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Bond Market Review

Intended for Institutional Clients Only

The Tantalus Armada

Comic Steven Wright once said: *"I have the world's largest collection of sea shells. I keep it scattered on beaches all over the world. Maybe you've seen some of it."* America's businesses and manufacturers have large inventories as well, but it's all floating on ships waiting off the west coast. Supply might not be that great a problem. However, unloading and distributing definitely is! To the outside observer, it appears we have far more supply than we can handle. We just can't reach it. Some reports say over $22 billion of product is on ships off the coast of California. Retailers across the U.S. are spreading out available duplicate boxes across the shelves (or using props) to make it appear there's ample product. We remember reading such stories about Venezuela and Cuba a few years back!

In the **B**ond **M**arket **R**eview (11/12/2019), we reported: *"The U.S. was already a leader in exports of oil products, but in September we became a net exporter of petroleum for the first time since records going back to 1978."* A lot of things have surely changed! The administration is pleading with OPEC and Saudi Arabia to increase oil production, but they've yet to budge. While crude oil is trading near $85/barrel, many foreign countries have pump prices for gas that are reflective of a $200/barrel price level. Partially due to high rain levels and supply/refinery issues, California gasoline prices are trading at record levels nearing $5.00/gallon.

Looking Ahead

- Equity cycles have trend–change highs due near November 3rd and 9th with weakness into December 3rd.
- Bond yields should have lows near November 10th–12th – around the Veterans Day holiday (11/11).
- The FOMC will update their interest–rate policy with their statement on Wednesday (11/03) at 2 p.m. ET.

Jabs and Knockdowns

Will the Fed wind down QE while the economy is slowing? Any entity stubborn enough to refuse to admit that inflation is real – is equally susceptible to fail to acknowledge that growth is slowing when it doesn't fit their plan. The Fed is still referring to inflation as transitory and members are pushing for the beginning of asset–purchase tapering later this year. With the next Fed meeting days away, is it at hand? We wonder if Fed Chair Jerome Powell will stick to his statements of wishing to see continued improvements in monthly payrolls before the QE taper begins? The Fed's minutes from the meeting that concluded on September 22nd were rather bold with expected action. They said: *"Participants generally assessed that, provided that the economic recovery remained broadly on track, a gradual tapering process that concluded around the middle of next year would likely be appropriate."* It was clear that some members wanted to move sooner and conclude purchases even faster. They said that if a decision was reached in the meeting on November 3rd, that tapering could commence in mid–November or mid–December.

The Atlanta Fed's GDP–Now forecast for Q3 began near 6.1% in late July. Through October, it steadily tracked down to .2%. However, the first estimate of Q3 GDP came in at 2.0% versus 2.60% expected. The **BMR** sees many signs of economic slowing that could lead to contraction. The Q3 updates could approach the Atlanta number! The first estimate for Q4 was just released at 6.6% and upgraded today to 8.2% – but we saw how the Q3 tracking dwindled.

The Fed's Beige Book confirmed what the **BMR** believes – that vaccine mandates are proving a great challenge to U.S. employment. The report said: *"Firms reported high turnover, as workers left for other jobs or retired. … Child–care issues and vaccine mandates were widely cited as contributing to the problem."* We are reading stories daily about large numbers of workers walking off the job rather than to be jabbed. Other stories cover large numbers of the labor force being dismissed for lack of compliance with vaccine mandates. We see a great problem if thousands of health care workers, police, firefighters, and other infrastructure–necessary workers are forced to quit their jobs. It's our opinion that this was not thought out very well. The New York Post just reported that 26 New York fire companies have been shuttered due to staff shortages caused by the vaccine mandates. Over 9,000 NYC workers were placed on unpaid leave today. More will follow. We must consider the implications of cuts in the military, pilots, air–traffic controllers, and others critical to infrastructure. We read another report that said dozens of top nuclear scientists with high security clearances were being fired from Los Alamos for refusing the jab. Not to worry though – Congress is currently exempt from the mandates, so they can continue failing to get legislation passed.

If we're right about the economic slowing, the Fed might begin tapering only to 'taper their tapering' a few months later. The upbeat news from the Beige Book was that growth expanded at a *"modest to moderate rate."* However, most regions reported significantly–elevated prices. Commodities have now joined the upward surge. Worker demand remained high, but low levels of labor supply are still a problem. Vax mandate firings will make this worse.

Treasuries, Agencies, and MBS

Yields have been higher across the curve with the short end returning to pre–pandemic levels. 2–year yields rose to their highest levels since March 2020 and 5–year rates hit the highest levels since February 2020. The 30–year bond yields followed the cycles closer than other maturities by trading lower into the 18th before turning higher. 10–year yields overshot support at 1.625% with a move over 1.68% but then reversed back to 1.52%. A trip to 1.47% to 1.50% should be in store with lower yields expected into November 10th to 12th. With the short end climbing, the yield curve became the most 'flat' since August – with 30–year yields actually inverting to 20–years! The 5 to 30–year yield spread also traded to the least of the year. The bond market is expecting the Fed to tighten in order to fight inflation – which should in turn lead to slower growth.

Into October 22nd, yields rose by 6, 7, 6, and 2.5 bps for the 2, 5, 10, and 30–year Treasury sectors. Last week, the curve twisted flatter with 2–year rates rising by 4.5 bps while yields fell by 1, 8, and 13.5 bps for the 5, 10, and 30–year sectors. Yields were mostly stable today with 5–year yields down by .5 bps and 30–year rates higher by 2.5 bps. Mortgage rates hit the highest levels since April. The Freddie Mac 30–year mortgage rate rose 4 bps to 3.09% into October 21st and then 5 bps to 3.14% this week. 15-year rates were at 2.12% in September but are now at 2.37%.

Foreign investments in U.S. Treasuries hit a record high of $7.56 trillion in August. Long–term holdings increased by $79.3 billion and net investments into U.S. assets increased by $91.0 billion. China's holdings dropped by $21.3 billion to $1.05 trillion for their lowest levels since 2010. They are still the #2 Treasury holder behind Japan, which increased holdings for a third month – reaching a new record of $1.32 trillion.

The U.S. Treasury's Monthly Budget statement revealed a September shortfall of $61.544 billion – which was the smallest deficit since September 2019 (which was a surplus). That left the annual fiscal 2021 deficit at $2.772 trillion, second only to fiscal 2020 – which saw massive stimulus at the outset of the pandemic and ended at a record $3.132 trillion. Fiscal 2021 ended 11.486% below 2020, but at a time (in March 2021) it had been 129.5% higher. A delay in plans for new stimulus kept 2021 below 2020 – as negotiations on the size and spending targets could not be agreed upon before the close of the fiscal year (in September). Forecasts had been for a deficit roughly $897 billion higher. Tax revenues beat projections by $465.2 billion. Very low borrowing costs also controlled expenses. The government can't control the debt ceiling with historically–low rates. Imagine the impact of tightening added to the equation!

On October 20th, the U.S. Treasury sold $24 billion 20–year bonds at 2.10%. That was the highest yield since June and demand fell to the September offering in an auction described as 'ugly.' The buying group that includes foreign central banks accounted for 64.8% of purchases versus 64.2% the previous month. The August 2041 maturity was reopened for this auction. The $24 billion 30–year bond auction brought 2.049% with dealers receiving a record–low allocation. Demand fell versus September and foreign buyers again increased purchases – stepping up from 69.7% to 70.5% of the supply for a reopening of the August 2051 maturity.

The 2–year note auction faired much better with demand greatly increasing versus previous offerings. $60 billion in supply brought .481% last Tuesday (10/26). Foreign buying increased from 45.3% to 58.1% for this auction. Wednesday's (10/27) $61 billion in 5–year notes brought 1.157% with demand also far better than during recent auctions. Foreign buying increased from 54.3% in September to 64.8%. Thursday's (10/28) $62 billion in 7–year notes reversed course with a poor showing and decreased demand. The 1.461% award was the highest since January 2020, though foreign buying rose from 60.1% of the issue to 63.9% of this supply.

10/29/21 Treasury Yield Curve	**2-Year: 0.499%**	**5-Year: 1.185%**	**10-Year: 1.555%**	**30-Year: 1.934%**
Weekly Yield Change:	+.044%	–.011%	–.079%	–.136%
10/22/21 Treasury Yield Curve	**2-Year: 0.455%**	**5-Year: 1.196%**	**10-Year: 1.634%**	**30-Year: 2.070%**
Weekly Yield Change:	+.059%	+.070%	+.062%	+.027%
Support:	0.504/ 0.544/ 0.584/ 0.624	1.149/ 1.174/ 1.199/ 1.226	1.556/ 1.586/ 1.616/ 1.646	1.968/ 2.004/ 2.039/ 2.074%
Targets:	0.442/ 0.412/ 0.382/ 0.352	1.124/ 1.100/ 1.075/ 1.050	1.527/ 1.497/ 1.467/ 1.437	1.935/ 1.900/ 1.865/ 1.830%

Economics

The minutes from the last FOMC meeting also said: *"Most participants saw inflation risks as weighted to the upside because of concerns that supply disruptions and labor shortages might last longer and might have larger or more persistent effects on prices and wages than they currently assumed."* Note the conclusion that higher prices are only because of labor shortages and supply disruptions while the **BMR** would contend they are also cyclical and driven by governmental policies and/or the Fed itself! Respondent's expectations for inflation out to 1 year in the University of Michigan survey are at 4.80% – the highest since 2008.

Fed Governor Randal Quarles said he and his colleagues expect that *"inflation likely will decline considerably next year from its currently very elevated rate."* Quarles talked about the factors keeping inflation higher. He said: *"If those dynamics should lead to this 'transitory' inflation to continue too long, it could affect the planning of households and businesses and un–anchor their inflation expectations."* Our question is this: How long is too long to be considered 'transitory?' The Fed started widely using the term in 2011 to describe low inflation, slow growth, and anything deemed temporary. In the **BMR** (5/08/19) when the term had long been used to describe low inflation, we concluded: *"We view the definition of transitory as: 'inconveniently failing to align with our policies!'*

The inflation gauge mostly followed by the Fed is the PCE Deflator. It rose .30% in September but, more importantly, sent the annual pace .20% higher to 4.40% – the highest since 1991. The FOMC will have to address this result on Wednesday. The Core PCE Deflator (ex food & energy) rose .20% and left the annual core pace at 3.60% – also the highest in 30 years! Trader Paul Tudor Jones said that inflation is the single biggest threat to the economy. We agree! Former Fed Chair Alan Greenspan said that some of the forces causing higher inflation might prove transitory but rising government debt and other underlying pressures could keep inflation elevated on a longer–term basis. At least his use of 'transitory' made sense! If growth slows and inflation persists, you'll find us exploring the presence and implications of stagflation!

U.S. Treasury Secretary and former Fed Chair Janet Yellen expects inflationary forces to remain high through the first half of 2022 but said the government would not *"lose control"* of inflation. However, the problem is global. German readings are in double figures and the highest since data began in 1977. Even foreign interest rates that were negative have recently surged 30 to 40 bps and many have turned positive. Social Security recipients will be getting a 5.9% bump in 2022 – the largest increase since 1982. That's great – but many costs have doubled! Temporary or not, Producer Prices jumped from an annual pace of 8.30% to a record 8.60% in September. PPI was .50% higher for the month. Core PPI (ex food & energy) rose .20% – accelerating the annual core pace from 6.70% to 6.80%. Price increases are near their very–elevated early '70s readings. Consumer Prices rose .340% in September – and the annual headline pace quickened from 5.30% to 5.40%. Core CPI rose .20% – though the annual core pace remained at 4.00%. With buying power eroded, hourly and weekly earnings net of inflation each dropped by .80%. Import Prices rose .40% in September and the annual pace accelerated from 8.90% to 9.20%. Export Prices rose .10%. The already–higher annual pace of Export Prices slowed from 16.80% to 16.30%.

A large drop in export shipments led to Q3 GDP coming in at 2.00% – below expectations of 2.60%. That was the lowest reading since the Covid collapse of Q1 and especially Q2 2020. The Atlanta Fed had estimates as low as .2% so it could have been worse. Of course, this is only the first release. Q3 Personal Consumption was 1.60% and the GDP Price Index for Q3 was 5.70%. Core PCE was a stout 4.50% (in line with the University of Michigan surveys.)

Not only did Initial Jobless Claims print below 300K for the first time since the pandemic, they've done so for 3 times in a row. They had dropped 33K to 296K and then fell to 291K and 281K. Continuing Claims also hit progressively lower lows, dropping 123K to 2,603K – and then falling to 2,480K and then 2,243K. From over 14 million just months ago, and over 25 million a year ago, the total number of Americans on benefits has now fallen to roughly 3.3 million. Recall that many states removed extended government benefits in the summer. Early retirements due to Covid–19 were reported to top 3 million. Wages have increased by 4.2% on a year–over–year basis versus last September and it's a job switchers' market with high numbers of 'quits' to move and find new jobs (or remain local). Compensation grew by 1.3% in Q3. However, in September, Personal Income fell by 1.00%. Personal Spending rose by .60%. Salaries rose by a record–pace 1.5% in Q3 for civilian workers, and a record 1.6% in Q3 for companies.

Consumer Comfort has been on a steady downtrend. It's fallen by 1.5 and 1.8 over the past 2 weeks to 47.9 – the lowest since February. Personal Finances dropped 2.3 and 2.2 to 60.9. The Buying Climate fell 2.7 and then by .8 to 40. University of Michigan Sentiment fell from 72.8 to 71.7 – the second lowest since 2011 (and then there's that loss to State …). Current Conditions dropped from 80.1 to 77.7 – the lowest since April 2020. Expectations dropped from 68.1 to 67.9. Unlike the other surveys, the Conference Board's Consumer Confidence survey rose for the first time in 4 months with an increase from 109.8 to 113.8. Their Present Situation survey improved from 144.3 to 147.4 and Expectations jumped from 86.7 to 91.3.

Industrial Production fell 1.30% in September and Capacity Utilization dropped from 76.20% to 75.20%. MNI Chicago PMI (purchasing managers) rose from 64.7 to 68.4. Kansas City Fed Manufacturing was 9 points higher to 31, Dallas improved 10 points to 14.6, and Richmond rose from –3 to +12. Other indicators slipped. The Chicago Fed National Activity Index dropped from +.05 to –.13. Empire (New York) Manufacturing fell from 34.3 to 19.8 and the Philadelphia Fed Business Outlook dropped from 30.7 to 23.8. ISM Manufacturing fell from 61.1 to 60.8 and New Orders dropped from 66.7 to 59.8. Not a surprise, Prices Paid rose from 81.2 to 85.7. ISM Employment showed more expansion – increasing from 50.2 to 52.0. September's Leading Index rose by .20%. Wholesale Inventories rose 1.10% while Retail Inventories fell by .20%. Business Inventories rose .60%. Orders for Durable Goods fell .40% but were .40% higher ex transportation. Orders for Capital Goods (business investment) rose by .80%.

The merchandise trade deficit (Advance Goods Trade Balance) rose from $88.2 billion to a record gap of $96.3 billion – as exports dropped 4.7%. Those goods need to be sold – and retail numbers have been improving though trailing Q2. September Retail Sales rose .70% versus an expected drop of .20%. August numbers were revised .20% higher to .90%. Ex autos, Retail Sales rose by .80%.

Homebuilder confidence rose from 76 to 80 (back to July levels). Single family readings rose to June levels and future sales optimism was the highest since December. The completion rate on home construction is taking the longest since August 2020. Housing Starts fell by 1.58% to 1.555 million annual units – led by slowdowns in multi–family units. Building Permits fell by 7.67% to 1,589K annual units.

Sales of Existing Homes rose by 6.97% to 6.29 million annual units – the best pace since January. The median selling price rose 13.2% over the past year to $352,800 – but the pace of gains has slowed. New Home Sales were the best since March with a 13.96% increase to 800K annual units. The surge was the best since July 2020 – though sales were off by 17.6% versus last September. Pending Home Sales were expected to rise by .50% in September but instead fell by 2.30% (the most since April) and were off by 7.20% to September 2020. The FHFA House Price Index rose by 1.40% in August and metro home prices were up by 1.17%. The pace (S&P Case–Shiller 20–city) slowed from 20.02% to a still very–elevated 19.66% – but that ended 13 successive gains. The annual pace for the Home Price Index rose from 19.75% to a record 19.84%. Construction Spending fell .50%.

Tuesday is set for October Vehicle Sales. Wednesday brings MBA Mortgage Applications (which rose .20%, fell 6.30%, and then rose .30% over the past 3 weeks). We'll get a first look into October payrolls from ADP Employment Change, the ISM Services Index, and September data for Factory Orders (and orders for Durable and Capital Goods). The FOMC interest–rate policy decision for November is also due that afternoon. Many are expecting an announcement on tapering asset purchases, but some slowing economic data and weaker payrolls could lead to a delay. Thursday gives us additional looks into October jobs from Challenger Job Cuts and jobless claims data. Also due are Q3 Nonfarm Productivity & Unit Labor Costs, the September Trade Balance (deficit), and Consumer Comfort. Friday reveals October payrolls, the U.S. Unemployment Rate, and related jobs data. Consumer Credit for September is also due. Next week is set for the release of Q3 Mortgage Delinquencies & MBA Mortgage Foreclosures. Tuesday (11/09) brings NFIB Small Business Optimism and Producer Prices (October PPI). Wednesday follows with Consumer Prices (October CPI) and other data moved ahead of Veterans Day on Thursday.

Equities

Our equity cycles were 'sideways to better' with highs into October 26th and November 3rd. The Dow Industrials made their high on the 26th and had a 266–point down day on Wednesday only to reverse higher. These sideways cycles often indicate that kind of choppiness. The S&P also made a record on Tuesday but then broke 4.600 for the first time on Friday to new highs. The Nasdaq broke its September 7th highs last week to also reach new records on Thursday and Friday. November started out with a continuation of bullishness with new highs in the Dow, the S&P, the Nasdaq, and many other U.S. indexes. We still expect a high on November 3rd and another downturn from the 9th. From whichever might be higher, the cycles call for a subsequent retreat into December 3rd. Following losses in September, stocks had their best monthly returns since November 2020 with the Dow gaining 5.84%; the S&P rising 6.91%; and the Nasdaq adding 7.27%. The Dow Transports surged 13.60% and bank stocks cleared 6.28%.

Over the last 2 weeks of October, the Dow gained 1.08% and then 142.54 points or .40% to 35,819.56. The Dow rose .26% to kick off November. The S&P added 1.64% and 1.33%. It was .18% higher today. The Nasdaq rose 1.29% and then 2.71% – and jumped .63% today. The Dow Transports gained 3.83% and then .85%. They rose .23% today. While most indexes rose for the past 2 weeks, bank stocks had gained 4.07% but then fell 2.78%. They surged 1.11% today. With possible weakness coming into early December, some profit taking and/or hedging might be in order.

Resistance:	Dow:	36,011/ 36,201/ 36,391/ 36,582	Nasdaq:	15,698/ 15,825/ 15,951/ 16,077	S&P:	4,631/ 4,665/ 4,699/ 4,733
Support:		35,821/ 35,632/ 35,444/ 35,256		15,450/ 15,325/ 15,205/ 15,078		4,598/ 4,564/ 4,530/ 4,496

Other Markets

In September, we wrote: *"We're trying cycle work on crypto–currencies and expect a low into October 27th."* While there's not enough existing data to get any medium to longer–term cyclic influence for our analysis, Bitcoin did dive into the 27th and then springboard out of it! Crude Oil rose 1.80% and then fell .23% over the past 2 weeks. Crude rose .57% today. We have an outstanding target of $92.80/barrel. Commodities lost .67% and then rose a slight .01% this week. They rallied .65% today. Gold gained 1.60% to 6–week highs but fell back .65% last week. Gold rallied .67% today. The U.S. Dollar lost .33% into the 22nd but gained .53% last week. It dropped back .26% today.

The Euro traded contra–Dollar with a .36% gain followed by a .73% loss. The Euro rallied .42% today. The Japanese Yen gained .63% but then lost .40% last week. The Yen fell .04% today. Corn rose 2.33% and then added 5.62% last week. Corn surged 1.89% today doing its part to add to the inflation equation. Cotton gained .87% and then surged 6.09% last week. Cotton then jumped up by 4.34% today.

"There are no rules here – we're trying to accomplish something." Thomas A. Edison

Doug Ingram, Financial Economist
Additional Information is Available on Request