POLICYMATTERSUSA

Economic and Financial Market Advisory
U.S. Fixed Income Weekly

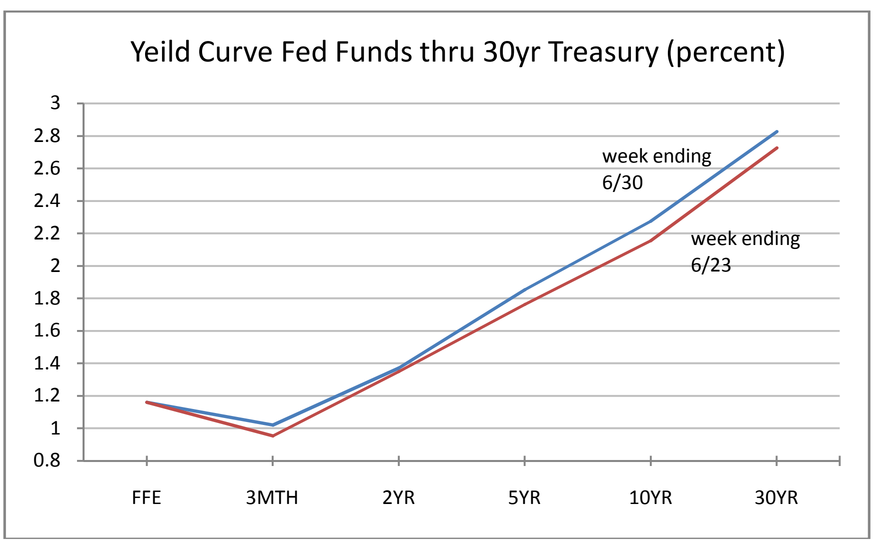
WEEK IN REVIEW

What a difference a week makes. Interest rates are going higher and the entire world knows it for sure…this time. It simply depends on the inflation data; it was hot, it was cold, it might get hot again. Inflation data continues to keep the attention of policy makers and market participants fussing over tenths of a point on headline, no wait; core inflation data (core excludes food & energy). All the while the typical consumer is wondering how the professionals can't see all the inflation they encounter each day at the grocery store (packaging inflation), at the real estate office for buyers and renters, for car repair costs, health insurance costs, taxes and most everything else, except for wholesale oil and gas.

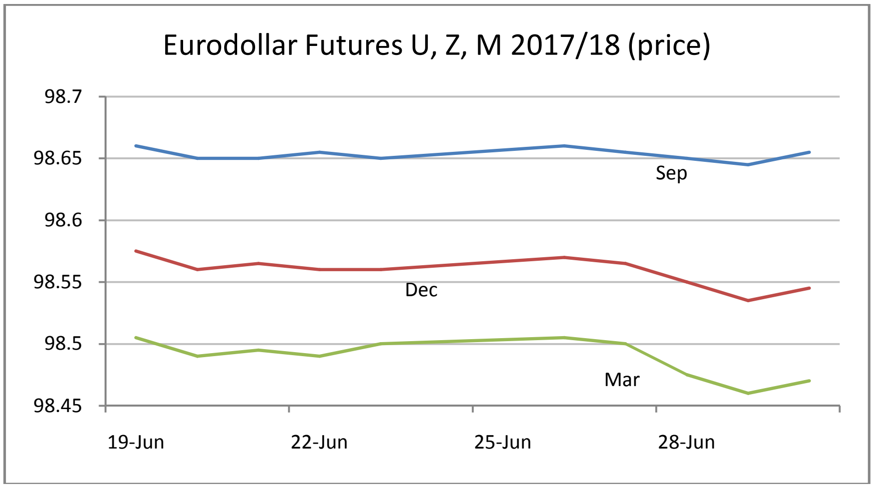
A dovish Fed statement from two weeks ago when they hiked the Federal Funds rate to a range of 1%-1.25% has been explained and reinterpreted since by Fed Presidents and Governors, both hawks and doves, trying to be transparent for markets. It isn't working. It reveals dissention, or at best uncertainty. The markets are losing faith in the ability of the Federal Reserve, the Bank of England, the European Central Bank, or the Bank of Japan to get the transition from historically easy money back to normalization correct.

For now we know for sure the Fed leads the world on undoing QE, just as they led the world on beginning QE. For the Fed the debate is when next to hike, when to begin balance sheet reduction. The ECB, the BOJ, the BOE, and the PBoC are beginning their debates on when to end QE and if they should begin balance sheet normalization. This process is going to be in fits and starts for all of them. This isn't the first time markets have thought rates were for sure moving higher; in 2013 interest rate swap groups revved up to take the borrowing world from floating to fixed rates certain interest rates were moving higher. They didn't. The Fed must normalize interest rates and remove the moral hazard from equity and bond markets. The rest of the world will follow. Regardless, the Fed appears to be on hold until 2018; the ECB, the BOJ, and the BOE will move in 2017.

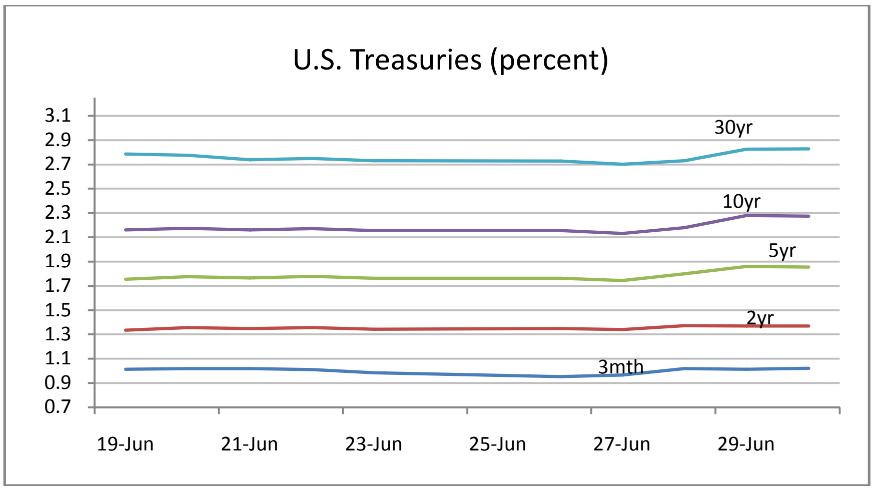
A quick note on equities: it is a bubble, don't put new money to work, keep a trailing stop for taking profits, don't try to pick top.



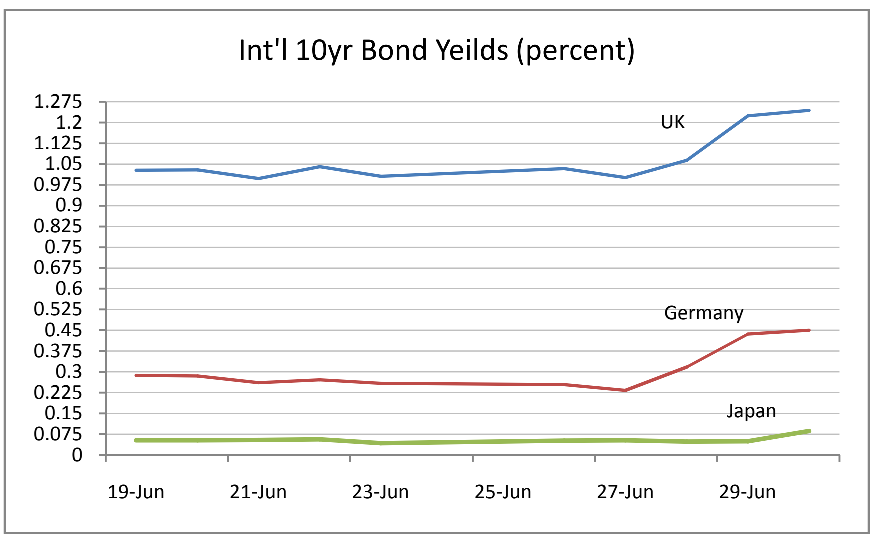
Short end inversion is dissipating as rates rose across the curve this week as central banks led by the Fed signal rates are going higher. The long end continued to outpace the short-end though as you can see we have clear separation along the whole curve this week, including the 2's and 5's. The 3mth rate was up 7bps, the 2yr up 2bps, the 5yr was up 9bps, the 10yr was up 12bps, and the 30yr was up 10bps. These are big moves and the long end is taking ques from central bank rhetoric to move rates higher. The 10yr has to get through 2.61, and above that 3% to confirm leg up. The 30yr has resistance at 3.20 and then 3.70 above. These are levels last seen 2013/14.



Flattening in the curve from Fed Funds to 3mths seen in the yield curve above can be seen here in the Eurodollar futures contracts. Uncertain about how far to take rates up in the days after the June Fed meeting hawkish talk and some elevated core CPI data from around the world this week caused Eurodollar traders to sell allowing for a flattening of the short end of the yield curve. As you can see in the March contract the probability of an early 2018 rate hike is increasingly priced in. Where will 3 month money be in 3 months? March 2018 futures say 1.5%...approximately. Based on data currently available the Fed is on hold for the rest of 2017, and will hike in Q1 2018.



Another picture, more confirmation of market expectations of Fed action. The long end confirms market expectations that interest rates are moving higher. Note, the Fed only controls the Federal Funds rate, the O/N rate. The Fed tries to cajole, or talk, the long end into the place they want it. We know this is a hard needle to thread from the Fed's experience from 2002 to 2006. The problem the Fed has on the long end is that the U.S. is safe haven in times of turmoil; thankfully there is none of that in 2017...HA!. While the Fed may want tighter monetary conditions, in the face of rising Geo-political uncertainly, or actual war, the U.S. yield curve becomes home for the worlds money.



This is where the real action was this week; ECB, BOE, BOJ. A lot of hawkish and confused talk came from the ECB and the BOE this week. BOE Gov Carney and BOE Chief Economist Haldane were deliberately hawkish in calling for an end to QE and a reduction in the balance sheet in 2017 without any real lead up to such aggressive rhetoric. Similarly, ECB Pres Draghi tried being hawkish but spooked markets earlier than desired, and was forced to walk back the tough talk later in the week. The EUR rallied. The ECB knows they are causing damage, and are trying to find the right time to end their QE program. Even the BOJ tried to talk tough on moving away from negative rates, though not as much traction for the JGB.

ECONOMIC DATA

Item	Actual	Exp	Prior
May Durable Goods Orders	-1.1%	-.4%	-.7%
Jun Consumer Confidence	118.9	116.7	117.9
MBA Mortgage Apps W/E 6/24	-6.2%		.6%
May Goods Trade Balance	-$65.9B	-$66B	-$67.6B
May Pending Home Sales	-.8%	.5%	-1.3%
Q1 Final GDP	.35%	.3%	.3%
Initial Jobless Claims W/E 6/24	244K	241K	241K
May Personal Income	.4%	.3%	.4%
May Personal Spending	.1%	.1%	.4%
Jun Chicago PMI	65.7	57.5	59.4

Expectations are the key to market movements each day and economic data is at the top of the list as a catalyst for those movements. This past week, the last week of every month, is a reasonably full calendar. As has been the case for some months now, largely on the back of optimism coming from the rhetoric of the Trump administration, the soft data points (surveys) were strong, while the hard data points (real output) were weak, except of course the historically low levels of initial unemployment claims. May Durable Goods Orders were in line with recent weak Factory Orders and indicates a consumer pulling back from large ticket items, and businesses from capital equipment. Excluding transportation, the Durable Goods Orders were up .1%. The Conference Board released their June Consumer Confidence data again showing a stronger than expected release as optimism about current and future conditions keep rising even though most other hard consumer data suggests the American consumer is retrenching. The May Goods Trade Balance worsened yet again as it has been doing nearly every month since 2009. Yet again China is the leading nation accounting for over 50 percent of our monthly goods trade deficit. For May the U.S. suffered a $65.9B deficit, a bit better than expected. May Pending Home Sales confirmed a slight weakening developing in housing as interest rates rise and job growth remains below potential, though partly offset by incremental wage and income increases. Pending Home sales for May (homes in contract waiting to close) came out at -.8%, worse than expected. This week we also got our final look at Q1 GDP (we get three looks at each qtr; Preliminary, Advance, and Final) which showed quarterly growth 0f .35%, or on an annualized basis 1.4%; not good. The U.S. economy still has not experienced a 3% real growth rate since 2007; a record stretch.

As usual on Thursday morning we got our best look at short-run labor market conditions with the Initial Jobless Claims data showing just 244K American's lost their job and had to file for unemployment insurance. We like this, though we suspect this number will be trending higher over the next 6-12 months. On Friday we got a peak into the health of the U.S. consumer/household with Personal Income and Personal Spending for the month of May. Both showed a positive print, though income was up higher than spending which meant Americans boosted their savings rate substantially over the intervening period. This ties in nicely with weak Retail Sales, Durable Goods, and Factory Orders. Lastly, late Friday morning we got another soft data point, the Chicago Purchasing Managers Index which was much stronger than expected, and stronger than the prior month. This is the challenge for analysts; how to square the positive and strong soft data with the somewhat negative and weak hard data. PMUSA relies on the hard data which indicates the U.S. will continue in a low growth environment with a stronger bias to the downside.

TREASURY AUCTIONS

How much did the U.S. Treasury borrow this week? It was a lot to be sure. The Treasury auctioned off and borrowed $213 BILLION; Oh the humanity! By the way, we have a budget ceiling crisis approaching. Don't worry, the members of Congress will kick the can down the road some more, miserably fail in their fiduciary responsibilities, and flip-flop on their 2016 campaign promises of eliminating deficits and vote for increasing the debt ceiling by another TRILLION dollars for another fiscal year. Yes, that is right, another $1T deficit coming in fiscal year 2018. It is embarrassing at this point. In any event, it makes no difference; the Treasury is having no problem at attracting lenders domestically or internationally. They can borrow all they want at very low rates; we'd be stupid not to take advantage of that, right?

This week the Treasury auctioned off 4wk bills, 3&6 month bills, and then 2, 5, and 7 year notes. FYI, anything less than a year is called a bill, over 1 year to 9 years notes, and above 10 years, bonds. On Monday, the Treasury borrowed $39b for 3 months at 1.0%, down 1 point from the prior week, with a strong bid-to-cover ratio of 3.10. The Treasury borrowed $33B in 6 month money at 1.11%, down 1 point from the prior week, with a strong bid-to-cover ratio of 3.35. The Treasury borrowed $26b in 2 year money at 1.348% with a strong bid-to-cover ratio of 3.03.

On Tuesday, the Treasury borrowed $34B of 5 year money at 1.828% with a modest bid-to-cover ratio of 2.33 (not bad, well above 1). The Treasury borrowed $40b of 4 week money which drew strong demand with a bid-to-cover of 3.11 (v 3.42 last week) at a rate of .89%, up 5 basis points from the prior week.

On Wednesday the Treasury auctioned off floating rate 2yr notes borrowing $13B at a rate of .08% (discount margin) with a bid-to-cover of 3.13. The Treasury auctioned off $28B in 7yr notes with a bid-to-cover of 2.46 with a yield of 2.056%.

As we approach the peril of debt ceiling negotiations the U.S. Congress and the White House continue to plunge America deeper into debt and every week we can see the evidence with Treasury auctions. If tomorrow the Treasury was unable to auction off any more bills, notes, or bonds, half of the U.S. government could not be funded.

WEEK AHEAD

Markets are open for half a day on Monday, they are closed on Tuesday to celebrate America's independence from the British Empire. The 2nd week since the last FOMC meeting and we get more talking Fed heads to help markets interpret their intentions. It starts with TV favorite St. Louis Fed President Bullard, the dove of doves at the Fed, and he'll be saying he thinks the Fed's message on rate hikes is too aggressive. Thursday we get San Francisco Fed Pres Williams talking on global growth. His words will be parsed carefully for any hint on rates hikes or balance sheet normalization, and on Friday we get the Fed's Monetary Policy Report at 11am which is a primer to the following week's testimony in front of Congress by Fed Chair Janet Yellen.

On the data front the first week of every month is a big one led by the Employment Situation Report (ESR) released by the Dept. of Labor on the first Friday of every month. The ESR gives us Non-farm Payrolls, the Unemployment Rate, Avg. Hourly Earnings, and the Avg. Work Week. This is the mother of all data reports and is released on the 1st Friday of every month. Anything above 185K for June will be considered strong and add to the debate on Fed hike timing. Anything below 150K will affirm the Fed on hold.

Prior to that, on Monday we will get Institute for Supply Management (ISM) Manufacturing Index (soft data point), and if recent trends remain, we can expect a better than expected release. Also on Monday we get a look May Construction Spending, and for May at least there should be no weather excuses for a weak number. As always on Wed morning we get a peek at Mortgage Applications for the week ending 6/24, and we also get to a look at May Factory Orders (FO). Given the negative print for April, and the weak Durable Goods Orders, we can expect another negative print from FO's. On Thursday, pushed one day because of July 4th, we get the precursor to the Friday jobs data with the release of the ADP Employment Report. Provided by the private payroll company ADP, this number helps set expectations for the Friday jobs data. Anything above 160 will be seen as positive for Friday (it excludes government jobs). If it is Thursday then it is Initial Unemployment Claims time and we can expect another calm number in the 245K-250K range. Also on Thursday we get the full release for May International Trade including services, and expect a print of -$48B, and we get a look at another soft data point, the ISM Services Index. Then on Friday, the mother of all data points, Non-Farm Payrolls. The whole world anxiously awaits this number gauging the health of the labor market of the largest and most powerful economy in the world.

Debt ceiling talk will begin creeping into markets, as will the ongoing lunacy of the Russian investigation in DC, with paralysis overtaking both the GOP leadership in Congress and the actions and activities of the Trump White House. Hot spots around the world will continue on the radar for the week; domestic political violence in the U.S., Qatar, Russia/NATO, North Korea, and the UK. Of course, don't forget the ultimate disrupter, Trump Tweets; now a risk element.

That is it for data this coming week. Market players will be relying on headline news events and technical analysis for trading opportunities while battling with continued low volatility in all sectors. We can expect Q2 financial services firm's earnings to show meaningful drops in trading revenue as a result of this low volatility. It is the fault of the algo, the black box, the robot and laser lines-of-site to shave off milliseconds to beat the human. Is that bad? It is not good.