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BOND MARKET REVIEW

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DeflateGate II

As bubbles unwind – they're often unkind. When the New England Patriots were determined to have been using deflated footballs, they were fined and Tom Brady was suspended for 4 games. Brady is now seeking total exoneration as the tests the NFL ran to determine his guilt apparently can't be replicated. What good is scientific data that can't be verified? The testing data reads like economic reports – and is not holding up to challenges. The first read on GDP for the first quarter was mildly positive. Then it was adjusted to a .70% contraction. It's expected to be revised again next Wednesday to reflect only a .30% slide. While not quite as negative, still not growth!

It turns out the real 'DeflateGate' was a global bet that EU prices would be so restrained that the wise choice was to bid bonds to negative yields. With a giant EU QE assist, even as late as April, many EU nations had negative yields on short maturity bonds – and a few were close to zero or negative out to 10–years! In the **B**ond **M**arket **R**eview (04/01/15), we noted the *"Bank of England just warning of their first deflation in 5 decades"*, *"the Bank of Japan still trying to wage a decades–long war against the same"*, and the European Central Bank struggling to preserve its member nations *"just months into its own giant QE."* You have to be committed to bid long–term bonds to negative yields, and bund investors are now bearing the brunt of that over optimism.

Point to point, the U.S. bond market had a calm week with yields mixed – and changing only around 1 bps. In the middle of that was some wild volatility with Greece missing (postponing) debt payments and appearing very uncooperative with ECB leaders that were trying to prevent a Greek exodus from the EU common currency. Greece's own citizens, who voted in leaders that were against austerity measures, were starting to hoard cash as many think that exit now inevitable. The next bailout deadline is now June 30th, when Greece needs to make payments on its $352 billion (EU equivalent) debt. Greece's Prime Minister Alexis Tsipras was called by U.S. Treasury Secretary Jacob J. Lew, who asked him to get serious about reaching an agreement. Tsipras instead went on the offensive arguing that the International Monetary Fund *"bears criminal responsibility for the situation in the country."* He said the ECB methods for seeking Greek concessions were *"financial asphyxiation."* In the wake of all this, and hints of upticks in inflation, EU bond investors have seen yields surge higher. While the German 2–year went from a –.29% to –.16%, that Greek equivalent soared from 17.55% to 29.11% – obviously not on inflation concerns but more on default risk. Germany's 10–year debt surged from .05% to .98%, but settled back a little to .81% given renewed global growth concerns. Greek 10–year debt climbed from 10.14% to 13.23%.

Based on previous data and comments by FOMC members, for most of 2014 the presumption was that the first Fed hike since 2008 would come by June 2015. It was assumed 6 months past the end of QE purchases, which originally would have been in December, but instead concluded in October – making even the April 2015 meeting a possibility for liftoff. April fell 'off the table' with negative Q1 GDP. Now both have come and gone! The FOMC text released today suggested labor and economic growth conditions were improving, albeit moderately. However, other than the headline U.S. Unemployment Rate, there was little concrete data and evidence to support the Fed acting at this time – or even the upcoming July 29 meeting as we see it. The Fed's text was little changed versus April. Despite the more–upbeat first paragraph, Fed officials downgraded their economic growth forecasts from March's 2.3% to 2.7% to only 1.8% to 2.0%. Thus, the Fed joined the IMF, the World Bank, and the OECD in reducing forecasts (as we covered last week). That sent short rates lower after the FOMC statement was released.

In their post–meeting comments, the Fed was still signaling a liftoff in rates sometime in 2015, and assuring the markets that the path to higher rates would be gradual. Fed Chair Janet Yellen said: *"Since the committee last met in April, the pace of job gains has picked up and labor-market gains have improved further."* She cited *"tentative signs of stronger wage growth."* She said the FOMC viewed first quarter GDP weakness as *"largely transitory."*

Looking Ahead

- We would sell rallies in bonds, as yields should be generally higher from June 22nd into late July.
- Our stock cycles point to a high in late June.

Treasuries, Agencies, and MBS

As we said earlier, bonds ended nearly unchanged despite a mid–week global panic concerning Greece's debt. For the week, U.S. 2–year debt rose 1.5 bps in yield with 5–year yields edging .5 bps higher. However, yields for 10 and 30–year maturities fell just over 1 bps. Into today, yields dropped nicely at the front end assisted by a non–aggressive Fed result. Yields fell 7.5, 12, 7.5, and 1 bps for the 2, 5, 10, and 30–year sectors. MBS spreads (for FNMA 30–year 3.0%) pulled in by 2 bps last week. June 22nd is our next trend–change expectation for a low yield.

Last Thursday's $13 billion 30–year bond brought a yield of 3.138% in an auction rated an above–average '4 of 5'. Demand improved versus last month and the yield was the highest since September. Foreign buyers accounted for 52% of the issue versus 50.8% in May. Auctions resume with a new 2–year next Tuesday (06/23), 5–year notes on Wednesday, and 7–year notes on Thursday.

06/12/15 Treasury Yield Curve	2-Year: 0.728%	5-Year: 1.745%	10-Year: 2.393%	30-Year: 3.103%
Weekly Yield Change:	+.017	+.004	–.015	–.011%
Support:	0.68/ 0.71/ 0.75/ 0.78 %	1.80/ 1.84/ 1.87/ 1.91%	2.41/ 2.45/ 2.49/ 2.53%	3.18/ 3.22/ 3.27/ 3.32%
Targets:	0.60/ 0.58/ 0.55/ 0.53%	1.73/ 1.70/ 1.65/ 1.61%	2.29/ 2.25/ 2.21/ 2.18%	3.09/ 3.04/ 3.00/ 2.96%

Economics

May Retail Sales rebounded with a 1.20% gain. They rose .70% for the 'control group'. The Import Price Index rose 1.30% in May, but that merely slowed the annual negative pace from a –10.50% to –9.60%. Likewise, Producer Prices rose .50%, and .10% ex food & energy – slowing the annual loss from –1.30% to –1.10%, but lessening the core pace (ex food & energy) from .80% to .60%. Initial Jobless Claims remained steady with a 2K rise to 279K. Continuing Claims rose from 2,204K to 2,265K. Industrial Production fell .20% and Capacity Utilization dropped from 78.30% to 78.10%. Business Inventories rose .40%. Empire Manufacturing fell from 3.09 to –1.98. University of Michigan Sentiment rose from 90.7 to 94.6, with expectations rising 2.6 to 86.8 and the current conditions read improving from 100.8 to 106.8. The NAHB Housing Market Index showed home builder optimism sharply higher (from 54 to 59). That said, even though Building Permits rose 11.80% to 1,275K, Housing Starts fell 11.1% to 1,036K. April saw large inflows into U.S. Treasuries as foreign investments increased by $106.6 billion – with $53.9 billion going into longer–maturities.

There will be no **BMR** next week as we are traveling. With the next issue scheduled for the first week of July, these are the more important economic releases. Thursday is set for the Current Account Balance (deficit) for the 1st quarter, Consumer Prices (May CPI), jobless claims data, Bloomberg Consumer Comfort (off .40 to 40.1 last week), Bloomberg Economic Expectations, the Philadelphia Fed Business Outlook, and the Leading Index (May LEI). Next Monday (06/22) gives us the Chicago Fed National Activity Index and May Existing Home Sales. Tuesday brings May Durable Goods Orders, the FHFA House Price Index, New Home Sales for May, and Richmond Manufacturing. Wednesday follows with MBA Mortgage Applications (which were down 5.5% last week), and updates for 1st–quarter GDP data. GDP is expected to be revised .40% higher to a still negative –.30%. Thursday brings May Personal Income and Personal Spending, the Fed's key inflation read from the PCE Deflator (Personal Consumption), and jobless claims data. Friday closes out next week's data with University of Michigan confidence and sentiment survey results. The following Monday (06/29) is set for May Pending Home Sales. Tuesday closes out June trading with S&P/Cash–Shiller home price data and Consumer Confidence. Wednesday (07/01) opens July trading with the first reads on the next Friday's June payroll numbers from Challenger Job Cuts and ADP Employment Change. Also due are Construction Spending, ISM Manufacturing, and June Vehicle Sales.

Equities

Following 3 weeks of losses, stocks were mixed but overall lightly positive last week and into today. On Monday, the Dow traded to its lowest levels since early April. The Dow gained 49.38 points or .28% to end at 17,898.84 last week, and is .21% higher this week. The Nasdaq lost 17.36 points or .34% to 5,051.10, but is .27% better this week. The S&P gained 1.28 points or .06% to 2,094.11, and is .30% higher since Friday. The Transports fell 1.09%, and are 1.20% lower this week. Bank stocks rose 1.61%, but were .55% lower into today with the Fed stalling.

Resistance:	Dow:	18,166/ 18,232/ 18,300/ 18,369	Nasdaq:	5,134/ 5,152/ 5,170/ 5,188	S&P:	2,124/ 2,130/ 2,136/ 2,141
Support:		17,899/ 17,839/ 17,767/ 17,697		5,077/ 5,044/ 5,025/ 4,991		2,100/ 2,095/ 2,089/ 2,084

Other Markets

Commodities rose .45% last week, and were off only .01% into today. Crude Oil traded 1.40% higher, but was .07% lower into today. Gold gained .94%, but has lost .20% since Friday. The U.S. Dollar dropped 1.43% last week, and was off another .52% into today. The Japanese Yen surged 1.78%, but is .03% lower since. The Euro gained 1.37%, and is .63% higher this week. Corn lost 2.08% and Cotton was .09% higher.

"If I had my life to live over... I'd dare to make more mistakes next time." Nadine Stair

Additional Information is Available on Request

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