COMMERCE STREET
Capital Management
1445 ROSS AVENUE
DALLAS, TEXAS 75202
214-545-6800

BOND MARKET REVIEW

April 05, 2017

Roundabout

Not only will the March payroll data come out Friday, but the group 'Yes' is set to enter the Rock & Roll Hall of Fame. Whether or not in tribute, the markets did their own version of 'Roundabout' today. The Nasdaq made a new high – only to lose .58% back to the mid–range of price data since late February. The markets were encouraged by the ADP Employment Report for March, which showed private payrolls surging by 263,000! Manufacturers and builders (and others making up the goods–producing industries) just put the best back–to–back months together since 2002. Construction hiring had the largest 2–month gains since 2006 and factories the best two months since 2010.

Yet the markets saw the Fed's March minutes as a big damper to the day. While the Dow had surged over 198 points higher in early trading, the Industrials ultimately closed down 41.09 points. In the **B**ond **M**arket **R**eview (02/22/2017), we noted that the headwinds to Fed policy were diminishing. We said: *"The Fed is growing confident that their job is done, that they can remove accommodation at a 'gradual pace', and that they might even begin to reduce the size of their balance sheet (by no longer reinvesting maturing assets)."* The lone dissenting vote to the FOMC policy statement on March 15th was from FRB Minneapolis President Neel Kashkari. In the **BMR** (03/22/2017) we noted: *"He said he favored a plan to normalize the balance sheet before hiking again."*

Looking Ahead

- Bond yields should make an important low near May 15th/19th.
- The **BMR** equity cycles show another high trend–change due near April 12th, and a low near April 17th.

Make no mistake, unwinding the balance sheet is a significant event. It will remove a large portion of the Fed's $4.5 trillion in holdings. A buyer the size of the Fed is a huge prop to U.S. assets, and the backing away removes that stabilizing force in the markets. Kashkari made sense though. By maintaining its balance sheet by purchasing more assets as maturities rolled off, the Fed was providing great stimulus while simultaneously removing it with rate hikes! His dissent and position was apparently enough to spur debate during the FOMC meeting. Back in February, FRB St. Louis's James Bullard, who does not have a vote this year, said that having raised rates, *"the FOMC may be in a better position to allow reinvestment to end or to otherwise reduce the size of the balance sheet."* He contended: *"Ending balance sheet reinvestment may allow for a more natural adjustment of rates across the yield curve as normalization proceeds."* The key wording in the March minutes released today was: *"Most participants anticipated that gradual increases in the federal funds rate would continue and judged that a change to the committee's reinvestment policy would likely be appropriate later this year."* Read that as near the end of the year, the Fed will taper or cease reinvestments – though policy wise, the **BMR** thinks they'll opt to taper instead of exercising a full stop. It's also probable, and the market reaction was such, that sizing down the balance sheet is in itself tightening – and that the resulting pace of interest–rate hikes could be even more gradual. The Fed said reductions *"should be conducted in a passive and predicable manner"* – maybe hoping to stave off a repeat of the 'taper tantrums' from the final rounds of the Quantitative–Easing asset purchases (that grew the balance sheet to its enormous size).

Richmond FRB President Jeffrey Lacker resigned his position with the FOMC on Tuesday. Lacker said he had discussed policy with an analyst in October 2012, and should have instead declined to comment. He said: *"I regret that in this instance I crossed the line to confirming information that should have remained confidential."* Lacker had been with the FOMC since 2004, but was not in the voting group this year. The investigation into leaks from Fed members is ongoing. Andrew Levin, previously a special adviser at the Fed board said: *"The story is not over today. … There are a number of distinct details that suggest Lacker wasn't the main source of the (leaked) information."*

Treasuries, Agencies, and MBS

While the market–based odds for another Fed hike on May 3rd remained at 13.3%, those for the June 14th meeting have been steadily increasing from a 50.2% (coin toss) last week to 63.2% today. Yields fell .5, 2.5, 2.5, and .5 bps last week for the 2, 5, 10, and 30–year Treasury sectors. Into today, they dropped another 2, 7, 5, and 2.5 bps. MBS spreads (FNMA 30–year 3%) narrowed by 1 bps last week.

03/31/17 Treasury Yield Curve	2-Year: 1.256%	5-Year: 1.922%	10-Year: 2.388%	30-Year: 3.010%
Weekly Yield Change:	–.003%	–.024%	–.025%	–.004%
Support:	1.265/ 1.285/ 1.300/ 1.335	1.895/ 1.930/ 1.965/ 1.995	2.385/ 2.430/ 2.465/ 2.510	3.025/ 3.050/ 3.070/ 3.095%
Targets:	1.225/ 1.205/ 1.180/ 1.160	1.825/ 1.790/ 1.755/ 1.720	2.310/ 2.270/ 2.235/ 2.200	2.980/ 2.960/ 2.935/ 2.915%

Next week, the U.S. Treasury will auction $24 billion 3–year notes on Monday (04/10), $20 billion 10–year notes on Tuesday (04/11), and $12 billion 30–year bonds on Wednesday (04/12).

Economics

Though forecast at 2.0%, and having been reported at 1.9% in the last revision, GDP for Q4 2016 beat expectations with 2.1% growth. Personal Consumption rose 3.50% instead of 3.00% and was the primary factor for the better result. Corporate profits rose 9.3% versus last year, rising the most since 2012. Weaker exports and higher imports were a drag on GDP – taking away 1.82% from growth. Since the last **BMR**, the Atlanta Fed's GDP–Now forecast for Q1 2017 fell to .9% after the final revision for Q4 2016 GDP and Personal Consumption data. This week, their forecast edged back to 1.2% on ISM Manufacturing and Construction Spending data. The GDP Price Index for Q4 rose 2.10%, and the core (ex food & energy) rose 1.30%. Personal Income rose .40% in February, while Spending rose only .10% and Real Personal Spending (adjusted for inflation) was .10% lower. It was evident in car sales. Vehicle Sales fell from 17.47M to a 16.53M annual pace in March. Domestic sales dropped from 13.65M to 12.97M. The Personal Consumption Expenditures Deflator rose .10%, though that took the Fed's preferred inflation gauge from 1.90% to just over their 2% target at 2.10%. Core PCE rose .20%, and the annual pace rose was steady at 1.80%. Initial Jobless Claims fell 3K to 258K, and Continuing Claims rose from 1,987K to 2,052K.

The service sector outlook slowed from 57.6 to 55.2, reaching its lowest growth in 5 months. Chicago Purchasing Managers grew from 57.4 to 57.7. University of Michigan Sentiment fell from 97.6 to 96.9. Their measure of Current Conditions dropped from 114.5 to 113.2 and Expectations slipped from 86.7 to 86.5. ISM Manufacturing continued to thrive, though falling .5 points from February's 57.7 (which was the highest since August 2014). ISM Prices Paid rose from 68 to 70.5 and New Orders slipped from 65.1 to 64.5. ISM Employment jumped from 54.2 to 58.9 – a good early indicator for March payrolls. Construction Spending rose .80%. Factory Orders rose 1.00%, but only .40% ex transportation. February orders for Durable Goods rose 1.80%, but only .50% ex transportation. Orders for Capital Goods fell .10%. The February Trade Balance deficit fell from $48.2 billion to a 4–month low of $43.6 billion.

Thursday will reveal the last two insights into March payrolls from Challenger Job Cuts and jobless claims data. Recall ADP said 263K private sector jobs were added. Also due is Bloomberg Consumer Comfort which fell from 51.3 to 49.7 last week. Friday reveals March payrolls, the U.S. Unemployment Rate, Labor Force Participation, Hourly Earnings and Hours Worked, February Consumer Credit, and Wholesale Inventories and Trade Sales. Next Monday (04/10) gives us the Fed's jobs dashboard (Labor Market Conditions Index Change). Tuesday follows with NFIB Small Business Optimism and JOLTS Job Openings from February. Wednesday brings MBA Mortgage Applications (off 1.60% last week), Import and Export Prices for March, and the Monthly Budget Statement.

Equities

The Nasdaq return for the 1st quarter of 2017 was a whopper, as tech stocks rose 9.82%! The Dow added 4.56% and the S&P rose 5.53%. The Dow Transports rose .80% and bank stocks gained .28%. Those gains were despite a March that was unkind to most indexes except the Nasdaq – which rose 1.48%. However, as we said, most others slumped with the Dow falling .72%, the S&P dropping .04%, the Transports tumbling 3.22%, and bank stocks plunging 4.33%. Still, for many indexes, such as the Dow and S&P, March closed out a 6th consecutive quarterly gain. For the S&P, there were 2 quarterly drops coming into this streak – with 9 quarterly gains preceding those 2 losses. It makes you wonder why anyone would short stocks, but they usually correct very quickly when they fall – and by large percentages. If you're not already prepared for those down–moves, it's usually too late.

Last week, the Dow closed out the month and quarter with a gain of 66.50 points or .32% to 20,663.22. It's .07% lower this week after surging higher this morning. The S&P gained 18.74 points or .80% to 2,362.72, but is .41% lower since Friday. The Nasdaq gained 83.00 points or 1.42% to 5,911.74, but is .80% lower this week. The Dow Transports rose 2.10% last week, but are .23% lower this week. Bank stocks gained 1.33%, but are now 1.54% lower.

Resistance:	Dow:	20,738/ 20,881/ 20,971/ 21,080	Nasdaq:	5,896/ 5,915/ 5,934/ 5,953	S&P:	2,366/ 2,378/ 2,389/ 2,401
Support:		20,612/ 20,521/ 20,450/ 20,377		5,858/ 5,839/ 5,820/ 5,801		2,349/ 2,343/ 2,337/ 2,325

Other Markets

Commodities gained 1.32% last week, and added .14% into today as Crude Oil rose 5.48%, and is 1.09% higher this week. Gold lost .10%, and is .15% lower this week. The U.S. Dollar gained .78% and is .22% better this week. The Japanese Yen fell .04%, but has risen .62% this week. The Euro lost 1.35%, but is .10% better this week. Corn gained 2.25% and added .14% into today. Cotton lost .18%, and then fell another 3.18% into today.

"The best mirror is an old friend." George Herbert

Additional Information is Available on Request

Doug Ingram, Managing Director – Commerce Street Capital Management