nd – so the better move might be from that date. Last week, the U.S. Treasury yield curve flattened with 2 and 5–year yields higher by 4.5 and 1.5 bps but 10 and 30–year rates lower by 2.5 and 4.5 bps. We continue to expect the curve to invert by September – when the FOMC is widely expected to hike rates another 25 bps. As of today, the market–based odds for an August 1st hike were only 24.8%, while at 81.4% the September 26th meeting continued to be the 'gradual pace' expectation for every other meeting – even though the Fed removed that language from their June statement. Another 25 bps would in itself bring the short and long ends of the curve right on top of each other – unless something happens to sway longer rates higher. On Tuesday, the 2–to–10–year spread fell to only 35 bps – the lowest level since August 2007. As of today, that spread stood at 36 bps.

The Current Account Balance for Q1 2018 was a deficit (outflow) of $124.1 billion. Total Treasury International Capital Flows showed $138.7 billion moving into U.S. assets in April. $93.9 billion went into longer–term U.S. debt. However, China was a net seller of $5.8 billion and Japan was a seller for the 8th month out of the last 9. Russia dumped half their Treasury holdings – selling a net $47.4 billion!

MBS spreads (FNMA 30–year 3.5%) narrowed by 1 bps last week. Next week, the U.S. Treasury will auction $34 billion 2–year notes on Tuesday (06/26), $36 billion 5–year notes on Wednesday (06/27), and $30 billion 7–year notes on Thursday (06/28).

06/15/18 Treasury Yield Curve	2-Year: 2.548%	5-Year: 2.798%	10-Year: 2.921%	30-Year: 3.047%
Weekly Yield Change:	+.048%	+.013%	–.026%	–.043%
Support:	2.595/ 2.636/ 2.675/ 2.715	2.798/ 2.820/ 2.837/ 2.869	2.927/ 2.946/ 2.969/ 2.992	3.071/ 3.094/ 3.116/ 3.139%
Targets:	2.516/ 2.477/ 2.437/ 2.397	2.785/ 2.729/ 2.694/ 2.641	2.891/ 2.878/ 2.849/ 2.823	3.036/ 3.006/ 2.986/ 2.960%

Economics

The second quarter continues to look very good. The Atlanta GDP–Now forecast slipped from 4.8% (last Thursday) to a still–solid 4.7% Q2 growth estimate as of Tuesday. With less than 2 weeks to close out the second quarter, it appears the U.S. economy will achieve its first full–year of 3% growth in a dozen years! Initial Jobless Claims are still hovering near the lowest levels since the early '70s. Last week, they fell from 221K to 218K. Continuing Claims, which lag a week, rose from 1,701K to 1,723K. Bloomberg Consumer Comfort rose from 55.8 to tie an 8–week high of 56.5. Their measure of Economic Expectations rose from 54.5 to 56. The Leading Index for May rose .20%.

University of Michigan Sentiment rose 1.3 to 99.3. Their Current Conditions survey surged from 111.8 to 117.9 – the second highest level since 2000! However, Expectations fell to a 5–month low (down from 89.1 to 87.4). The Philadelphia Fed Business Outlook fell from 34.4 to 19.9 as their index of new orders tumbled 22.7 points (the largest drop since October 2008). With that drop following a huge rise in May, the index is still promising and there could be some timing issues. Empire Manufacturing rose from 20.1 to 25. Manufacturing production fell .7% in May leading Industrial Production .10% lower. Auto production dropped 6.5% for its largest falloff since July 2013. Capacity Utilization fell from 78.10% to 77.90%.

With lumber prices rising and existing home sales cooling, homebuilder optimism fell from 70 to 68 (NAHB Housing Market Index). The 6–month outlook fell to its lowest level since November. In May, sales of Existing Homes fell .37% from a 5.45M annual pace to 5.43M. Inventories fell to the lowest reading for the month of May in the data series, while median home prices rose 4.9% to last year reaching a record $264,800. The FHFA House Price Index rose .10% in April. Housing Starts rose in May to a decade high 1,350K annual units (up 4.98% from 1,286K). However, Building Permits fell 4.62% (from 1,364K to 1,301K).

Next Monday (06/25) is set for New Home Sales for May, the Chicago Fed National Activity Index, and Dallas Fed Manufacturing Activity. Tuesday brings metro–home prices (S&P Case–Shiller 20–city index), the Conference Board Consumer Confidence surveys, and the Richmond Fed Manufacturing Index. Wednesday's data includes Pending Home Sales for May, MBA Mortgage Applications (which last week rose 5.10%), Wholesale & Retail Inventories for May, the Advance Good Trade Balance (deficit), and orders for Durable & Capital Goods.

Equities

The Nasdaq surged to new highs on Wednesday, but again this week most other indexes remained well below their January highs. The Dow Industrials lost 226.05 points or .89% last week to 25,090.48 and are 2.51% weaker since Friday. The S&P managed a slight .02% gain of .63 points to 2,779.66 but are 1.08% lower this week. The Nasdaq gained 100.87 points or 1.32% to 7,746.38 and is also lower this weak – but only by .43%. The Dow Transports rose 1.24% but are off by 2.23% this week. Bank stocks lost 2.12% but are a modest .11% higher this week.

Resistance:	Dow:	24,658/ 24,798/ 24,955/ 25,134	Nasdaq:	7,724/ 7,767/ 7,804/ 7,854	S&P:	2,770/ 2,782/ 2,791/ 2,803
Support:		24,487/ 24,348/ 24,193/ 24,037		7,681/ 7,638/ 7,596/ 7,533		2,745/ 2,732/ 2,719/ 2,706

Other Markets

The U.S. Dollar gained a strong 1.33% last week, completing an 8th gain in the past 9 weeks. However, the Dollar is off .40% this week. Crude Oil lost 1.03% but is .74% better this week. Commodities have been with oil and counter the Dollar. They lost 1.90% last week but are bucking the trend into today – down by .94%. Gold was in that same mode, losing 1.81% last week against a strong Dollar but also lower this week by .58%. The Japanese Yen dropped 1.01% last week but is .61% better this week. The Euro lost 1.35% and is .05% lower this week. The British pound rallied as one of the Bank of England's main economists joined dissenters in supporting rate hikes. Corn lost 4.37% and is off by 1.18% this week. Cotton dropped 4.44% and then 'bailed' 8.24% into today!

"It is better to know some of the questions than all of the answers." James Thurber

Additional Information is Available on Request

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