BOND MARKET REVIEW

January 18, 2018

12 Strong

Back in 2001, we observed: *"Things are pretty good – for being as bad as they are."* In light of the 'fake news awards' and recent economic news coverage, you'd think: 'Things are pretty bad – for being as good as they are!' The recent stock market gains represent the best first year for a President since Franklin Delano Roosevelt.

How do you know what to believe? The Fed's Beige Book came out this week, and reported the economy was (once again) growing – with almost all of the 12 districts showing *"modest to moderate gains."* The report said: *"The outlook for 2018 remains optimistic for a majority of contacts across the country."* The Beige Book held that *"challenges finding qualified workers"* due to on–going labor tightness were in some instances *"constraining growth."* With the Fed's warnings about needing to tighten in order to avoid falling behind the curve, the **B**ond **M**arket **R**eview would wonder: 'Is there really a danger of overheating at a 'modest to moderate' pace?'

We were told the tax–reform legislation wouldn't pass through to job and wage gains for workers, but incoming reports are showing otherwise. This week, Apple said they would repatriate nearly $250 billion in overseas cash, and pay around $38 billion in taxes as a result. They plan to invest around $350 billion in the U.S. economy and create 20,000 new jobs. The U.S. corporate tax rate was one of the highest in the world, but is now very competitive – and a great concern to other nations. We also heard on the news that over 200 companies had announced plans to raise wages and/or hire more workers. However, since we only 'heard' it on the news, we don't know if it's true or not…

The Atlanta Fed's GDP–Now forecast for Q4 2017 had dipped to 2.8% as of last week's **BMR**. Retail trade, Industrial Production, and Housing Starts have now flipped that forecast up to 3.4%. In our (12/14/17) issue, we said: *"While the **BMR** doesn't see the economy as currently being in danger of overheating, the last time GDP growth was above 3% for 3 quarters was Q1 2006."* That was on a cumulative basis. The last time 3 quarters were each above 3% was the end of Q1 2005. Depending on the final release, there's a real shot now – as Q2 and Q3 were 3.1% and 3.2%!

All the Money in the World

How many businesses could stand to lose their best 3 customers? Not only has the Fed begun to shrink their balance sheet by tapering the reinvestment of maturing mortgage and bond payments, but China and Japan are also reducing their holdings of U.S. debt. The two countries own roughly 36% of all foreign–held U.S. debt – which in November had fallen to the lowest level in nearly 18 years. Japan's holdings are the lowest in over 4 years, and China's have fallen to the lowest since July. Fundamentally, yields are trading higher from the FOMC raising rates – but 3 of the largest buyers backing away is also a great concern.

A Chinese rating firm cut U.S. debt to BBB+ with a negative outlook. Those ratings from Dagong Global Credit had previously been A– and stable. They reasoned: *"Tax cuts have increasingly adverse effects on the government's repayment resources."* Sounds like they've been listening to American news! There are numerous cases in U.S. history where this just wasn't true at all. A Bloomberg report said the U.S. BBB+ rating was now the same as Colombia's. We highly doubt China will be loading up on Columbian debt in lieu of U.S. options. Let's see how they vote with 'real money.'

Looking Ahead

- Equities have a trend–change low due near January 25th/26th.
- Interest rates should be higher into January 23rd, and then lower into January 26th.
- The next FOMC interest–rate policy statement is due on January 31st at 2 p.m. ET.

Treasuries, Agencies, and MBS

With 2–year yields rising to 2% for the first time since September 2008, a rarity also occurred as 2 to 30–year maturities all narrowed within the same 'handle.' Back in September 2008, the yields on 10 and 30–year debt were closer to 4%! Last week, yields rose 4, 6, 7, and 4 bps for the 2, 5, 10, and 30–year Treasury sectors, leaving those rates at 2.000%, 2.347%, 2.548%, and 2.849%. 54.8 bps separated the 2 to 10–year, and 84.9 bps the entire curve. Yields have risen higher this week, with those sectors climbing another 4.5, 7, 8, and 5.5 bps.

MBS spreads (FNMA 30–year 3%) narrowed by 2 bps last week. Next week, the U.S. Treasury will auction $26 billion 2–year notes on Tuesday (01/23), $34 billion 5–year notes on Wednesday (01/24), and $28 billion 7–year notes on Thursday (01/25).

01/12/18 Treasury Yield Curve	2-Year: 2.000%	5-Year: 2.347%	10-Year: 2.548%	30-Year: 2.849%
Weekly Yield Change:	+.038%	+.058%	+.071%	+.038%
Support:	2.055/ 2.075/ 2.095/ 2.120	2.434/ 2.473/ 2.514/ 2.553	2.646/ 2.686/ 2.726/ 2.766	2.942/ 2.987/ 3.032/ 3.077%
Targets:	2.020/ 1.975/ 1.945/ 1.920	2.398/ 2.355/ 2.319/ 2.275	2.604/ 2.577/ 2.528/ 2.490	2.899/ 2.855/ 2.818/ 2.781%

Economics

Retail Sales rose .40% in December, and with a .10% bump to .90% increase for November – finished the year with the best 2 months since 2010! Ex autos, sales also rose .40%, but November sales numbers were revised .30% higher to a 1.30% increase. More 'good news' came from Initial Jobless Claims, which fell from 261K to 220K – the largest drop since April 2009 to the lowest level since February 1973. Continuing Claims rose by 76K – from 1,876K to 1,952K. Bloomberg Consumer Comfort rose from 53.5 to 53.8 – the best level since March 2001. The current view of the economy also hit a near 17–year high. Economic Expectations, the view 6 months out, rose from 47 to 52.5.

Empire Manufacturing fell from 19.6 to 17.7, and the Philadelphia Fed Business Outlook was also a little less optimistic, dropping from 27.9 to 22.2. Real Average Weekly Earnings rose an annual .70% in December, falling from November's .80% year–over–year pace. However, Real Average Hourly Earnings rose from .20% to a .40% annual pace for December. Consumer Prices rose .10% in December, with the annual pace dropping from 2.20% to 2.10%. However, the result ex food & energy rose .30%, hiking that annual core pace from 1.70% to 1.80%. The core result beat estimates and was probably welcomed by the Fed. Business Inventories rose .40%. Industrial Production rose by .90% (versus .50% expected), gaining for a 4th month, and finishing the healthiest quarter since 2010. Capacity Utilization improved from 77.20% to 77.90%! Factory output was up 1.3% in 2017 – the best in 5 years.

Home builder optimism fell 2 points to 72, as the NAHB Housing Market Index eased from the highest reading since 1999. There's little doubt that it's been hard to break ground on new construction with the severe cold of recent weeks. Housing Starts dropped 8.24% in December to 1,192K (annual) units, and Building Permits fell .08% to 1,302K units, though single–family permits rose to 881K (the highest since mid–2007)! Foreign entities bought a net $33.8 billion in U.S. assets in November. They invested $57.5 billion in longer–term U.S. holdings.

Friday is set for the University of Michigan sentiment surveys. Next Monday (01/22), brings the Chicago Fed National Activity Index. Tuesday follows with the Richmond Fed Manufacturing Index. Wednesday brings MBA Mortgage Applications (which rose 4.10% last week), the FHFA House Price Index (November), and December Existing Home Sales.

Equities

Though it was big news when the Dow Industrials surged through 25,000 for the first time on January 4th, just 7 trading sessions later (on Tuesday 01/16) it cleared 26,000! Most U.S. Indices made new highs on Tuesday. The Dow hit a new high today, before closing lower – but still over 26,000. The Japanese Nikkei hit its highest level today since November 1991. Hong Kong broke through to new highs this week, finally rising above the previous October 2007 record – though the Shanghai Composite is still 43% off the highs made that month. Stock market optimism is the highest since April 1986, which is a clear warning sign – as in, who is left to buy and push prices yet higher? However, it wasn't until August 1987 – 16 months later, when the market peaked and then crashed over 40% lower. A little healthy skepticism about lofty prices is not a bad thing – but stepping in front of a train by shorting stocks could be most unhealthy! Stocks have a 'momentum peak' in place, but the average weeks to a final bull–market high from such a peak is around 60 (considering all major bull markets since 1900). [Source: Leuthold Weeden]

The Dow put together two 500–point weeks in a row with last week's 507.32–point 2.01% gain to 25,803.19. It's .83% higher this week with one day to go. The Nasdaq rose 124.50 points or 1.74% to 7,261.06, and is .48% higher this week. The S&P gained 43.09 points or 1.57% to 2,786.24, and is .42% better this week. The Dow Transports rose 4.23% (giving them a clear 2–week win of 7.17%), though they are .97% lower this week. Bank stocks rose 3.81%, but are .27% lower this week.

Resistance:	Dow:	26,153/ 26,313/ 26,476/ 26,637	Nasdaq:	7,330/ 7,377/ 7,419/ 7,463	S&P:	2,807/ 2,821/ 2,834/ 2,848
Support:		25,835/ 25,572/ 25,371/ 25,194		7,291/ 7,248/ 7,208/ 7,152		2,782/ 2,769/ 2,748/ 2,726

Other Markets

Commodities rose 1.35% last week, and are .15% higher this week. Crude Oil had gained 4.65% – rising to just below $65/barrel, but is .54% lower this week. Gold gained .95%, but is .58% lower this week. The Dollar fell for a 4th week, dropping 1.02%, and is .48% lower this week. The Japanese Yen surged 1.76%, but is off a small .05% this week. The Euro gained 1.44%, and is .30% higher this week. Corn fell 1.42%, but is 1.52% higher this week. Cotton gained 4.70% last week, and is 1.16% better so far this week.

"I have enough money to last me the rest of my life, unless I buy something." Jackie Mason

Additional Information is Available on Request

Doug Ingram, Managing Director – Commerce Street Capital Management