Financial Market Weekly

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BOND MARKET LOW-YIELD CONUNDRUM REVISITED

Actually, there isn't any mystery about low bond yields. The Fed did it. They put their foot down on the bond market a long time ago. But we don't want to give away the story ending. The Fed's low rates policy since 2008 has taken all the interest rate risk, and all of the uncertainty, out of the market. There is no uncertainty, we are all just waiting on the passage of time… in so many ways. Or maybe not. The Fed median forecast has a 3% Fed funds rate way out in 2019, yet you have newly minted Fed officials joining the Federal Open Market Committee who without much on the job experience are already telling spellbound audiences they aren't sure rates will ever get to 3%. Still talking down the economy down, saying the economy isn't strong enough to handle higher interest rates as they let American savers starve. It won't be a pork and beans year for them, this year it will be just beans. At least until we get the three new Fed governors that Trump has proposed installed, joining arms with the other four: Yellen, Fischer, Brainard, Powell. Hopefully, the incoming three will have fresh ideas to guide policy on other than the "natural rate of interest." And then a new Fed Chair is expected to start on February 3, 2018. Trump's economics team will get around to naming the next Chairman just as soon as they finish with healthcare, tax reform, and infrastructure spending.

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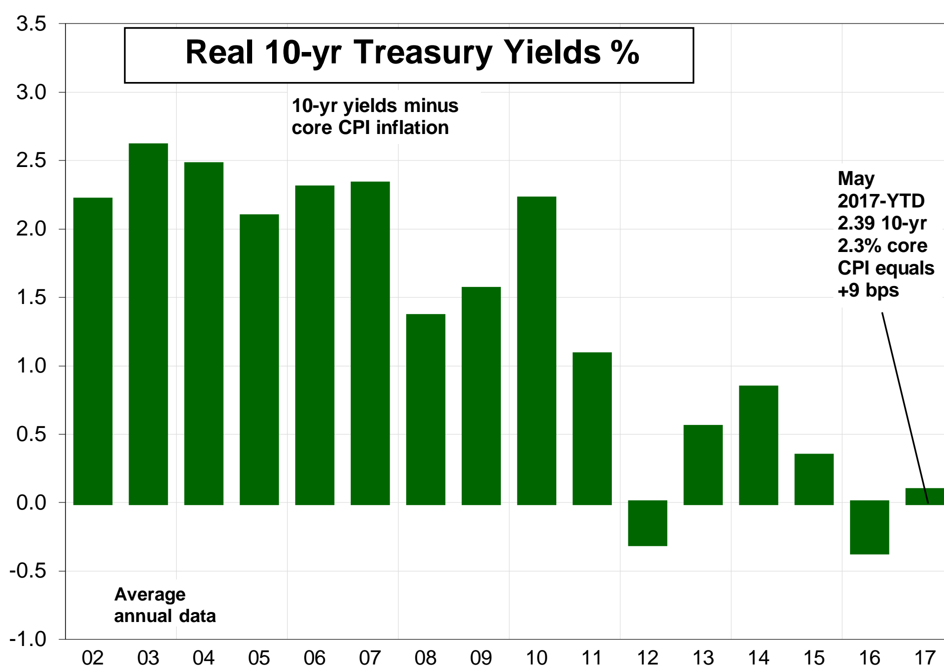
As far as low bond yields being a conundrum, this is from Greenspan's original testimony to the Congress on [February 16, 2005](). One can only laugh at the 2.15% 10-yr Treasury yield of today as this is written being compared to Greenspan's low yields conundrum as 10-yr yields were 4.10% when he spoke over 12 years ago, almost double where they are now. He thought 4.1% was low. Back then he seemed to wonder, wonder why because the Fed had at that point lifted the Fed funds rate from the 1% cycle lows to 2.5% without pushing bond yields higher. (btw-Yellen voted Yes to all those rate hikes)

> There is little doubt that, with the breakup of the Soviet Union and the integration of China and India into the global trading market, more of the world's productive capacity is being tapped to satisfy global demands for goods and services. Concurrently, greater integration of financial markets has meant that a larger share of the world's pool of savings is being deployed in cross-border financing of investment. The favorable inflation performance across a broad range of countries resulting from enlarged global goods, services and financial capacity has doubtless contributed to expectations of lower inflation in the years ahead and lower inflation risk premiums. But none of this is new and hence it is difficult to attribute the long-term interest rate declines of the last nine months to glacially increasing globalization. For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience.

One difference between now and 2005 is the lack of any real yields for investors, savers, baby boom retirees. Interest rates are lower than inflation. The 10-year Treasury yield was over 200 bps higher than core inflation looking back at the years 2002 up through 2007 before the not-so great recession. In 2016, 10-yr yields averaged 1.84% or 36 bps less than 2.2% core inflation. This trend could be with us for a while unless and until the Fed finds some new religion and raises short-term interest rates significantly higher. Consistent rate hikes too at every press conference meeting, not this stop and start stuff under the yellow caution light all the time. We will see for example where 10-yr Treasury yields trade once the Fed, wait for it, gets the Fed funds rate to 3.0%. We are assuming bonds will trade at 3.0% unless the fixed income market remains broken, distorted by the strong desire of thousands to aggressively minimize interest costs and pay that low-end of the curve short-term rate for as long as they can.

	10-yr Treasury Yield	Core CPI	Real Yield bps
2002	4.61	2.4	221
2003	4.01	1.4	261
2004	4.27	1.8	247
2005	4.29	2.2	209
2006	4.80	2.5	230
2007	4.63	2.3	233
2008	3.66	2.3	136
2009	3.26	1.7	156
2010	3.22	1.0	222
2011	2.78	1.7	108
2012	1.80	2.1	-30
2013	2.35	1.8	55
2014	2.54	1.7	84
2015	2.14	1.8	34
2016	1.84	2.2	-36
2017	2.39	2.3	9

2017-to May



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	16-Jun 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
30-Yr Treasury	2.78	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10
10-Yr Note	2.15	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90
5-Yr Note	1.74	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70
2-Yr Note	1.32	1.60	1.85	2.10	2.40	2.60	2.85	3.10	3.35	3.35	3.60
3-month Libor	1.27	1.65	1.90	2.20	2.45	2.70	2.95	3.20	3.45	3.35	3.70
Fed Funds Rate	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50
2s/10s spread	83	90	85	90	80	80	65	60	45	55	30
Libor/funds spd	2	15	15	20	20	20	20	20	20	10	20

FEDERAL RESERVE POLICY

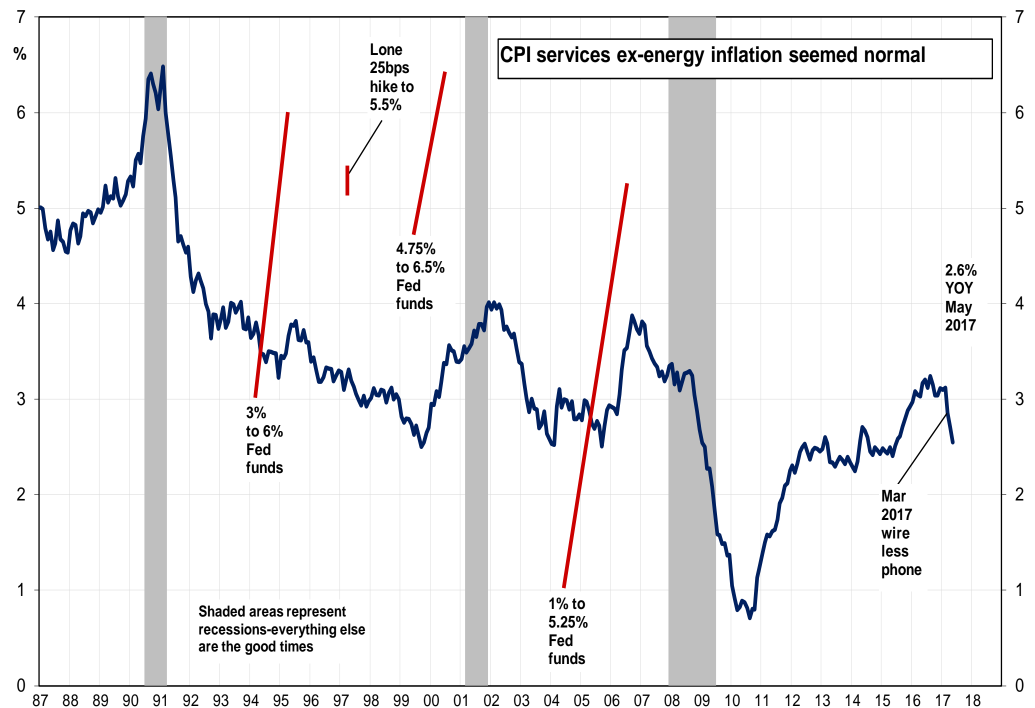
The Fed meets July 25-26 to consider its monetary policy, which is likely to be about as dead of a meeting as any they have ever held since liftoff way back in December 2015. The current debate is currently over whether they will raise rates in September and at the same time officially announce the start of the balance sheet wind down, or as we call it, can they walk and chew gum at the same time. We would assume they are planning to announce the wind down start in September and will wait until the December meeting to squeeze in the last of the three rate hikes they have forecast for this year

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	21-Jun	14-Jun	7-Jun	31-May	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2464.958	2464.871	2464.783	2464.696	479.782
Federal agency debt securities	8.097	8.097	8.834	8.834	0.000
Mortgage-backed securities	1781.099	1782.601	1770.958	1770.958	0.000
Primary credit (Discount Window)	0.009	0.010	0.003	0.016	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)	1.709	1.709	1.709	1.709	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	0.042	0.036	0.040	0.035	62.000
Federal Reserve Assets	4520.9	4522.6	4508.9	4505.9	961.7
3-month Libor %	1.29	1.25	1.22	1.21	2.82
Factors draining reserves					
Currency in circulation	1555.694	1555.470	1556.333	1556.472	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	198.769	163.056	165.138	270.326	0.000
Reserve Balances (Net Liquidity)	2164.616	2291.433	2270.846	2129.606	24.964
Treasuries within 15 days	12.885	0.000	0.000	0.000	14.955
Treasuries 16 to 90 days	34.923	47.807	47.806	44.608	31.549
Treasuries 91 days to 1 year	256.067	256.065	256.062	259.257	69.272
Treasuries over 1-yr to 5 years	1174.361	1174.347	1174.333	1174.320	170.807
Treasuries over 5-yrs to 10 years	353.826	353.806	353.787	353.768	91.863
Treasuries over 10-years	632.897	632.846	632.794	632.743	101.337

**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

Officially, we are sticking with the forecast that they will raise rates 25 bps to 1.50% on September 20. Unemployment is too low and rates too far away from normal, neutral levels.

They have one more rate hike to go this year. Or at least 12 out of 16 Fed officials feel that way, with 4 foot-draggers. The position of the naysayers hardened a little if that's the word because in March, 3 out of 17 did not want to see a 1.5% Fed funds rate by December. Now 4 out of 16 don't want it. [Lost one: 16 not 17 voters, Fed governor Tarullo the unofficial regulatory czar resigned,



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and waiting on Trump's pick to take on the role.] The inflation slowdown seems to concern some of the Fed officials. There's always something the Doves feel is not quite right in the "economy." Fed governor Brainard was the first to mention this we think in a speech on May 30, Navigating the Different Signals from Inflation and Unemployment. Core CPI was 1.9% year-on-year in April when she spoke and it is now 1.7% year-on-year in May. Fed Chair Yellen says it's temporary due to the recent decline in prices of that cell phone in your pocket and your meds in the other pocket. The economy will enter its ninth year of expansion in July and to back off of a rate hike because inflation is "too low" must be something that sends former Fed Chairmen's heads spinning. This is the first Federal Reserve in history that has not returned interest rates to normal levels following a recession. Hiding behind "too low" inflation seems a cowardly excuse with the economy at full employment.

The public does not care where inflation is right now, although if anything, it seems like prices are going up pretty fast. Inflation if not in the goods imported from China, sitting on the store shelves, there is certainly inflation in the services economy. Stayed in a hotel room recently, gotten a haircut, or taken a vacation? CPI services inflation ex-energy is running 2.6% the last year. How is it exactly that inflation is too low? [Yes, okay, okay it has slowed recently 0.2% May, 0.1% Apr, -0.1% Mar, after steady 0.3s November 2016 through February 2017.] We guess the core PCE inflation that Yellen favors was 1.8% year-to-year at the start of the year and has drifted a few tenths lower to 1.5% in April and this has some Fed officials concerned. It could slow further in the May report due out on Friday, June 30 if the CPI inflation drop last week is any guide.

Fed Individual Forecasts				
Fed funds rate by year-end				Longer
Votes	2017 End	2018 End	2019 End	run
1	1.125	1.125	1.125	2.500
2	1.125	1.625	2.375	2.750
3	1.125	1.875	2.375	2.750
4	1.125	1.875	2.625	2.750
5	1.375	2.125	2.625	2.750
6	1.375	2.125	2.625	2.750
7	1.375	2.125	2.875	3.000
8	1.375	2.125	2.875	3.000
9	1.375	2.125	3.000	3.000
10	1.375	2.375	3.000	3.000
11	1.375	2.375	3.125	3.000
12	1.375	2.625	3.125	3.000
13	1.625	2.625	3.125	3.000
14	1.625	2.625	3.250	3.000
15	1.625	2.750	3.375	3.500
16	1.625	3.125	4.125	
17				
Median	1.375	2.125	2.938	3.000
Meeting	Jun 2017	Jun 2017	Jun 2017	Jun 2017

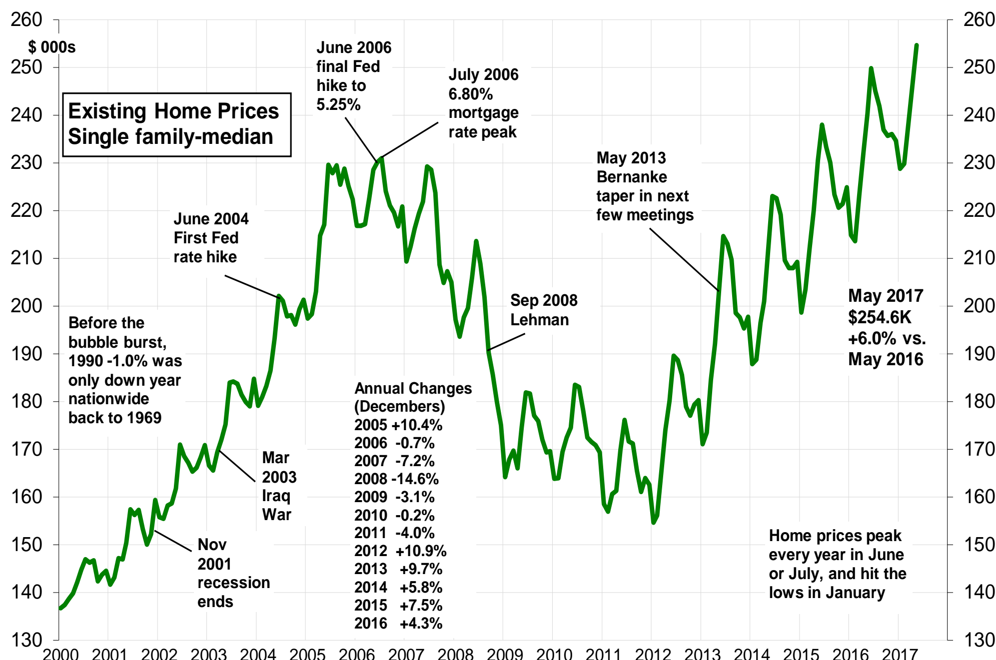
There was an interesting news headline on Monday from Chicago Fed President Evans saying how it was important to educate the public on the importance of hitting the Fed's 2% inflation target. Good luck with that. For Pete's sake, the Fed didn't even have a 2% inflation target until Bernanke made it an official target back in January 2012, so it can't be that doggone important. And they were not concerned about "too low" inflation until they voted on it in January 2016 as part of the annual reaffirmation of its "Longer-Run Goals and Policy Strategy."

We went for years and years without an inflation target at all. Let's ask the people how worried they are about inflation. Let them vote (see what we get this time). A recent Gallup poll says only 6% of Americans think the "economy in general" is the most important problem. Inflation is nowhere on the list of important concerns facing the nation. Unemployment and Jobs, Jobs, Jobs is the primary concern of 6% as well. The biggest concern is dissatisfaction with government or poor leadership at 25%. That's going to be tougher for the Fed's low rates policy to fix.

OTHER ECONOMIC NEWS THIS WEEK

Consumers still trading homes like hotcakes

Breaking economy news. And we want to be completely clear. There is no new housing bubble. Home price appreciation nationwide remains moderate. Existing home sales activity remains at a high level showing buyers and sellers can still strike a deal and help make the economy go. There is no uncertainty or trepidation in these home resales data whatsoever. 5.62 million of sales in May at an annual rate remains lofty relative to last year. Home resales peaked at 7.25 million in September 2005 before the housing bubble burst a decade ago so homebuyers are not trading properties like hotcakes, but the home resales pace is respectable for this late in the economic expansion. The only damper being put on the market for existing homes seems to be higher prices. Homebuyer traffic seems to miss getting translated into a final sale only because of higher home prices that show no sign of moderating. We would expect even higher sales if it were not for sky-high real estate prices.



Single-family existing home prices hit a record in May at $254,600 which is 6% higher than this time last year. The Fed can't find enough inflation to satisfy them, but maybe they are looking in the wrong place. The inflation in home prices was 6% the last year and it just isn't going to stop until the Fed raises interest rates at a quicker pace. Their low interest rate policy has improved financial conditions enough if we take a look at home price inflation.

Net, net, the housing market continues to heat up with strong existing home sales activity and significantly higher home values with prices setting new records every day. It looks like a housing bubble all over again only coming back this time as mostly higher home prices driven up increasingly by outright speculation.

This is one economic indicator that argues strongly for the Federal Reserve to continue raising rates at a gradual pace this year. The market has taken a September rate hike off the table, but we wouldn't be so sure. The housing market shows the economy is stronger than you think. More homes trading hands mean greater consumer purchases of appliances, curtains, electronics, power tools, lawnmowers, even maybe a new car to put in the driveway. The economic expansion enters its ninth year next month and today's housing data guarantee that it is going to last. Bet on it.

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