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Bond Market Review

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Elasticity

Are stocks headed higher into Elysium or stretching to the breaking point? The recovery since the plunges into the February 9th and April 2nd lows is certainly impressive for the Nasdaq and S&P, but less so for the Dow Industrials. This market is either very resilient or ready to snap like a rubber band that has no more 'give.' World markets did a reverse of 'buy the rumor, sell the fact' as they rallied with the trade tariffs beginning to take place. Hong Kong fell to the lowest level since October before rebounding on Monday. China's Shanghai Composite had fallen back to March 2016 levels 25% off February highs. Deutsch Bank failed U.S. stress tests and fell to a multi–decade low. Global stocks lost $10 trillion in the first half of 2018, and German and Chinese stocks had their worst starts since 2010. The last week of June also saw the second largest weekly outflow from global equities with $21.2 billion out of ETFs and $8.5 billion in mutual fund redemptions. The U.S. Dollar had its best quarter since Q4 2016 and Crude Oil surged the most since April 2016 – ultimately hitting our upside target on July 3rd. Nevertheless, U.S. markets have been behaving and rebounding as if there were only modest concerns over an escalating trade war.

The U.S. economy has shrugged off negative politics and trade–war concerns to possibly enjoy its best quarter of growth since Q3 2014. While the New York Fed model is forecasting 2.79% GDP growth for Q2 2018, the Atlanta GDP–Now forecast (which has a good track record for its approach and results) has been hovering between 3.8% to 4.1% since the end of June – and was reading as high as 4.8% for a few prior releases. It fell back to 3.8% on Friday, following the June payroll numbers and the foreign trade deficit.

The four releases of data that offer some insight into monthly payrolls were all indicating that the June jobs numbers might disappoint. ISM Employment eased from 56.3 to 56, Challenger Job Cuts rose 19.6% (more cuts) versus June 2017, ADP Employment Change showed private payrolls increasing by 177K versus 190K expected (under for a 4th month), and while still low – jobless claims numbers had been near the higher end of the range of recent data. The June numbers beat expectations of 195K as Nonfarm Payrolls grew by 213K. 37K jobs were added for the 2–month revision. Private Payrolls rose 202K with 21K also added to May's new 239K total. Despite the worry over trade, Manufacturing added 36K jobs. While the U.S. Unemployment Rate rose from 3.80% to 4.00%, it was for a good reason! The Labor Force Participation Rate increased from 62.70% to 62.90% and a new record 155.576 million were employed. A record 255K Americans aged 85–and–up are still working! The Under–employment Rate also ticked up .20% to 7.80%. Average Weekly Hours were steady at 34.5. Average Hourly Earnings rose .20% but the year–over–year wage growth remained at 2.70% – showing no upside movement. Also, despite the positives in the report, a large part of the gain was a 145K increase in part–time workers while full–time jobs declined by 89K.

Looking Ahead

- Equity cycles show stocks stair–stepping to lower lows due near July 18th, August 3rd, and August 13th.
- Yields should key on equities, and trade lower into month end if stocks retreat with their cycles.

Treasuries, Agencies, and MBS

The last week of June saw 30–year yields drop once again below 3% and last week the spread between 2 and 30–year yields dropped to only 39 bps. On Thursday (07/05) the spread between 2 and 10–year yields dropped to 28 bps – revisiting that 11–year low again today. That was keeping with the recent trends of tightening closer and closer to inversion, and once again the lowest spread since August 2007. The FOMC was said to be considering other measures besides a flat–or–inverted curve to signal coming recessions. That sounds like the old: 'It's different this time' argument. Is it? With spreads getting so tight, bond investors are still willing to bet against inflation and the Fed. Conventional wisdom is to not fight the Fed, but will they be the ones to step across the line that leads to the fight? With the 2–to–10–year spread sitting at 28 bps, it won't take but one more 25–bps rate hike to put the curve right on top of itself. What the FOMC views as an academic exercise to control interest rates and economic growth could turn into a rather dangerous game of 'chicken.'

In the last week of June, yields dropped 1.5, 3.0, 3.5, and 5.0 bps for the 2, 5, 10, and 30–year sectors. Last week, 2–year rates rose by 1 bps, but those outer–sector yields dropped another 2, 4, and 6 bps – giving us 2 weeks of flattening in the U.S. Treasury curve. Into today, however, yields were roughly 3 bps higher across the curve – of course leaving it with last week's 'flatness.' Bonds have a trend–change date near the end of the month that the **B**ond **M**arket **R**eview expects to be driven by equities. If equities reverse lower this week, we think yields will continue lower into month end. However, the reverse is also possible. Stocks should give us a direction over the next few days.

The Fed is currently allowing a 'symmetric' inflation goal, indicating some tolerance for their targeted rate to rise above 2.00%. However, bonds are in a precarious position. Is the economy really overheating or at least in danger of doing so, or have global central bankers failed to realize there might be a 'new normal' in interest rates? While there are problem economies around the world (with Italian debt threatening the European Union), most quality global debt alternatives versus the U.S. are still trading at very–low if not negative yields. It's also important to note that the European Central Bank is still purchasing assets with their QE program – even if they do have plans to taper down the size through the end of 2018. The ECB had also assured their markets it would not hike rates until mid–2019. ECB President Mario Draghi weighed in on trade, expecting a larger impact from trade tariffs and protectionism than he views as widely thought.

The FOMC's minutes from their June 13th meeting included thoughts that it was *"premature to conclude that the committee had achieved"* its 2% goal. The minutes held that *"most participants noted that uncertainty and risks associated with trade policy had intensified."* While reluctant to consider and weight the usual aftereffects of an inverted curve (as we discussed earlier), the minutes allowed that *"a number of Fed officials said it was important to watch the yield curve slope."* (Will they 'watch' it pancake in September???)

The minutes went on to say *"labor market conditions continued to strengthen in recent months, and that real gross domestic product appeared to be rising at a solid rate in the first half of the year."* In keeping with their existing policy for hikes at the most for every other meeting, the minutes explained *"participants generally judged that, with the economy already very strong and inflation expected to run at 2% on a sustained basis over the medium term, it would likely be appropriate to continue gradually raising the target range."* As of today, the market–based odds for the next presumptive FOMC increase stood at 16.5% for August 1st and 86.2% for the September 26th meeting.

MBS spreads (FNMA 30–year 3.5%) widened by 1 bps last week. Today's 3–year note auction brought 2.685% for $33 billion in supply. Demand was very weak compared to recent auctions and the yields was the highest since May 2007. The group that includes foreign central banks bought only 39.6% of this issue versus 51.4% last month. The U.S. Treasury will auction $22 billion 10–year notes on Wednesday (07/11), and $14 billion 30–year bonds on Thursday (07/12). The May issues of 2028 and 2048 are expected to reopen for the 10 and 30–year offerings.

07/06/18 Treasury Yield Curve	**2-Year: 2.539%**	**5-Year: 2.719%**	**10-Year: 2.823%**	**30-Year: 2.930%**
Weekly Yield Change:	+.009%	–.020%	–.038%	–.060%
06/29/18 Treasury Yield Curve	**2-Year: 2.530%**	**5-Year: 2.739%**	**10-Year: 2.861%**	**30-Year: 2.990%**
Weekly Yield Change:	–.013%	–.029%	–.035%	–.050%
Support:	2.618/ 2.658/ 2.698/ 2.737	2.753/ 2.762/ 2.773/ 2.780	2.850/ 2.864/ 2.874/ 2.881	2.960/ 2.970/ 2.981/ 2.992%
Targets:	2.540/ 2.502/ 2.462/ 2.421	2.743/ 2.734/ 2.724/ 2.713	2.836/ 2.826/ 2.816/ 2.806	2.943/ 2.937/ 2.926/ 2.915%

Economics

Jobless claims and layoffs may be very low, but that doesn't mean turnover is as well. JOLTs job openings were down from a record 6.84 million in April to 6.638 million in May. However, while the labor force grew with the number of unemployed rising from 6 million to 6.6 million, there were still more job openings than there were workers to fill them! You might guess that with that many jobs available, people that had jobs would seek out one that suited them better or was more rewarding in compensation and benefits. That presumption would be correct! 3.349 million Americans quit their jobs in April and 212K more (the largest increase since December 2015) or 3.561 million quit their jobs in May. As a stat, 'quits' hit the highest level of the recovery – and in all data going back to 2000.

Personal Income rose .40% in May, but Personal Spending was only .20% higher – and 'Real' Personal Spending was flat. Though that data seems to point to a slowdown, Consumer Credit surged higher. Expected near $12 billion, credit surged $24.6 billion higher – seemingly inconsistent with the spending data. Revolving credit hit a new high of $1.39 trillion – surging by $9.8 billion, the most since November. Confidence surveys were also inconsistent. Bloomberg Consumer Comfort rose from 57.3 to 57.6 – a 4th advance and just below the 58.1 reading in April that marked a 17–year high! However, while University of Michigan Sentiment rose from 98 to 98.2 and Current Conditions jumped from 111.8 to 116.5, Expectations (the hope index) fell from 89.1 to a 5–month low 86.3. NFIB Small Business Optimism slipped from 107.8 to 107.2.

The Chicago Purchasing Manager's report increased from 62.7 to 64.1. Construction Spending rose .40% in May. For the first time in 6 years, the Fed's favorite inflation gauge hit 2.00%. The PCE Deflator rose .20% in May with the annual pace for the consumption measure rising from 2.00% to 2.30%. The core result (ex food and energy) also rose .20% quickening the annual pace from 1.80% to the Fed's target of 2.00%.

Initial Jobless Claims were modestly higher, rising from 227K to 231K. Continuing Claims rose from 1,707K to 1,739K. The service industries accelerated the most in 4 months, rising from 58.6 to 59.1 (ISM Non–Manufacturing). Business activity in the service sector hit its highest level since 2005. Results above 50 indicate expansion, and ISM Manufacturing also 'expanded' healthily from 58.7 to 60.2. ISM Prices Paid fell from 79.5 to 76.8 and New Orders declined from 63.7 to 63.5.

Exports increased 1.9% and soybean shipments nearly doubled as nations could be loading up ahead of the expected tariffs. Overall, the Trade Balance deficit for May plunged $3 billion to $43.1 billion – the least since September 2016. Vehicle Sales rose from 16.81M to a 17.38M annual pace in June. Factory Orders rose .40% in May while April's drop was cut in half to .40%. Ex–transportation, orders rose .70% and were revised .50% higher to a .90% increase for April. Durable Goods Orders fell .40% but were flat ex–transportation. Capital Goods Orders rose .30%.

Wednesday is set for Producer Prices (June PPI), Wholesale Trade Sales & Inventories, and MBA Mortgage Applications (which last week fell by .50%). Thursday gives us jobless claims data, Consumer Prices (May CPI), earnings data, the Treasury's Monthly Budget Statement for June, and Bloomberg Consumer Comfort. Friday is set for Import Prices and the University of Michigan sentiment surveys.

Next Monday (07/16) brings June Retail Sales, Empire Manufacturing, and May Business Inventories. Tuesday follows with Industrial Production, Capacity Utilization, homebuilder outlook (the NAHB Housing Market Index), and TIC Flows (net foreign Treasury operations). Wednesday brings June Housing Starts & Building Permits, and the Fed's Beige Book (the outlook for the 12 Fed districts).

Equities

After tumbling 309.48 points or 1.26% to close out June, and having lost 509.59 points the week before, the Dow Industrials and most indexes have rebounded nicely. That 2–week loss of 3.26% was followed by a July kickoff of 185.07 points or .76% to 24,456.48. The Dow is off to a 1.89% gain this week. The S&P fell 1.33% the last week of June and then rallied 41.45 points or 1.52% last week to 2,759.82. It gained another 1.23% into today. The Nasdaq lost 2.37% into June 29th but then gained 2.37% or 178.08 points to 7,688.39 – and is also higher by .92% this week. The Dow Transports lost 3.97%, rebounded 1.25% last week, and were 1.73% better into today. Bank stocks lost 2.62%, gained .42%, and are 1.94% better this week.

Resistance:	Dow:	24,900/ 25,132/ 25,291/ 25,398	Nasdaq:	7,770/ 7,806/ 7,858/ 7,902	S&P:	2,790/ 2,807/ 2,820/ 2,834
Support:		24,662/ 24,505/ 24,352/ 24,195		7,694/ 7,638/ 7,595/ 7,551		2,769/ 2,764/ 2,756/ 2,743

Other Markets

Crude Oil hit $75.27/barrel last Tuesday, the highest level since November 2014 – and right within our long–standing *"**BMR** target range of $74.90 to $76.00."* Coincident with that high, and following selloff, it was announced that Saudi Arabia had agreed to pump more oil after a request from President Trump. Crude Oil was up 8.12% the last week of June but fell .47% last week. It was .42% higher into today. Commodities gained 1.44% and then lost 1.16% the first week of July. They are .12% higher this week. Gold lost 1.02% and then rose .10%. Gold is .03% lower this week but the cycles are improving in such a way that those that rotate sectors could consider adding gold to portfolios.

The U.S. Dollar rose .18% to close out June and then fell .61% for only a third loss out of the last 12 weeks. It's .13% better this week. The Euro gained .28% and then added another .53%. It's off by .02% this week. The Japanese Yen fell .72% and then rose .26% last week. It's down .48% this week. Corn lost 1.96%, gained .43%, and is 3.41% lower this week. Cotton lost .06%, rose 1.17%, and is 1.30% higher this week.

"If you want to make an apple pie from scratch, you must first create the universe." Carl Sagan

"I haven't slept for ten days, because that would be too long." Mitch Hedberg

Additional Information is Available on Request
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