Summary

During an abbreviated week, economic data included a decline in services sentiment, although the measure remained quite strong. Job openings improved, while jobless claims were mixed—as initial claims rose but continuing claims sustained their decline.

U.S. equity markets gained slightly last week, outperforming foreign—especially emerging markets which fell back sharply. Bonds in the U.S. and developed markets gained as interest rates continued to fall, surprisingly many investors. Commodities lost ground last week, largely led by declines in the grain complex.

Economic Notes

(0) The **ISM non-manufacturing/services index** for June fell by -3.9 points to a still-high 60.1, below consensus estimates of a lesser drop to 63.5. Underlying metrics were lackluster, with overall business activity, new orders, and supplier deliveries falling several points, but remaining in expansion. Employment, on the other hand, fell by -6 points slightly into contraction (however, this was based on weakness in real estate and education, while all other sectors rose). Prices paid ticked down by a point, but remained near 80—at historically high levels.

(0) The **JOLTs** job openings report showed an increase of 16k in May to 9.209 mil., including revisions, falling just below the 9.325 mil. expected by consensus. The job openings rate was flat at 6.0%, while the hiring rate fell by a tenth to 4.1%. The rate of layoffs fell by a tenth to 0.9%, while the quits rate fell by -0.3% to 2.5%. The primary trend seems to be a rising availability of jobs, while workers available to fill these slots could be more challenged.

(0/+) **Initial jobless claims** for the Jul. 3 ending week rose by 2k to 373k, above the decline to 350k expected by consensus. Claims increases were strongest in CA, TX, and PA. **Continuing claims** for the Jun. 26 week fell by -145k to 3.339 mil., below the 3.350 mil. expected. On the continuing claims side, results have been increasingly driven in states choosing to eliminate enhanced benefits prior to the Federal expiration in Sept. When extended benefit programs were included, the rolls continued to decrease in late June to about 8.5 mil. nationwide.

(0) The **FOMC meeting minutes** for June offered a bit more color on the decision-making process and timeline for the eventual 'taper'. The consensus seemed to be that conditions are improving faster than previously thought, which pulled the timeline into late 2021—likely December, although it appears November is also a possibility. The still-high level of uncertainty was noted, as was the recent path of inflation higher, although that remains described as 'transitory' and due to shorter-term supply disruptions and rebounding demand. It's possible that agency MBS may begin to be unwound before treasuries, with sharply higher home prices not needing the extra boost from mortgage bond buying to create lower rates.

Question of the Week

Why are U.S. treasury yields falling lately as economic conditions are recovering?

U.S. treasury rates continue to baffle investors. The 10-year yield tends to be one of the most frequently-estimated yet difficult-to-predict data points in the investment landscape. In addition to commercial lending rates, its importance is hinged on it being the general base rate for 30-year fixed residential mortgages.

Normally, interest rates tend to rise as expectations for stronger economic growth, especially if those for inflation do as well. Conversely, falling rates indicate rising fears, slower growth, and/or tempered inflation (all of which can often go together), as market expectations look to more accommodative central bank policy if an erosion in conditions continues. Other factors can be at play also, but these are the general tendencies.

For the 10-year treasury note, recent strategist expectations have called for a rise back toward 2.00% in keeping with stronger inflation numbers and 'reflating' growth. The solicitations for 'rising rate' financial products have been picking up speed as well. Instead, rates fell to 1.25% last week—the lowest point since mid-February. Often strength in bond prices (and lower yields) is coordinated with equity weakness, as investors move from 'risk on' to 'risk off' positioning. In this case, though, the equity market has remained robust. Strategists, who often like to have answers to these questions, seem to remain perplexed.

There are a few possible reasons for the rate reversal:

- Growth. The post-pandemic reflationary growth trend may be peaking. As rates and economic growth tend to go together, a flattening of future growth prospects can put a cap on rate expectations. This doesn't mean 'bad' growth, but just a quicker reversion back to normal than previously thought. Above-trend growth is still expected for 2021 and 2022, although some estimates lately have been ticking down by a few tenths of a percent.
- Inflation. As more research on the topic has been dissected, and pricing in some goods has eased, markets appear to be coming around to the thesis that recent price spikes will be 'transitory,' in keeping with the Federal Reserve's description. This is as opposed to the view that recent strong fiscal spending and long monetary accommodation would push future inflation to a sustained higher plateau not seen in since the late 1970s/early 1980s. This debate has not yet resolved, and only time will provide a clearer indication of any inflation persistence into next year and beyond. But, for now, some of the fear has abated.
- Market technicals. Treasuries continue to see strong interest from foreign buyers—due to their reputation as the world's 'risk free' asset, and as their own government sovereigns still offer minimal, zero, or even negative yields. Whenever treasury rates have risen even a bit, this foreign demand has picked up. This has been coupled with regular U.S. treasury operations, which has generated fewer bonds for sale this year. Simply, demand has overwhelmed supply, pushing prices up and yields down. The 'obvious' trade of shorting treasury bonds to take advantage of rate increases has been ineffective, so buying to cover these short positions may also be playing a role.
- Hidden bad news, aka 'the bond market knows something we don't'. Due to their conservative use in portfolios, and inherent low returns with little room for error, bond markets have often priced in bad news before equity markets do. This could be coupled with the items above, or reflect growing pessimism over further recovery. Growing attention around the Covid 'delta variant,' which has proved more contagious (even for some that are vaccinated), seems to be raising some fears about future interruptions in activity or even lockdowns once again.

What's to come? We won't speculate, as rate forecasts don't tend to be helpful. Base short-term rates remain lower than average, in fact negative on a real yield basis, in contrast to slightly positive real rates earned historically. A pricing model by credit research firm Moody's—which incorporates GDP, CPI, the fed funds rate, and Fed balance sheet size—has recently pegged the fair value of the 10-year at 1.60-1.65%. We've also seen 1.75% or so quoted as a fair value estimate. Of course, these are lower than the 2%+ rates feared (or hoped for), although conditions are subject to change quickly along with any of the above inputs.

Over time, long-term treasury yields are a function of short-term base rates, with a term spread added, which reflects expectations for inflation and growth (noted earlier). Low short-term rates naturally pull down longer-term bond rates as well, although the steepness of the curve will affect the degree of this. If inflation especially does pick up, it would be reasonable to assume rates would as well, especially if rates start to pick up globally. However, the yield premium for U.S treasuries vs. foreign governments has kept treasury demand high for years.

Estimates of real economic growth after the 2021-22 rebound are estimated to revert back to prior 'normal' levels (of around 2%). This is based on demographics/labor force growth and productivity estimates. Based on this factor alone, such tempered growth doesn't create an environment supportive of strongly higher rates. Inflation remains the wildcard. While supply shortages can be eventually resolved, an environment of fewer workers (rising labor costs) and more dependents could be somewhat inflationary, but how deeply this trickles into CPI remains under debate.

This is another reminder of why it's not a bad idea to own some traditional fixed income (even government bonds, despite perpetually low yields in recent years), regardless of what the pundits say. Despite the unappealing prospect of locking in a rate of less than 2% for 10 years, treasuries remain one of the least-correlated assets to equities and other risk assets in an asset allocation portfolio in the near-term. These can provide an important buffer if and when volatility hits.

Market Notes

Period ending 7/9/2021	1 Week (%)	YTD (%)
DJIA	0.25	15.05
S&P 500	0.42	17.24
NASDAQ	0.43	14.47
Russell 2000	-1.11	16.00
MSCI-EAFE	-0.07	9.26
MSCI-EM	-2.60	3.22
BBgBarc U.S. Aggregate	0.31	-1.18

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2020	0.09	0.13	0.36	0.93	1.65
7/2/2021	0.05	0.24	0.86	1.44	2.05
7/9/2021	0.06	0.23	0.79	1.37	1.99

U.S. stocks ended the week positively, despite some late week creeping concerns about growth slowing relative to expectations caused some downward volatility. President Biden also signed a series of executive orders designed to improve competiveness and lower prices in certain industries, including technology and pharma. This didn't appear to be taken poorly by financial markets, which seem to have adopted the consensus view that antitrust actions may be more difficult or less likely than first feared.

By sector, utilities, consumer discretionary, and technology fared best, up nearly a percent; energy was the laggard, down over -3% for the week with continued volatility in OPEC+ negotiations. Real estate gained over 2% as interest rates continued to tick downward.

The earnings season for the second quarter is beginning, with expectations of continued improvement to a year-over-year rate of 65% (per FactSet). This would represent the strongest quarter since the over-100% recovery in late 2009, and an acceleration upon the Q1 increase of 52%. By sector, it appears earnings growth will be led by energy, industrials, and consumer discretionary, with expected gains well over 200% each.

Foreign stocks were mixed in developed markets last week, with positive returns in Europe and the U.K. offsetting declines in Japan and the emerging markets—notably in Brazil, China, and South Korea. Japan announced a 'state of emergency' for the upcoming Olympics later this month, meaning it could be conducted without fans, dampening a potential growth spurt often seen in countries hosting an Olympics, and seemed to threaten sentiment a bit surrounding reopenings improving globally. The spread of the Covid 'delta variant' appears to be a concern especially in both Europe and the emerging markets, where vaccination rates are far lower. The Bank of China cut bank reserve requirements, which was seen as less of a monetary policy move, and more of a redirection of credit to smaller companies, as growth there has stalled as of late.

The ECB announced a policy similar to that of the U.S. Fed, calling for a goal of symmetric 2% inflation, which allows for a similar overshoot near-term. This is actually a bolder step than it appears. While the U.S. has experienced moderately high inflation (late 1970s), it's been nothing like the historical precedent in Europe (Germany in 1920s), which has created a hyper-vigilance about allowing rising prices. Another unique component is the specific mention and inclusion of owner-occupied housing costs in their assessment (the contribution of which would likely raise the measure).

U.S. bonds fared positively, led by strong return for long-term U.S. treasuries as interest rates declined across the yield curve, with lesser positive returns from investment-grade corporates. High yield and floating rate debt saw minor declines. Foreign bonds were mixed, with developed markets rising along with similar declines in yield, and emerging market local currency bonds falling back sharply.

Commodities generally lost ground across the board last week, despite little movement in the dollar, with small gains in metals offset by largely by weakness in the agricultural group. Corn declined -10%, with wheat and others down significantly as well, as improvement in Midwest weather forecasts moderated negative sentiment around crop shortages. The price of crude oil bounced around a bit before ending down nearly a percent to around $74.50/barrel, with no OPEC+ production announcement. Their meeting extension last week was designed to agree upon a higher level of crude production by member states, although political infighting and gaming between countries caused breakdowns, as has happened in the past. Any agreement is based on hopes that more supply would come on board to meet growing consumer demand—and temper prices a bit. Unleaded gasoline has been the unfortunate beneficiary of higher energy prices, right at the time when many are headed out on the road as pandemic restrictions lift.

Unfortunately, many of the dynamics behind the OPEC+ meetings are geopolitical in nature, a regional power struggle of sorts, rather than economic. In this last case, it's been the UAE contingent asserting independent thinking versus the traditionally dominant Saudi Arabia. Each individual nation has the incentive to produce as much as possible (to maximize their own revenues), while the incentive of OPEC+ as a whole is to find the best balance between high revenues and avoiding oversupply and/or demand destruction from too-high prices. Historically, failed OPEC+ production agreements have been a mixed blessing for oil prices, as not checking agreements that keep production at high levels can oversupply the global market, creating a glut, which can be catastrophic for prices (although not so bad for consumers).

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, Deutsche Bank, FactSet, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Moody's, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.