Financial Market Weekly

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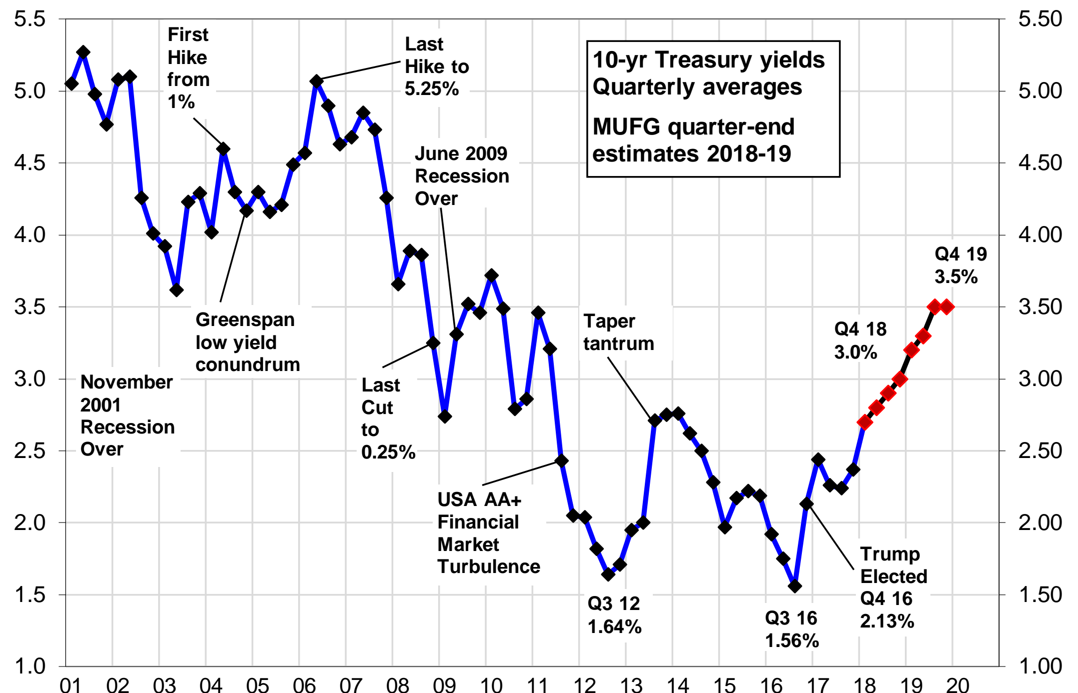
BOND YIELDS HIT CLOSER TO 3% QUICKER THAN OUR YEAR-END FORECAST

Bond yields keep moving up, partly on Wall Street dealers upping their forecasts this year. A couple of inflation wildfire outbreak reports were the major force behind this year's yield rally. Fed policy is also important as bond yields seem to have magically maxed out in the last two interest rate cycles right where the Fed funds rate peaked. Do you feel lucky? How high do you think the Fed is going to push rates in this cycle. Stretching a little, the December Fed meeting forecasts say 3.25% at the end of 2020 so bond yields are getting a little ahead of what is almost a three year journey of Fed rate hikes to normal levels. Bonds of course may be trying to discount the Fed going 4 times in 2018 instead of the 3 times policymakers forecast at the December meeting because inflation is starting to rear its ugly head. What determines where bond yields trade? Okay, that would be Fed policy and inflation, what else? Well, the new element is supply. A factor we have not heard much from since the Obama trillion-dollar deficit years 2009-12. Supply is the factor that has Wall Street dealers looking for sharply higher yields. The massive tax cuts and $400 billion of additional Government outlays have got to be paid for somehow. Primarily by more Treasury auctions,



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at least until the fiscal stimulus works its wonderful magic--increasing economic growth to 3% and bringing in more revenues to pay for the tax cuts. The other issue of course is the demand side for Treasury debt and here it is important to remember that much of those Obama trillion-dollar deficit years were funded with debt bought by foreigners and the Fed's QE stimulus purchases. No more QE is coming (we hope) and lately foreigners have not been buying as much of our National Debt.

Inflation fears come and go

Step 1
Average hourly earnings 2.9% on February 2, 2018
Bonds 2.79 to 2.85% that day

Step 2
Core CPI 0.3% February 14
Bonds 2.82 to 2.92% that day

Mostly worried about the "inflation fears go." Inflation doesn't go up in a straight line.

To conclude, it seems reasonable to think bond yields are going up the next couple of years with the Fed rate hikes. The Fed's "longer run" Fed funds rate still looks low to us at a December meeting median forecast of 2.75% though and may limit the bond market sell-off at some point in the next few years if they don't up the "natural rate" forecasts eventually under Powell's leadership. More immediately however, we are not as confident as the market that there is an outbreak of inflation so we did not want to ramp up the bond yield forecast much higher. On the other hand, the supply of new Treasury debt is likely to be greater than the demand for Treasury securities, so we don't want to lower the bond yield forecast either. Since the recession, foreigners bought 53 percent of the increase in our National Debt. Thank you. Will they be there tomorrow is the big question? We suspect not in the same numbers. Anyway, our best guess is that 10-year yields finish the year around 3.0% and end up at the end of 2019 at 3.5%.

** More on Supply/Demand and Inflation to Value Treasury Yields

Bond yields are low relative to inflation. In 2017, 10-yr yields averaged 2.33%, 83 bps higher than core PCE inflation. Yields came down in 2012, the year after the financial market turmoil and never went back up. Boston Fed President Rosengren said Friday the U.S. would have low real interest rates for some time, and this from a relative hawk who voted against Yellen in favor of a rate hike in September 2016. We were thinking it was the Fed's stubbornly low rates policy that is keeping 10-yr yields down, as is telling the world the economy is not strong enough to handle a 2.75% Fed funds rate until way out in December 2019.

	10-yr Treasury Yield	Core PCE	Real Yield bps
2002	4.61	1.7	291
2003	4.01	1.5	251
2004	4.27	1.9	237
2005	4.29	2.2	209
2006	4.80	2.2	260
2007	4.63	2.2	243
2008	3.66	2.1	156
2009	3.26	1.2	206
2010	3.22	1.3	192
2011	2.78	1.5	128
2012	1.80	1.9	-10
2013	2.35	1.5	85
2014	2.54	1.6	94
2015	2.14	1.3	84
2016	1.84	1.8	4
2017	2.33	1.5	83

2017-to December

Supply could be a factor pushing up bond yields. The Federal budget deficit could be $1.2 trillion in fiscal year 2019, and add $360 billion from the Fed balance sheet unwind. Foreigners bought a lot of our debt in 2009-12, but not as much since. China had a $375 billion trade surplus last year with the US; that isn't changing, but the foreign purchases may not offset the Treasury's financing demands the next two years.

Federal Budget Deficits fiscal years ending September $bln

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
OMB (FY17 Budget)	458	1,412	1,294	1299	1086	679	484	438	584	665
Fed QE Purchases of Govts		293	7	600	0	414	387	13	2	2
Treasuries Held in Custody fgn central banks	256	624	392	212	193	38	89	-20	-185	232
Foreign private purchases Govts (TIC)	252	267	579	320	218	53	178	210	85	143
Commercial Bank holdings Treasuries	1	50	103	-17	23	-36	186	64	62	0

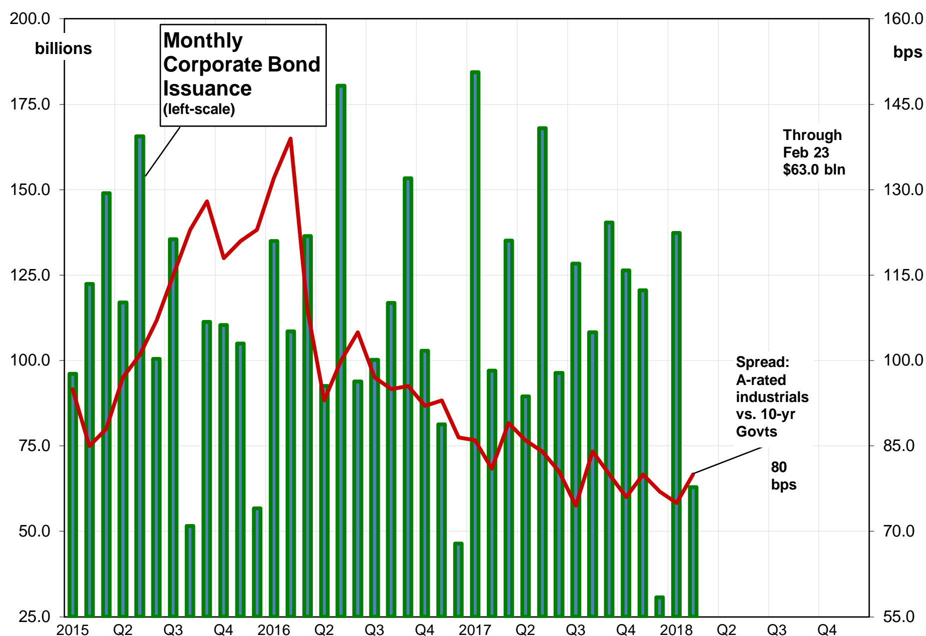
MARKETS OUTLOOK

	29-Dec 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
30-Yr Treasury	2.74	3.00	3.10	3.20	3.30	3.40	3.45	3.65	3.60	3.80	3.75
10-Yr Note	2.41	2.70	2.80	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.70
5-Yr Note	2.21	2.50	2.50	2.70	2.85	3.05	3.20	3.45	3.45	3.65	3.70
2-Yr Note	1.89	2.15	2.30	2.55	2.80	3.00	3.15	3.40	3.40	3.60	3.80
3-month Libor	1.69	2.05	2.20	2.45	2.70	2.95	3.10	3.35	3.35	3.60	3.85
Fed Funds Rate	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75
2s/10s spread	52	55	50	35	20	20	15	10	10	10	(10)

The 2018 bond yield rally made a new high this week at 2.95%, somehow after the release of the January Fed meeting minutes on Wednesday. The higher 2.95% bond yields seemed to bring the stock market back down from its highs. Dow industrials rallied on the Fed minutes as well and were up 303 points on the day at 230pm NY time only to come crashing down 470 points into the close from the highs of the day. The bond yield high did not last for long, and in retrospect is not entirely explainable on the "fundamentals."

CORPORATES: BOSTON SCIENTIFIC, MASTERCARD, PPG INDUSTRIES

Corporate offerings were $18.4 billion in the February 23 week versus $10.7 billion in the February 16 week. On Wednesday, Boeing sold $1.4 billion 5s/10s/20s/30s. It priced a $350 million 3.25% 10-yr (m-w +10bp) at 58 bps (A2/A). The aircraft manufacturer will use the proceeds for general corporate purposes. Corporate bonds (10-yr Industrials rated A2) were 80 bps above 10-yr Treasuries this week versus 78 bps last Friday.



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FEDERAL RESERVE POLICY

The Fed meets March 20-21 to consider its monetary policy. Fed Chair Powell gives his semiannual Monetary Policy Report testimony before the House on Tuesday, February 27. We are not looking for Powell to show his cards and give the markets any hint on how many rate hikes he thinks the Fed needs to make this year.

Here are our colorful comments made after the release of the January 30-31 Fed meeting minutes on Wednesday this week.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	21-Feb	14-Feb	7-Feb	31-Jan	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2432.066	2436.173	2436.192	2436.211	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1768.298	1771.927	1760.743	1760.743	0.000
Primary credit (Discount Window)	0.018	0.002	0.019	0.046	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	1.710	1.715	1.715	1.715	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	0.000
Central bank liquidity swaps	0.067	0.062	0.039	0.673	62.000
Federal Reserve Assets	4458.9	4482.2	4468.0	4465.6	961.7
3-month Libor %	1.92	1.85	1.80	1.78	2.82
Factors draining reserves					
Currency in circulation	1621.652	1616.273	1612.559	1607.532	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	45.171	38.518	48.120	65.797	0.000
Reserve Balances (Net Liquidity)	2215.339	2226.188	2240.014	2323.217	24.964
Treasuries within 15 days	32.047	48.610	16.563	16.563	14.955
Treasuries 16 to 90 days	92.002	92.002	97.821	97.821	31.549
Treasuries 91 days to 1 year	314.372	270.849	297.077	297.078	69.272
Treasuries over 1-yr to 5 years	1069.165	1107.777	1081.307	1081.309	170.807
Treasuries over 5-yrs to 10 years	300.215	295.684	322.161	322.166	91.863
Treasuries over 10-years	624.265	621.252	621.263	621.274	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

Without "further" ado, Fed minutes pave the way for a March rate hike

Breaking economy news. FOMC meeting minutes from the January 30-31 meeting. A March rate hike looks likely, if not, better tell the markets who see odds better than 90%. But maybe it's our imagination or maybe the market's imagination, but it looks like investors focused on the headlines that some of the Fed members were getting cold feet, we mean, some of the Fed members see a significant risk that inflation will lag and never reach the Fed's 2% target. (Why is the 2% inflation goal so important again? Almost sounds like it's a mantra for some Fed members as important as "Buy American, Hire American, Import Americans" in other quarters down there in Washington D.C.)

The stock market seemed to go up a lot on the Fed minutes maybe thinking one and done for some time after a March rate hike. Philadelphia Fed President Harker was out earlier this morning saying he favored just two rate hikes in 2018. On the other hand, the stocks trade was probably done by bots taking advantage of greater liquidity and volumes from market-moving news in order to execute their program trades. As long as stocks go up, let the bots trade we say. Who cares about fundamentals.

The focus for markets and the Federal Reserve is clearly on inflation as it is the half of their mandate from Congress that is not on target. Fed officials even got an inflation forecasting lecture this meeting from the Fed economics staff. Unfortunately, the inflation wildfire outbreak occurred after the meeting with the 2.9% average hourly earnings "wages" in the jobs report on February 2, and last week's 0.3% core CPI, both pushing bond yields higher and a lot of Wall Street firm's interest rate forecasts higher as well.

Anyway, in the Policy Action section of the minutes, it doesn't look like that many Fed officials are worried about too low inflation. It said, "a couple of members expressed concern about the outlook for inflation" because of little sign of inflation in the data or in wage growth, but of course after the meeting,

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wages in the jobs report are up and core CPI inflation is as well. The Committee seems as confused as ever with several members saying they saw both upside and downside risks to inflation.

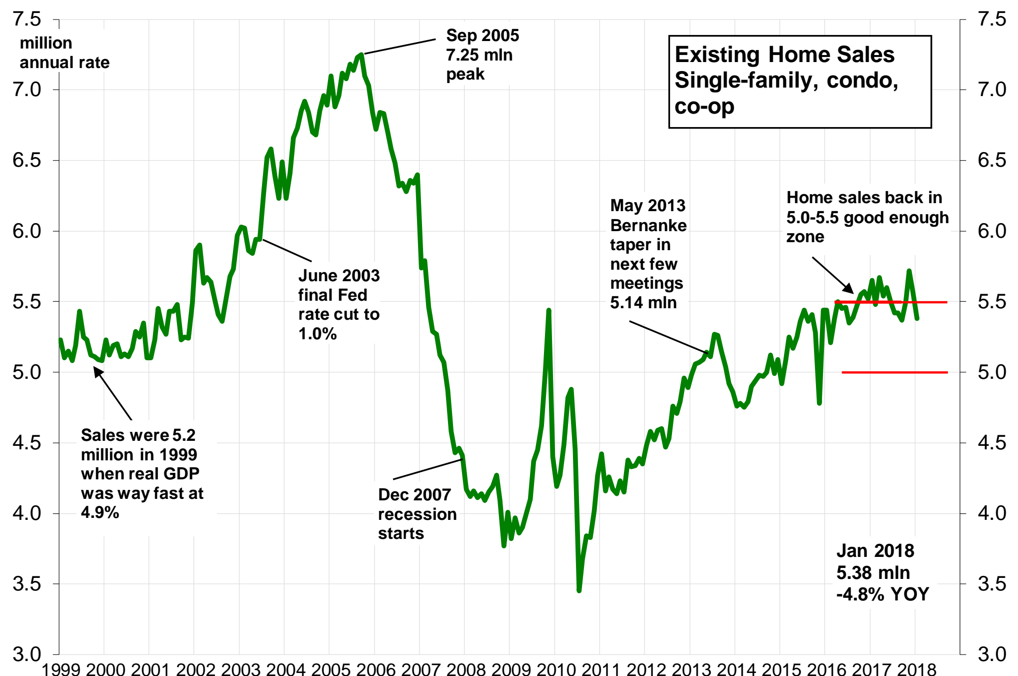
Net, net, the Fed is going with a rate hike in March, bet on it after today's January meeting minutes. The minutes say indeed that when they inserted the word "further" in the meeting press statement on January 31, in the sentence "The committee expects that economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate…" that the word further was indeed a nod-nod, wink-wink signal that the economy was strengthening and that they needed to raise interest rates again at the upcoming March meeting to balance the risks between good and evil, we mean to move rates up to balance the risks between the outlooks for inflation and unemployment.

The Fed's models tell them a low unemployment rate eventually means more inflation so interest rates have to move up gradually to higher levels is the bottom line. Rate hike. March meeting. Bet on it. Most of you already have with Fed funds futures discounting 23 bps of a 25 bps move. Bet big, bet the ranch. Two pips. Let's go. Don't leave any money on the table.

OTHER ECONOMIC NEWS THIS WEEK

Existing home sales hit the skids to start the year (Wednesday)

Breaking economy news. Existing home sales tumble for a second month, but the trend is volatile and hard to read. Home resales rose strongly in October and November, but then fell back in December and January which wiped out the entire jump in sales late last year. The volatility is making it hard to get an idea of just how confident home buyers are. Existing home sales always lag because the sales are recorded when the sales contract is closed which can be one or two months after the purchase decision is made. January's sales today of 5.38 million could easily reflect buyer down payments from November. The tax cuts effect may not be fully reflected in current sales, holding activity down, but on the other hand, home buyer financing costs are going up with the bond market sell-off in February. Higher mortgage rates are likely to take a toll on existing home sales in coming months. Mortgage rates were still below 4% in the middle of January but now a month later are more or less 4.4%.



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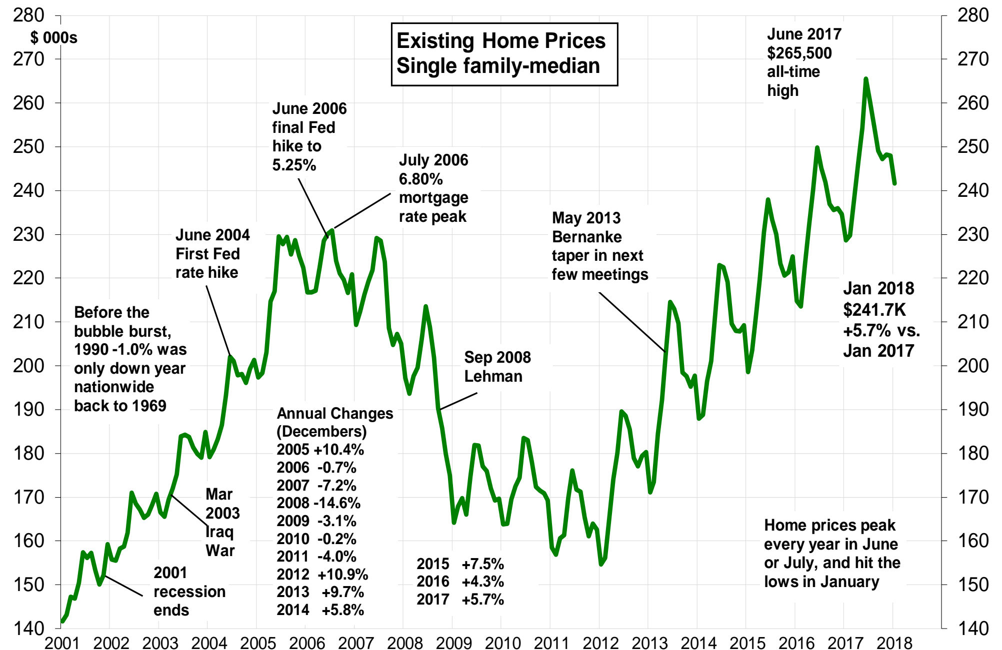
Net, net, existing home sales activity is no longer setting records in this long recovery from the housing bust over a decade ago. At best the trend in home resales over the last eighteen months is sideways, and at worst, the trend is pointing the way down. There is still a relative lack of supply on the market as baby boomers delay making retirement plans and shelter in place for now. One thing is for sure, existing home sales will not be boosting the retail sales of furniture or appliances that help make the economy run. If home resales do not pick up with the tax cuts this will throw a monkey wrench into the Trump administration's plans to jumpstart subpar economic growth. Buy American clearly does not apply to existing homes that are on the market right now.

At least single family home prices are still going up and not all that extra fast which makes one wonder how short the supply of homes is on the market right now. The median price was $241,700 in January, down from the $265,500 seasonal peak in June last year, but still 5.7% higher than it was last year. Single family home prices normally bottom every year in January before the upswing in spring.



Stay tuned. Story developing. There may be some headwinds ahead for home resales with rising mortgage costs affecting how much the buyer can afford and this could put a damper on existing home sales ahead and take some of the wind out of the economy's sails. Three percent economic growth looks a little less achievable today. Get ready to pay for those massive tax cuts when faster economic growth doesn't bring in the tax collections the administration is banking on. Someone's going to have to pay. Massive tax cuts never were a free lunch and now it’s looking downright expensive.

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