K N O W L E D G E D R I V I N G C O M P E T I T I V E A D V A N T A G E
COMMERCE STREET Capital Management
1445 ROSS AVENUE, SUITE 2700
DALLAS, TEXAS 75202 • 214-545-6800

BOND MARKET REVIEW

May 20, 2015

Zeppelinomics

The **B**ond **M**arket **R**eview considered the FOMC minutes, inflation, and the stock market – and reasoned we were still at a crossroads. In the early '70s, rockers Led Zeppelin put it like this: *"Yes, there are two paths you can go by, but in the long run – There's still time to change the road you're on!"* As with their statement, the minutes from the April 28–29th FOMC meeting were optimistic but carefully crafted. Fed Chair Janet Yellen no doubt considered the dot–plot *"sign on the wall but she wants to be sure, 'cause you know sometimes words have two meanings."* While inflation has been in check and growth has been challenged, stocks have risen with only a few corrections since March 2009. We see the meaning in *"a new day will dawn for those who stand long!"* The Nasdaq is up over 300% to that low – and very close to its record highs of March 2000. The Dow is up 185%, and hit new record highs this week. The same goes for the S&P, which is 220% higher since March 2009. However, the Dow Transports are on 'that other path' – having fallen today to the lowest levels in over 6 months! Stocks usually get *"a spring clean for the May queen"* as the axiom 'sell in May and go away' usually holds true as statistically the second–worst month for equities. It certainly has for been for transportation stocks! Should we *"be alarmed now?"*

While institutions earning a spread or investors buying stocks see *"how everything still turns to gold"*, it's not been that easy for the Fed. It's clear that the FOMC would have liked to begin raising their benchmark rates by mid–2015. However, even though anticipating growth will resume following a dismal start for 2015, Fed officials must be wondering what arsenal they possess should the economy instead stall! Last week, we learned that economists for the New York Fed just downgraded their U.S. growth forecasts. They cited lower oil prices and restrained spending by consumers and businesses. Slow growth and weak spending most likely had already removed a June hike from consideration. The minutes confirmed that stance while not totally ruling it out. They said: *"Many participants, however, thought it unlikely that the data available in June would provide sufficient confirmation that the conditions for raising the target range for the federal funds rate had been satisfied."* The minutes also said: *"Many participants judged that the pace of improvement in labor market conditions had slowed."* In fact, we noted last week that the Fed's labor dashboard had declined for a second month, and a few FOMC members questioned if they were currently providing *"sufficient accommodation"* – and cautioned against acting too soon! Others remained concerned about how inflation was running well below longer–run objectives.

Another double path was inflation. FRB Chicago President Charles Evans said he doesn't expect *"inflation rising to our 2% target until 2018."* He said: *"I likely will not feel confident enough to begin to raise rates until early next year."* Global central banks have been overly optimistic and wrong in their inflation forecasts over the past few years. We think Evans explained that 'double path' very well. He said: *"Symmetry is crucial. … We need the probability that inflation is above 2% to be the same as the probability it will be below 2%."* He said having *"enough accommodation to achieve the Fed's 2% objective in a timely manner"* was necessary to *"avoid a loss of credibility."* The FOMC said they expect growth to resume at a *"moderate pace"* following conditions they deemed *"transitory"* in the first quarter. They noted the headwind dangers of a continued drop in oil prices or a rise in the dollar versus other currencies. The **BMR** thinks the probable effect of raising rates at this point would be to further strengthen the dollar – which would actually add to those headwinds! *"Oooh…It really makes me wonder!"*

Looking Ahead

- We would sell rallies in bonds, as yields should be generally higher into late July.
- Stocks should have cycle trend–change lows near May 29th and June 11th.
- For those that gave their all for freedom, the markets will close Monday in observance of Memorial Day.

Treasuries, Agencies, and MBS

The March report for foreign U.S. Treasury flows showed a $100.9 billion outflow. Belgium alone accounted for nearly $100 billion – or nearly all that drop. Japan had taken the top spot in Treasury ownership away from China in February. China had been the top Treasury holder for any nation since 2008 – and just retook that spot from Japan with a March pickup of $37.3 billion. (OPEC rose to #3 above Belgium). Overall, $17.6 billion was moved or added to longer maturities. Despite recent volatility, the yield curve only slightly steepened last week. U.S. Treasury yields fell by 3.5, 3, and .5 bps at 2, 5, and 10–years, but were 3 bps higher for the 30–year sector. Foreign bonds also steadied, checking the rout for now, while remaining near their recently higher–yield levels. Since Friday, U.S. yields were higher by 5, 9, 10.5, and 12 bps. MBS spreads (for FNMA 30–year 2.5%) pulled in by 2 bps last week. Next week, the U.S. Treasury will auction $26 billion 2–year notes on Tuesday (05/26), $35 billion 5–year notes on Wednesday (05/27), and $29 billion 7–year notes on Thursday (05/28).

05/15/15 Treasury Yield Curve	2-Year: 0.538%	5-Year: 1.461%	10-Year: 2.143%	30-Year: 2.930%
Weekly Yield Change:	–.036	–.028	–.006	+.029%
Support:	0.59/ 0.61/ 0.64/ 0.66 %	1.57/ 1.63/ 1.69/ 1.76%	2.29/ 2.33/ 2.41/ 2.48%	3.09/ 3.14/ 3.18/ 3.27%
Targets:	0.57/ 0.55/ 0.53/ 0.51%	1.51/ 1.45/ 1.40/ 1.34%	2.18/ 2.13/ 2.10/ 2.05%	2.92/ 2.86/ 2.81/ 2.75%

Economics

Consumer Confidence came in below expectations with a drop from 95.9 to 88.6. That University of Michigan survey showed Current Conditions off 7.2 points to 99.8 (to the lowest since last October) and the Expectations component off 7.3 points to 81.5 (the lowest since November). While Empire Manufacturing rose from a –1.19 to +3.09, Industrial Production contracted for a 5th month with a .30% drop. Capacity Utilization fell .40% to 78.20%. Based largely on weak traffic, home builder outlook fell 2 points to 54 (NAHB Housing Market Index). April Housing Starts rose 20.23% to 1,135K units – the most since November 2007 and the largest increase since February 1991. They were up 5.98% year–over–year. Building Permits rose 10.12% to 1,143K. That was 7.93% higher versus last April. With a 16.7% jump, single–family home construction rose the most since January 2008.

Thursday is set for jobless claims data, Existing Home Sales for April, the Leading Index (LEI), the Philadelphia Fed Business Outlook, the Chicago Fed National Activity Index, and Kansas City Fed Manufacturing Activity. Also due are Bloomberg Economic Expectations and Bloomberg Consumer Comfort (which last week dropped .2 to 43.5). Friday gives us Consumer Prices (April CPI), and the bond market will close early (2 p.m. EDT) to begin the Memorial Day weekend. Take time Monday to remember those that gave their lives to preserve our freedom. Tuesday brings April Durable Goods Orders, S&P/Case–Shiller and FHFA home price data, Richmond and Dallas Fed Manufacturing, April New Home Sales, and Consumer Confidence. Wednesday gives us MBA Mortgage Applications, which fell 1.50% last week.

Equities

Though the Nasdaq is still off its April highs, the Dow, S&P, and S&P100 shrugged off seasonal factors to reach new record highs. The equity–index cycles remain mixed, but our trend–change dates of May 29th and June 11th remain unchanged and should still be lows. For the week, the Dow rose 81.45 points or .45% to 18,272.56. It's up this week, but only by .07%. The S&P gained 6.63 points or .31% to 2,122.73, and was .15% ahead for the week into today. The Nasdaq rose 44.74 points or .89% to 5,048.29, and is also stronger than other indices this week as it's higher by .46%. Curiously, those positive forces failed to help the Dow Transports – which dropped today to the lowest levels since October 27th (almost 7 months). The Transports lost .98% last week, and are 2.04% lower since Friday! Though well off their record highs from February 2007, bank stocks rose .05% last week to the highest levels since September 2008, and are 1.58% better this week.

Resistance:	Dow:	18,350/ 18,418/ 18,486/ 18,554	Nasdaq:	5,096/ 5,114/ 5,132/ 5,150	S&P:	2,134/ 2,146/ 2,157/ 2,169
Support:		18,213/ 18,064/ 17,963/ 17,804		5,063/ 5,043/ 5,024/ 4,999		2,123/ 2,111/ 2,101/ 2,088

Other Markets

Commodities and currencies were mostly in contra–Dollar mode. Last week, Commodities rose 1.00%, but they've fallen 2.17% since Friday – as Crude Oil rose .51%, but then fell 1.19%, and Gold rallied 3.06%, but then fell 1.35%. The Dollar dropped 1.82% – losing ground for a 5th week, but it's up 2.50% this week. The Japanese Yen gained .43%, but dropped 1.76% into today. The Euro also had risen 2.25%, but likewise tumbled 3.12% into today. Corn rose 1.95%, but lost 1.50% this week. Cotton shared the same dollar–driven pattern, rising 1.03%, but then trading 4.02% lower.

"O beautiful for heroes proved In liberating strife, Who more than self their country loved,
And mercy more than life!" Katharine Lee Bates

"It is rather for us to be here dedicated to the great task remaining before us - that from these honored dead we take increased devotion to that cause for which they gave the last full measure of devotion - that we here highly resolve that these dead shall not have died in vain - that this nation, under God, shall have a new birth of freedom - and that government of the people, by the people, for the people, shall not perish from the earth." Abraham Lincoln

Additional Information is Available on Request

Doug Ingram, Managing Director – Commerce Street Capital Management