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BOND MARKET REVIEW

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The 'Underlying Inflation Gauge'

With inflation not hitting their targets, what's the Fed to do? Create their own indicator! Granted, Consumer Prices ticked up in August after 5 previous failures to meet expectations. However, the Personal Consumption Expenditures Deflator has been registering below 1.50% – and it's one of the FOMC's favorite inflation gauges. Last week, the New York Fed released its new indicator designed to measure underlying inflation. The Underlying Inflation Gauge for August came in at 2.74% – conveniently above the PCE Deflator's 1.40% and the 1.90% annual CPI. Problem solved! This 'UIG' indicator takes into account the unemployment rate, stock prices, bond yields, purchasing manager reports, and many other components. The prices–only measure came in at 2.2% – still above the Fed's 2% target. It's easy to see how stock prices could help the 'UIG' come in at its highest level since November 2007, even though the PCE Deflator for August was the lowest since September 2016. The **B**ond **M**arket **R**eview would fail to see how the unemployment rate would be useful in such an indicator – especially given the lack of wage pressures in recent years. That disconnect alone should question the validity of the new gauge. We'll monitor the UIG going forward. There's always the chance that it turns out to be predictive of future trends, but being double the PCE Deflator we'd also question the disparity between the two. It may be that the component weighting needs some work. After all, we remember the '70s. Stocks were going nowhere, but inflation was surging – peaking just before the bull market began.

Doubting Dotting Doting

The UIG aside, until finally breaking through important support on Wednesday, yields were signaling that bond–market participants were not in concert with the Fed's projections for interest rates. Last week, the FOMC announced plans to begin reducing asset reinvestments in October (to shrink their balance sheet) and released new dot–plot projections that clearly signaled a 25–bps rate hike in December. While four members had projected a stay, one signaled a 50–bps hike, while eleven thought 25 bps was in store. At the beginning of the year, 4 hikes had been projected. Never mind that the long–term forecasts have been off for years, and that over that time bonds have been right! Still, the Fed is doubtful that markets are taking their forecasts seriously. FRB St. Louis President James Bullard said he was *"finding it pretty concerning"* that the markets were not lining up with the Fed's projections. Speaking to the reluctance of bonds and inflation to line up with recent forecasts, he said: *"It is a lack of credibility and reliance on a model that has not been working over the past five years."* Nevertheless, unlike the UIG readings, Bullard said: *"Inflation expectations are uncomfortably low at this point."* No wonder there's no love for the dots!

Fed Chair Janet Yellen said: *"It would be imprudent to keep monetary policy on hold until inflation is back to 2%."* She also said the Fed should be *"wary of moving too gradually."* With those beliefs, it's easy to see why – data aside – she and others dotted up a December hike! She told another group that she and her colleagues *"may have misjudged the strength of the labor market."* What if that's still the case? Dallas' Robert Kaplan said that a number of reasons for U.S. inflation not approaching their target *"are not – underline not – transitory!"* Yellen has insisted that it is (transitory) – despite some contradictive data. FRB San Francisco's John Williams said global central banks need to have a *"true policy strategy debate."* Though speaking in the future tense, he no doubt was considering the path of emergence from the financial crisis when he said: *"The challenges of using interest rates to keep the economy on track and inflation stable are going to be very difficult."* He also said he thought *"2.5% is about the new normal"* for the FOMC funds target. The market odds for a December hike rose to 70% this week, but fell to 66.6% today.

Looking Ahead

- Bond yields should move higher into a peak near October 4th, and top from another peak near the 20th.
- The **BMR** equity cycles project a downtrend from October 12th to the 20th.

Treasuries, Agencies, and MBS

The International Monetary Fund contended that weak productivity growth and the number of part–time workers have contributed to slow wage growth. They said wage growth is markedly lower than the levels preceding the financial crisis. In the U.S., health care act restrictions on the number of hours considered full time continue to hold back those that would rather work full time.

Last week, MBS spreads (FNMA 30–year 3%) pulled in by 3 bps. Yields rose last week, but pulled back into Tuesday. However, on Wednesday, bonds broke key support levels sending 5 and 10–year yields to their highest levels since early July. 2–year yields broke to their highest levels since October 2008, as bonds began to embrace the FOMC's plan to unwind asset purchases, and hike rates in December. Last week, yields rose by 5, 5.5, 5, and 1 bps for the 2, 5, 10, and 30–year Treasury sectors. Through today, yields rose another 2, 3, 6, and 9 bps – steepening the curve.

On Tuesday, the U.S. Treasury sold $26 billion 2–year notes at 1.462%. Demand rose versus August's sale, and the yield was the highest since the October 2008 issue. The group that includes foreign central banks bought 44.2% of the issue versus 45.8% last month. Wednesday's $34 billion in 5–year notes came at 1.911%. Demand was the lowest since June, and foreign buying rose from 69.1% last month to 69.6%. Today's $28 billion in 7–year notes came at 2.13% – the highest since March. Demand rose to last month, and foreign buying was up from 68.8% to 70.6%.

09/22/17 Treasury Yield Curve	2-Year: 1.433%	5-Year: 1.862%	10-Year: 2.251%	30-Year: 2.780%
Weekly Yield Change:	+.051%	+.056%	+.048%	+.010%
Support:	1.495/ 1.515/ 1.530/ 1.550	1.932/ 1.967/ 2.000/ 2.037	2.265/ 2.290/ 2.330/ 2.370	2.900/ 2.922/ 2.945/ 2.966%
Targets:	1.465/ 1.445/ 1.405/ 1.375	1.866/ 1.828/ 1.795/ 1.758	2.216/ 2.181/ 2.145/ 2.110	2.860/ 2.820/ 2.787/ 2.705%

Economics

Q2 GDP was raised from 3.00% to 3.10%. That was the best pace since Q1 2015, and much better than the Q1 2017 result of 1.2%. However, the effects of the hurricanes are yet to be determined, and the latest Atlanta Fed GDP–Now estimate for Q3 2017 is a point less at 2.10%! Personal Consumption remained at a healthy 3.30% and the Price Index at 1.00%. Core PCE remained at .90%. Initial Jobless Claims rose 12K to 272K, and Continuing Claims fell from 1,979K to 1,934K. After 3 straight drops, Bloomberg Consumer Comfort rose a point to 51.6. While the Conference Board Expectations survey rose from 101.7 to 102.2, their post–storm Consumer Confidence result eased from a 5–month high 120.4 to 119.8, and Present Conditions fell from 148.4 to 146.1. The Chicago Fed National Activity Index fell from .03 to –.31, but Kansas City Fed Manufacturing Activity rose a point to 17, Dallas rose from 17 to 21.3, and Richmond was 5 points higher to 19. In August, Orders for Durable Goods rose by 1.70%, and were .20% higher ex transportation. Orders for Capital Goods were up by .90%, beating expectations. August Wholesale Inventories rose 1.00% and Retail Inventories rose .70%.

The supply of New Homes in August rose to the highest level since July 2014, and sales fell 3.45% to a 560K annual pace. Sales appear to be stalling – as Pending Home Sales for August fell the most (by 2.60%) since January. In July, metro–home prices rose more than forecast as the S&P Case–Shiller CS 20–City index rose .35% and the annual pace quickened from 5.65% to 5.81%. Their House Price Index also increased from 5.82% to 5.94% (annually).

Friday closes out September trading with Personal Income & Spending for August, the Fed's key inflation gauge (the PCE Deflator), Chicago Purchasing managers, and University of Michigan sentiment surveys. Next Monday (10/02) brings August Construction Spending and ISM data for Manufacturing, Prices Paid, New Orders, and Employment – the first read on Friday's September jobs report. Tuesday follows with September Vehicle Sales. Wednesday gives us MBA Mortgage Applications (which fell by .50% last week), the service sector outlook (ISM Non–Manufacturing Composite) and another read on September jobs from ADP Employment Change (private payroll data).

Equities

The S&P rose to another record high on Wednesday, and to a record close today – as did a few other small–cap indices and the Dow Transports. The Dow Industrials and Nasdaq are lagging a bit. Last week, the Dow gained 81.25 points or .36% to 22,349.59. It's .14% higher this week. The S&P rose 1.99 points or a slight .08% to 2,502.22, but is .31% higher this week. The Nasdaq lost 21.55 points or .33% to 6,426.92, but is .41% better this week. Bank stocks had a second strong week, following a 4.04% gain with a 3.44% rise. They're 1.70% higher hit week. The Transports are outperforming having risen 1.66% last week and 1.88% into today – headed for a possible 6th weekly increase!

	Dow:	Nasdaq:	S&P:
Resistance:	22,449/ 22,521/ 22,599/ 22,672	6,475/ 6,515/ 6,556/ 6,596	2,512/ 2,525/ 2,538/ 2,550
Support:	22,300/ 22,223/ 22,147/ 22,067	6,434/ 6,396/ 6,356/ 6,317	2,501/ 2,489/ 2,476/ 2,466

Other Markets

Crude Oil rallied 1.54% – and appears headed for a 4th weekly gain with a 1.78% rise into today to $51.56/barrel. Commodities lost .26% and are .31% lower this week. Gold was 2.12% lower, and is off .60% this week. The U.S. Dollar rose .11% and has surged 1.05% this week on the prospects of higher rates. The Japanese Yen lost 1.05%, and is off another .31% this week. The Euro gained .05% last week, but is now off a stout 1.38% since Friday. Corn lost .35% and is .28% lower this week. Cotton lost 1.48%, but is .74% better this week. The North Korean threat to the U.S. is considered to be mostly to Pacific territories. However, Japan and South Korea are the allies most at risk. Despite that, South Korean bond sales have risen 22% since June 30th versus the same period last year.

"They always say time changes things, but you actually have to change them yourself." Andy Warhol

Additional Information is Available on Request

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