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Bond Market Review

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A Darker Shade of Beige

The Fed's Beige Book said: *"Economic activity increased in most of the U.S., with 8 of 12 Federal Reserve Districts reporting modest to moderate growth."* The **BMR** would repeat that 'modest to moderate' are not signs of overheating! The report continued: *"Outlooks generally remained positive, but many Districts reported that contacts had become less optimistic in response to increased financial market volatility, rising short–term interest rates, falling energy prices, and elevated trade and political uncertainty."* Some districts had slowed. New York said economic activity leveled off and Kansas City said activity was flat. Most districts reported labor as tight with employers struggling to find workers across all skill levels.

President Trump is unhappy with rising rates as well. Last Tuesday (01/08), he tweeted: *"Economic numbers looking REALLY good. Can you imagine if I had long–term ZERO interest rates to play with like the past administration, rather than the rapidly–raised normalized rates we have today?"* Trump has pulled no punches in criticizing the Fed for fighting his efforts to negotiate trade and spur the economy. With the Fed's December hike very ill–timed according to the market's negative response, he wasn't alone.

The Fed's minutes from their December meeting didn't match Chairman Powell's rather–hawkish post–meeting press conference – and have allowed some bullishness to reenter stocks. The markets read the Fed as stubbornly on a trajectory to raise rates into 2019 and run the balance sheet off in the same fashion – on *"automatic pilot."* Despite Powell avoiding any dissent in the vote, the minutes said: *"A few participants, however, favored no change in the target range at this meeting, judging that the absence of signs of upward inflation pressure afforded the Committee some latitude to wait and see how the data would develop amid the recent rise in financial market volatility and increased uncertainty about the global economic growth outlook."* They also said: *"A number of participants noted that, before making further changes to the stance of policy, it was important for the Committee to assess factors such as how the risks that had become more pronounced in recent months might unfold and to what extent they would affect economic activity."* They also wanted to access the hikes already in place – and their evolving impact to the economy. The minutes noted: *"Many participants expressed the view that, especially in an environment of muted inflation pressures, the Committee could afford to be patient about further policy firming."* Dissent in the ranks!

These comments did not sound like a Fed dead set on hiking with economic blinders! Though there was no vote of dissent, there were those against the hike – and more 'wait and see' patient–type members are rolling on as voters while a few hawks are rolling off. One of those 'voices of reason' regaining a vote is St. Louis FRB President James Bullard. He said there was no urgency to hike and the Fed was *"bordering on going too far and possibly tipping the economy into recession."* Sounds like there's a nay vote to any early–2019 hikes! Chicago's Charles Evans said the Fed had good capacity to wait and carefully take stock of the incoming data. Even some hawks were whistling a different tune. Kansas City's Esther George said the Fed could be patient and pause. Boston's Eric Rosengren said there should be no particular bias to raising or lowering rates until the data more clearly indicate the path for growth.

Looking Ahead

- Stock cycles are mixed but with possible lows coming with bond yields on the 25th and on January 31st.
- Bond yields should make lows into trend changes due near January 25th–28th and February 13th.
- U.S. markets will be closed on Monday (01/21) for the Martin Luther King, Jr. Day Holiday.

Treasuries, Agencies, and MBS

So far, yields bottomed right on our expected January 3rd trend–change and have risen since. The next 2 yield lows should be into the January 25th–to–28th window and near February 13th. We would sell rallies or and/or hedge portfolios if yields indeed drop into those trend–change targets. Last week, yields continued to rise with the 2, 5, 10, and 30–year sectors up by 5, 3, 3.5, and 5 bps. 5–year yields were under 2–year yields by 1.5 bps but have since reversed to .5 bps over with yields rising only 2 bps at 2–years but higher by 4, 5, and 4 bps for the longer maturities into today.

MBS spreads (FNMA 30–year 3.5%) narrowed by 3 bps last week. While the odds for another FOMC hike were 0% across the board for 2019 as of our yield–cycle low on January 3rd, they rose to 19.9% for September 2019 as the highest possibility through today – or only a 1 in 5 chance. We had projected no more hikes in 2019 if the Fed hiked in December – which they did, and then appeared to have instantly regretted as the markets were greatly disturbed by how out of touch the FOMC seemed to be. Earlier this week, at 26.7%, the odds for a cut in January 2020 were the largest 'chance' given either way for the next 9 meetings.

Obviously, given the negative response and subsequent backtracking a move for the January 30th meeting has been at 0% since December – but rose to .5% today (a 1 in 200 longshot). When asked if the next move could be an increase or a cut, Atlanta FRB President Raphael Bostic said *"yes."* He said the FOMC needed to signal they were not *"locked into a particular trajectory for policy."* He also said we were in a 9–and–a–half year expansion, which the **B**ond **M**arket **R**eview would note as one of the weakest historically – with 'modest to moderate' the chief descriptor of the slight gains since the financial crisis.

There's no need to revisit the numbers but U.S. debt continues to offer a great value versus global alternatives – which are not only riding 3–month lows, but many have negative yields even out to 5 years and beyond! (Euro–area production fell the most in 3 years in November – adding to the danger of an EU slowdown.) Given the expectations for no more imminent Fed action, the upside for U.S. yields (downside for bonds) should be limited to 50 to 75 bps at the most over the coming months.

Last Tuesday (01/08), the U.S. Treasury sold $38 billion 3–year notes at 2.559%. That was the lowest yield since last April, but demand was the lowest since 2009. The group that includes foreign central banks bought 41.9% of the issue – down from 50.5% in December. Last Wednesday's (01/09) 10–year auction brought 2.728% for $24 billion in supply. Demand rose versus December and foreign buying fell from 63.1% of that auction to 56.9%. The yield was the lowest since the January 2018 offering and the November 2028 maturity was reopened to add this supply. The November 2048 maturity was also reopened to add $16 billion 30–year bonds at 3.035% last Thursday (01/10). The yield was the lowest since July 2018 and demand fell to recent offerings. Foreign buying accounted for 57.3% of the issue, down from 66.4% in December.

Reviewing the BMR Forecasts for 2018

- The Fed would like to hike 2 to 3 more times in 2018, and there are no early indications that the likely call is one or the other. A lot depends on jobs and GDP growth, but 2 hikes would appear minimal. It's worthy of note that there are some doves on the committee that would still like to see more hard evidence of wage inflation before taking further action.
    - The doves disappeared under the leadership of Chairman Jerome Powell. Powell seemed on a mission to raise rates and did so 4 times. We think neutral was one or two hikes ago, and that Powell hiked rates in part to show he was independent and not influenced by President Trump.
- GDP should continue to dwell in the 3% range. We don't see a case for a rise to 4% or a drop to 2%.
    - It appears the U.S. had its first 3% annual GDP since 2005. The data hasn't come yet.
- 2018 is the next 4–year cycle low for stocks, so we would picture a sizeable pullback during the year. Depending on the timing of a pullback, stocks could still return 8 to 11% this year.
    - With the pullback coming into year end, the timing wasn't there for decent 2018 returns, and there was a Dow loss of 5.63%. Into December 24th, it was indeed a sizeable pullback!
- Rates should make lows near the 3rd week of March, mid–July, mid–September, and early November.
    - These were spot on – except the September low came in early.
- The highest yields should come in near early May, late July, and early October.
    - Mid–May was better, but the peaks were late July and early October. Amazing – look at a chart!
- Trend–changes for bonds could occur near August 15th and January 8th (2019).
    - August 15th was days before the huge upswing into the October 5th peak in the 10–year note. We tweaked the dates better during the year – and the January 8th low predicted a year ago was changed to the 3rd – and hit as expected.
- We fully expect the curve to invert if (and around when) the Fed hikes a second time in 2018.
    - The curve was close to inversion after the second hike in June and remained so to date. The 5–year did invert to the 2–year but not until later in the year.
- Stocks have lows due near the end of January, the 3rd week of March, mid–May, mid–August, and late October. Highs could come in early March, mid–June, and late August.
    - One would have received a nice bounce from any of the low dates except for the end of January which was adjusted to February 9th in the **BMR (01/25/18)**. Our best cycle call was for a low due on April 2nd beginning in the **BMR (03/22/18)**. Stocks surged from there to the October high.
- We don't expect the returns for stocks or bonds to rival 2017. The U.S. is tightening and removing QE, and the European Central Bank is doing so as well. There will be less 'easy money' to play with.
    - With those given 'players' in full force, the returns just weren't there!

With equities currently not aligning properly with our cycle models, we're going to work on our 2019 cyclic forecast to try to maximize its efficacy. We'll place the 2019 projections in next week's **BMR**. Sorry for the delay. There have been a few fatigue–causing health issues that have thwarted our work.

01/11/19 Treasury Yield Curve	2-Year: 2.543%	5-Year: 2.530%	10-Year: 2.702%	30-Year: 3.034%
Weekly Yield Change:	+.048%	+.028%	+.033%	+.052%
Support:	2.625/ 2.665/ 2.704/ 2.744	2.631/ 2.651/ 2.692/ 2.731	2.805/ 2.824/ 2.844/ 2.864	3.122/ 3.145/ 3.167/ 3.190%
Targets:	2.547/ 2.505/ 2.466/ 2.386	2.612/ 2.572/ 2.532/ 2.493	2.786/ 2.766/ 2.746/ 2.726	3.100/ 3.079/ 3.056/ 3.033%

Economics

Many data series have been and are continuing to be delayed due to the government shutdown. Some that are listed as due may be delayed until the shutdown is over. As we expected, Initial Jobless Claims seemed to be overstated Christmas Week as they were for Thanksgiving. For the post–Christmas week, they fell from 233K to 216K – and then dropped to a 5–week low 213K the following week – despite the negatives and ramifications of the government shutdown! Continuing Claims fell from 1,750K to 1,722K, but then rose to 1,737K – still near multi–decade lows. JOLTS Job Openings fell to a 5–month low in November, but still maintained a level above the number of Americans listed as unemployed! The drop from 7.131M to 6.888M was roughly 870K above the number of those unemployed. The first look at Q4 GDP will come near month end (government willing) and the result should give us the first annual 3%+ growth since 2005. We need something solidly above 2.3% for that result and the latest Atlanta GDP–Now Q4 forecast was 2.8% as of Wednesday! The New York Fed's projection was 2.48% as of last week and St. Louis was right on top of Atlanta with a 2.788% projection. A banking panel is projecting only 2.1% for 2019 – and 1.7% in 2020. However, a broader group of economists is expecting 2.3% GDP growth in 2019.

Bloomberg Consumer Comfort fell from 59.6 to a 4–month low 58.5 last week – readings better for Republicans than from Democrats, and the highest since 2001 for low income earners. That index slipped to 58.1 this week but their survey on Economic Expectations dropped from 50 to a 2–year low of 44.5 – despite being the highest since 2002 only a few months ago. The buying climate fell to the lowest since November. NFIB Small Business Optimism slipped from 104.8 to 104.4, with expectations 6 months out contributing to the downside. Empire Manufacturing fell from 11.5 to 3.9 – the lowest since May 2017 for the New York region. However, the Philadelphia Fed Business Outlook rose from 9.1 to 17 – the best reading since October. Homebuilder sentiment improved from a 3–year low of 56 to 58 – the first rise in 3 months. Consumer Credit beat expectations of a $17.5 billion increase in November by rising $22.149 billion! Though some government data is delayed, the Redfin data on December housing showed an 11% decline – the largest for any month since 2016.

Consumer Prices fell .10% in December, shrinking the annual pace from 2.20% down to 1.90%. Core CPI (ex food & energy) rose .20%, allowing the annual pace to steady at 2.20%. Wages showed improvement as Real Average Weekly Earnings rose 1.20% (versus last December) and Hourly Earnings were up 1.10%. Producer Prices fell .20% in December, though the annual pace remained at 2.50%. Ex food & energy, Core PPI fell .10% for its first downtick in a year. Annual Core PPI was steady at 2.70%. December Import Prices fell 1.00% but were .30% higher ex petroleum. Export Prices fell .60%.

Friday brings Industrial Production and Capacity Utilization, the University of Michigan sentiment surveys, and Existing Home Sales for December. November data that is listed as coming over the next 2 weeks but hindered by the shutdown includes the Advance Goods Trade Balance, Retail, Business and Wholesale Inventories, New Home Sales, Construction Spending, Factory and Durable Goods Orders, International Treasury Flows and the Trade Balance. December data includes the Monthly Budget Statement, Retail Sales, Housing Starts and Building Permits. Wednesday is set for MBA Mortgage Applications (which surged 23.50% and 13.50% the past 2 weeks on lower rates), the FHFA House Price Index, and Richmond Manufacturing.

Equities

The cycles worked well into the lows on December 21st and 24th, but stocks rallied out of that window for a low and have not pulled back into mid–January as expected. The energy should be positive for a number of days even though the markets didn't move down into the 16th/17th. The cycles still point up from these dates. Cycles are not a science, but they incorporate a scientific approach. The latest rally in stocks is promising, but the technicals are still challenged. We'd still like to see a better pullback into the end of January, February 21st, or March 8th before accumulating positions for a longer holding horizon. Hopefully we'll be able to see a lineup of prices and cycles that looks good over the next 2 to 8 weeks.

The Dow gained 562.79 points or 2.40% last week to 23,995.95 and is 1.56% better this week to kick off 2019 with a 4.47% gain. Last year's loss was 5.63%. The S&P gained 2.54% to 2,596.26 and is 1.53% better this week. The Nasdaq rose 3.45% to 6,971.48 and is up another 1.62% this week. The Dow Transports gained 4.34% last week and are 1.37% ahead this week. Bank stocks gained 1.54% last week and have surged 5.86% this week!

Resistance:	Dow:	24,745/ 24,912/ 25,068/ 25,230	Nasdaq:	7,184/ 7,226/ 7,268/ 7,311	S&P:	2,675/ 2,688/ 2,701/ 2,714
Support:		24,598/ 24,366/ 24,124/ 23,971		7,087/ 7,016/ 6,975/ 6,933		2,650/ 2,636/ 2,611/ 2,586

Other Markets

After a drop into January 14th, Crude Oil is holding near one–month highs but still has a low due near January 25th. After that, the cycles are positive into mid–March. Crude gained 7.57% last week and 13.81% over the past 2 weeks. It's up another .93% this week. Commodities gained 2.73% and are .94% better this week. Gold gained .29% and is .22% ahead this week – which would be a 5th gain! The U.S. Dollar lost .51% to mark a 4th down week but is .47% better this week. The Japanese Yen rose .03% but was .72% weaker into today. The Euro rose .65% but has lost that and more with a .70% loss into today. Corn lost 1.24% but is .46% higher this week. Cotton lost .04% but has rallied 2.59% into today. The Brexit deal has turned into U.K. Prime Minister Theresa May's 'wall.' Her latest proposal was voted down by a 230–vote margin. The EU has raised its own invisible wall to thwart the deal by refusing to compromise on letting England have an easy out. With President Macron still seeing protests in France, it's not a great time to be a leader in the free world.

Quotes from some great Americans that passed in 2018

"God has given us two hands, one to receive with and the other to give with."
"Mountaintops are for views and inspiration, but fruit is grown in the valleys."
"The only time my prayers are never answered is on the golf course."
Reverend Billy Graham

"It's my firm conviction that when Uncle Sam calls, by God we go, and we do the best that we can."
R. Lee Ermey

"Every birthday is a gift. Every day is a gift."
"People really don't have to give you anything, so appreciate what people give you."
"When God loves you, what can be better than that?"
Aretha Franklin

"Don't confuse being 'soft' with seeing the other guy's point of view."
President George H.W. Bush

"I don't have inspiration. I only have ideas. Ideas and deadlines."
"I have always included minority characters in my stories, often as heroes. We live in a diverse society — in fact, a diverse world, and we must learn to live in peace and with respect for each other."
Stan Lee

Additional Information is Available on Request
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