Banes Capital Management, LLC.

6410 Poplar Ave., Suite 320 – Memphis, TN 38119 – (901) 261-5900 Fax: (901) 261-5999

Bond Market Review

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Binary Decisions

Last week, the Dow Industrials were down, up, and down and up – strongly up twice but even more so the two times to the downside. The Memorial Day holiday left no tiebreaker, so the Dow was off for the week. Likewise, the North Korea summit was on, then off, then on again. News headlines last week were replete with nearly all our trading partners worried about whether the proposed U.S. trade tariffs were on or off, and how they would affect global economies going forward. California was reportedly passing a law where, based on usage statistics, you had to chose between doing laundry or taking a shower each day to ration water. Which switch do you hit there? 'Well at least my clothes smell good!' Life was simpler when Jethro only bathed on Saturdays …

The FOMC has been in binary mode as the term 'gradual rate increases' implies the on–again off-again removal of accommodation at every other meeting. That means the presumptive FOMC rate hike for next week is rapidly approaching with the market setting 100% odds for that June 13th move since the statement following the May 2nd meeting. Waves of positive economic data have likely done little to sway the committee from this next move.

While we're flipping switches, rising payrolls and falling unemployment are always good signs. However, those numbers are far more impactive with increasing wages and stable or rising labor–force participation. That aside, the positives in the May payroll report far outweighed the drawbacks. The ADP Employment Change (private payroll) data improved by 178K in May and Challenger Job Cuts reported 4.80% less cuts versus May 2017. ISM Employment rose from 54.2 to 56.3 showing improved strength in manufacturing payrolls. Most economists underestimated the strength in May payrolls thinking with unemployment so low that 200K–plus results were probably behind us.

The 223K gain in Nonfarm Payrolls beat expectations by 33K and sent the U.S. Unemployment Rate down from 3.90% to 3.80%. That was a 48–year low – matching April 2000's 3.80% for the lowest reading since 3.50% in December 1969! There was a 2–month revision adding 15K jobs. Private payrolls grew by 218K and Manufacturing added 18K jobs. The Underemployment Rate fell from 7.80% to 7.60%. Average Weekly Hours remained at 34.5, but Average Hourly Earnings rose .30% – accelerating the annual pace from 2.60% to 2.70%. The wage gains were welcomed as even though the labor market has been tightening, wage pressures have not followed suit as expected. The damper in the report was the Labor Force Participation Rate dropping from 62.80% to 62.70%. The weaker news was that the number not in the labor force rose to a record 95.915 million Americans in May! Couple that with 6.065 million unemployed and there are nearly 102 million not employed or not in the labor force.

With the May data coming in on June 1st, the **B**ond **M**arket **R**eview is a little suspect of its accuracy – and we would expect a number of revisions. However, the strongest news was that the economy added a record 904K full–time jobs in May while losing 625K lower–quality or part–time jobs. The Fed's Beige Book reported that *"overall activity expanded moderately … with few shifts in the pattern of growth."* We've become accustomed to the 'modest to moderate' pace for growth going back to the financial crisis – asking when will we see solid or robust? It's one reason the **BMR** hasn't been overly concerned about the U.S. economy overheating just yet. However, this Beige Book said: *"The Dallas District was an exception, where overall economic activity sped up to a solid pace."* The report also said: *"Manufacturing shifted into higher gear with more than half the Districts reporting a pickup in industrial activity"* while a third said activity was *"strong!"* Employment and wages also rose at a *"modest to moderate"* rate, but once again Dallas was *"solid!"*

Not only was the Beige Book promising, but after the May payroll report the Atlanta Fed's Q2 GDP estimate rose to 4.8%. That would be the strongest since 5.2% in Q3 2014, but that year had a negative first quarter! Anything over 3.8% would give the U.S. an annual GDP over 3% for the first time in over a decade. Q2 was revised .1% lower to 2.2% but that hasn't knocked us off course! In St. Louis, many employers were relaxing restrictions on drug testing and hiring felons to cope with the labor shortages. Vermont was offering a $10,000 incentive to move to the state and work remotely for out–of–state companies. They have roughly 16K fewer workers than they did in 2009. Texas should continue to do well. U.S. oil output rose to a record high in March, jumping 215K barrels per day to 10.47 million bpd. Texas production rose 4% to 4.2 million bpd – a record high going back to the beginning of a data series that started in 2005. The U.S. passed Saudi Arabia's near 10 million bpd, but lags Russia's nearly 11 million bpd.

Looking Ahead

- Equities should make an important high near June 8th or June 18th (the next 2 trend–change highs).
- Yields should peak near June 14th and reverse lower into June 22nd and July 11th.
- The FOMC will announce their interest–rate policy stance next Wednesday, June 13th at 2:00 p.m. ET.

Treasuries, Agencies, and MBS

We expected yields to trade lower into month end, and while they held out into a May 17th top – they relented to the cycles and plunged into May 29th and the 31st. Yields fell by 37, 35, and 29 bps at 5, 10, and 30–years from their 17th high. Into the 25th, yields dropped 7, 12.5, 12.5, and 10.5 bps for the 2, 5, 10, and 30–year Treasury sectors. Last week, yields for those sectors were lower by a modest .5, 1.5, 3, and 4 bps. Into today, yields were back up (as were stocks), rising 4.5, 4.5, 4, and 3.5 bps. On Thursday, the curve fell to its flattest level since September 2007 reaching a flat 43 bps between 2 and 10–year notes. Today established a new decade–plus flatness low of 42.5 bps! As next week's FOMC rate increase comes to bear, and the cycles hold longer yields down, the flatness should continue – ultimately leading to inversion.

There's once again concern over credit quality contagion in emerging markets and the EU. The spread between 5–year U.S. and Italian debt was roughly 197 bps a few weeks ago. Now it's 117. The ECB cut back buying of Italian debt drawing cries of foul. Nevertheless, 80 bps of loss in a few weeks is troubling as it indicates the dumping of Italian debt. Japan was the largest creditor nation in 2017, and the U.S. was the biggest debtor (no surprise).

Mortgage refinancing fell to its lowest level since December 2000. MBS spreads (FNMA 30–year 3.5%) widened by 5 bps into May 25th and another 1 bps last week. On May 24th, the U.S. Treasury sold $30 billion 7–year notes at 2.93%. Demand rose versus the April sale. The group that includes foreign central banks bought 65.5% of the issue, a little less than the 65.8% allocation in April. Next week, the U.S. Treasury will auction 3 and 10–year notes on Monday (06/11) and 30–year bonds on Tuesday – early in the week to clear the way for the June 13th Fed meeting.

06/01/18 Treasury Yield Curve	**2-Year: 2.473%**	**5-Year: 2.749%**	**10-Year: 2.903%**	**30-Year: 3.051%**
Weekly Yield Change:	–.005%	–.017%	–.029%	–.042%
05/25/18 Treasury Yield Curve	**2-Year: 2.478%**	**5-Year: 2.766%**	**10-Year: 2.932%**	**30-Year: 3.093%**
Weekly Yield Change:	–.071%	–.123%	–.125%	–.106%
Support:	2.519/ 2.557/ 2.600/ 2.637	2.786/ 2.825/ 2.864/ 2.899	2.940/ 2.978/ 3.003/ 3.066	3.075/ 3.096/ 3.119/ 3.141%
Targets:	2.471/ 2.441/ 2.400/ 2.359	2.746/ 2.710/ 2.677/ 2.619	2.894/ 2.867/ 2.834/ 2.783	3.053/ 3.031/ 3.008/ 2.986%

Economics

Into May 19th, Initial Jobless Claims rose from 223K to a 7–week high 234K. They relaxed back to 221K last week – still idling just above the lowest levels since the '70s. Continuing Claims rose from 1,712K to 1,742K, and then fell back to 1,726K. Personal Income rose .30% in April but Spending increase by .60%. Spending contributes about 70% to the economy but overspending decreases the savings rate – which dropped to 2.8%, the lowest since December 2017 (and just above record lows). On a yearly basis, spending has now outpaced incomes for 28 months in a row. Q1 GDP slipped from 2.30% to 2.20% and Personal Consumption eased to 1.00% from 1.10%. The GDP Price Index fell from 2.00% to 1.90% and Q1 Core PCE (Personal Consumption Expenditures) rose 2.30% (down from 2.50%).

The PCE Deflator is the Fed's preferred gauge of prices and the core rate remained short of their 2.00% goal. The PCE Deflator rose .20% in April but remained flat at 2.00% annually. Ex food & energy, core PCE also rose .20% but was unchanged at only 1.80% (annually). St. Louis FRB President James Bullard said inflation expectations remain *"somewhat low"* and that suggested *"further normalization may not be needed to keep inflation near target."*

Bloomberg Consumer Comfort rose from 54.6 to 55.2 into May 20th and was flat at 55.2 this past week. The Conference Board's Consumer Confidence survey rose from 125.6 to 128. The Present Situation component rose from 157.5 to a 17–year high 161.7 (vs March 2001). Expectations improved from 104.3 to 105.6. University of Michigan Sentiment eased from 98.8 to 98 and their survey of Current Conditions fell from 114.9 to 111.8. Expectations improved from 88.4 to 89.1. With backlogs the most in 14 years, ISM Manufacturing improved from 57.3 to 58.7. Prices Paid rose from 79.3 to 79.5. New Orders rose from 61.2 to 63.7. The Chicago Purchasing Managers outlook rose from 57.6 to a 4–month high 62.7 and Dallas Fed Manufacturing Activity increased from 21.8 to 26.8. Kansas City improved 3 points to 29.

The 1.49% slump in New Home Sales for April was also evident in sales of Existing Homes which declined by 2.50% since March (from 5.60M to a 5.46M annual pace). Low inventories, increasing prices, and higher rates were held to blame. Available inventories fell 6.3% versus last year and median prices rose 5.30%. April Pending Home Sales fell 1.30% but were up .40% versus last year. The FHFA House Price Index rose .10% in March. Zillow reported home values rising at the fastest pace in 12 years with a 6.9% year–over–year gain. Many areas are up 10% or more – with San Jose experiencing a 26% annual gain!

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The House Price Purchase Index increased by 1.70% for Q1 2018. Metro Home Prices rose .53% (S&P Case–Shiller 20–City Index) quickening the annual gain from 6.76% to 6.79%. The Home Price Index rose from 6.51% to an annual gain of 6.53%. April Construction Spending rose 1.80%.

The Advance Goods Trade Balance deficit fell from $68.6 billion to a 6–month low $68.2 billion. Retail Inventories rose .60% in April while Wholesale Inventories were unchanged. Factory Orders had their worst April since 2012, dropping .80%. Orders rose .40% ex transportation. Orders for Durable Goods plunged 1.60% but were .90% higher ex transportation. Orders for Capital Goods rose 1.00%. While April was rather soft, the early May numbers were showing improvement. Recall the Beige Book said manufacturing shifted into a higher gear!

Tuesday is set for JOLTS Job Openings for April and the service–sector outlook (ISM Non–Manufacturing Composite). Wednesday brings MBA Mortgage Applications (which fell by 2.90% last week), Q1 Nonfarm Productivity & Unit Labor Costs, and the April Trade Balance (deficit). Thursday is set for jobless claims data, Bloomberg Consumer Comfort, and April Consumer Credit. Friday gives us Wholesale Trade Sales & Inventories for April. Next Tuesday (06/12) brings NFIB Small Business Optimism, Consumer Prices (May CPI), Weekly and Hourly Earnings, and the Treasury's Monthly Budget Statement for May. Wednesday follows with Producer Prices (May PPI) and the FOMC June meeting statement on interest–rate policy.

Equities

Equities reversed their seasonal trends and had a positive May. Stocks are still advancing out of our April 2nd cycle low, though the structure in the Dow Industrials looks weak to us – and the Transports are troubling as well. The S&P appears a little stronger, while the Nasdaq closed at a new record high today. Our cycles are positive for the next few weeks, but they argue for getting out of positions by mid–June to avoid the next wave down – which could start near June 11th or near the 20th. The Dow gained 1.05% in May though one third of that gain came from only one of its 30 components – as Apple rose 13.08% with an index weight of roughly 5.32%. Apple weights 11.95% of the 100–stock Nasdaq, while Amazon is 9.90% and Microsoft is 9.61%. As those 3 stocks go, so goes the index!

The Dow lost 117.88 points or .48% last week to 24,635.21 as the 2 down days were weaker than the 2 big gains. We had said: *"If the Dow can break 25,225 the bullish case will greatly improve. Breaking 24,500 and then 24,000 to the downside would be very negative for the market's structure."* The Dow hit 25,086 on May 21st and then fell to 24,248 on May 29th. It's now back in 'no man's land'. The cycles had called for a high near the 22/23rd and a low near May 30th. The Dow is .72% higher this week. The Nasdaq gained 120.48 points or 1.62% last week to 7,554.33, and it's .69% better this week. The S&P rose 13.29 or .49% to 2,734.62 and is up .45% this week. The Transports were also lower last week, albeit by only .06%. They are down by .73% this week. Bank stocks lost 1.32% but are .42% better this week.

Resistance:	Dow:	24,828/ 24,886/ 24,987/ 25,064	Nasdaq:	7,645/ 7,687/ 7,731/ 7,777	S&P:	2,752/ 2,759/ 2,765/ 2,772
Support:		24,674/ 24,594/ 24,463/ 24,358		7,555/ 7,516/ 7,454/ 7,404		2,740/ 2,735/ 2,727/ 2,711

Other Markets

Our cycles called for Crude Oil to drop from a high near May 21st into a low near the 29th, and then to rise into June 6th. The first two hit spot on, but after a bump following the 29th crude has drifted lower. A better date for a high is June 20th to be followed by a drop into July 2nd. Crude oil dropped 4.77% and 3.05% over the past 2 weeks and is 1.61% lower this week. That led Commodities to drop .17% and .80%, and to follow with a 1.41% loss so far this week. The U.S. Dollar gained .63% and .04% to complete 7 weekly increases, but it's .19% lower this week. The Japanese Yen fell gained 1.24%, but then fell .12% and is .26% lower this week. The Euro fell 1.03%, but then rose .07% and is .34% better this week. Corn lost 3.57% last week and is 2.75% lower this week. Cotton gained 4.58% but was 1.29% lower into today.

"My computer beat me at chess... so I beat it at kickboxing." Demetri Martin

Additional Information is Available on Request

Doug Ingram, Financial Economist