Financial Market Weekly

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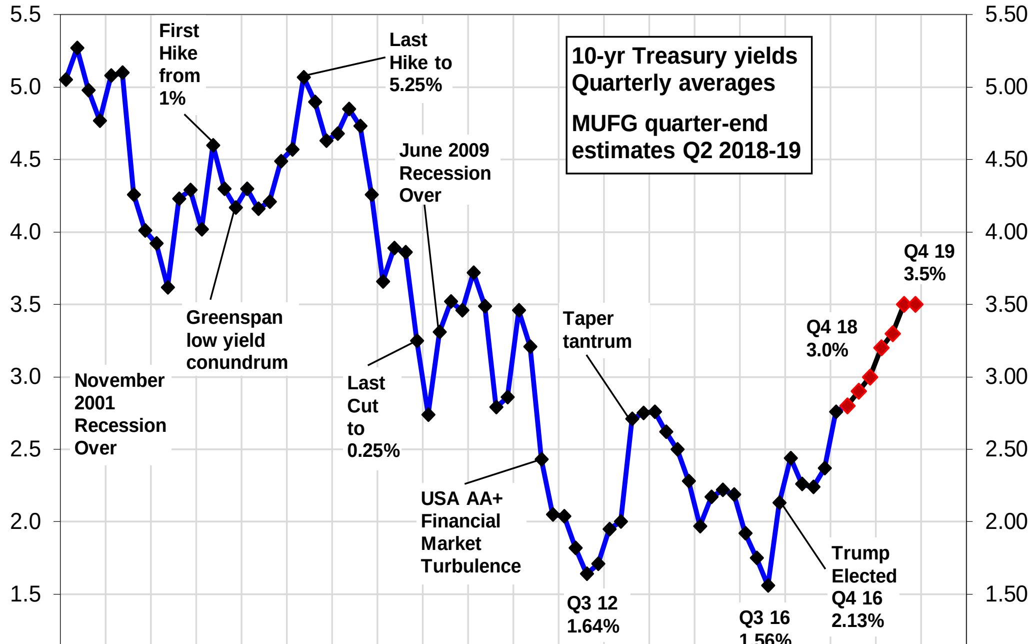
TREASURY BOND YIELDS TO MOVE HIGHER THE NEXT TWO YEARS

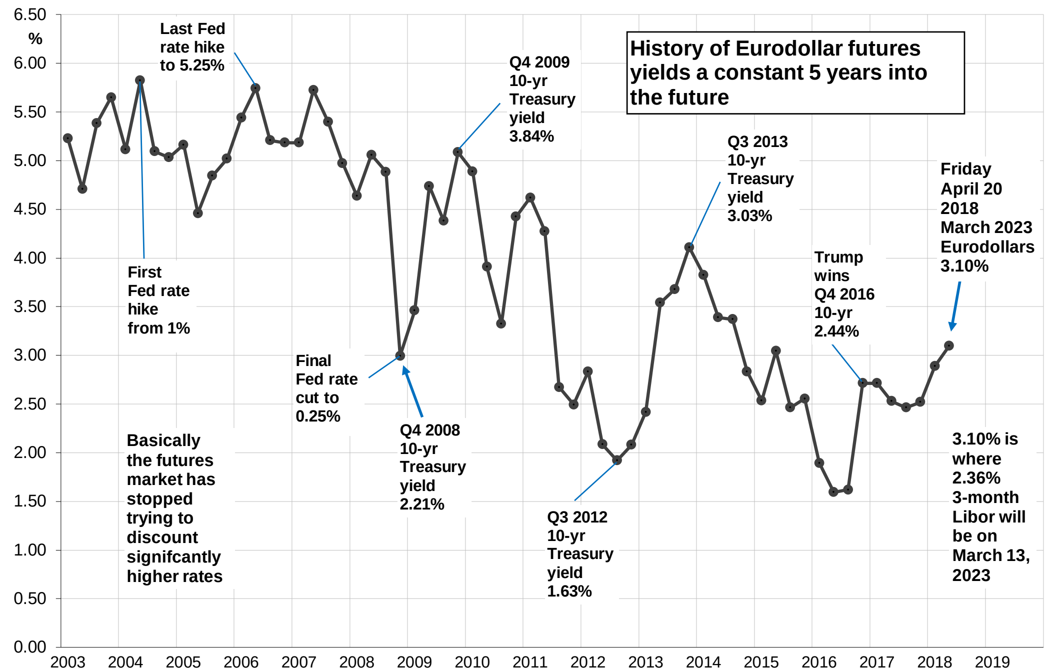


Sure thing, higher yields are coming, starting tomorrow, the next trading day apparently, after Friday night's close at the high yield of the year of 2.96%. Four basis points away from 3.0%. In years past, yields moving above important psychological yield thresholds like 3.0% have generated follow-through buying from investors hedging mortgage security portfolios. This didn't happen at the end of 2013 however. 10-yr yields closed above 3% at 3.03%, the high yield for 2013 on Tuesday, December 31, 2013, and never closed above 3% again. A weak 87K payroll jobs number a week later took the expectation for Fed rate hikes off the table permanently.

Yields can move above above 3%, but t he question is will these yields stick, is the move sustainable. There were a couple of higher bond yield scares this year, one centered on the inflation outbreak that never was, and the other was the massive trillion dollar Federal budget deficits coming on at just the time that foreigners have been buying fewer Treasury securities that pay for all this government deficit spending. The bond market sold off this week, making a run at 3%, but we are still getting impatient on this long wait for higher bond yields.

It’s out there our 3.5% 10-yr yield forecast at the end of 2019, but the Federal Reserve has its role to play. The backbone of bond yields is always overnight interest rates that the Fed controls. The median forecasts say the Fed funds rate will be 3.5% at the end of 2020, so that matches our forecast. Good news, even if we match up a year off. The bad news is that Fed Chair Powell says the 3.5% forecast at the end of 2020 cannot be relied on, forget about it, they cannot see that far into the future. That is certainly true. So what we are left with is that the Fed funds rate might be 3.0% at the end of 2019, according to the Fed; will that support our 3.5% 10-yr forecast? And don’t ask us about the increasing talk that an inverted 2-yr-10-yr yield curve will stop the Fed “tightening” in its tracks. Just another reason why the market is skeptical the Fed will ever be able to get interest rates that high in this cycle.

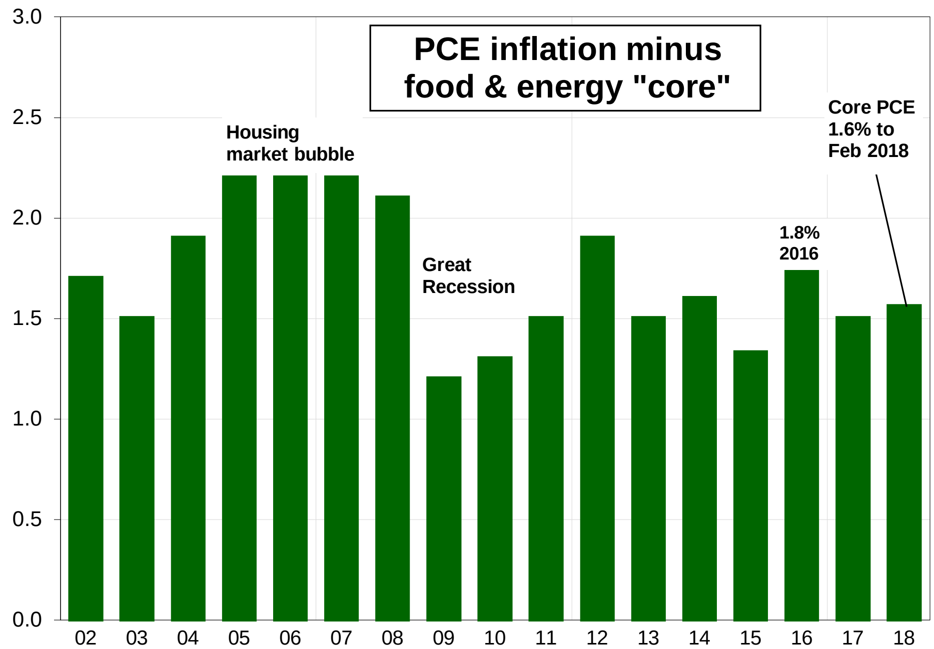
Eurodollar futures like Powell & Crew also say they can’t see that far into the future



What is the market saying? You can take the forward curve for where 3-month Libor “money market” yields will be in the future, we mean to say the March 2023 Eurodollar future yield where it is possible to bet (prudently, with permission of your risk management and compliance departments) on where 3-month Libor, now at 2.36% on Friday, April 20, where 3-month Libor will be when the March 2023 Eurodollar futures expire on March 13, 2023… all this assuming there is a Libor then. There will have to be some kind of 3-month yield that trades at a basis point spread off of the Fed funds rate in the future though. Just don’t mention 3-month Treasury bill yields. Been there. Done that. Anyway, March 2023 Eu rollar futures closed at 3.10% on Friday, April 20. So that’s 3-month Libor of 2.36% today or 3.10% in March 2023. The point is that the futures used to see higher rates ahead than they do now which may mean something for how high interest rates go in this cycle. 10-yr Treasury yields rebounded to 3.84% at the end of 2009 and Eurodollar futures said 3-month Libor would be over 5% five years later. 10-yr Treasury yields were 3.03% at the end of 2013 and Eurodollar futures looked for the Fed to move rates higher to 4.11%. Now futures see just 3.1% five years down the road. Same as 10-yr Treasury yields today more or less.

Future expectations of short-term yields controlled by the Fed are not so high. The Fed funds rate is still just 1.75% and won’t be 3% according to the schedule for another 20 months at the end of 2019. Putting the shoe on the other foot, higher 10-yr yields could help move expectations of how high Powell needs to push rates.

More inflation and more supply of bonds hitting the market are two major factors that can push 10-yr Treasury yields higher. Core PCE inflation may move up three-tenths to 1.9% on Monday, April 30, but there is little indication that core PCE inflation will move much higher than 2.2%. Core inflation never moved above 2.2% on a sustained basis during the mid-2000s and the Fed has now viewed that period as a policy mistake, they moved interest rates to 5.25% which was too high, and too fast at 200 bps per year. They won't move too high, too fast against inflation again.



When it comes to more supply, the Treasury auction schedule borrowed more the last two quarters, but mostly in short-term debt, Treasury bills, which is one of the reasons offered for the big jump in 3-month Libor yields. Shifting to greater supply of bonds and notes could change market psychology and lead to higher yields. The auction schedule right now is nothing like it was during the Obama years of trillion dollar Federal budget deficits. How much is coming, and don't ask will China buy their share: CBO's estimate of the Federal budget deficit for the year starting October 1 is $981 billion and add to this the $360 billion wind down of the Fed's balance sheet of Treasury holdings. Treasury holdings have unwound, if that's the word, by just $52 billion since the unwind was announced in grand style at the September 2017 Fed meeting.

Monthly Treasury Coupon Auction Amounts ($ bln)								Total per
Month	Total	2-yrs	3-yrs	5-yrs	7-yrs	10-yrs	30-yrs	quarter
Mar 18	156	30	28	35	29	21	13	458
Feb 18	158	28	26	35	29	24	16	
Jan 18	144	26	24	34	28	20	12	
Dec 17	144	26	24	34	28	20	12	438
Nov 17	150	26	24	34	28	23	15	
Oct 17	144	26	24	34	28	20	12	
Mar 10	192	44	40	42	32	21	13	583
Feb 10	199	44	40	42	32	25	16	
Jan 10	192	44	40	42	32	21	13	
Dec 09	192	44	40	42	32	21	13	578
Nov 09	199	44	40	42	32	25	16	
Oct 09	187	44	39	41	31	20	12	
Sep 09	182	43	38	40	29	20	12	540
Aug 09	184	42	37	39	28	23	15	
Jul 09	174	42	35	39	28	19	11	
Jun 09	169	40	35	37	27	19	11	495
May 09	172	40	35	35	26	22	14	
Apr 09	154	40	35	35	26	18	--	
Mar 09	161	40	34	34	24	18	11	438

To conclude, we will stick with the 3.5% 10-yr Treasury target at the end of 2019 for now. It could get there to 3.5% sooner than the Fed does. There are some soft factors that could scare bond yields higher in the near term, but yields could always fall back and bonds rally again before the end of 2019. In the mean time, traders are betting on a yield rally. Stand back. Let's see how high 10-yr yields get the next couple of weeks.

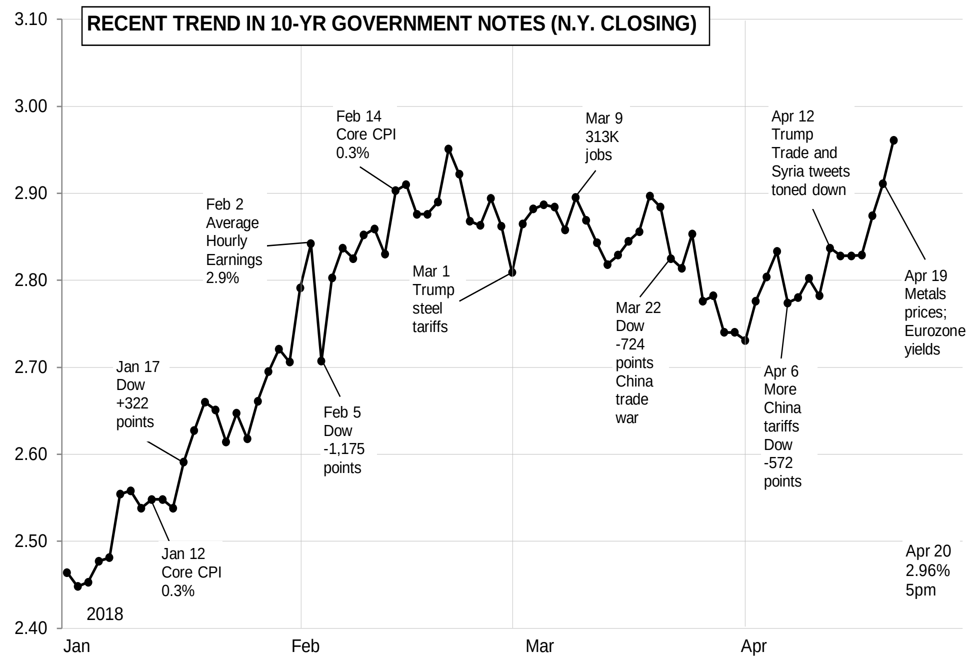
Soft Factors for Higher Bond Yields

** Commodities prices higher, namely crude oil
** Eurozone yields, first ECB rate hike is?
** Bank of England, don't ask

MARKETS OUTLOOK

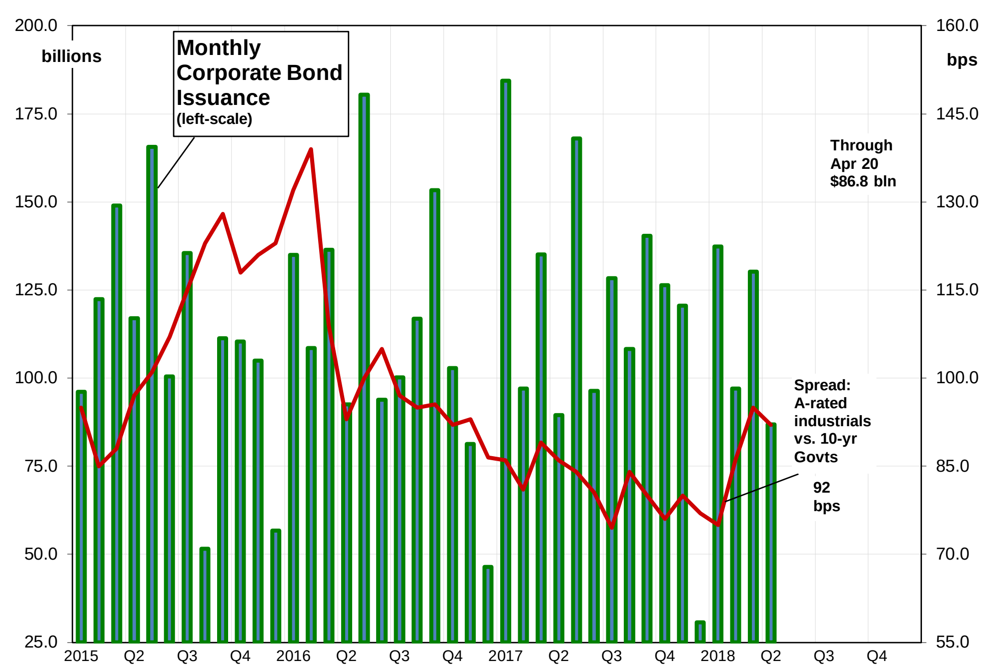
	29-Mar 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.97	3.10	3.10	3.20	3.35	3.45	3.60	3.55	3.75	3.75	3.90	4.00
10-Yr Note	2.74	2.80	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.70	3.90	4.00
5-Yr Note	2.56	2.60	2.70	2.80	3.05	3.15	3.40	3.45	3.65	3.65	3.90	4.00
2-Yr Note	2.27	2.40	2.55	2.80	3.00	3.15	3.40	3.40	3.60	3.80	4.00	4.20
3-month Libor	2.31	2.30	2.55	2.80	3.05	3.30	3.55	3.55	3.70	3.95	3.95	4.20
Fed Funds Rate	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75	3.75	4.00
2s/10s spread	47	40	35	20	20	15	10	10	10	(10)	(10)	(20)

The 10-yr Treasury yield closed at 2.96% this week, 13 bps higher than the week before. Thursday was the defining day with Treasury yields rising along with metals prices (winter, we mean, inflation is coming) and yields were up sharply in Europe: Spain, Italy, and France, Germany too. The tone of the market has changed dramatically to the bearish side in April, with higher yields expected by all.



CORPORATES: MOSTLY FINANCIALS THIS WEEK, CARGILL, DELTA AIRLINES

Corporate offerings were $48.9 billion in the April 20 week versus $12.0 billion in the April 13 week. On Monday, Delta Airlines sold $1.6 billion 3s/5s/10s. It priced a $500 million 4.375% 10-yr (m-w +25bp) at 155 bps (Baa3/BB+). The airline will use the proceeds to repay borrowings outstanding in two term loan facilities. Corporate bonds (10-yr Industrials rated A2) were 92 bps above 10-yr Treasuries this week versus 92 bps last Friday.



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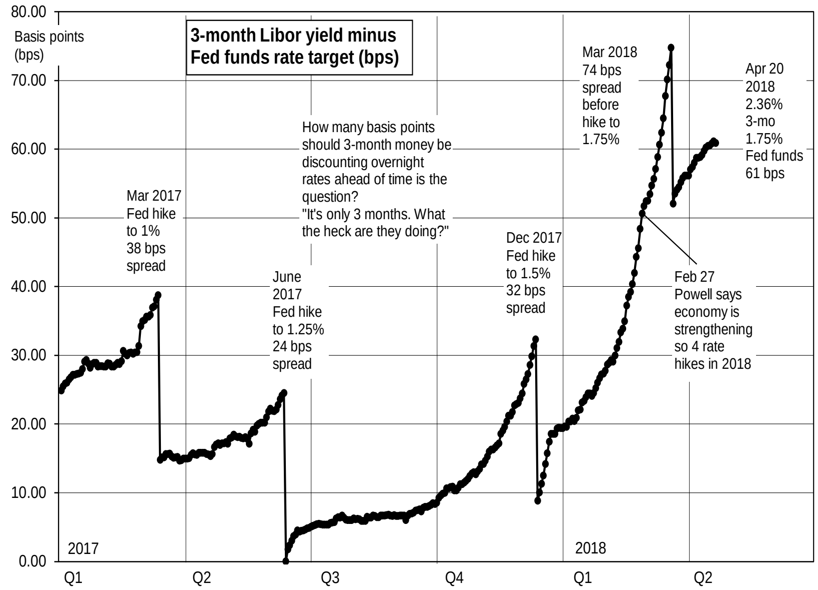
FEDERAL RESERVE POLICY

The Fed meets May 1-2 to consider its monetary policy. There is no press conference and no chance of anything happening. Two more rate hikes this year according to the median Fed forecast (7 of 15 say 3 more hikes this year), which meetings will they choose, June, September, or December? For the June 12-13 meeting, the rate hike odds are 90%. Three-month Libor is 2.36%, 61 bps above the 1.75% Fed funds rate, and already discounting a 25 bps Fed rate hike on June 13.

Selected Fed assets and liabilities Fed H.4.1 statistical release billions, Wednesday data	18-Apr	11-Apr	4-Apr	28-Mar	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2413.079	2413.060	2413.031	2424.883	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1756.290	1754.369	1754.368	1754.368	0.000
Primary credit (Discount Window)	0.000	0.000	0.002	0.002	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	1.710	1.709	1.709	1.709	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	0.000
Central bank liquidity swaps	0.082	0.079	5.011	0.079	62.000
Federal Reserve Assets	4433.3	4431.2	4433.4	4439.3	961.7
3-month Libor %	2.36	2.34	2.32	2.30	2.82
Factors draining reserves					
Currency in circulation	1642.295	1640.817	1640.597	1636.934	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	14.021	2.361	4.570	17.898	0.000
Reserve Balances (Net Liquidity)	2067.159	2128.844	2098.731	2119.605	24.964
Treasuries within 15 days	34.346	0.229	0.229	31.201	14.955
Treasuries 16 to 90 days	86.282	119.506	119.506	89.281	31.549
Treasuries 91 days to 1 year	289.430	290.370	290.367	298.438	69.272
Treasuries over 1-yr to 5 years	1079.919	1080.029	1080.010	1081.513	170.807
Treasuries over 5-yrs to 10 years	308.229	296.322	296.395	298.012	91.863
Treasuries over 10-years	614.872	626.605	626.525	626.439	101.337

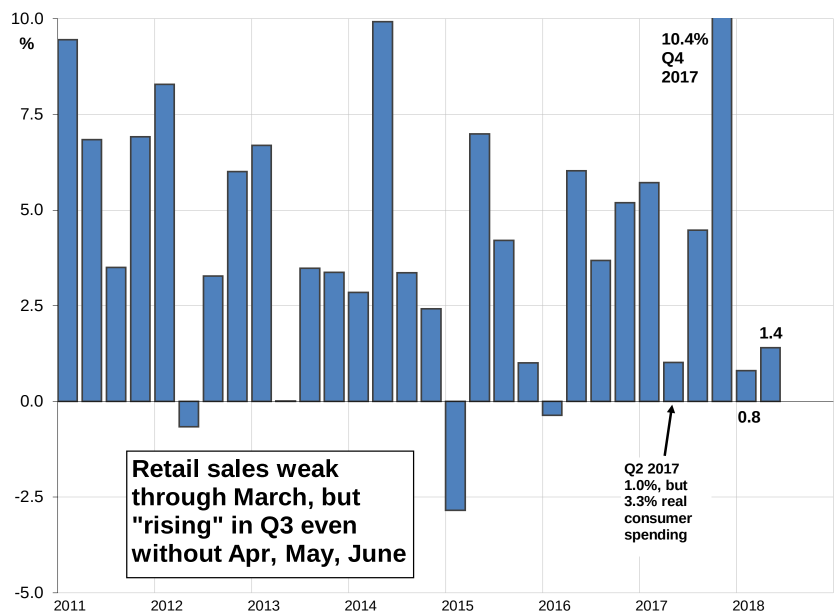
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08



OTHER ECONOMIC NEWS THIS WEEK

It's springtime and time for the consumer to buy a brand spanking new car (Monday)

Breaking economy news. Retail sales for March. Retail sales finally increased for the first time this year after falling for three consecutive months. March retail sales rose 0.6% after 0.1% monthly declines in December, January, and February. The old rule of thumb was that three consecutive monthly declines in retail sales signaled a recession, but fourth quarter retail sales were enormous as consumers spent their tax cuts early perhaps. Q4 2017 retail sales jumped 10.4%, and now spending has slowed to 0.8% in Q1 2018. First quarter real GDP estimates for output rising more than 2.5% are on life support as consumers pull back their support for more growth. Q1 2018 real GDP is due out Friday, April 27.



Most of the weakness seen had been in auto and light truck sales. Non-auto sales have risen every month in the first quarter. Today's 0.6% retail sales increase in March was mostly driven by a rebound in car & light truck sales. We already had the data in hand showing car & light truck sales rebounded to 17.4 million in March from 17.0 million in February at annual rates.

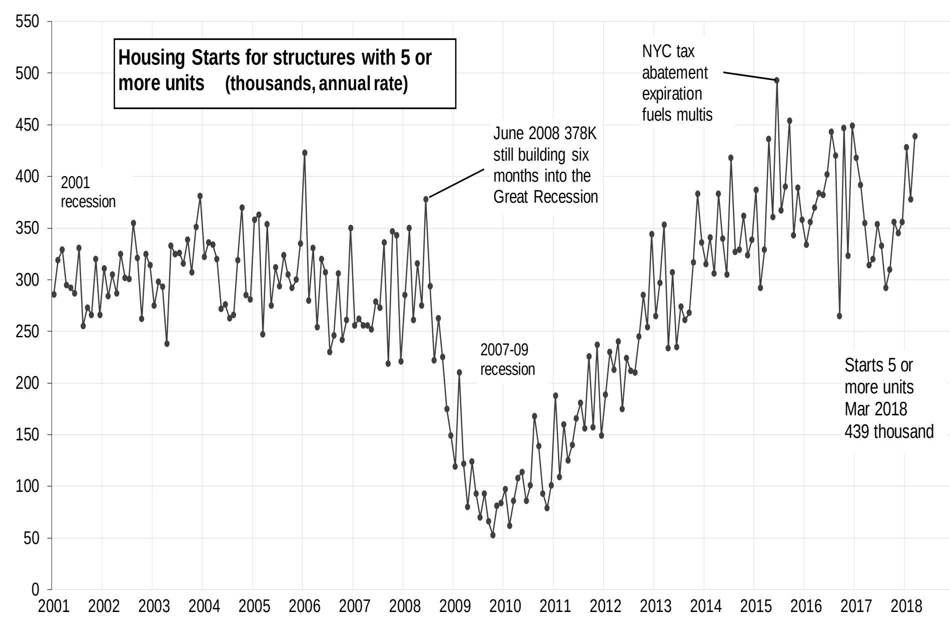
Over the last year, most of the consumer's wallet has gone to higher gasoline prices. Spending at gas stations rose 10.4%. The second biggest increase was seen in Internet sales from your sofa (or while driving your car) using your smart phone which rose 7.6% the last year. Amazon and friends have not taken over yet however as non-store retailers account for just over 11 percent of total retail sales.

Net, net, consumers are doing their part to drive the economy forward as they restart their engines from a cold and snowy winter. Fed officials were looking past this slowdown in retail sales and they were right. Retail sales bounced back in March after a three month hiatus as consumers remain confident and their pockets stuffed with cash from those massive tax cuts. Tax withholding tables were adjusted in mid-January for most workers and this freed up some extra cash that should have been evident for consumers by the end of January.

The trade war and battered stock market may yet cause the consumer to temper their consumption expenditures, but for the moment, the sun is out and shining, so consumers are dancing their savings away. The economy has not gone off the rails yet, and Fed officials can continue to march interest rates up at a gradual pace with the next rate hike expected at their meeting in June.

If you are renting an apartment, this month's starts number is for you (Tuesday)

Breaking economy news. Housing starts rise 1.9% in March to 1.319 million in March. This is the third best monthly reading on home construction in this long recovery for housing since the bubble burst over a decade ago. Residential housing construction will be adding to GDP in the first quarter and the economy plainly needs the growth as consumers went AWOL in the first quarter barely leaving their homes to shop.



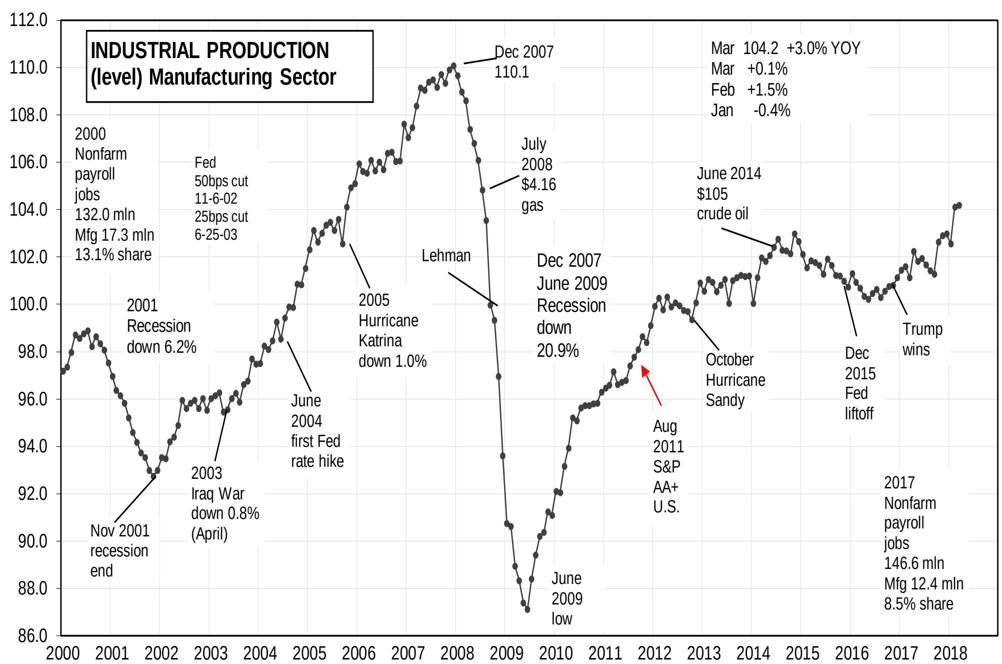
Net, net, the improvement in housing starts will put a little spring in the economy's step at the end of the first quarter. The economy can thank its lucky stars or maybe thank the Millennials weighed down by student loans who are forcing a seismic shift on housing preferences in the US. With home prices sky-high it is better to rent than to buy and homebuilders know it. Housing starts of 5 or more units soared by 16.1% in March to 439 thousand as builders armed with new tax incentives clearly believe in the old adage that if they build it, they will come.

More sobering however in today's data was the 3.7% drop in single-family home construction to 867 thousand in March. One of the reasons that there is a new housing bubble in home prices is the lack of supply on the market, and homebuilders are not doing enough to put new supply out there. We don't know whether the rise in mortgage rates as the Fed continues to raise interest rates has injected some new caution into the markets or what, but builders may have the sense that the cycle is closer to the end than the beginning perhaps as the era of free money comes to an end. Housing is becoming more unaffordable as prices continue to rise and financing costs move ever higher and this has made single-family home builders more cautious perhaps. One thing is for certain, home prices are still going higher so if you are on the sidelines, you better buy a new home while you can still afford it. Stay tuned. Story developing.

Manufacturing is growing at the 3% pace that Trump is looking for (Tuesday)

Breaking economy news. SF/NY Fed President Williams in headlined remarks is saying he expects the economy to continue to improve. That's a relief, for a moment there we had some doubts.

Let's try again. Breaking economy news. Industrial production rose 0.5% in March after rising 1.0% in February and output is running strong with a year-on-year gain of 4.3%. Companies look newly emboldened by the historic cut in corporate tax rates as every sector is going up. Year-on-year changes: consumer goods 3.6%, business equipment 4.4%, construction 3.3%, materials 5.5%. GDP is languishing in the first quarter, but another measure of output is industrial production and it is going gangbusters, showing greater optimism fueled with tax cuts money from Congress apparently.



Net, net, industrial output continues to strengthen with no caution seen yet from the heated trade war rhetoric. Manufacturers are very sensitive to the demand for their goods from America's overseas trading partners, and so far, companies are not seeing any material pullback in their operations. The factory lights are all on and shining bright at the start of the year and this makes us confident in our 2018 economic outlook. Manufacturing production rose 0.1% in March and the February gain was revised upward to 1.5%, so there was no pullback. Manufacturing production is rising 3.0% the last year so at least one sector of the economy is hitting the Trump administration's benchmark for success. We are winning. What could be better than that.

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