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Bond Market Review

Intended for Institutional Clients Only

The Bullring – Pain is Coming

We left for a much–needed vacation 4 weeks ago – traveling more than one state away for the first time since the pandemic. I apologize for this **B**ond **M**arket **R**eview being very late as I got my own version of the 'Rockin' Pneumonia and the Boogie–Woogie Flu.' Though it was not Covid, it's been most miserable. Jerry Lee Lewis could have been singing to my 24/7 cough when he said: 'You shake my nerves and you rattle my brain.' Nothing seemed to bring any relief. However, we were blessed with good health during the trip – and had a great time with family.

Despite GDP–growth results that placed us in a textbook recession, Fed Chair Jerome Powell, Treasury Secretary Janet Yellen, and the administration have argued that growth is slower but resilient. However, when a bull has taken this many hits in the bullring, he might still seem to have plenty of charge – but most everyone in the arena knows that the end game will be most unfortunate. While we were gone, we were told there is no recession and no inflation. It's too bad all the data doesn't agree with those opinions. July payrolls were strong, but we don't think enough to sway the outcome. Strong labor is the only thing holding the dreaded condition of stagflation at bay. We saw the passage of an 'Inflation Reduction Act' which someone said was the most misleading name since Greenland.

When Q1 GDP of –1.6% was followed by Q2 GDP reported at –.9%, the economy was officially in at least a mild recession that we termed 'Mini–R.' It was revised to –.6% today but still negative. Yellen and others said the economy was not in recession but instead in a state of transition. (Does that mean it's transitory?) It's clear to the **BMR** that should the economy do better from here, they will claim we 'transitioned' from a 'mild recession.'

Looking Ahead

- Equity cycles show stocks making a low near August 30th and a high near September 2nd or the 9th.
- The bond–yield cycles show rates turning sideways to lower from a top near August 29th.
- The markets will be closed for Labor Day on Monday, September 5th. Bonds will close early on the 2nd.

While GDP growth came fighting back after a knockdown from Covid, the sheer amount of recently negative hits argues that the economic 'bull' may be weakening. In that sense, multiple 'banderillas' have already been placed by these negative events. Covid, inflation, high fuel prices, rising interest rates, slumping housing, and many other factors are still at work. For the record, I've never seen a bullfight but I think the analogy fits. There are some major data and news releases that are troublesome – and each could be a new dagger to the economy.

- 10 months in, the budget deficit is $726 billion. With the expected 50–bps hike in September, 2.75% rates will add $825 billion in debt service per year the $30 trillion in U.S. debt – possibly doubling the annual shortfall. If the Fed moves to 4% as some members wish, that debt service could reach $1.2 trillion per year!
- The war in Ukraine is challenging food supplies and the U.S. is funding the defense at a great cost. The war itself makes for a 3rd dagger in that same category.
- Inverted yield curves almost always signal recession. Ours is the most inverted in decades.
- The housing market is cratering to multi–year lows. A record number of homebuyers just canceled contracts.
- While Consumer Prices didn't move up in July, they remain at multi–decade highs. Inflation on groceries just hit a 43–year high. The fed's favorite inflation gauge was at a new 40–year high in June.
- Legislation and executive action. The Inflation Reduction Act will raise inflation – as will the forgiveness of student loans (which is also unfair to the masses that paid – and it robs from other Americans).
- Ford Credit Delinquencies are rising. It's our guess they're not alone.
- Americans are buying, but on record credit usage. Savings rates have tumbled to a 13–year low.
- Consumers are behind on rents and one in every 6 households is said to be late on energy bills. Shutoffs are imminent without government intervention – which would of course add more inflation.
- A lack of border controls and the subsequent costs (even to sanctuary cities) drives up prices and costs. New York City stated they would be paying over $300 million a year to house new immigrants in hotels.
- Parts of the US are seeing severe drought conditions – which will challenge the economy and inflate food costs. Europe is seeing their worst drought in hundreds of years. Some of Europe is already in recession with Germany's Retail Sales crashing the most on record. European Central Bank chief Christine Lagarde said climate–change was a major factor in soaring inflation.

The July jobs numbers breathed some life into the bull – and labor is the core argument for the Fed's non–recession stance. However, as we've said before, the Fed tightens to *slow* the economy. Should we be surprised it's working?

Fed Thoughts and Jackson Hole Hawks

Much pain – no gain. We don't have much faith in central bankers when markets and conditions force them out of their comfort zone. It happened during the financial crisis and is once again at hand. Do we think the same crew that so wrongly evaluated inflation has the wherewithal to reverse it? Of course, the tag to that question should be – without ruining the economy?

Speaking to getting inflation back to the Fed's 2% target, economist El–Erian (Allianz SE) said: *"It's going to take some time because the Fed has been asleep at the wheel."* He said they can't blink! They didn't. The take on rates became 'higher for longer.' Powell said another *"unusually large increase"* could be appropriate at the next meeting.

With the Fed hiking at the fastest pace in decades, all eyes were on their annual symposium retreat in Jackson Hole, Wyoming. Powell's statement was clear. Pain is coming and the Fed will keep at it until the job is done. The **BMR** thinks it could be a very long time before inflation returns to 2%. The market started to price in another 75–bps hike instead of 50–bps after Powell's short speech. Up until Friday, Powell continued to be viewed as leaning dovish – despite the tightening. With this statement, he asserted himself as a bona fide hawk. That also troubled markets that didn't see him as going 'all in.' Of course, most Fed members are on record supporting more and numerous hikes.

Coming into the meeting, FRB Richmond President Richard Barkin said: *"We're committed to returning inflation to our 2% target and we'll do what it takes to get there."* He said: *"There's a path to getting inflation under control but a recession could happen in the process."* That 'whatever it takes' slogan was the one the European Central Bank used during the financial crisis – and they did!

As of July 27th, the Fed had a unanimous vote in adding a second 75–bps hike. At that time, Powell also said there was no recession. However, the Fed is often late to the game – as they were in finally recognizing inflation. Back in the **BMR (04/07/2008)**, we said: *"Fed Chairman Bernanke finally capitulated that a recession is possible as homebuilding, employment, and consumer spending will deteriorate. He said: "It now appears likely that real gross domestic product will not grow much, if at all, over the first half of 2008 and could even contract slightly.'"*

Contract slightly? We're just saying they don't guess well! The great recession was on the way. Considering the plunge in housing data, we thought of a piece from the **BMR (02/26/2007)**. We said: *"FRB Dallas President Robert Fisher said: 'I don't see a recession staring us in the face...' He opined: 'Yes, there is a downdraft from housing, but there are other offsets in the economy.' We disagree! From 2000 to 2006, housing was the economy! With $1.5 trillion in ARMs resetting this year, it will be more than the subprime markets that are affected from a credit standpoint."*

The minutes from the FOMC meeting that concluded on July 27th said that inflation was *"unacceptably high"* with broad–based pressures – things we all know! They said that inflation continued to merit a *"restrictive stance of policy."* They also allowed for more larger hikes and said they could even *"tighten the stance of policy by more than necessary to restore price stability."* More than necessary? That's one scary thought!

Treasuries, Agencies, and MBS

In the last **BMR**, we said: *"Unless long end yields move 75–bps higher next week along with the Fed's next expected action, the resulting inversion will be the widest in decades and the most in my records."* Earlier this month, the yield curve was the most inverted since August 2000 for the 2–to–10–year (at –49 bps) and for more than 3 decades at 2–to–5–years (–31 bps). Since the last **BMR**, the 10–year yield dove from 3.08% to 2.52% – and then rose back to 3.12%. Though rising back recently, many auction yields had fallen up to 55 bps from their previous levels into the last part of July. Correspondingly, Freddie Mac 30–year rates fell from 5.54% on July 21st to 4.99% on August 4th. This past week, they were back to 5.55%. 10–year yields were 7 bps higher in early trading this morning.

While the ends of the curve twisted in different directions over the past 2 weeks, the midsection has been clearly rising. Into the 19th, yields fell by 1 bps at 2–years but rose by 13.5, 14, and 10.5 out on the 5, 10, and 30–year end. With the odds of a 75–bps hike beginning to dominate following the hawkish tones of Jackson Hole, 2–year yields soared above 3.43% making a new high for the year – and hitting the loftiest level since November 2007. Yields ended this past week higher by 16.5, 11.5, and 7 bps for the 2, 5, and 10–year sectors but were lower by 2 bps at 30–years. Most recent auctions were deemed 'ugly', though the last 3, 7, and 10–year were received very well.

Overall, $22.1 billion flowed into U.S. assets in June. $121.8 billion was moved into longer–term U.S. debt. Over the past 12 months, foreign entities sold a record annual $231.5 billion in U.S. equity positions. After selling Treasury holdings for a record 7th month, China's holdings dropped back to the lowest levels since June 2010. The U.S. Treasury's Monthly Budget Statement showed a $211.1 billion deficit in July. That left the fiscal year 2022 total with a $726.1 billion shortfall at 10–months in. The budget deficit is running 71% below fiscal 2021.

08/26/22 Treasury Yield Curve	**2-Year: 3.400%**	**5-Year: 3.207%**	**10-Year: 3.043%**	**30-Year: 3.194%**
Weekly Yield Change:	+.165%	+.113%	+.068%	–.021%

08/19/22 Treasury Yield Curve	**2-Year: 3.235%**	**5-Year: 3.094%**	**10-Year: 2.975%**	**30-Year: 3.215%**
Weekly Yield Change:	–.012%	+.137%	+.141%	+.103%

Economics

Despite good payroll gains in July, Initial Jobless Claims have been elevated compared to the April–May lows which averaged 171K on a monthly basis. Claims fell 2K to 243K last week which was a little below the 247K monthly average. They had reached an 8–month high a few weeks ago. Continuing Claims were averaging around 1.315 million in June but fell 19K last week to 1.415 million, under the 1.425 million monthly average. Some private reports (non–government) show over 50% of companies are laying off some workers. Some tech companies have been reducing staff for most of the year. Interestingly, multiple jobholders just hit a record high.

JOLTS Job Openings fell from 11.303 million to 10.698 million in June but were still well above those unemployed. Openings were the lowest since last September and the decrease was the third largest on record. Challenger Job Cuts showed 36.3% more layoffs versus July 2021. It's old news now but Nonfarm Payrolls for July beat expectations of 250K with a healthy 528K increase. That was the best payroll pickup since February. The 2–month revision was a positive 28K adds. Private payrolls grew by 471K and Manufacturing added 30K jobs. The U.S. Unemployment Rate dipped to 3.50% from 3.60%. However, the Labor Force Participation Rate fell .10% to 62.10%. Underemployment was steady at 6.70%. Average Hourly Earnings rose .50% though the annual pace remained at 5.20%. Average Weekly Hours were steady at 34.6.

University of Michigan Sentiment bounced back from July lows, improving from 51.5 to 58.2. Current Conditions were .5 better to 58.6 and Expectations jumped from 47.3 to 58.0. It was promising that inflation expectations eased .20% to 4.80% – still high, but a move in the right direction. NFIB Small Business Optimism was .4 better to 89.9 for the first gain this year. ISM Manufacturing slipped from 53 to 52.8 and ISM Services rose from 55.3 to 56.7. The Philadelphia Fed Business Outlook improved from –12.3 to +6.2 and the Chicago Fed National Activity Index rose from –.25 to +.27. The Leading Index for July fell .40% and other manufacturing was challenged. The Richmond Fed Manufacturing Index fell from flat to –8 and Kansas City retreated from 13 to 3. Empire (New York) Manufacturing tumbled from +11.1 to –31.3. Industrial Production rose by .60% and Capacity Utilization improved from 79.90% to 80.30%. Orders for Durable Goods were flat in July. Ex transportation, they rose .30%. Orders for Capital Goods rose .40%.

Q2 GDP had come in at –.90% with the first estimate but was just revised .30% higher to –.60%. The Atlanta Fed's GDP now for Q3 stands at 1.6% – down from 2.5% earlier in August. Q2 Personal Consumption rose 1.50%. The GDP Price Index was revised .20% higher to 8.90%. and the core (ex food & energy) remained at 4.40%. The merchandise trade deficit (Advance Goods Trade Balance) was around $10 billion below expectations but still lofty at $89.1 billion. Personal Income rose .20% in July, but Personal Spending was only .10% higher. Retail Sales were flat in July. Ex autos, they rose .40%. We're still big on spending money we don't have as Consumer Credit jumped $40.154 billion in June for the 2nd greatest monthly increase on record.

Consumer Prices were flat in July but still at multi–decade highs on an annual basis. The annual pace fell from 9.10% to 8.50%. The core (ex food & energy) rose by .30% which left the annual core CPI pace unchanged at 5.90%. Real Average Hourly Earnings – adjusted for inflation, fell by 3.00% annually. Real Average Weekly Earnings fell by 3.60%. Households are paying roughly 47% more for electricity than they did a year ago. As we said earlier, inflation on groceries is the highest in 43 years. Fuel may be a little cheaper, but these factors, and higher rents (up 5.7%), work very hard against household income. Many staples have increased at annual double–digit records with flour up 22.7%, milk up 15.6%, bread up 13.7%, and eggs increasing by 38%. Producer Prices fell .50% in July for the first drop since the pandemic. Annual PPI dropped from 11.30% to 9.80%. Core PPI rose .20% with the annual core PPI pace dropping from 8.40% to 7.60%. July Import Prices fell 1.40% – dropping the annual pace from 10.70% to 8.80%. July Export Prices fell 3.30% – cooling the annual pace from 18.10% to 13.10%. The PCE Deflator, which is considered the Fed's favorite inflation gauge, cooled a bit in July. It fell .10% and slowed the annual pace for Personal Consumption Expenditures from a 40–year high of 6.80% to 6.30%. The core rose .10% though the annual core pace also slowed – from 4.80% to 4.60%.

The housing sector is suffering deep setbacks. Higher rates and inflation have taken their toll on affordability. Homebuilder confidence fell for an 8th month in the worst slide since 2007. The NAHB Housing Market Index fell from 55 to 49. May 2020 was the last time in contraction (below 50). The FHFA House Price Index rose 1.40% in May. The annual pace of housing prices slowed from 20.64% to 19.75%. Metro home prices rose 1.32% – leading the annual pace to fall from 21.22% to 20.50%. Housing Starts tumbled 9.57% in July to 1.446 million annual units – the lowest reading since September 2021. Single family starts were the lowest since June 2020. Building Permits dropped 1.30% to 1.674 million annual units. Sales of Existing Homes fell 5.87% to 4.81 million annual units – for a 6th drop to the lowest level in over 2 years. Sales of New Homes dropped to the lowest since 2016. July New Home Sales plunged 12.65% to 511K annual units. Turnover is now 10.9 months – the longest inventory supply since 2009. Pending Home Sales followed June's 8.60% drop with a 6th drop this year of 1.00% for July. Sales are off 22.50% versus July 2021 – the steepest yearly drop since 2011.

Monday is set for Dallas Fed Manufacturing Activity. Tuesday follows with the FHFA House Price Index for June and other home price data, Conference Board Consumer Confidence, and JOLTS Job Openings (July). Wednesday closes out August with MBA Mortgage Applications (which fell 2.30% and then 1.20% over the past 2 weeks), ADP Employment Change (private payrolls), and MNI Chicago PMI (purchasing). Thursday kicks of September with Challenger Job Cuts, jobless claims data, Nonfarm Productivity, ISM Manufacturing, and August Vehicle Sales. Bonds will close early on Friday (09/02) but August payrolls and related data will come in the morning. Also due are Factory and Durable Goods Orders. ISM Services follow next Tuesday (09/06) after Monday's Labor Day holiday.

Equities

In past years we've discussed the seasonal factor for stocks rising for 2 weeks into Labor Day (or with Labor Day in the middle). This year appears to be setting up as well with another upturn possible from August 30th into a high near September 2nd or 9th. After the 9th, the equity cycles once again weaken. Stocks rose from the cycle due on July 22nd/25th. In fact, after dropping nearly 35% from November through June, the Nasdaq entered 'bull market' status with a 24.76% rise into August 16th. It's since corrected by 7.9%. Stocks rose into Tuesday, August 16th, and then dropped for a week into the 23rd. All markets were keyed on the Fed's comments following their annual symposium at Jackson Hole and equities fell hard as traders began leaning to expectations of another 75–bps hike in September. The Dow Industrials lost over 1,000 points on Friday.

We still have lower targets outstanding for the S&P of 3,577 and 3,261. However, the up move did give us a higher and possibly–interim target of 4,444. Everything depends on the Labor Day seasonals. With the large Friday loss, many stock indexes went negative for August. The Dow ended down 1,423.34 points or 4.22% lower for the week to 32,283.40. The S&P lost 4.04% and the Nasdaq fell 4.44%. The Dow Transports fell 2.65% and Bank stocks ended the week 4.01% lower. Stocks opened lower today with the Dow off around 300 points. The S&P was off around .85% in early trading.

Other Markets

Crypto had done well since our last cycle low and should now benefit from an up move from a low due now into September 6th. Crude Oil gained 2.52% last week and Commodities gained 2.42%. Gold fell .66% for the week. We're showing better cycles to buy gold in mid or late October. The U.S. Dollar rose .60%. The currency likes the higher rates. The Japanese Yen fell .49% and the Euro lost .71%. For the first time since 2002, the Euro fell below parity with the Dollar. Corn surged 6.83% and Cotton gained 1.98%.

"If we all did the things we are capable of doing, we would literally astound ourselves."
Thomas A. Edison

"Too bad the only people who know how to run the country are busy driving cabs and cutting hair."
George Burns

Doug Ingram, Financial Economist
Additional Information is Available on Request

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