BUSLOAD OF FAITH: FINANCIAL MARKETPLACES
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In his song "Busload of Faith", Lou Reed chants: "you need a busload of faith to get by".

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CONCLUSION

The United States 10 year government note is a widely-watched marketplace benchmark and guide. It ended its major bull move in summer 2016, establishing a yield bottom on 7/6/16 at 1.32 percent. Although the rate for the US Treasury 10 year note has walked peacefully sideways in a fairly narrow path over the past year or so, its yield nevertheless on balance has crept upward from its 9/8/17 interim trough at just over two percent toward its critical barrier around 2.65pc. In the UST's bear move, the UST yield probably will pierce this 2.65pc target in the near term, with 1/2/14's 3.05pc elevation the next height in sight.

After establishing a major top in December 2016/January 2017 at 103.2, the broad real trade-weighted US dollar ("TWD"; Federal Reserve, H.10; monthly average) slipped 7.8 percent to 95.2 in September 2017, slightly below crucial support around 96.2 to 96.6. Despite a slight bounce for a couple of months following that September depth, the TWD has renewed its bearish assault on 96.2/96.6 and probably will break decisively beneath that floor (and September 2017's minor low) relatively soon.

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Economic phenomena and fields interrelate in various fashions. Apparent links and relationships between financial (and political) variables and trends (including convergence/divergence and lead/lag ones) of course can change, sometimes dramatically. In any case, although marketplace history is not marketplace destiny, historical analysis still can offer guidance regarding future probabilities.

The current intertwined relationship and trends of rising US Treasury yields alongside the weakening United States dollar likely is of substantial significance for financial marketplaces in general, not just US government interest rates and key currencies.

History signals that climbing US interest rate yields often precede (connect with; lead to) pinnacles in the Dow Jones Industrial Average and the S+P 500. In the current economic and political landscape, further feebleness in the broad real trade-weighted US dollar probably will warn of (or confirm) important tops in advanced nation and emerging marketplace stock marketplace benchmarks.

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See "Marketplace Vehicles: Going Mobile" (12/13/17), "History on Stage: Marketplace Scenes" (8/9/17), and other essays.

CREDIT AND CREDIBILITY

Let's highlight a few factors suggesting the probability of further yield ascents in the US government marketplace (and related interest rate playgrounds).

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Not only does the iconic Federal Reserve Board nowadays (although slowly) pursue policy "normalization" via raising the Federal Funds rate and downsizing the size of its bloated balance sheet. The European Central Bank and Bank of Japan, though still embracing widely-praised highly accommodative monetary schemes such as yield repression and money printing (quantitative easing), have hinted they eventually will shift from their expansionary schemes (though admittedly they are not rushing to do so).

The European Central Bank decided in October 2017 to reduce its monthly net asset purchases from Euro 60 billion to €30 billion from January 2018 until at least September 2018. Will the ECB, given the strength of the European recovery and increasing confidence in the return of about two percent inflation, further reduce purchasing rate of debt securities? In fact, "We don't see it as a recovery anymore, but as an expansion", sermonized Benoit Coeure, a member of the ECB's Executive Board ("Interview with Caixin Global", 12/30/17). He added: "Given what we see in the economy, I believe that there is a reasonable chance that the extension of our asset purchase programme decided in October can be the last." See also the ECB's "Account of the monetary policy meeting" (12/13-14/17).

The Bank of Japan slightly cut the total purchases of its buying long-term debt scheme in January 2018 (see Financial Times, 1/10/18, p19; Bloomberg website, 1/10/18).

Moreover, note that the Bank of Canada began raising policy rates in mid-2017 and anticipates eventual further boosts (12/6/17). The Bank of England (12/14/17), Sweden's central bank (12/20/17), and the Norwegian central bank (12/14/17) all cautiously indicate eventual rises in policy rates.

The assorted recent and potentially upcoming central bank policy shifts ("tightening", or at least a willingness to engage in a somewhat "less easy" monetary scheme) should be interpreted together. The overall central bank handwriting on the wall portends a growing likelihood of a generalized (even if slow and at different times) global interest rate increase. The widely-watched US government playground is not an island. Will one (or several together) of such central bank moves away from very generous accommodation programs, or at least warnings regarding this ("forward guidance"), also spark a "taper tantrum" in interest rate and stock marketplaces?

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Central banks and armies of other financial domain watchers observe "inflation" yardsticks as one consideration in developing a perspective on, explanations regarding, and forecasts for national and global interest rate and many other marketplace trends. Numerous measures of inflation exist. For example, consider America's CPI-U and personal consumption expenditure inflation To what extent should financial pilgrims include wages, asset prices such as stocks or real estate, or commodity levels and trends in developing viewpoints on "US inflation in general" and American government bond (and other) yields in particular?

The Federal Reserve Bank of New York wizards devised an "Underlying Inflation Gauge". "The UIG provides a measure of underlying inflation and is defined as the persistent part of the common component of monthly inflation." The UIG's "full data set" is broader (because it incorporates additional macroeconomic and financial variables) than the "prices-only" (CPI series based) measure.

The prices-only level was 2.18pc in December 2017. The full data set increased to 2.98 percent (almost three pc) that month; this is the highest August 2006's 3.10pc.The NY Fed concluded:

“The UIG measures currently estimate trend CPI inflation to be approximately in the 2.2% to 3.0% range” (1/12/18).

Arguably, given the UIG’s full data set’s breadth as well as the variety of species of “inflation”, the UIG’s full data set by itself is a better overall guide to “inflation” and probabilities for prospective UST rate elevations than the prices-only one, or the two measures linked together.

The Fed’s December 2017 Economic Projections place the “Longer run” Federal Funds rate range at 2.8-3.0pc (12/12-13/17; see Table 1 and Figure 2).

Most marketplace preachers believe that nominal UST yields eventually (over the murky so-called long run) should incorporate some real return relative to inflation. Thus the UIG “trend CPI inflation” range (about 2.2 to 3.0 percent) and the Fed’s viewpoint for the longer run Federal Funds rate both suggest (argue) that current UST 10 year yields under 2.6 percent are low. Start at the 2.2pc low of the current UIG range. A one percent real return over 2.2 percent indicates a 10 year UST yield of 3.2pc. One pc over the 2.5pc current midpoint of the UIG gives 3.5 percent. A one percent addition to December 2017’s full data set nearly 3.0pc equals four pc.

Absent a governmental need or legal/regulatory (or similar) requirement to hold “risk-free” debt securities such as the UST, why hold on to such securities if they offer mediocre or no return relative to inflation? In addition, such rising interest rate trends obviously risk the creation of capital loss, particularly on low-coupon instruments.

Besides, what if the high priests at the Fed permit inflation to rise above their adored two percent goal? The President of the New York Federal Reserve Bank recently pronounced: (“The Outlook for the U.S. Economy in 2018 and Beyond”; 1/11/18): “But, let me be clear: A small and transitory overshoot of 2 percent inflation would not be a problem.” What with the Fed decide is small, or transitory?

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To what extent will increasing credit demand via America’s federal budget deficits and related increasing US indebtedness help to inspire US government (and other) interest rates to march higher? Many pundits have faith that America (at least for the next several years) will have little difficulty in financing its debt. Yet even if that is so, that ability does not preclude increases in US Treasury rates. All else equal, if debt needs and perhaps even creditworthiness become more and more of an issue, government yields probably will tend to climb.

In any case, who will pay for America's current and prospective federal budget deficits? Many people complacently believe that foreigners (whether official institutions or the general public) will keep buying and holding a substantial share of US federal debt.

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The new tax "reform" legislation will widen already significant budget gaps existing prior to its enactment.

For US federal budget deficits before recently enacted tax "reform", see "An Update to the Budget and Economic Outlook: 2017 to 2027" (6/29/17). According to this epistle, they rise from about $563 billion in 2018 (down from 2017’s $693bb) to over one trillion dollars per year in 2022 and thereafter through 2027. Debt held by the public expands from $14.7 trillion in 2017 to $19.1tr in 2022 and $25.5tr in 2027. See Table 1.
https://www.cbo.gov/publication/52801

US debt held by the public as a percentage of GDP was about 35 percent in fiscal 2007. The global economic disaster of 2007-09 helped this percentage to soar quickly. However, it has not slipped significantly even after several years of recovery. It hovered at about 77 percent in 2017; 2017's height is the highest since the heavenly summit of around 100 pc of GDP shortly after World War. The CBO predicted prior to the current reform legislation that it would exceed 91 percent in 2027.

The CBO's long term budget outlook, before the passage of recent tax legislation, conjectured that federal debt held by the public will reach 150 percent of GDP by 2047.
https://www.cbo.gov/publication/52480

Despite fervent hopes and ardent claims by the President and other loyal tax reform apostles, the legislative reforms will not miraculously stop budget deficits from growing. Most mainstream views warn of expanding debt. Thus the new law increases already noteworthy current and looming deficit burdens.

The Congressional Budget Office's most recent cost estimate for the reform law prior to its enactment estimated the legislation would balloon the deficit by about $1.5 trillion over the next 10 years. That estimate does not include the effects of macroeconomic feedback (12/15/17).
https://www.cbo.gov/publication/53415
The President of the Federal Reserve Bank of New York (citing Congress's study from the Joint Committee on Taxation; 12/22/17) estimates incremental economic growth and thus higher tax revenues will make the cost around $1.1 trillion over the next ten years.

In marketplace territories and political realms, once in a while an important yet supposedly long run risk or problem (or potential disaster) sometimes also can increasingly be viewed as a significant near-term difficulty that requires diligent consideration and appropriate action sooner rather than later.

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See also "Federal Debt and the Statutory Limit, November 2017".
https://www.cbo.gov/publication/53336
Will ongoing Washington political quarrels (which reflect substantial cultural divisions) and debates about government spending priorities and levels (and related talk of shutdowns) cause heightened focus on budgetary and deficit details in general? Will this encourage yields to rise?

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The Treasury International Capital Report is an important guide to overseas participation in the US government debt marketplace. The most recent TIC release was 12/15/17 (next anticipated on 1/17/18).

Foreigners own a substantial share of US Treasury securities. As of October 2017, Mainland China ($1.2 trillion) and Japan (about $1.1tr) are the two largest. As of October 2017, there were $6.3 trillion in foreign holdings of these debt securities (marketable and non-marketable Treasury bills, notes, and bonds); foreign official holdings of $4.1tr represent about 64 percent of this.
http://ticdata.treasury.gov/Publish/mfh.txt.

In any event, history underlines that substantial net foreign net buying of US Treasury securities is not guaranteed. Suppose they become net sellers.

Note the January 2018 rumor that Chinese senior government officials have recommended slowing or halting purchases of US Treasuries (Bloomberg News, website, 1/10/18).

In recent months, what have been the net purchases (or net sales) by foreigners (official institutions and public combined) of UST notes and bonds? The Treasury does not include T-bills in a key monthly TIC report addressing this, although that would not change the statistics significantly. For the first ten months of calendar 2017, foreigners were net purchasers of about $5.5 billion dollars per month of UST notes and bonds. That is merely $66 billion per year, and that rate will not readily fill the looming and gaping budget holes. In five of the ten months, they were net sellers of UST.

In calendar 2016, foreigners averaged net selling of almost $27.2 billion of UST notes and bonds per month.

Moreover, since October 2014, the "foreign official institutions" category has been a net buyer of UST notes and bonds in only three calendar months. What happens to US rates if the overseas general public (not just the foreign official sector) reduces its net buying rate, or become net sellers?

If foreigners are only modest net buyers of UST notes and bonds, and obviously if they are net sellers, presumably devoted domestic US entities and individuals will have to purchase the debt securities to satisfy America's ravenous budgetary requirements. How enthusiastic will the US home front congregation be at current or even modestly higher rate levels? Domestic institutions and individuals (whether in Wall Street or Main Street parishes) probably will not be avid net buyers, especially if inflation benchmarks rise.

And will higher US inflation please potential foreign buyers?

The Federal Reserve, as that shepherd is slowly normalizing its balance sheet (note its current forward guidance principles), probably will not be a substantial net buyer of UST (via money printing/quantitative easing) anytime soon.

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The US Treasury 10 year note has meandered sideways in a fairly narrow channel for many months, with highs around 2.65 percent (2.64pc on 12/15/16; 2.63pc on 3/13/17) and a low neighboring two percent (2.01pc on 9/8/17; 2.10pc 6/14/17).

Around 2.65 percent in the UST is a key level. Not only was 12/15/16's top 2.64pc. Half the 5.32pc major high on 6/13/07 is 2.66pc. Twice 7/6/16's 1.32pc bottom is 2.64pc. Recall a minor top during 2013's "taper tantrum", 2.67pc on 6/24/13. A UST 10 year note move fairly close to or above 2.65 percent, and especially beyond 3.05pc (1/2/14's top), probably would provoke increased volatility (agitation) in interest rate territories, and it also probably will trigger bearish responses by the S+P 500 and other stock benchmarks.

The US 10 year government note yield has been moving higher since attaining its US election period interim trough at 1.72 percent (11/9/16) and since 9/8/17's 2.01pc low, as has the S+P 500. But that does not mandate that a major move to higher rates (the UST bear move commenced with the major low in yields in July 2016) will continue to reflect (be associated with; confirmed by) rising equity prices.

Marketplace history alerts onlookers in financial pews; a sustained rising US government interest yield pattern is an important variable warning of notable reversals in bull stock marketplace trends. For example, as the blissful Goldilocks Era danced toward to its 2007 end, ascending US government interest rate yields (UST 10 year note yield major pinnacle 5.32 percent 6/13/07) arguably preceded (led) the major peak in American stocks (S+P 500 initial plateau 7/16/07 at 1556, major high 10/11/07 at 1576). Moreover, US government debt levels are greater now than in 2007. And as America's cultural (including partisan political ones) divisions probably are greater than they were in 2007, and as significant concerns about the quality of President Trump's leadership are widespread, that arguably makes it more difficult for the nation to solve its noteworthy fiscal (and other) problems, especially with the 2018 mid-term election on the horizon.

Near 1/2/14's 3.05 percent height, don't forget the interim troughs around 3.25pc as 2007-09's economic crisis developed (1/23/08 and 3/27/08 at 3.28pc and 9/16/08's 3.24pc). Above January 2014's summit stands 2/9/11's 3.77pc plateau and several earlier tops around four percent.

DOLLAR LAMENTATIONS (THE BEAR TREND)

The broad real trade-weighted dollar ("TWD"; Federal Reserve, H.10, monthly average; March 1973=100) is a better indicator for the "overall" US dollar trend than individual FX cross relationships.

The broad real TWD probably established a major peak at 103.2 in December 2016/January 2017. Although the broad real TWD tumbled 7.8 percent to 95.2 in September 2017, it edged up to 96.7 in October; November's 97.0 and December 2017's 96.7 neighbor October 2017's height.

The plateau in the nominal TWD (which has daily data, most recent data is for 1/5/18) was 12/28/16 at 128.9 (1/3/17 at 128.8). The fall to the subsequent low on 9/8/17 at 116.7 was 9.5 percent. The nominal TWD high since 9/8/17 is 10/27/17's 121.3 (1/5/18 elevation 118.3).

The broad real TWD's major high near the end of the global economic disaster was March 2009's 96.6. Note also April 2016's interim low around 96.4 during the ascent to the December 2016/January 2017 pinnacle.

Although of course the January 2018 monthly average data point for the broad real trade-weighted dollar does not exist, the broad real TWD probably currently is assaulting major support around 96.2 to 96.6.

Look at the recent travels of several key currency cross rates against the US dollar. See the Fed H.10 currency trade weights for the "Broad Index of the Foreign Exchange Value of the Dollar". The Euro Area is about 17.2 percent, China is almost 21.6pc, Canada is 11.9pc, Mexico 12.8pc, Japan 6.5pc, and the United Kingdom 3.6pc. Together these add up to almost 73.6 percent of the TWD.

Given its substantial weight in the TWD, the Euro FX's recent cross rate rally over 1.210 (the important 9/8/17 high was 1.209; the Euro FX slipped to 1.155 on 11/7/17) to around 1.230 is important. Note the similar directional jump higher (and roughly similar timing) in the Chinese renminbi. Recall 9/8/17's 6.439 high in the renminbi against the dollar. Although the Chinese renminbi made a low on 9/29/17 at 6.683, it has strengthened against the US dollar. Its appreciation has carried it to about 6.435, right around the 9/8/17 height.

The Japanese Yen also made a minor top against the dollar on 9/8/17 at Y107.3. Though the Yen fell to about Y114.7 in fourth quarter 2017 (11/6/17), it has rallied sharply to Y110.4 (fairly close to the 9/8/17 level). The Canadian Dollar made a September 2017 high against the dollar as well (9/8/17 at 1.206). Though the CD weakened to 1.292 on 10/27/17, its subsequent climb took it back to 1.236 (1/5/18).

The Mexican Peso reached a major trough against the dollar not long after Trump's November 2016 election triumph with 1/11/17's 22.04 (Euro FX low 1/3/17 at 1.034). The Peso remains beneath its 7/19/17 rally high around 17.45. However, it has been strengthening in recent weeks. Recall 12/26/17's 19.91, and compare it to the recent elevation beneath 18.85.

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Currency trends and levels intersect with and offer guidance for yield patterns and elevations in government and corporate interest rate marketplaces. The US dollar and other currencies also intertwine with stock benchmarks. These include not only the S+P 500 and Dow Jones Industrial Average, but also signposts for other advanced nations and emerging marketplaces. Currency, interest rate, and equity marketplaces entangle and influence in a variety of ways the levels and patterns for commodities "in general" (with petroleum being an especially important field).

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All else equal (without considering other variables), a "weak" US dollar tends to raise the price of dollar-denominated assets such as stocks. However, what is a weak, strong, or normal US dollar level is subjective (a matter of opinion); so are definitions of and viewpoints regarding "trend". And although some proverbs proclaim that a "weak US dollar equals (or usually generates) strong US stocks"/"strong US dollar equals weak (US) stocks", that relationship is not always (or necessarily) true in historical practice. After all, assorted diverse and competing perspectives and a wide variety of variables can and do influence stock (and other) fluctuations, trends, and levels.

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Underscore the subsequent US stock rally in the S+P 500 from around the time of the nominal TWD's interim low on 9/8/17. Keep in mind that the dollar's trough on that 9/8/17 date occurred in several of its very important currency cross relationships. The S+P 500 rallied "alongside" the dollar's (modest) appreciation after 9/8/17. The S+P 500 created a price gap as it spiked upward; the S+P 500's 9/8/17 high was about 2467, 9/11/17's low 2475.

Suppose the recent (resumed) weakness in the broad real trade-weighted US dollar continues. Then the history of the past few months (since around 9/8/17) probably foretells that the US dollar breakdown (which began in December 2016/January 2017) eventually will connect with S+P 500 weakness (dollar weakness tied to a S+P 500 decline). The climb in the UST 10 year yield, especially as it also resumed from 9/8/17's 2.01 percent, also indicates the likelihood of this scenario.

Remember that both US dollar and US Treasury benchmarks are around "key levels" nowadays.

All else equal, dollar depreciation generally displeases overseas owners of dollar-denominated assets, including stocks and debt securities. How pleased will overseas owners of US Treasury notes and bonds be if rates are rising while the dollar also is depreciating?

In any case, stock marketplace bear trends have not been magically abolished. A decisive broad real TWD breakdown under 96.0 may spark a significant reversal of the current bull trend in the

S+P 500 (and related advanced and emerging marketplace stock arenas). If a sustained breach in the UST 10 year yield above the 2.65 percent rampart accompanies (links to) this US dollar feebleness, the equity price decline likely will be more substantial.

FAITH

Regarding and within cultural fields such as economics and Wall Street, all perspectives and stories are subjective and reflect faith. Definitions, selection of variables, outlooks, propositions, arguments, and conclusions involve and display opinions, not objectivity (real science).

Many cultural viewpoints embrace a rhetoric of rationality/irrationality (and related language of reasonableness, logic, intelligence, common sense, and so forth). In any case, marketplace gospels abound; they also compete. Values of good and bad (and indifferent) permeate economic (and political) discourse, whether on Wall Street, Main Street, or elsewhere. Isn't "investment", particularly in US securities (and especially stocks), generally a good (praiseworthy; "reasonable/prudent") practice? For many believers in the American Dream, there is faith that good US stocks are an appropriate (good; reasonable) vehicle to own.

Viewpoints regarding price (and other economic variables) as to "average" (natural, normal, typical) and "high" (too high; overshooting; expensive) and "low" (too low; undershooting; cheap) express opinions, not an objective (scientific) truth. Statements regarding some so-called "true (or fair) value", as well as views regarding an alleged natural or equilibrium (or reasonable or unreasonable) price (or marketplace situation) likewise are subjective.

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Sometimes faith in a financial or political creed, or confidence that a marketplace situation or pattern will persist, is substantially shaken or finally broken.

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Nowadays, many observers have very strong (even if not blind) faith in the ability of the glorious Federal Reserve and other majestic central bankers to control, or at least guide, financial outcomes to a generally good (or at least pretty good) ending (at least for most of us, perhaps). Going forward, it will be interesting to ascertain the extent to which this devotion turns out to be justified.

There is a similar widespread belief (as well as ardent prayer) that China's political and economic leadership will be able to produce keep producing favorable economic results. Yet despite such hopes, the International Monetary Fund's "Financial Sector Stability Assessment with China" (12/6/17) quietly speaks of "substantial credit expansion", "high corporate debt", "risky lending". And "widespread implicit guarantees have added to these risks. A reluctance among financial institutions to allow retail investors to take losses; the expectation that the government stands behind debt issued by state-owned enterprises and local government financing vehicles; efforts to stabilize stock and bond markets in times of volatility; and protection funds for various financial institutions, have all contributed to moral hazard and excessive risk-taking."

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"The Dow Breaks 25,000; The Party Will Come to an End, but When?" headlines the NYTimes (1/5/18, ppA1, 13). Despite the sharply divergent and frequently hostile views currently on the American political stage (note the wide variety of cultural divisions), will relative complacency generally continue to reign in the US (and global) stock marketplace playgrounds? Is there any “moral hazard” or “excessive risk-taking” going on? Stock volatility measures such as the VIX still are low. The trough to date is 11/24/17’s 8.56; before the end of the Goldilocks Era and the advent of the global economic crisis, the VIX established a major bottom at 9.39 on 12/15/06. For many months, there have been few noteworthy falls in the S+P 500. Many choirs continue to sing the “buy the dip” hymn. Moreover, and although the bull charge in US stocks has been a long running one, some prophets believe there will be a further wonderful “melt-up” in American equity prices before they descend significantly. Despite attaining highs in November 2017, consumer confidence (Conference Board) and small business confidence still are quite lofty (watch to see if these confidence indicators slip lower in the next several months).

Numerous pulpits herald that as a result of the recently enacted US federal corporate tax cut and other corporate tax changes (“reform”), corporate profits of US companies next year will be blessedly boosted by an average of ten percent (for example, see the Financial Times, 12/18/17, p10 and 12/21/17, p3). But what if corporate earnings growth rates and levels turn out to be notably less than sunny forecasts? The NY Fed President recently commented that “the reduction in the effective tax rate for corporations—or what they typically pay in practice—is only about 3 to 4 percentage points, far smaller than the reduction in the statutory rate.”

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