Financial Markets This Week

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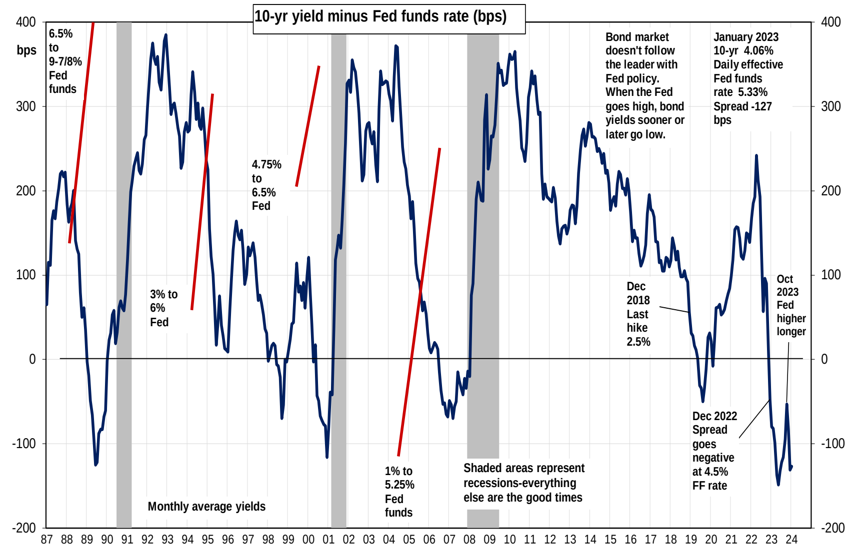
BOND YIELDS PATIENT

Bond yields are at 4%, patiently waiting on the Fed to cut rates later this year. The economy is stronger than Fed officials had predicted, but inflation is coming down anyway despite the labor market not rebalancing. A 4% 10-yr Treasury yield will eventually be in the same place anyway if the Fed pushes its policy rate to 3% after the yield curve re-rights itself to a normal positive slope.

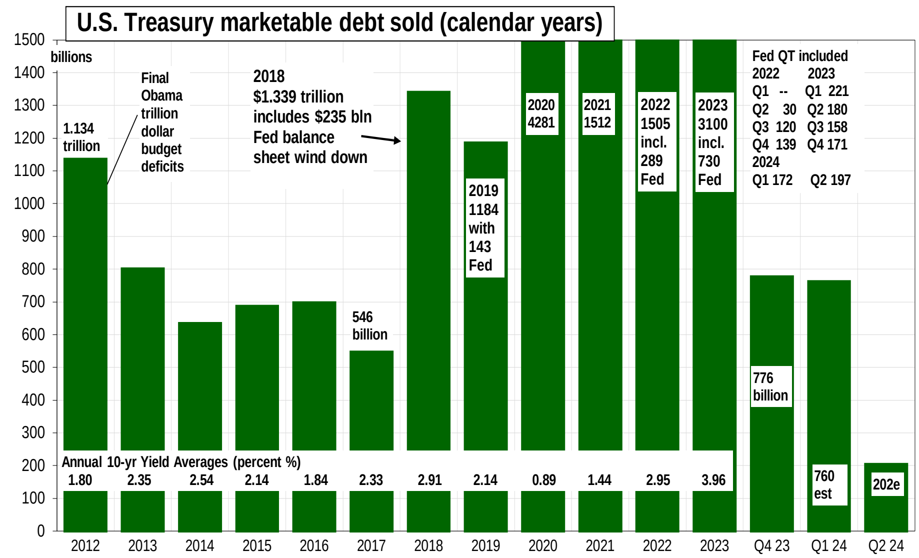


It is a risky world out there over the next decade, and 10-yr yields should be above the Fed's overnight policy rate at some point to reflect that. 4% Treasury minus 3% Fed funds spread of 100 bps might be conservative. The spread did move significantly negative in 2023, but stopped inverting around the time of the final Fed rate hike to 5.5% at the end of July, where the so-called daily effective Fed funds rate here is 5.33%. 10-year yields moved up after the Fed's higher for longer forecast at the September 2023 meeting briefly. In June 2023, the Fed said rates would be 4.75% at the end of 2024, September said, no, rates would only be 5.25% in 2024, and now the December 2023 forecasts are back to 4.75% at the end of 2024. 10-yr yields are probably stuck here around 4% unless there is a recession or some reason for the Fed to push rates back to zero again like they did in the 2020 pandemic.

2023-24 Treasury auction amounts (notes/bonds)								
$ bln	Total	2-yr	5-yr	7-yr	3-yr	10-yr	30-yr	20-yr
Jul	222	42	43	35	40	32	18	12
Aug	246	45	46	36	42	38	23	16
Sep	246	48	49	37	44	35	20	13
Oct	255	51	52	38	46	35	20	13
Nov	276	54	55	39	48	40	24	16
Dec	276	57	58	40	50	37	21	13
Jan		60	61	40	52	37	21	13
Feb					54	42	25	
2,5,7,20 years settle last day of month; 3,10,30 on the 15th								

Supply concerns, bigger Treasury securities auctions, helped push up 10-year yields initially during the August 2023 quarterly refunding announcements, the terms and the quarterly borrowing requirement. Neither the 10-yr note auction on Wednesday this week nor the 30-yr bond auction on Thursday was received that well in the minutes after the auction results were announced around 1pm ET. But supply does not seem to be rejected by investors at current yield levels despite the growing chorus of concern by many that the national debt is too high and Congress is doing nothing to address it. The 10-yr auction amounts at the quarterly refundings are manageable even as they have been moving up: $35 billion May

2023, $38 billion August 2023, $40 billion November 2023, and $42 billion on Wednesday. Keep in mind it is a refunding and not all new cash as the amounts of notes and bonds offerings keep moving up. The February 2024 quarterly refunding this week was $121 billion 3s,10s, 30s, but there is $105.1 billion of securities maturing to buy the new stuff potentially, so the new cash is just $15.9 billion. Kind of like the national debt, subtract out foreign holdings and social security nonmarketable funny money debt, and there is no national debt, or less of it anyway. One of the reasons why the Treasury refunding announcement was better received this month was they don't anticipate raising coupon auction amounts for "at least the next several quarters." After they get done with the bump they announced last Wednesday that is where the 10-yr auctions will increase by another $2 billion.



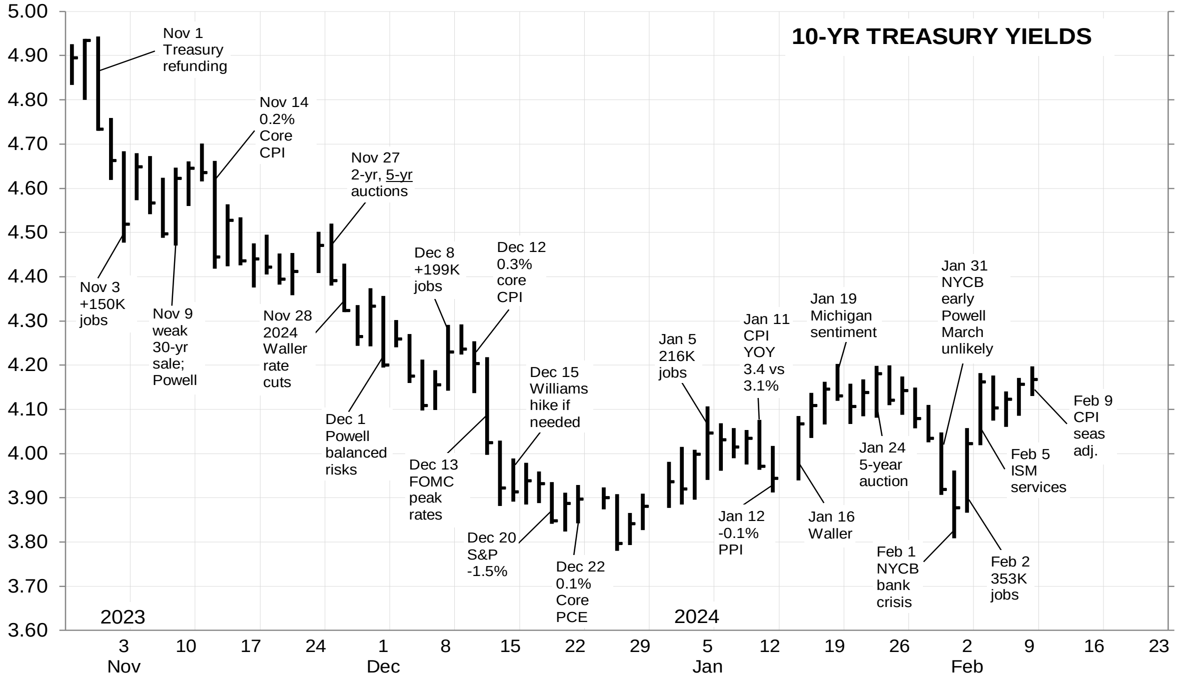
The market also liked the announcement of the quarterly borrowing requirement on Monday, January 29 at 3pm ET. Calendar year 2023 borrowing was an astounding $3.1 trillion which includes the Fed's $730 billion QT wind down, but somehow the market found comfort that Q1 2024 borrowing was revised down to $760 billion from the prior $816 billion estimate, and Q2 2024 is just $202 billion because of the April income tax payments.

We want to bring back inflation into bond yield valuation. Could low inflation bring 10-year yields down? 10-year yields were 3.96% on average in 2023, 144 bps below the 5.4% core CPI inflation rate. Core CPI year-year was 3.9% in December matching Treasuries, but core CPI was 0.3% in the months of November and December, so inflation won't be coming down much further without some more 0.2% monthly changes ahead. There were four 0.2% monthly core CPI changes in 2023. Powell did not sound confident about inflation going lower when he mentioned a lot of the favorable inflation readings have been due to declining goods prices that may not continue that long into the future. The Fed does target PCE inflation and core PCE inflation is lower of course as shelter prices have a bigger weight in core CPI than core PCE. Our guess is that 4% 10-year yields will continue to stick around, both due to supply concerns and normalization of the yield curve, where bond yields won't follow the Fed funds rate down to the Fed's 2026 3% forecast.

%	Core CPI	Core PCE	Diff
2002	2.4	1.7	0.7
2003	1.4	1.6	-0.2
2004	1.8	2.0	-0.2
2005	2.2	2.2	0.0
2006	2.5	2.4	0.1
2007	2.3	2.2	0.1
2008	2.3	2.0	0.3
2009	1.7	0.9	0.8
2010	1.0	1.4	-0.4
2011	1.7	1.6	0.1
2012	2.1	1.9	0.2
2013	1.8	1.5	0.3
2014	1.7	1.5	0.2
2015	1.8	1.2	0.6
2016	2.2	1.6	0.6
2017	1.8	1.6	0.2
2018	2.1	1.9	0.2
2019	2.2	1.6	0.6
2020	1.7	1.3	0.4
2021	3.6	3.6	0.0
2022	6.2	5.2	1.0
2023	5.4	4.1	1.3
2023-to December			

	10-yr Treasury Yield	Core CPI	Real Yield bps
2002	4.61	2.4	221
2003	4.01	1.4	261
2004	4.27	1.8	247
2005	4.29	2.2	209
2006	4.80	2.5	230
2007	4.63	2.3	233
2008	3.66	2.3	136
2009	3.26	1.7	156
2010	3.22	1.0	222
2011	2.78	1.7	108
2012	1.80	2.1	-30
2013	2.35	1.8	55
2014	2.54	1.7	84
2015	2.14	1.8	34
2016	1.84	2.2	-36
2017	2.33	1.8	53
2018	2.91	2.1	81
2019	2.14	2.2	-6
2020	0.89	1.7	-81
2021	1.44	3.6	-216
2022	2.95	6.2	-325
2023	3.96	5.4	-144
2023-to December			

INTEREST RATES

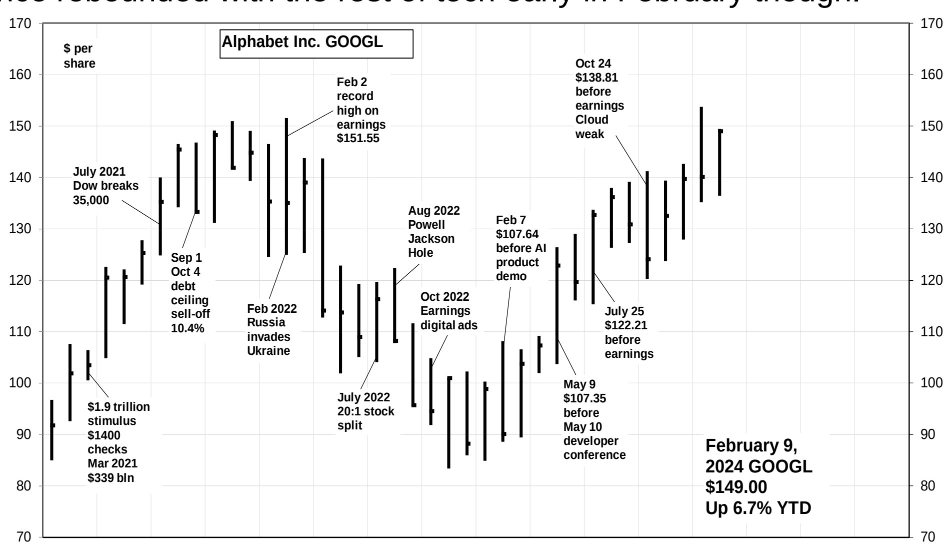


Bond yields moved up sharply on Monday, Fed voices on no need to hurry are there, “dealers set up for the quarterly refunding auctions on Mondays,” but the yield high was made on the increase in ISM services at 10am ET. Services are not all that strong, but the number beat market expectations. On Friday, yields fell to the 4.13% low when the core CPI seasonal factors did not change much. But by the end of the session, yields were threatening to break above 4.20% which is the latest line in the sand. Stocks apparently thought CPI seasonal factors might be big news and it looks like it held off a move in the S&P 500 on Thursday, but the green light came out, and the S&P 500 did indeed make a new record high close Friday of 5,026.61 up 5.4% YTD. Focus is on CPI due out Tuesday, February 13 but whatever the number, core PCE inflation has been much lower recently, i.e. the Fed’s target.

Alphabet, Inc. (GOOGL) up 6.7% YTD

The stock fell 7.5% the next day from $151.46 after earnings on January 30. The company keeps getting compared unfavorably with Microsoft reports, but in this case, the problem seemed to be that it missed on advertising. Advertising was weaker Q4 2022, and now Q4 2023 is $65.5 billion, 11.0% above the prior year. Stock has since rebounded with the rest of tech early in February though.

Calendar Year Mln $	Revenue	Advertising	Cloud	Operating Income
Q4 2023	86,310	65,517	9,192	23,697
Q3 2023	76,693	59,647	8,411	21,343
Q2 2023	74,604	58,143	8,031	21,838
Q1 2023	69,787	54,548	7,454	17,415
Q4 2022	76,048	59,042	7,315	18,160
Q3 2022	69,092	54,482	6,868	17,135
Q2 2022	69,685	56,288	6,276	19,453
Q1 2022	68,011	54,661	5,821	20,094
Q4 2021	75,325	61,239	5,541	21,885

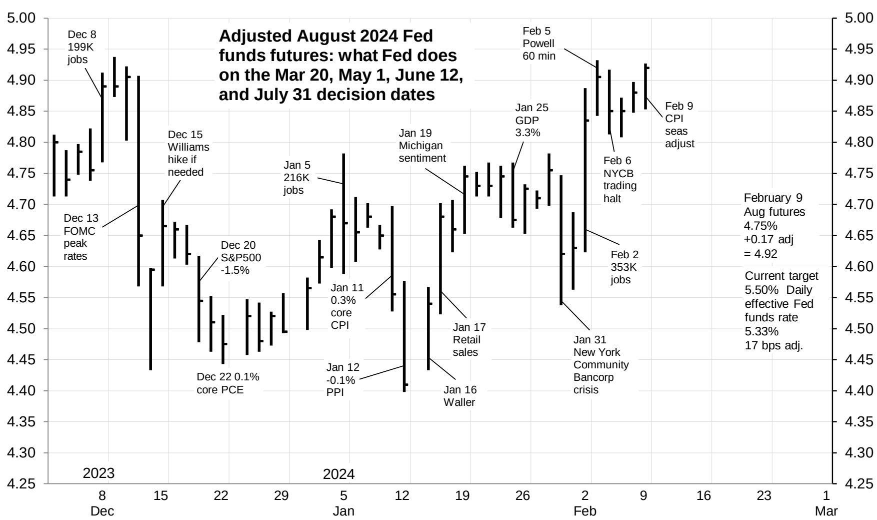


FEDERAL RESERVE POLICY

The Fed meets March 19-20, 2024 to consider its monetary policy. There will be an update to their forecasts, where the December meeting forecasts argue persuasively for equal 25 bps cuts this year in June, September, December. [Minneapolis Fed President Kashkari] kicked the week off on Monday with the theme of no need to hurry on rate cuts this year. That was after [Powell made a TV] appearance on Sunday night on the Grammys, rather he was on 60 minutes during the Grammys. This was Sunday after he gave his press conference following the meeting on Wednesday, January 31, so the remarks were similar and March is ruled out for a rate cut. April Fed funds futures got the message and settled on Friday at an adjusted 5.455% or discounting just 4.5 bps of a 25 bps rate cut on March 20. They gave up the hope for a March rate cut after the 353K payroll jobs report on February 2.

Selected Fed assets and liabilities						Change
Fed H.4.1 statistical release						from
billions, Wednesday data	7-Feb	31-Jan	24-Jan	17-Jan	3/11/20*	3/11/20
Factors adding reserves						to Feb 7
U.S. Treasury securities	4692.608	4692.721	4722.302	4724.025	2523.031	2169.577
Federal agency debt securities	2.347	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	2417.156	2417.156	2428.644	2431.710	1371.846	1045.310
Repurchase agreements	0.000	0.000	0.000	0.000	242.375	-242.375
Primary credit (Discount Window)	2.334	3.189	2.785	2.295	0.011	2.323
Bank Term Funding Program	164.869	165.238	167.768	161.501		
FDIC Loans to banks via Fed	0.000	0.000	0.000	0.000		
Paycheck Protection Facility	3.298	3.320	3.338	3.364		
Main Street Lending Program	15.103	15.083	15.394	15.375		
Municipal Liquidity Facility	0.001	0.001	0.001	0.214		
Term Asset-Backed Facility (TALF II)	0.000	0.000	0.000	0.046		
Central bank liquidity swaps	0.230	0.219	0.224	0.216	0.058	0.172
Federal Reserve Total Assets	7682.1	7680.2	7728.0	7724.6	4360.0	3322.070
~~3-month Libor %~~ SOFR %	5.31	5.32	5.31	5.32	1.15	4.160
Factors draining reserves						
Currency in circulation	2327.380	2326.951	2329.477	2335.971	1818.957	508.423
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000	0.000
U.S. Treasury Account at Fed	821.575	865.481	815.159	773.544	372.337	449.238
Treasury credit facilities contribution	7.438	7.438	7.438	7.438		
Reverse repurchases w/others	553.055	615.379	639.560	590.191	1.325	551.730
Federal Reserve Liabilities	4126.358	4268.525	4238.298	4132.281	2580.036	1546.322
Reserve Balances (Net Liquidity)	3555.738	3411.717	3489.709	3592.326	1779.990	1775.748
Treasuries within 15 days	82.267	83.218	69.991	67.690	21.427	60.840
Treasuries 16 to 90 days	230.601	229.458	250.636	250.063	221.961	8.640
Treasuries 91 days to 1 year	552.753	530.721	552.163	556.572	378.403	174.350
Treasuries over 1-yr to 5 years	1580.352	1602.637	1594.803	1594.890	915.101	665.251
Treasuries over 5-yrs to 10 years	741.769	741.790	749.752	749.792	327.906	413.863
Treasuries over 10-years	1504.865	1504.897	1504.956	1505.016	658.232	846.633
Note: QT starts June 1, 2022	Change	2/7/2024	6/1/2022			
U.S. Treasury securities	-1078.171	4692.608	5770.779			
Mortgage-backed securities (MBS)	-290.290	2417.156	2707.446			
**March 11, 2020 start of coronavirus lockdown of country						

Kashkari thinks differently (didn't he run for Governor of California?) and he focuses more on 10-yr Treasury yields than the Fed funds rate, and likes to try to get at a real longer term market yield, favoring Treasury 10-year TIPS (that no one trades, Treasury Inflation Protected Securities)… basically, because 10-yr yields have dropped, they were as high as 5.02% on October 23 and Friday's close was 4.17%, monetary policy (the 5.5% Fed funds rate) is not too tight and in no danger of slowing the economy precipitously. So the Fed can proceed slowly. Fine with us. Again, don't lower the Fed funds rate below the "neutral" 4.25% rate the Fed thought neutral was in its first January 2012 interest rate forecast.



August Fed funds futures adjusted are 4.92% and if the Fed does go in June, September, December, it should be 5.25%. Still hoping for the moon.

Fed funds futures call Fed hikes	
Current target: February 9 -- 5.50%	
Rate+0.17 Contract	Fed decision dates
5.455 Apr 2024	Mar 20
4.915 Aug 2024	May 1, Jun 12, Jul 31
Last trade, not settlement price	

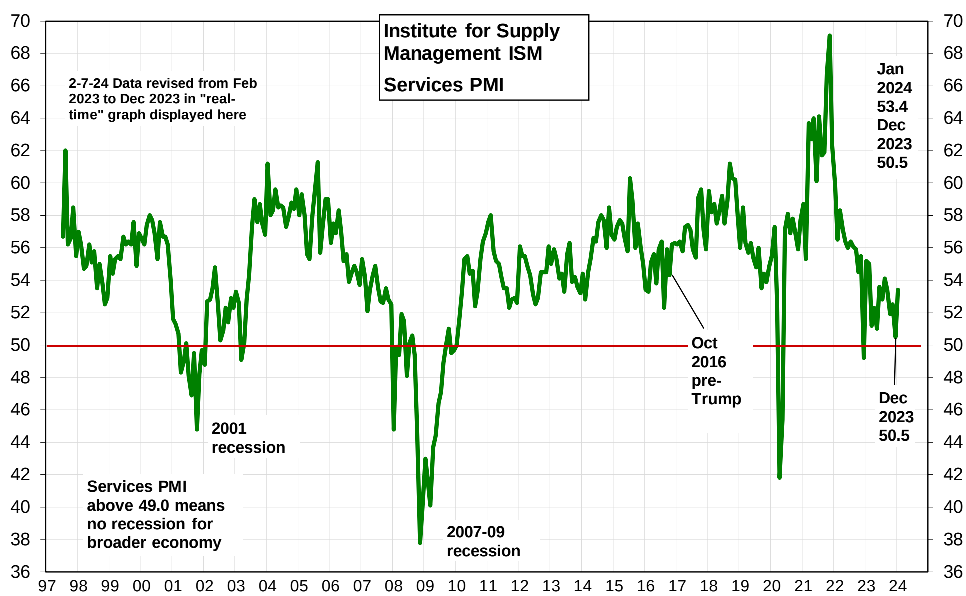
Next up: January CPI inflation report Tuesday, February 13															
Monthly	2023											2023	2022		
% Changes	Dec	Nov	Oct	Sep	Aug	Jul	Jun	May	Apr	Mar	Feb	Jan	Dec	Nov	Oct
Core CPI inflation	0.3	0.3	0.2	0.3	0.2	0.2	0.2	0.4	0.5	0.3	0.5	0.4	0.4	0.3	0.4
Core PCE inflation	0.2	0.1	0.1	0.3	0.1	0.1	0.2	0.3	0.3	0.3	0.4	0.5	0.4	0.3	0.3
Core PCE YOY	2.9	3.2	3.4	3.6	3.7	4.2	4.3	4.7	4.8	4.8	4.8	4.9	4.9	5.1	5.3
Core CPI YOY	3.9	4.0	4.0	4.1	4.3	4.7	4.8	5.3	5.5	5.6	5.5	5.6	5.7	6.0	6.3

OTHER ECONOMIC NEWS

ISM services (Monday)

Breaking economy news. ISM services index moved the market as it beat market expectations. Services PMI was 53.4 in January from 50.5 in December. In the last twelve months the high was 53.6 in June 2023, so it isn't going much of anywhere.

The services industry is seeing renewed signs of life thanks to resilient American consumers that continue to lead the way. It looks like an early spring for the economy this year that is still expanding despite the Federal Reserve's monetary restraint. The Fed may have gotten it wrong on so-called neutral rates because a 5.5% Fed funds rate is not slowing activity down. The upswing in orders and employment were exceptional. Stronger services activity in the economy comes with a caveat in that price pressures are reemerging here and there after being relatively dormant. Inflation isn't nailed down yet. The only deflation is in copper, gloves, soybeans, diesel fuel and gasoline. Some Fed officials don't want to completely rule out a rate cut at the March meeting, but mounting price increases reported by the services sector indicate the Fed cannot relax its guard quite yet. Bet on rate cuts if you must starting this summer, but an earlier March rate cut looks completely out of the question.



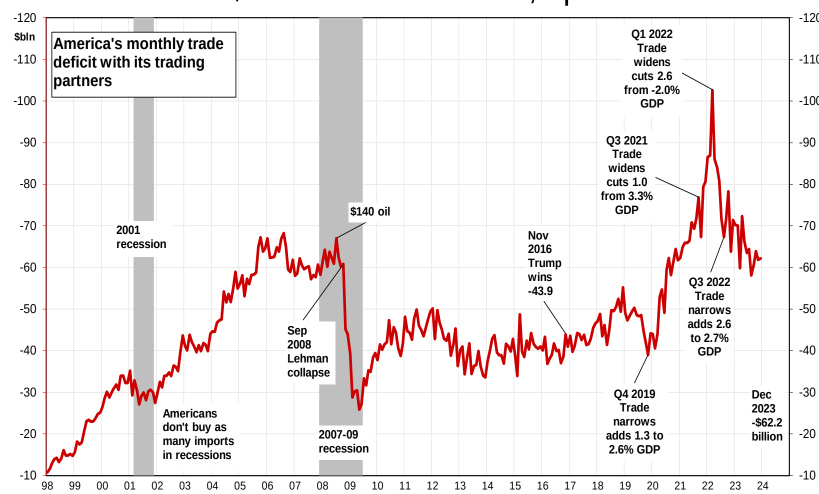
Trade deficit steadies (Wednesday)

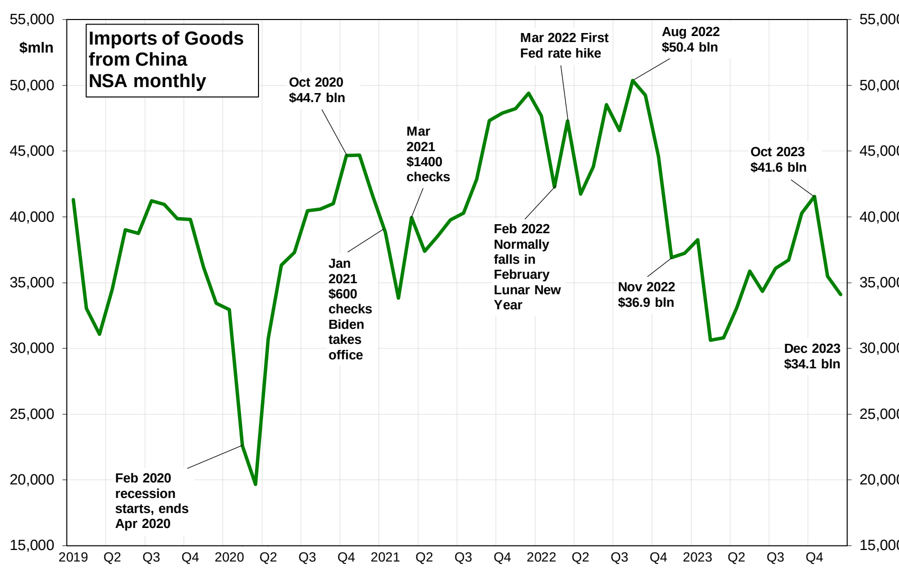
Breaking economy news. The US trade balance for December. A $62.2 billion deficit in December was little changed from $61.9 billion in November. The one-month change is modest but the full year trend is striking. The deficit fell to $773.4 billion in 2023 from $951.2 billion in 2022. Exports of goods fell 1.9% in 2023 to $2,050.7 billion so it is little wonder that export-driven US manufacturing remains down in the dumps where industrial production remains below the peak set way back in September 2022. September 2022 was the peak following the recovery from the short two-month pandemic recession. The all-time high for production was set in 2018 before the China-US trade war made for a soft patch in manufacturing activity. Speaking of trade war, US imports from China were $427.2 billion in 2023, down 20.3% from $536.3 billion in 2022; the peak was $538.5 billion in 2018. No wonder China's economy is doing poorly with exports to the US down by this amount. Exports equal jobs. US imports from Mexico were $475.6 billion in 2023, up 4.6% from 2022.

Annual Trade Pattern

$bln	Deficit	Exports	Imports	China Imports	Mexico Imports
2022	-951.2	3018.5	3969.6	536.3	454.8
2023	-773.4	3053.5	3826.9	427.2	475.6
% Chg	-18.7	1.2	-3.6	-20.3	4.6

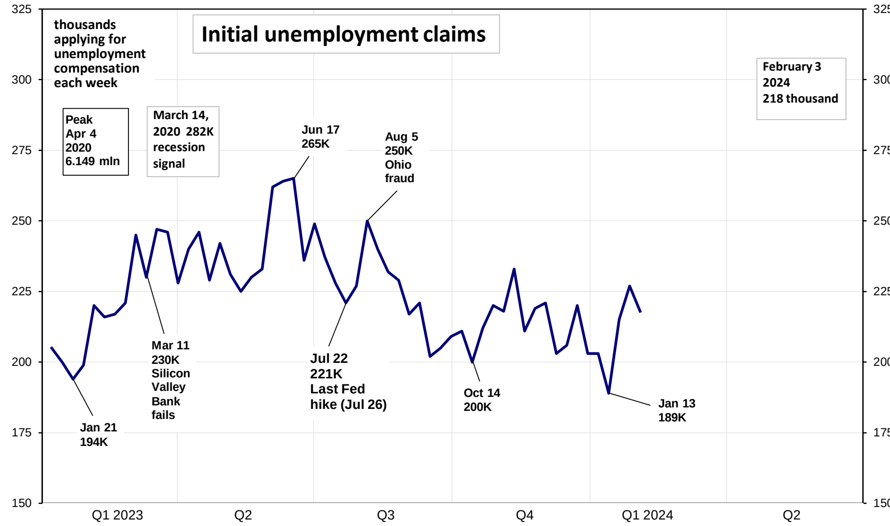
Net, net, the trade deficit has steadied in the final months of last year and shows no sign of adding or subtracting from economic growth ahead in early 2024. These data are in nominal terms and in real dollars, exports did add 0.7 percentage points to 3.3% real GDP in Q4 2023, but half of that increase was in services not goods, and only the latter would help US manufacturers. The US normally imports more goods and services from the rest of the world year after year, but 2023 was a rare time where US imports fell and so added 0.3 percentage points to 2.5% full year growth… GDP Gross "Domestic" Product meaning imports from foreigners are subtracted from growth.



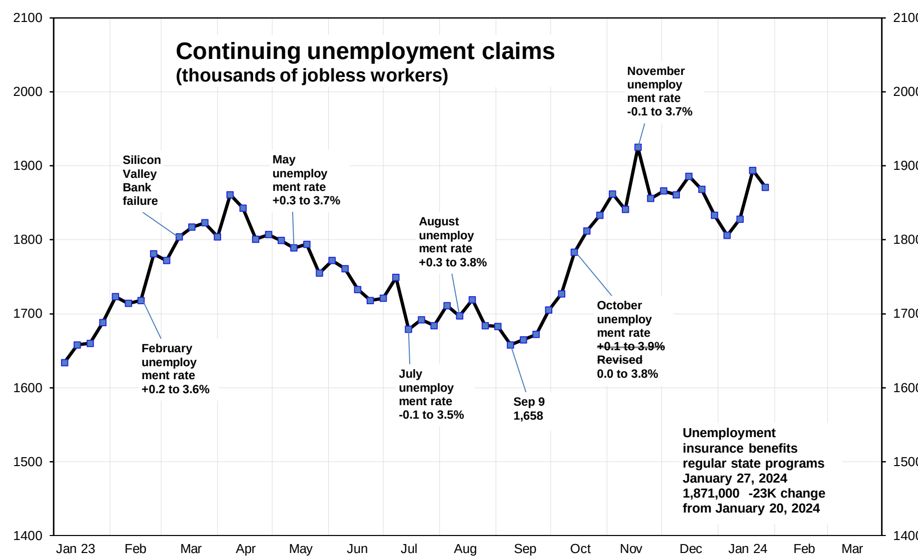


Jobless claims fall (Thursday)

Breaking economy news. First-time jobless claims fell 9K to 218K in the February 3 week. The total number of Americans receiving benefits fell back 23K to 1.871 million in the January 27 week. These so-called continuing unemployment claims are doing their normal, now you see it, now you don't, recession warning signal, as the number had jumped from 1.806 million in the January 13 week to 1.894 million in the January 20 week before falling back today. We still believe continuing unemployment claims are a good indicator of labor market deterioration and eventual recession, but there have been many false positives for this economic cycle over the last two years, ever since the first Fed rate hike in March 2022 actually.



Net, net, the labor market remains solid as a rock and this argues for Fed officials to take their time with taking down their key interest rate as monetary policy may not be as restrictive as policymakers assumed. Growth is not slowing down, layoffs are not picking up despite the highest interest rates in two decades. The central bank forecasts still believe neutral for interest rates was 2.5%, but this is now being called into question as the labor market is not rebalancing to a significant degree. The basic message from today's report is not only are there not enough job losses to point to a recession, there are no significant job losses to see at all. The belt-tightening layoffs and cost-cutting talked about in many company earnings reports is not showing up in the weekly unemployment claims statistics. If there are more jobless out there, they are not getting unemployment benefits.



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