Banes Capital Group, LLC
6410 Poplar Ave. Suite 500
Memphis, TN 38119 (901) 261–5900
Strategies / April 11, 2022 #984

Bond Market Review

Intended for Institutional Clients Only

What to Dread from the Fed

While Fed Chair Jerome Powell would like to keep things orderly and telegraph the expected path for rates and asset purchases, various FOMC members put the markets on edge with their comments. The long–awaited FOMC minutes were expected to give us color – and it was red for global bonds. Even before the release, Fed Governor Lael Brainard said the FOMC *"will continue tightening monetary policy methodically through a series of interest rate increases and by starting to reduce the balance sheet at a rapid pace as soon as our May meeting."* Though markets were already pricing in a 50–bps hike in May, few thought a 'rapid' reduction of the balance sheet would begin that soon. For the record, that's Quantitative Tightening! QE to QT in one month? She said she expected the balance sheet to roll off quicker than during the previous recovery. One site reported the Fed's Treasury holdings as $5.76 million (showed in millions). That staggering $5.76 trillion is just a part of their $8.94 trillion balance sheet. Not only will the Treasury and MBS markets be losing a large buyer, the minutes said the Fed would reduce holdings by $95 billion each month – compared to the $50 billion per month from 2017 to 2019. That sent the bond market into panic.

Little had been mentioned concerning the Fed's gargantuan $8.94 trillion balance sheet. Last Wednesday's minutes from the Fed's meeting that concluded on March 16th were a little surprising as the Fed's 'Hawkometer' swung full tilt with accelerated hikes and balance–sheet reduction high on their agenda. The pain didn't stop there. A number of FOMC members have stated that 50–bps hikes were on the table as soon as May. FRB St. Louis President James Bullard piled on with his comment that: *"I would like the committee to get to 3–3.25% on the policy rate in the second half of this year."* Markets that had consider 4 hikes this year and then 7 25–bps moves after March were suddenly presented with 12! Bullard said such a move was necessary to deal with the *"inflation we have got in front of us."*

Jobs are certainly not in the way! The economy had another good month of gains with 431K jobs added in March. Initial Jobless Claims fell to the lowest levels since 1969 and JOLTs data revealed that there are 1.8 jobs available for every unemployed American. The markets are viewed as a combination of technical and fundamental factors. For the moment, this one is being driven by fear. Cycles and fundamentals are giving way to just how much pain can be inflicted by a campaign of rate hikes. Not only are the hikes now feared to be more precipitous, but the Fed's new determination to sell assets and reduce their balance sheet will reverse the market–friendly effects of QE with the economic brakes of QT. Prices could also 'brake' our economy. The 'inflation tax' for each American family was calculated to be up $5,200 versus last year. Families are spending $433 per month more for fuel, goods, and services than they did last year – and they are spending, though borrowing at a record pace (which could be another danger).

Looking Ahead

- Equity cycles are showing a high near April 20th/21st.
- Bond yield cycles show lows due near April 14th and May 2nd.
- U.S. markets will be closed on Good Friday (04/15). Bonds close early on Thursday (04/14) at 2 p.m. ET.

The **B**ond **M**arket **R**eview doubts that the Fed will be raising rates much past 2.00%. Even though Q4 GDP was 6.90%, the Atlanta Fed's GDP–Now forecast for Q1 is now only 1.1% – just slugging along, even before the war added to inflation, rates surged higher, and the Fed's latest plans were announced. Consumer Credit just showed we are borrowing at a record pace – and so is the country. As we said in the **BMR** (12/13/2021): *"One of our concerns is that each 25–bps rate hike adds about $75 billion in annual debt service as the national debt approaches $30 trillion."* Are we to believe Congress will quit spending? We are currently on track for another fiscal deficit topping $1 trillion. Have any of the Fed members suggesting what a return to 'normal' of 2.50% or Bullard's 3.25% would mean? If rates do rise to 3%, the debt service alone will double the annual deficit by surging to $900 billion! Holding rates low would better help – as would lower oil prices to reduce inflation. The capacity is still there. We suspect that few have done the math on the real costs of electric cars. (Hint – it's much higher, and the cars cost twice as much.)

Additionally, we've held that low–to–negative quality foreign bond rates would serve as a tether to hold U.S. rates from running to the upside beyond attractive spreads. In February, U.S. 10–year yields were around 175 bps higher than those of Germany and Japan. Though most global rates have moved higher, U.S. rates just moved to a 200–bps spread to Germany and 245 bps to Japan. The so called 'real interest rate' is nominal rates less inflation. For most of my pre–'financial crisis' career, the 10–year note priced around 1.5% to 2.5% over the CPI rate – which would be a yield of 10% (or 8.5% to core CPI) at present. Without going into the math, U.S. real 2–year yields versus those of Germany just set a record spread of 400 bps. We think that is a 'rubber band' that will only stretch so far …!

FRB New York's John William said we need to get rates back to neutral or normal. He then added *"whatever that means"* – because who does? He said it didn't need to be done immediately but could be accomplished in *"a sequence of steps."* Clearly, baby steps have been ruled out as the expected pace is now frantic. Speaking to the unknown destination, the minutes said: *"Participants judged that it would be appropriate to move the stance of monetary policy toward a neutral posture expeditiously."* When playing 'Grand Funk Railroad' – the joke was 'if you don't know the next chord – just turn up!' We're on an expeditious trip to an unknown destination. What could go wrong?

Treasuries, Agencies, and MBS

Yields soared on Fed talk of funds rates topping 3%. Even before more–recent increases, the yields between February and March auctions were nearly 60 bps higher for the newer offerings. As of today, 2–year yields of 2.60% were the highest since February 2019. The 2.82% 5–year was the highest since December 2018. A 2.78% yield on the 10–year note was the highest since January 2019 and the 2.82% reached on the 30–year bond was the highest since May 2019.

The war in Ukraine ceased to provide a 'flight to quality' bid as it had early on. Into April 1st, yields twisted flatter with the 2 and 5–year rising by 18.5 and 1.5 bps while the 10 and 30–year sectors saw a drop of 9 and 15.5 bps. Yields came back with a vengeance last week as they rose by 6.6,19.5, 32 and 38.5 bps for the 2, 5, 10, and 30–year sectors. Longer rates were trading up around 6 to 8 bps today. The yield targets we provided previously were 'blown out' to the upside. Upside resistance is 2.89% for the 10–year note. Targets beyond that are 3.07% and then 3.25%. For the downside, 2.26% should be a trading range low for yields for now.

Freddie Mac 30–year mortgage rates rose from 4.16% to 4.72% over the past 3 weeks to the highest levels since December 2018. The last time rates were in the 5% zone was February 2011. 15–year rates surged from 3.39% to 3.91%. In the fastest–rising pace since 2003, home refinancings slid to a 3–year low. The Muni bond market had its worst quarter since 1994. For those of us in the business that long, 1994 was a very tough year that revealed why those 300 bps stress tests were needed – because that's what we got!

As the March auctions were closing out, parts of the yield curve were inverting. Though inversions almost always lead to economic slowdowns or recessions, the 'it's different this time' crowd was back in numbers. On the 28th, $50 billion 2–year notes came at 2.365% in an auction described as 'ugly' with demand plunging versus the previous offering. The buying group that includes foreign central banks accounted for only 55% of the supply compared to a prior 65.6%. The yield was the highest since February 2019. Later that day, $51 billion 5–year notes brought 2.543% in a much better offering that saw improved demand to February – though 66 bps higher in yield. That yield was the highest since January 2019. Foreign allocations still fell – from 67.8% to 60.2%. On the 29th, $47 billion 7–year notes brought 2.499% with the best demand since August 2020. Foreign buying slipped from 63.9% to 60.9% of this issue. The $16 billion 20–year bond auction had a record low dealer award and came at a record high yield of 2.651%. Demand soared to a record high and foreign buying rose from 62.9% to 64.4% in this reopening of the February 2042 maturity. This week, the U.S. Treasury will auction $46 billion 3–year notes today (04/11), $34 billion 10–year notes on Tuesday (04/12), and $20 billion 30–year bonds on Wednesday (04/13).

04/08/22 Treasury Yield Curve	**2-Year: 2.516%**	**5-Year: 2.756%**	**10-Year: 2.705%**	**30-Year: 2.720%**
Weekly Yield Change:	+.057%	+.196%	+.320%	+.286%
04/01/22 Treasury Yield Curve	**2-Year: 2.459%**	**5-Year: 2.560%**	**10-Year: 2.385%**	**30-Year: 2.434%**
Weekly Yield Change:	+.186%	+.014%	–.092%	–.153%

Economics

Though revisions have distorted the data, Initial Jobless Claims fell to the lowest level since 1968 with a drop to 166K into March 19th, a rise to 202K, and then a matching drop to 166K again last week. Continuing Claims were revised from 2 readings that would have been new pandemic lows of 1,419K and 1,307K to higher levels of 1,542K and 1,506K (so the real pandemic low was in February at 1,469K). They then rose to 1,523K. ADP Employment Change was right with expectations with a 455K increase. Challenger Job Cuts showed 30.10% less cuts versus last year. Nonfarm Payrolls for March came in at a respectable 431K versus an expected 490K – albeit the fewest since September. 95K jobs were added in the 2–month revision. Private payrolls rose by 426K, close to the ADP result. Manufacturing added 38K jobs and the U.S. Unemployment Rate fell from 3.80% to 3.60%. The Underemployment Rate dropped from 7.20% to 6.90%. The Labor Force Participation Rate was .10% higher to 62.40%. Average Hourly Earnings rose .40% – accelerating the annual pace from 5.20% to 5.60% (the largest uptick since May 2020). Average Weekly Hours worked fell from 34.7 to 34.6. JOLTS Job Openings for February remained high at a near record 11.266 million, down from 11.283 million in January. That result is roughly 80% more than those unemployed.

With savings depleted, Consumer Credit rose more than double expectations to a record $41.82 billion. That was up from a January result revised higher from $6.838 billion to $8.931 billion. March Vehicle Sales fell off from a 14.07 million annual pace to 13.33 million a year. Q4 GDP grew by 6.90% (down from an earlier 7.00% estimate). Personal Consumption fell from 3.10% to 2.50%. February Personal Income rose by .50% and Personal Spending was up by .20% – below estimates of .50%. The services sector had its first gain in 4 months, improving from 56.5 to 58.3.

University of Michigan Sentiment fell from 62.8 to 59.4 as the Ukraine war and inflation weighed on responses. Current Conditions fell from 68.2 to 67.2 and Expectations dropped from 59.4 to 54.3. Inflation expectations were steady at 5.40%. Conference Board Consumer Confidence rose from 105.7 to 107.2. Their Present Situation was 10 points better to 153 though Expectations dropped from 80.8 to 76.6. The Fed's favorite inflation gauge was .60% higher in February. That PCE Deflator accelerated from 6.00% annually to a 40–year high of 6.40%. Ex food & energy, the core was up by .40%. The annual core rose from 5.20% to 5.40%.

ISM Manufacturing fell from 58.6 to an 18–month low of 57.1 in March. Prices Paid surged from 75.6 to 87.1. New Orders fell from 61.7 to 53.8. Labor was improving with ISM Employment rising from 52.9 to 56.3. Factory Orders fell from a 1.50% increase to a .50% contraction for February. Ex transportation, they rose by .40%. Orders for Durable Goods fell by 2.10% and were off by .60% ex transportation. Orders for Capital Goods fell .20%. MNI Chicago PMI (purchasing managers) rose from 56.3 to 62.9. Kansas City Fed Manufacturing Activity improved from 29 to 37. Dallas fell from 14 to 8.7.

The merchandise trade deficit narrowed from a record $107.6 billion as the Advance Goods Trade Balance declined slightly in February to a second–highest $106.6 billion. The Trade Balance deficit nearly matched the January record at $89.2 billion. Those kinds of results led to the large Current Account Balance deficit of $217.9 billion of Q4 2021.

The FHFA House Price Index rose 1.60% in January. Metro home prices were up by 1.70% – accelerating the annual pace from 18.58% to 19.10% (S&P Case–Shiller 20-City). The home price index also accelerated from 18.88% to 19.17%. Sales of New Homes fell for a second month in February with a 2.03% decline to 772K annual units. The supply of homes was the most since August 2008. Median prices were up 10.7% to last year. In February, Pending Home Sales were off by 4.10% for the 4th drop in a row. Construction Spending rose by .50%.

Tuesday (04/12) is set for NFIB Small Business Optimism, Consumer Prices (March CPI), and the U.S. Treasury's Monthly Budget Statement for March. Wednesday follows with MBA Mortgage Applications (which were lower by 6.8% and 6.3% over the past 2 weeks) and Producer Prices (March PPI). Thursday reveals Retail Sales for March, Import Prices, and jobless claims data. Though most trading is closed for Good Friday, data releases include Industrial Production & Capacity Utilization for March, Empire Manufacturing, and TIC Flows (net foreign transactions of U.S. assets). Next Monday (04/18) brings the homebuilder optimism and outlook survey (the NAHB Housing Market Index). Tuesday follows with March Housing Starts and Building Permits. Wednesday updates Existing Home Sales for March and the Fed's Beige Book (outlook for their 12 districts).

Equities

Stocks had their worst quarter in 2 years, but it will probably be ages before we again see a quarter like Q1 2020! The 4.57% drop in the Dow Industrials was less than 25% of that pandemic drop (which was a lesser 23.20% for the quarter after having plunged 36.18% into the lows on March 23, 2020). Stocks are lower today with the Dow off over 200 points or 1.46%, the S&P trading 1.12% lower, and the Nasdaq dropping 1.49% late morning.

The Dow fell .12% into April 1st and then dropped 97.15 points or .28% last week to 34,712.12. The S&P gained only .06% but then dropped 1.27% last week. The Nasdaq gained .65% and then tumbled 3.86% last week. The Dow Transports lost 5.34% and plunged 6.71% last week. Bank stocks had plunged 6.67% into the 1st and then lost 2.28%.

Other Markets

Crude Oil tumbled 12.84% and then lost another 1.02% last week (though pumps still show $4 plus!). Commodities fell 4.60% but then rose 1.71% last week. Gold lost 1.80% and then added 1.17%. The U.S. Dollar lost .20% and then rallied a strong 1.14% on tightening Fed policy. The Japanese Yen dropped .38% and then tumbled 1.49%! The Euro gained .55% into the 1st but lost 1.50% last week to the stronger Dollar. Corn fell 2.52% but then rose 4.59% last week. Cotton lost .99% and was off another 1.59% last week.

"In spite of the cost of living, it's still popular." Laurence J. Peter

"The trouble with our times is that the future is not what it used to be." Paul Valery (1871 - 1945)

Doug Ingram, Financial Economist
Additional Information is Available on Request