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Bond Market Review

July 18, 2019 #890

Musketeers at the Ready

Regarding the expected July 31st FOMC rate cut, it's (almost) all for one, some for two, and a few for none! Our opinion, and that of many economists/analysts, was that the robust June payroll numbers most probably took a 50–bps interest–rate cut off the table for the Fed's July policy statement. However, over the past few days, bonds have been behaving as if the greater game was still on. As of last week, traders were expecting at least a 25–bps cut at a sure 100% – with the chances for a 50 bps–cut less than 20%. As of today, the odds of a 50–bps drop moved up to 39.5%. To date, Jerome Powell has the least dissenting votes for any Fed Chair in nearly 7 decades. That one nay vote came in June with St. Louis FRB President James Bullard preferring a cut at that meeting. There could be dissent on both sides with a few favoring 50–bps and 2 or 3 inclined to watch more incoming data. Having hiked rates 9 times, albeit sporadically, the Fed once gain wields some ammo to combat sluggish growth. However, as we approach month end, it's unclear who's on board and how many shots they're willing to fire.

Kansas City's Esther George said she hadn't seen anything to alter her outlook to leave rates alone. Nevertheless, this will be the first cut in a decade. Supporting George, the Fed's Beige Book said: *"The outlook generally was positive for the coming months, with expectations of continued modest growth"* despite concerns over trade uncertainty. The report was mostly positive – noting some challenges to manufacturing, but there had been a modest pickup in a few districts. The Atlanta Fed's GDP–Now forecast rose from 1.3% to 1.6% for Q2 2019 – slowing from 3.1% in Q1.

Ready. Fire! Aim. Fed Vice Chair Richard Clarida said: *"You don't need to wait"* for an economic turndown to get so bad it requires a *"dramatic series of rate cuts."* That's a huge reversal from the usual 'watch the incoming data' stance of Powell and most FOMC members. Fed Chair Powell had said the Fed would act as appropriate given increased uncertainties. The one thing that has the **B**ond **M**arket **R**eview thinking the Fed starts with a 25–bps move is that it took so long for Powell to capitulate. Even if the markets expect 50 bps, such a start might be seen as panic given a Chair that was so resistant to cease tightening – much less to admit a policy mistake and reverse with a vengeance. Chicago's Charles Evans said 2 cuts could bring inflation to the Fed's goal, adding *"because we've been under–running for so long."* Bullard, the lone dissenter last month, said a cut might soften the blow from trade uncertainty, but that he was not for *"competitive devaluation"* of the U.S. Dollar. The debt markets are listening to New York's John Williams who said given the limited amount of stimulus at the Fed's disposal, *"it pays to act quickly at the first sign of economic distress."* That remark drove the front end of the curve down.

Japanese inflation hit a 2–year low prompting the BOJ to come up with more stimulus. South Korea beat everyone to the game with a surprise cut – along with reducing their growth and inflation forecasts. Within a few months, we'll all be astonished by how many central banks join the 'cutters.' The ECB will most likely enter a fresh bout of QE as well. That means fresh round of asset purchases. In the early '80s, I wrote a sophisticated cash–flow bond swap model. Back then, I locked out being able to price purchases to negative yields – thinking that most illogical. While some holdings would turn negative given their internal characteristics, default, or derivative qualities, the thought of paying a premium for a T–Bill or intentionally locking in a negative return 'didn't compute.' Who knew there would ever be a $13 trillion supply of such paper? The less you buy, the better – and the best strategy to beat benchmarks!

The Dutch government was said to be campaigning for former finance minister Jeroen Dijsselbloem to be the next director of the International Monetary Fund. Since I still type with 2 fingers, if he becomes the next IMF chief, I'll lose around 15 minutes each time he makes the news. Christine Lagarde leaves the IMF on September 12th to takeover leadership of the European Central Bank after Mario Draghi steps down at the end of October.

Looking Ahead

- Equity cycles show choppy trading with a trend–change low due near July 25th.
- Bond cycles show yields remaining low but making a trend–change low also around July 25th.
- The FOMC will announce their latest stance on interest–rate policy on Wednesday, July 31st at 2 pm ET.

Treasuries, Agencies, and MBS

Interest rates didn't make any new lows over the past week, but they have remained low – in keeping with the cycles, and our outlook. Cycles aside, the fundamentals of what the Fed has termed *"uncertainties"* and *"downside risk"* combined with recently–challenged global data are doing their part to keep central banks on alert and 'ready to act.' Those factors should serve as a tether along with quality global–debt alternatives stuck in a quagmire of very low to negative yields and some central banks possibly entering new rounds of quantitative easing. Most global debt is trading at multi–year low yields. We expect yields to drop into their July 25th trend–change date.

Last week, the yield curve steepened with yields dropping 1.5 bps at 2–years, but rising by 4, 9, and 10.5 bps at 5, 10, and 30–years. Treasuries rallied into today, thumping yields back down by 9, 10.5, 10, and 8 bps (for those sectors). Next week, the U.S. Treasury will auction $40 billion 2–year notes on Tuesday (07/23), $41 billion 5–year notes on Wednesday (07/24), and $32 billion 7–year notes on Thursday (07/25). Demand may have drifted for recent auctions, but there's an awful lot of buying! In May, foreign entities moved $3.5 billion into longer U.S. maturities. Overall, $32.9 billion moved into U.S. assets in May.

07/12/19 Treasury Yield Curve	2-Year: 1.848%	5-Year: 1.872%	10-Year: 2.123%	30-Year: 2.647%
Weekly Yield Change:	–.014%	+.040%	+.088%	+.105%
Support:	1.834/ 1.869/ 1.904/ 1.939	1.813/ 1.830/ 1.848/ 1.866	2.060/ 2.077/ 2.095/ 2.112	2.586/ 2.606/ 2.626/ 2.647%
Targets:	1.800/ 1.765/ 1.730/ 1.695	1.778/ 1.761/ 1.744/ 1.726	2.026/ 2.009/ 1.991/ 1.974	2.567/ 2.547/ 2.527/ 2.507%

Economics

Initial Jobless Claims rose from 208K to 216K – still very low and non–threatening to the labor market. Continuing Claims fell from 1,728K to 1,686K. Despite the negatives out there, Bloomberg Consumer Comfort rose from 63.8 to a new 18–year high of 64.7. Their Economic Expectations survey rose from 50.5 to an 8–month high 55.0. U.S. Manufacturing saw a little rebound. Empire Manufacturing rose from –8.6 to 4.3 and the Philadelphia Fed Business Outlook surged 21.5 points higher from .3 to a 1–year high of 21.8! That was the best 'Philly Fed' improvement since June 2009 – as the economy was coming 'out' of recession! Though Industrial Production (which includes mining and utilities) was flat and Capacity Utilization fell from 78.10% to 77.90%, Manufacturing Output rose by .40% in June. Auto production rose 2.9%. In June, the Leading Index fell by .30% (following a flat May).

Not only is consumer confidence resilient, so is consumption! June Retail Sales rose .40% (though May slipped from a .50% increase to .40%). Ex autos sales rose .40%. Business Inventories rose .50%.

Producer Prices didn't rise much, but they were more than the 0.0% forecast with a .10% increase. The annual pace fell from 1.80% to 1.70%. Ex food & energy, PPI rose .30% with the annual core rate flat at 2.30%. Import Prices fell .90% in June. That dropped the annualized pace to last June from –1.10% to –2.00%. Ex petroleum, prices fell .40%. Export Prices fell .70%, with the annual pace also more negative from –.80% to –1.60%.

Home–builder confidence rose from 64 to 65 (the NAHB Housing Market Index) just under May's 2019 high of 66. June Housing Starts fell .95% from 1,265K to 1,253K (annual units). Building Permits were way off – dropping 6.08% from 1,299K to 1,220K (annual units).

The next **BMR** will follow the Fed's policy statement on July 31st. Friday is set for the University of Michigan sentiment surveys. Next Monday brings the Chicago Fed National Activity Index. Tuesday follows with the FHFA House Price Index, Richmond Fed Manufacturing, and Existing Home Sales for June. Wednesday brings MBA Mortgage Applications (which fell 1.10% last week) and New Home Sales for June. Thursday is loaded with June Wholesale & Retail Inventories, Durable Goods Orders, Capital Goods Orders, jobless claims data, and Kansas City Fed Manufacturing. Friday gives us a first look at Q2 U.S. GDP.

The following Monday (07/29) is set for Dallas Fed Manufacturing Activity. Tuesday brings Personal Income & Spending for June, the PCE Deflator (Fed's favorite inflation gauge), Metro home prices, June Pending Home Sales, and the Conference Board's sentiment surveys. FOMC day comes on Wednesday (07/31) with the Fed's July interest–rate policy statement, a first look into July payrolls from ADP Employment Change private payrolls), and MNI Chicago PMI (purchasing managers).

Equities

Stocks built on the momentum coming out of the July 9th cycle low with the major indexes rising to new highs earlier this week. It's still a concern to us that the small and medium–cap stock indices failed to make new highs (and of course the Dow Transports that are lagging as well). Last week, we said: *"On a micro level stocks should turn down into July 18th/19th – when another trend–change low is due."* Stocks traded to the lowest levels since July 9th today – filling that cycle. As we've said, the cycles remain choppy, and another low is due near July 25th.

The Dow Industrials rallied 409.91 points or 1.52% to 27,332.03 last week but are .40% lower this week. The Nasdaq gained 1.01% but was off by .45% into today. The S&P gained .78% but fell .62% into today. The Dow Transports rose 1.45% but have fallen back .94% so far this week. Bank stocks lost .14% and are .98% lower this week.

	Dow:	Nasdaq:	S&P:
Resistance:	27,398/ 27,567/ 27,735/ 27,898	8,238/ 8,261/ 8,285/ 8,308	3,007/ 3,014/ 3,027/ 3,041
Support:	27,072/ 26,887/ 26,743/ 26,578	8,194/ 8,172/ 8,150/ 8,128	2,987/ 2,974/ 2,967/ 2,960

Other Markets

Crude Oil gained 4.69% last week but is 8.15% lower this week. Reflecting that move, Commodities rose 1.98% but fell 3.75% into today. Gold gained .86% and added 1.13% through today – trading just shy of $1,450/oz. for the first time since May 2013! The U.S. Dollar lost .48% last week but is a slight .03% better this week. The Japanese Yen gained .52% and has added another .57% this week. The Euro rose .40% and is .06% higher this week. Corn gained 3.57% but is 5.56% lower this week. Cotton lost 1.70% and is off another 2.53% this week.

Saturday is the 50th anniversary of America's lunar landing.

"Houston, Tranquility Base here. The Eagle has landed."
NASA astronaut Neil Armstrong after landing on the moon July 20, 1969.

"That's one small step for man, one giant leap for mankind."
Apollo 11's Neil Armstrong as he stepped onto the moon.

"I believe this nation should commit itself to achieving the goal, before the decade is out, of landing a man on the moon and returning him safely to Earth."
President John F. Kennedy in special State of the Union message on May 25, 1961.

"Here men from the planet Earth first set foot upon the moon. July 1969 A.D. We came in peace for all mankind."
Plaque on the lunar module.

Additional Information is Available on Request
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