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Bond Market Review

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The Hunt for Red October

Once again, it's the season that has a habit of pulling equities into some sort of abyss. Last week, stocks had their worst drop since March and then had their best day (since then) on Tuesday of this week. The U.S. markets had been holding up quite well, but there are signs that the negative influence of cycles are troubling global markets. A bear market is defined as a pullback of 20% or more while a correction is marked by a lesser 10%. While trade wars and rising rates have roiled emerging markets, to date far less damage has been done to U.S. markets.

The U.S. small–cap Russell 2000 and the tech–stock–laden Nasdaq fell into correction territory last week as they reached pullback levels of 12.12% and 10.56%. While the Dow and S&P have pulled back over 7% versus their October highs, the Dow Transports are off 11.03% since September and bank stocks traded off 15.83% versus their January high. Those markets considered, German stocks are off by 15.72% to January, but Hong Kong and China have lost 24.96% and 30.70% since then. Tariffs aside – there continues to be a huge imbalance in trade with the deficit in China rising to another record $36.8 billion in August. Emerging market stocks have lost 25% since January.

Locos Banqueros Centrales Federales

Though the correct Hispanic term for the FOMC is 'la Reserva Federal de Estados Unidos', President Trump said the Federal Reserve was *"going loco"* in raising interest rates this year. Trump may have scored a preemptive strike by setting up Fed policies as the reason for the markets selling off. In that respect, he can say the economy and the markets were doing very well before the FOMC stepped in to tighten more. When asked if the recent selloff was because of trade conflicts with China, the President said: *"That wasn't it. The problem I have is with the Fed. … The Fed is going wild. They're raising interest rates and it's ridiculous."* He added: *"The Fed is going loco!"* To make sure it was understood, Trump said: *"They're so tight. I think the Fed has gone crazy."*

A day before the 831–point selloff in the Dow last Wednesday, the International Monetary Fund cut its forecasts for global growth citing the trade wars and troubles in emerging markets. They cut U.S. forecasts from 2.7% for 2019 down to 2.5% – leaving their 2.9% forecast for 2018 in place. In their first downgrades since July 2016, they cut global growth for 2018 down by .2% to 3.7%. Emerging–market countries have been screaming foul as they feel the Fed is not considering the global impacts of their policy moves. Indonesian officials expressed concerns saying the U.S. *"needs to be very mindful that spillover from the effect of their policies is very real"* leading to Fed Vice Chairman Randal Quarles to comment: *"We do consider the implication of our own policy to emerging markets."*

When it comes to the deficit, the President has a great case. Last year's $523 billion in interest payments to service U.S. debt was a record – that will only increase with rising rates and larger auction levels! Today, Trump said: *"My biggest threat is the Fed because the Fed is raising rates too fast. You look at the latest inflation number, they're very low."* For all the news versus fake news, he's right about recent data. Of course, the President was widely criticized for his statements – even by past Fed Chairs, members, and some leading economists, but he's used to that as well. The Fed's minutes from their meeting that concluded on September 26th were released yesterday. From the 'dot plot' rate forecasts and member comments, it was clear to the **B**ond **M**arket **R**eview that the FOMC intends to move forward with their gradual pace of hikes. December would be the next hike 'in play.' Though a 'neutral rate' has yet to be formally established, FRB Chicago's Charles Evans said officials should consider raising rates *"maybe 50 basis points above"* that threshold. His estimate of the neutral rate (which is neither restrictive nor accommodative) was in the 2.75% to 3.00% ballpark. If most members are in that hiking–above–neutral camp, it's a hawkish one! On the other side (with Trump), though not a voter this year St. Louis' James Bullard said rates were about where they need to be now. Bullard explained that there were currently weaker links between the unemployment rate and inflation possibly – stemming from expectations for low inflation, the aging U.S. population, and slowing demographics.

Looking Ahead

- Our equity cycles continue to point to a trend–change low near October 26th.
- Yields should be holding below last week's highs and descending into November 5th.

Treasuries, Agencies, and MBS

As the debt service hit a record $523 billion, the U.S. budget deficit grew 17% versus fiscal 2017, rising from $666 billion to $779 billion – the largest annual shortfall since 2012. The stepped–up borrowing for the Treasury led to Tuesday's first ever sale of 2–month (8–week) T–Bills. The bills brought 2.17% for $25 billion in supply. Looking through Trump's 'glasses', when these bills mature – rates will be 25 bps higher! Given ever–increasing borrowing levels and higher rates, fiscal 2019 debt servicing will be off to a new record pace.

The market–based odds for a November Fed hike were 6.1% as of today, but the 'gradual pace' increase expected by the FOMC for December 19th stood at 76.3%. Yields followed their large jump into October 5th with a better week last week. With an assist from plunging equities, yields fell 3, 5.5, 7, and 7 bps for the 2, 5, 10, and 30–year Treasury sectors. Into today, yields were again higher by 2, 1, 2, and 3 bps for those sectors – as equities held modest gains for the week. Last week, mortgage applications saw their largest decline in over a year with a drop of 7.1%. In one of those 'what have we learned' moves, another story covered a new program of zero–down mortgages for borrowers with poor credit scores. Subprime is back!

Last week, MBS spreads (FNMA 30–year 3.5%) widened by 1 bps. Last Wednesday (10/10), the U.S. Treasury sold $36 billion 3–year notes at 2.989%. Demand fell versus the September auction and the yield was the highest since May 2007. The group that includes foreign central banks bought 46.9% of the offering versus 46.3% last month. The Treasury also sold $23 billion 10–year notes on Wednesday that brought 3.225% – significantly higher to the 2.957% last month. Demand fell to September and the August 2028 issue was reopened to add this supply. Foreign buying rose from 63.9% last month to 64.5%. Last Thursday (10/11), the Treasury also reopened the August 2048 30–year bond to add $15 billion in supply at 3.344%. That was the highest auction yield for the long bond since July 2014. Demand was higher versus September and foreign buyers accounted for 64.4% of this issue versus 61.7% then. Next week, the U.S. Treasury will offer $38 billion 2–year notes on Tuesday (10/23), $39 billion 5–year notes on Wednesday (10/24), and $31 billion 7–year notes on Thursday (10/25).

10/12/18 Treasury Yield Curve	**2-Year: 2.855%**	**5-Year: 3.016%**	**10-Year: 3.162%**	**30-Year: 3.335%**
Weekly Yield Change:	–.032%	–.054%	–.072%	–.070%
Support:	2.909/ 2.954/ 2.999/ 3.044	3.072/ 3.090/ 3.116/ 3.136	3.214/ 3.241/ 3.266/ 3.288	3.390/ 3.412/ 3.435/ 3.458%
Targets:	2.864/ 2.829/ 2.788/ 2.747	3.049/ 3.027/ 3.008/ 2.983	3.177/ 3.155/ 3.132/ 3.110	3.369/ 3.346/ 3.324/ 3.301%

Economics

The Atlanta Fed GDP–Now forecast rose to 4.2% for Q3 2018 after PPI and Wholesale Trade data but stood at 3.9% after Industrial Production and Housing Starts. However, the New York Fed forecast is only 2.25% while St. Louis' reading is closer to Atlanta's at 3.85%. White House economist Kevin Hassett said 4% was possible but he would be *"euphoric"* with anything over 3%. August job openings rose to another record as the JOLTS data continued to show available positions well above the September unemployed of 5,964K by over a million at 7,136K! The hiring rate was the best since 2007 at 3.9%. Initial Jobless Claims rose 8K to 215K two weeks ago and then fell to 210K last week in data that is just above the lowest levels since the late '60s. Continuing Claims fell from 1,656K to 1,653K, and then dropped to 1,640K – the lowest level for those receiving benefits since 1973.

Confidence data slipped a bit but most data was just off 17–year highs. Bloomberg Consumer Comfort fell from 61.6 to 59.5 but then rose back to 60.8. Bloomberg Economic Expectations rose from 57.5 to 58.5. The University of Michigan data was similar with Sentiment dropping from 100.1 to 99, Current Conditions falling from 115.2 to 114.4, and Expectations slipping from 90.5 to 89.1. NFIB Small Business Optimism fell from 108.8 to 107.9. The Leading Index for September rose .50%. Empire Manufacturing rose from 19 to 21.1 while the Philadelphia Fed Business Outlook slipped from 22.9 to 22.2 – a modest slowdown.

Retail Sales were far below forecasts for a .60% increase with a modest .10% gain. Ex autos, they dropped .10%. That drop was the most in 16 months and reflected a large tumble in restaurant spending. Wholesale Inventories rose by 1.00% while Trade Sales were .80% higher. Business Inventories rose .50%. Industrial Production rose .30% and factory output increased by .20%. Capacity Utilization was unchanged at 78.10%.

Homebuilder optimism rose from 67 to 68 for the first gain in 5 months. The gauge of the 6–month sales outlook rose to a 3–month high. However, Housing Starts fell 5.28% from 1,268K to an annual 1,201K pace. Multi–family starts fell 15.2%. Building Permits fell .64% from 1,249K to a 1,241K annual pace.

September Producer Prices rose .20% though the annual pace slowed from 2.80% to 2.60%. It was the first increase in 3 months. Core PPI (ex food & energy) also rose .20% – though the annual pace quickened from 2.30% to 2.50%. Consumer Prices rose .10% (versus .20% estimates). That lesser pace slowed the annual rise from 2.70% to 2.30%. The gain was also .10% for core CPI – though the annual core pace was unchanged at 2.20%. Real Average Weekly Earnings rose 1.10% versus last September and Real Average Hourly Earnings were .50% higher year–over–year. Import Prices rose .50% but the annual pace slowed from 3.80% to 3.50%. Ex petroleum, prices were flat.

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$108.2 billion in foreign funds flowed into U.S. assets in August. With some reallocations, $131.8 billion flowed into longer–term U.S. debt. China's holdings fell for a 3rd month (dropping $6 billion to $1.165 trillion) and Japan's dropped as well (falling from $1.046 trillion to $1.03 trillion).

Friday is set for Existing Home Sales for September. Next Monday (10/22) brings the Chicago Fed National Activity Index. Tuesday follows with Richmond Fed Manufacturing. Wednesday gives us MBA Mortgage Applications (which were down 1.7% and then 7.1% over the past 2 weeks), the FHFA House Price Index, New Home Sales for September, and the Fed's Beige Book. Thursday is set for jobless claims data, the merchandise trade (deficit), Wholesale & Retail Inventories, Orders for Durable & Capital Goods, Pending Homes Sales, Bloomberg Consumer Comfort, Pending Home Sales for September, and Kansas City Fed Manufacturing Activity. Friday follows with Q3 GDP and the University of Michigan sentiment surveys.

Due to our travel schedule, the next **BMR** is scheduled for the last week of October. Data for early that week starts Monday (10/29) with Personal Income & Spending and the PCE Deflator. Tuesday brings metro home prices and the Conference Board confidence surveys.

Equities

Last week, we said: *"Our equity cycles continue to show weakness into October 26th and last week's internals began to show some vulnerability."* Stocks sold off last week with the Dow losing 1,107.06 points despite a 287–point rally on Friday. Though the Dow rallied 547 points on Tuesday as U.S. markets had their best day since March, it was less than 40 points higher into today!

Last week, the Dow Industrials lost 1,107.06 points or 4.19% to 25,339.99. They were .16% higher into today. The S&P fell 118.44 points or 4.10% last week to 2,767.13 but rose .06% through today. The Nasdaq dropped 291.55 points or 3.74% to 7,496.89 and was off a modest .16% into today. The Dow Transports fell for a 4th week – losing 6.40% for its worst loss since January 2016. It's .81% lower this week. Bank stocks fell 5.71% for their worst week since March and are .58% lower this week.

Resistance:	Dow:	25,597/ 25,813/ 25,998/ 26,247	Nasdaq:	7,526/ 7,611/ 7,664/ 7,723	S&P:	2,782/ 2,805/ 2,831/ 2,862
Support:		25,284/ 25,180/ 24,966/ 24,549		7,441/ 7,371/ 7,280/ 7,186		2,756/ 2,731/ 2,705/ 2,679

Other Markets

Crude Oil continued to pull back from our October 2nd trend–change. Energies do turn positive near the 23rd but then turn down again from October 31st in what projects to be a whippy market. Crude fell 4.04% last week and is 3.77% lower this week. Commodities fell .55% and were .66% lower into today. Gold rose 1.41% and added .69% into today. The U.S. Dollar lost .41% last week but rebounded .77% through today. The Japanese Yen surged 1.33% higher but was unchanged into today. The Euro gained .31% but lost .93% into today. Corn rose 1.49% but was .80% lower into today. Cotton gained 2.46% but lost .41% through today.

"To play it safe is not to play." Robert Altman

(Speaking to the new normal and neutral interest rates)
"The trouble with normal is it always gets worse." Bruce Cockburn

Additional Information is Available on Request
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