BANES CAPITAL GROUP

Banes Capital Group, LLC
6410 Poplar Ave. Suite 500
Memphis, TN 38119 (901) 261–5900
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Bond Market Review

Intended for Institutional Clients Only

Back in the U.S.S.R.

The Beatles tune made it sound like a good place to visit, but for decades the Soviets had to build walls and use armed guards to keep people in. Vladimir Putin managed to wait for the Chinese Olympics to end in order to invade Ukraine in an attempt to reassemble the disbanded union, but Ukraine doesn't want to be to be back in the U.S.S.R.! Negative reporting is not allowed. In fact, CNN was forced out of Russia – this time for covering 'real' news.

With global growth already slowing, inflation surging, and supply chain problems not about to ease, the war is going to exacerbate already–existing challenges. In Europe, gas prices doubled (from high levels) over the past 2 weeks. Those nations looking to Russia for energy supplies are searching for replacements. Russia has already seen great losses in soldiers and armed vehicles, copters, and planes – while their army was instead told they would be greeted as liberators. While they have the forces to prevail, they have very–little global support. The Russian Ruble fell to record lows versus the Dollar and other currencies. MasterCard and Visa said they would not support operations in Russia. In this interconnected world, Russian citizens will not be happy with no cash or supplies available for something very preventable. With the Ruble tumbling and no access now to Visa, MasterCard, or American Express, Russians will have great difficulty in buying goods – and the resupply of food sources is in question. Putin said all debts to other nations would be paid in Rubles – which have dropped from around 15 cents each to less than a penny.

In the last **B**ond **M**arket **R**eview, we asked: *"Will they – or won't they? Global markets are also on edge as to whether or not Russia will invade Ukraine."* As Russia crossed into Ukraine, stock index futures plunged. On Thursday (02/24), the Dow Industrials tumbled 859 points or 2.59% – but came back with a 996–point rally to end the day 92 points higher! Friday followed with an 835–point gain to finish 2.51% better. With a somewhat milder .49% loss on the 28th, the Dow ended 3.53% lower for February – which had been an 8.14% loss as of the low on the 24th. It was a reversal of the classic 'buy the rumor, sell the fact' as markets were sold on the buildup of forces on the border, and then rallied on the invasion. Nevertheless, stocks have lost ground back to the levels reached the day the war started.

There are few secrets anymore. The buildup and progress of the invading forces had been on display for the world to see. This is not the era for surprise attacks. Modern day drone and news coverages show the progression of armies in real time. In live shots, the armored vehicles never seem to be making any advance. As they are stalled, more and more anti–tank and other formidable weapons are coming in. For an invading army making slow progress, Russian citizens with any internet coverage will realize they are not being told the truth – but dissent draws a high price.

The Atlanta Fed's GDP Now Forecast had risen as high as 1.7% in mid– February but now stands at 0% for Q1 2022. If you consider little GDP growth and the war, one would wonder why the Fed is even considering a 25–bps hike. Even if the Fed had considered a 50–bps kickoff, it's highly doubtful they would entertain that option under the background of war. With war, slowing growth, a flat yield curve, and surging prices pointing to another recession, how far away can QE5 be? Don't be so sure we see more than 100 bps in hikes before the Fed is once again forced to reevaluate global conditions. We could provide many instances of Fed members calling for hikes at every meeting, but one has to consider more than just inflation – and taking a look at growth, the war, and reasons not to kill progress.

Looking Ahead

- Equity cycles are sideways to down – with a low due near March 18th.
- Bond yield cycles are also sideways to down. The next low in yields is due near March 14th.
- Spring those clocks forward one hour early Sunday morning for Daylight Savings Time.
- The FOMC will announce their interest–rate policy on Wednesday, March 16th, at 2 p.m. ET.

The Fed's Beige Book noted continued disruptions due to COVID. They said: *"Economic activity has expanded at a modest to moderate pace since mid–January."* That leaves the Fed clear to hike rates. They said prices rose at a robust pace, but consumer spending was weaker to the prior report. They said supply chain issues continued especially in the construction sector. Workers remained scarce and there continued to be an elevated degree of uncertainty.

Fed Chair Jerome Powell spoke to the House finance panel and said: *"I am inclined to propose and support a 25–bps rate hike."* He's the chair, he wants to be transparent, so that's what we expect next Wednesday. He said the Fed needs to be neutral – which is rates between 2% and 2.5%. He expects an economic *"soft landing."* Speaking to the Senate Banking Committee, he said the Fed recognized *"highly uncertain"* impacts of the war with expected *"upward pressure on inflation."* He said the economy was strong – though the labor market is extremely tight.

Treasuries, Agencies, and MBS

With Fed members calling for hikes at every meeting and an initial 50–bps jumpstart in March, yields were climbing with few wanting to fight the Fed on their new path. Just a few weeks ago, we said: *“Rate hike expectations went from 3 or 4 to 7.”* War changes things! From thoughts of hiking at every meeting, stagnant growth and turbulent times may send the U.S. and global economies into recession. A short round of hikes could even be followed by QE5. Into February 25th, yields rose by 10.5, 4.5, 3.5, and 3 bps for the 2, 5, 10, and 30–year Treasury sectors. With the uncertainly and some ‘flight to quality’, yields for those sectors reversed lower by 9.5, 23, 23, and 12 bps last week. Rates rose again today, adding 7.5, 6.5, 4.5, and 3 bps for those sectors. The 10–year has resistance in the 1.71% zone and support near 2.05%. With sideways cycles, we would lift hedges near 2.05% and put them back on near 1.71%.

The yield curve just fell to its flattest levels since March 2020 – with the 2 to 10–year spread falling to 22.5 bps (from over 150 bps in April of 2021). Flat to inverted yield curves have a strong track record for predicting slowdowns and recessions – so paying close attention is warranted. QE should end this week, clearing the Fed to hike rates by an expected 25 bps next Wednesday.

After reaching 4–week highs, Freddie Mac 30–year mortgage rates have now fallen the past 2 weeks. They dropped from 3.92% to 3.89% – and then to 3.76%. Over that period, 15–year mortgage rates fell from 3.15% to 3.01%. During the last full week of February, the U.S. Treasury sold $52 billion 2–year notes on Tuesday (02/22) at 1.553%. That was the highest yield since December 2019. Demand was very good, though down from January. The buying group that includes foreign central banks accounted for 65.6% of the issue versus 66.0% in January. The dealer award was the lowest on record. Wednesday followed with $5 billion 5–year notes that brought 1.88%. Demand was good but down a little to January. Foreign buying was 67.8% of the issue versus 68.7% in January, though the dealer award was again at a record low. The yield was the highest since May 2019. Thursday’s $50 billion in 7–year notes also had great demand and brought 1.905% – the highest yield going back to July 2019. Foreign buying rose from 62.6% to 63.9% for this auction. Dealers had the 4th lowest award since 2009. This week, the Treasury will be offering $48 billion 3–year notes on Tuesday (03/08), $34 billion 10–year notes on Wednesday (03/09), and $20 billion 30–year bonds on Thursday (03/10).

03/04/22 Treasury Yield Curve	**2-Year: 1.479%**	**5-Year: 1.639%**	**10-Year: 1.733%**	**30-Year: 2.158%**
Weekly Yield Change:	–.093%	–.228%	–.231%	–.118%
02/25/22 Treasury Yield Curve	**2-Year: 1.572%**	**5-Year: 1.867%**	**10-Year: 1.964%**	**30-Year: 2.276%**
Weekly Yield Change:	+.103%	+.046%	+.033%	+.032%

Economics

January payrolls had seemed very much in jeopardy as ADP Employment Change showed 301K losses versus an expected 180K gain! They couldn’t have been a worse predictor as Nonfarm Payrolls for January came in at 467K versus only 125K expected. Not only that, but 709K jobs were added in the 2–month revision. Private Payrolls increased by 444K versus 35K expected, so the big question was – how could the ADP result be so far off? We said ADP couldn’t have done a worse job in forecasting, as we asked: *“Private Payrolls increased by 444K versus 35K expected, so the big question was – how could the ADP result be so far off?”*

ADP had to be greatly embarrassed! They said February private payrolls rose 475K versus 375K expected but had the most ridiculous revision we’ve seen with January changed from losing 301K jobs to gaining 509K. How do you miss by over 800K – when you do the paychecks??? Nevertheless, this data is in closer touch with reality as the economy added 678K Nonfarm Payroll jobs in February! That was the most jobs added since July. January jobs were revised higher by 14K and there was a 2–month net revision of 92K more jobs. Private Payrolls increased by 654K and Manufacturing added 36K. That sent the U.S. Unemployment Rate down from 4.00% to 3.80%. The Labor Force Participation Rate bumped up by .10% to 62.30%. The Underemployment Rate rose from 7.10% to 7.20%. Average Hourly Earnings were flat and decreased on an annual basis from a 5.50% pace to 5.10%. Average Weekly Hours bumped up from 34.6 to 34.7.

Challenger Job Cuts were off by 55.90% for February (less firings). Initial Jobless Claims fell from 249K to 233K into February 19th. They then fell to 215K for the week ending February 26th. That was the lowest level for 2022. Continuing Claims fell from 1,589K to a pandemic low 1,474K – and then ticked back up to 1,476 the following week. Small businesses ‘planning to hire’ fell from 26% in January to 19% in February.

Confidence fell to 11–year lows as University of Michigan Sentiment fell from 67.2 to 62.8. Current Conditions dropped from 72.0 to 68.2 – and Expectations tumbled from 70.7 to 59.4. Inflation expectations fell .10% to 4.90%. The Conference Board’s Consumer Confidence measure dropped from 113.9 to a 5–month low of 110.5. The Present Situation rose .6 to 145.1 but Expectations fell from 88.8 to 87.5. ISM Manufacturing improved from 57.6 to 58.6 on New Orders (which rose from 57.9 to 61.7). ISM Prices Paid fell from 76.1 to 75.6. ISM Employment dropped from 54.5 to 52.9. The Richmond Fed Manufacturing Index dropped from 8 to 1, but Dallas rose from 2 to 14 and Kansas City increased from 24 to 29. The Chicago Fed National Activity Index rose from .07 to .69 but MNI Chicago PMI (purchasing managers) fell from 65.2 to 56.3.

January Factory Orders rose for a 9th month, increasing by 1.40%. Ex transportation, they rose 1.00%. Orders for Durable Goods rose 1.60% and .70% ex transportation. Orders for Capital Goods rose 1.00%. The merchandise trade gap (deficit) rose to a new record on rising import costs. That Advance Goods Trade Balance increased from a $100.5 billion gap to $107.6 billion. February Vehicle Sales dropped from a 15.04–million–unit pace in January to 14.07 million. Another report noted that used–car prices relaxed for the first time since August. In Q4, Nonfarm Productivity rose by 6.60%. Unit Labor Costs rose by .90%. The ISM Services Index dropped from 59.9 to a 1–year low (but still respectable) 56.5.

Q4 2021 GDP remained at 7.00% though Personal Consumption was revised .20% lower to 3.10%. The GDP Price Index rose from 6.90% to 7.10% and Core PCE (ex food & energy) for Q4 rose from 4.90% to 5.00%. After Omicron challenges in December, Personal Spending recovered from a .80% drop to a 2.10% gain in January. However, Personal Income was flat! Consumer Credit expanded at the slowest rate in nearly a year with a $6.838 billion increase versus $24.5 billion expected. The Fed's favorite inflation gauge was again higher to new 40–year highs. The PCE Deflator rose .60% in January. The annual pace increased from 5.80% to 6.10%. The core, ex food & energy, rose .50% – which raised the annual core pace for Personal Consumption Expenditures from 4.90% to 5.20%.

The House Price Purchase Index rose 3.30% in Q4 2021. The FHFA House Price Index was 1.20% higher as the annual pace of gain again rose – from 18.79% to 18.84%. Metro Home Prices rose 1.46%. That S&P Case–Shiller 20–City Index accelerated annually from 18.35% to 18.56%. Sales of New Homes fell for the first time in 3 months. In January, sales dropped 4.53% – from 839K to 801K. Pending Home Sales fell 5.70% for the largest drop in 11 months with mortgage rates surging higher – and were off by 9.10% versus last year. Construction Spending rose 1.30% in January.

Tuesday brings NFIB Small Business Optimism and the January Trade Balance (deficit). Wednesday gives us MBA Mortgage Applications (which fell by 13.10% and then .70% over the past few weeks) and JOLTS Job Openings for January. Thursday reveals jobless claims data, Consumer Prices (February CPI), and the U.S. Treasury's Monthly Budget Statement for February. Friday is set for University of Michigan preliminary sentiment readings for March. Next Tuesday (03/15) gives us Producer Prices (February PPI), Empire (New York) Manufacturing, and TIC Flows (net foreign flows into U.S. assets). Wednesday is set for February Retail Sales, Import Prices, homebuilder optimism (NAHB Housing Market Index), and the FOMC interest–rate decision for the Fed's March meeting.

Equities

Over the past 2 weeks, we've seen the 2 largest rallies of the year – but today was the largest down move. Stocks continue to capitulate to the consequences of war and have been joined by weaker cycles. The 'buy any pullback' crowd that has traded with a Fed assist for years is seeing a new paradigm. Huge losses turned our cycle work sideways. That means choppiness, which is not very helpful. The next convergence of positive energy is near April 8th. From an accumulation standpoint, we would delay major positioning until then. Lows are due near March 10th and 18th. Another high is due near March 24th.

Stocks closed February again lower. For the Dow Industrials, a January loss of 3.32% was followed by a 3.53% loss in February. It was hard to get an early ready on March, as a 597.65–point loss on the 1st was reversed by a 596.40–point gain on the 2nd. However, by the end of the week, the Dow was off by .92% for March and 443.95 points or 1.30% lower for the week to 33,614.80. That marked a string of 4 losses for the Dow – though one week was only .06% lower. This week began with a 2.37% plunge. The Nasdaq lost 2.78% last week and fell 3.62% today alone! The S&P was down by 1.27% last week and tumbled 2.95% today. The Dow Transports were higher by 1.22% last week (one of the only winners) but dropped 3.89% today. Bank stocks had a 3rd weekly loss and were down 7.67% last week. They dropped 4.63% today in what was a broad loss for most indices.

Other Markets

While during daytime trading, Crude Oil hit $130/barrel, over the weekend it rose as high as $139! Corn hit a 10–year high – as did Soybeans. Wheat rose to levels not seen in 14 years as already–strong commodity markets surged on the challenges of war. Gold broke through $2,000/oz. for the first time since August. In late December, Crude Oil was trading as 'low' as $66/barrel. A little over a year ago, the average price of gas was around $2.17/gallon. Today, we saw an all–time record of $4.14/gallon. In parts of Europe, gas has doubled over the past few weeks. Consumers already battered by the highest inflation rates in decades are being presented with new challenges.

Commodities just saw their biggest gain week since 1974 with a surge of 13.43%. They added 1.43% today. Crude Oil surged 26.30% last week and rose another 3.22% today. These are products used everyday and will add a spike to inflation already at multi–decade highs. Gold rose 4.19% and added 1.49% today. The U.S. Dollar surged 2.12% last week as the Fed confirmed imminent rate hikes. The Dollar rose .63% today. The Japanese Yen gained .63% last week but fell .44% today. The Euro lost 3.02% last week and tumbled another .68% today. Corn jumped 14.71% last week but pulled back by .96% today. Cotton dropped 1.57% but rose .38% today. Nickel jumped 82%. Russia is a chief supplier – and the metal is used for stainless steel and battery production.

"Beware lest in your anxiety to avoid war you obtain a master."
Demosthenes (384 BC – 322 BC)

"In the absences of a decent time machine, fiction remains the most sturdy vehicle for visiting other eras."
Tom Nolan

Doug Ingram, Financial Economist
Additional Information is Available on Request