BANES CAPITAL GROUP

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Bond Market Review

Intended for Institutional Clients Only

<u>25 or 6 to 4</u>

After 22 years, we found a way to work in this early–Chicago song as a theme! The Fed hiked 25 bps as widely expected but then signaled 6 more to come – at each of their upcoming (and remaining) 2022 meetings. Completing that thought, lone dissenting voter FRB St. Louis President James Bullard voiced the song's 'should I try to do some more?' wanting to see 4 25–bps hikes by July. After Fed Chair Jerome Powell said he was open to larger hikes if necessary to combat inflation, the yield curve began to price in a 50–bps hike for May. While the Fed's 'dot plot' had signaled 6 more 25–bps moves this year, and more beyond, the bond market began to price in 7 more for 2022. Numerous Fed members have now said they are open to half point hikes. They didn't do that this time because they have been trying to be transparent and had not voiced that possibility. That's now changed. Bullard stepped up his game and said he wants the Fed to *"move aggressively"* on inflation and use the 1994 model and get rates up *"to 300 bps this year to be mildly restrictive."* By the way, 1994 was ugly! That means Bullard want at least 10 more 25–bps moves in 2022 – which would call for multiple 50–bps moves. No wonder rates are soaring upward!

The **B**ond **M**arket **R**eview is for a more orderly path. Growth has already slowed. Even with the lofty inflation numbers, the Fed must consider how rapidly the economy could be thrown into recession. The unknowns of the war in Ukraine are also a concern. When the Fed hiked rapidly before, the resetting coupons on adjustable–rate mortgages and loans led to massive defaults and ushered in the financial crisis. We hope the Fed will take time to consider all those headwinds before an overreach. In the FOMC statement, they noted strong 'job gains' and that 'inflation remains elevated' as we all know. The war has made already–high fuel prices surge to onerous levels. It's worth including their opinion: *"The invasion of Ukraine by Russia is causing tremendous human and economic hardship. The implications for the U.S. economy are highly uncertain, but in the near term the invasion and related events are likely to create additional upward pressure on inflation and weigh on economic activity."*

Citing facts 'not in evidence,' the committee said: *"With appropriate firming in the stance of monetary policy, the Committee expects inflation to return to its 2% objective and the labor market to remain strong."* Given the length of time to acknowledge inflation, the Fed may not possess the handle on it that they presume.

<u>Looking Ahead</u>

- Equity cycles are turning lower near March 23rd/24th. We expect a low near April 8th.
- Bond yield cycles are also turning lower from March 24th and point to a low near April 13th.

<u>Treasuries, Agencies, and MBS</u>

Monday was the worst single day for bonds in years. Yields surged with the 2–year note rising to 2.13%, the 5–year note reaching 2.34%, and the 10–year note hitting 2.31% – all the highest since May 2019, and with the 5 to 10–year curve inverting. The 10 to 30–year spread fell to its smallest reading since 2007. The 30–year bond rose to 2.54% on Friday, which was the highest since August 2019. Nothing good comes from slowing growth and yield–curve inversions. Bond markets are pricing in a recession – which usually follow inversions within a year or 2. Very few expected the Fed to do anything but a 25–bps hike to begin. Speaking to Jerome Powell, we said: *"He's the chair, he wants to be transparent, so that's what we expect."* With Powell on Monday saying a 50–bps hike could be considered – that transparency turned into trading panic. We don't view Powell as ultra 'hawkish' but he's trying to convince the markets that he means business!

This week's upward trek followed 2 already–strong weekly advances in yields. For the past 2 weeks, 2–year yields rose 27 and then 19 bps, 5–year rates rose 31 and then 19.5 bps, 10–year yields rose 26 and then 15.5 bps, and 30–year bond rates rose 20 and then 6.5 bps. Yields for those sectors rose another 18, 18, 14, and 9.5 bps on Monday alone and now stand 23, 25.5, 23, and 18 bps above last week's lofty levels. The newest path has a high in rates due near March 24th. Rates should then fall into April 13th. Yields could go as high as 2.39% to 2.43% but there's good support there. Long term targeting had 2.26% to 2.32% which has already been met. Our hourly targets also point to 2.39%. It's obvious now that the upper end of our 1.71% to 2.06% zone was greatly overrun. Equilibrium would now be just below 2% with a 1.66% to 2.39% much–wider trading range.

Freddie Mac 30–year mortgage rates rose above 4% for the first time in nearly 3 years (to May 2019). In 2 weeks, 30–year rates rose from 3.76% to 3.85%, and then to 4.16% – the highest level since April 2019. 15–year rates moved up from 3.01% to 3.09% and then to 3.39%. The Trade Balance deficit expanded from $82 billion to $89.7 billion from December to January.

Earlier this month, the U.S. Treasury sold $48 billion 3–year notes at 1.775%. The auction was ugly with demand falling to the lowest level since November. The buying group that includes foreign central banks accounted for 55.1% of this auction versus a prior 68.5%. $34 billion 10–year notes came at 1.92% – the highest since July 2019, but low compared to now! Demand was the lowest since December and foreign buying dropped from 77.6% to 68.2% for this reopening of the February 2032 maturity. The $20 billion 30–year bond auction went well. The 2.375% yield was the highest since the May 2021 auction, but demand was the best since September 2021. Foreign buying rose from 68.0% to 71.5%. That was the second highest allocation on record with dealer buying falling to a record low. The February 2052 maturity was reopened for this new supply. On Wednesday (03/23) the U.S. Treasury will auction $16 billion 20–year bonds (February 2042 maturity).

Following the first monthly surplus since September 2019, the Treasury's Monthly Budget Statement once again fell into familiar deficit territory in February with a $216.59 billion shortfall. February is usually a deficit month – and has been for 56 if the last 68 fiscal years. With no monster stimulus packages, fiscal 2022 is running 54.56% lower than at this point 5 months into 2021. The 5–month fiscal 2022 total deficit of $475.6 billion stands as the smallest start since FY 2018. In January, foreign entities and central banks channeled $294.2 billion into U.S. assets. $58.8 billion went into longer term U.S. debt.

03/18/22 Treasury Yield Curve	**2-Year: 1.939%**	**5-Year: 2.144%**	**10-Year: 2.152%**	**30-Year: 2.423%**
Weekly Yield Change:	+.189%	+.196%	+.157%	+.067%
03/11/22 Treasury Yield Curve	**2-Year: 1.750%**	**5-Year: 1.948%**	**10-Year: 1.995%**	**30-Year: 2.356%**
Weekly Yield Change:	+.271%	+.309%	+.262%	+.198%

Economics

Initial Jobless Claims rose from 216K to 229K and then fell back to 214K. Continuing Claims (which lag a week) rose from 1.469 million to 1.490 million, and then dropped to a new pandemic low of 1.419 million. JOLTS Job Openings were revised around 500K higher to a new record 11.448 million in December and January came in at 11.263 million (which without the revision would have been a record). The staggering results show nearly 4.8 million more available positions than the number of Americans listed as unemployed. Those quitting their jobs fell to 2.8% – the least in 3 months. The Household Change in Net Worth rose from $2.686 trillion in $5.297 trillion in Q4.

February Retail Sales improved by .30% but followed January results that were revised from 3.80% up to 4.90%! That was a .10% miss but ex autos, sales were expected to rise by .90% and they rose only .20%. NFIB Small Business Optimism dropped from 97.1 to 95.7. Preliminary confidence numbers in the University of Michigan surveys were most likely affected by thoughts on the war and higher fuel prices. Sentiment fell from 62.8 to 59.7 – the lowest since 2011. Current Conditions dropped from 68.2 to 67.8 (the lowest since 2009) and Expectations tumbled from 59.4 to 54.4 (the lowest since 2011). Inflation expectations surged from 4.90% to 5.40% – the highest since 1981.

The Leading Index (LEI) for February rose from –.50 to +.30%. The Philadelphia Fed Business Outlook jumped from 16 to 27.4 and the Richmond Fed Manufacturing Index rose from 1 to 13. However, Empire Manufacturing (NY) fell from +3.1 to –11.8 (the lowest since 2020) and the Chicago Fed National Activity Index dropped from .59 to .51. Industrial Production rose by .50% in February. Factory Output rose by a 4–month high 1.20%. Capacity Utilization rose from 77.3% to 77.6%. The Atlanta Fed's GDP–Now forecast for Q1 rose from negatives to 1.3% last week.

The February inflation numbers don't include the price shocks from the war in Ukraine – even though politicians are using that event to explain the earlier data away. Consumer Prices rose .80% in February – hiking the annual pace from 7.50% to a new 40–year high of 7.90% (to 1981). The core, ex food & energy, saw a CPI rise of .50% – accelerating the annual core pace from 6.00% to 6.40%. Adjusted for inflation, Real Average Hourly Earnings fell from –1.80% to –2.60% (annually). Real Average Weekly Earnings rose from –3.00% to –2.30%. The March numbers will be very much higher. Also pre–war, Producer Prices rose .80% – accelerating annually from 9.70% to 10.00% – hitting double digits for the first time. January results were revised .20% higher to 1.20% and bumping that annual pace to 10.00% as well. Core PPI rose .20% which eased the annual pace from 8.50% to 8.40%. Import Prices rose 1.40% in February – up from an annual 10.70% to 10.90%. Export Prices were up by 3.00% – rising from 15.00% to 16.60% annually.

Homebuilder confidence (NAHB Housing Market Index) fell to the lowest level in over 6 months with a drop from 81 to 79. Higher mortgage rates will begin to present a real challenge to the industry. February Housing Starts soared to the highest level in 16 years with a 6.76% gain to 1.769 million annual units. However, Building Permits fell 1.90% to 1.859 million annual units – and multi–family permits plunged 4.5% for the month. Higher prices and increasing rates sent Existing Home Sales down by 7.24% to a 6–month low 6.02 million annual units. That was the largest drop since May 2020.

Wednesday is set for MBA Mortgage Applications (which rose by 8.50% and then fell 1.20% over the past 2 weeks) and New Home Sales for February. Thursday releases jobless claims, the Q4 Current Account Balance, Orders for Durable and Capital Goods for February, and Kansas City Fed Manufacturing Activity. Friday reveals Pending Home Sales for February and University of Michigan sentiment.

Next Monday (03/28) brings the merchandise trade deficit (Advance Goods Trade Balance) and Dallas Fed Manufacturing Activity. Tuesday follows with home price data, Board Consumer Conference, and JOLTs Job Openings. ADP Employment Change and the Q4 GDP update come on Wednesday. Challenger Job Cuts and the PCE Deflator come on Thursday. Friday reveals March payrolls and the U.S. Unemployment Rate.

Equities

For the Dow Industrials, the largest down day of the year on March 7th was followed by another loss on the 8th – and then a 2,303–point rally through today's high. Last week's 5.496% rally was the best weekly gain for the Dow since November 2020. Last week's 1,810.74–point gain sent the Dow to 34,754.93. It's .15% higher this week after a down and up day. The Nasdaq gained 8.18% last week and is 1.55% better this week. The S&P gained 6.16% and has added 1.09% through Tuesday. The Dow Transports rallied 8.30% but are only .10% higher this week. Bank stocks rose 5.96% last week and are outperforming with a 1.73% gain early this week.

Other Markets

Crude Oil peaked so far over $130/barrel on March 7th but has since eased back below $110/barrel. Crude was 4.23% lower last week but rallied back 6.74% through today. Commodities lost .97% last week but are 2.34% higher this week. Gold pulled back 8.83% off its March 8th near–record high over $2,078/oz. and was 2.81% lower last week. Gold fell .40% through today. The Dollar is holding ground on the promise of higher U.S. rates. The Dollar fell .91% last week but was .30% higher through today. The Japanese Yen tumbled 1.60% last week and lost another 1.37% so far this week. The Euro gained 1.27% last week but is .20% lower this week. Corn lost 2.98% but is 1.52% higher this week – still near decade highs. Cotton rose 4.82% and is 2.51% better this week – riding 11–year highs.

"Finance is the art of passing money from hand to hand until it finally disappears." Robert W. Sarnoff

"An honest politician is one who, when he is bought, will stay bought!" Simon Cameron (1799 - 1889)

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Additional Information is Available on Request

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