BOND MARKET REVIEW

August 05, 2015

A Retraction of the Contraction

U.S. growth for the first quarter had been first estimated at only .20%, but revised to a .70% contraction, and then lessened to only a .20% drop in last month's revision. Second–quarter GDP showed a rebound of 2.30%. While that was a little less than expected, the previous first–quarter contraction was redacted to instead show .60% growth. Improved Consumer Spending is leading the way. Consumer Spending grew to 2.9% in the second quarter, following 1.8% for Q1 2015. However, there were also subtractions in revisions to previously–reported annual statistics. For the 3 years ending in 2014, GDP was shaved by .3 points to 2.1% (rather than 2.4%). 2013 GDP was only 1.5%, compared to the 2.2% result reported in 2014. That placed 2013 as the lowest–growth year since 2009.

A Lego Brickumentary

There were no great surprises in last Wednesday's (July 29th) FOMC policy statement. However, based on other comments and a modestly more optimistic statement, the Fed is obviously still hoping things are stacking up well enough to begin rate hikes in 2015. While growth in the second quarter did rebound from negative to modestly–positive first–quarter growth, there wasn't enough data to support a liftoff in the July meeting. It's clear from comments made by Fed Chair Janet Yellen (and many supporting her in the FOMC), that their focus is strongly on beginning rate hikes sometime this year. This statement was little changed – but a bit more upbeat, though there just wasn't enough current data to support a July move. What the **B**ond **M**arket **R**eview perceived was just a general rewording of the June statement with nothing material.

While economists are roughly 50%–50% on a September move, the futures markets are closer to 40%–60% in projections that September will mark that beginning. At least 2 FOMC members believe the Fed should wait until 2016. A few also have thoughts similar to those of Federal Reserve Governor Jerome Powell. Today he said the *"time is coming"*, but wants to see how the data unfolds. He said he'll be *"very, very focused on the data."* We see the historical GDP downgrades as illustrative of a still–challenged economy. In mall–walking terms, not even a brisk pace – and well short of a jog, run, or sprint. Most of the rate–hike talk is based on improvements in payrolls, and certainly not on inflation (where CPI is running well short of Fed targets). In fact, last week, data showed that salaries and wages rose in the second quarter at the slowest pace on record (for a data set beginning in 1982).

Looking Ahead

- Bond cycles are mixed. We would continue to sell rallies, as a yield high is due near August 18th.
- Stocks should turn down again from a high due near August 5th/6th.

Treasuries, Agencies, and MBS

Global default worries had been focused on Greece, which 'delayed' debt payments to the ECB and IMF until a bailout loan of just a little more than enough to make those payments was secured a few weeks ago. U.S. territory Puerto Rico actually missed its $58 million debt payment of principal and interest earlier this week. They only paid a partial interest payment of $628K. A vice president with Moody's, Emily Raimes, said: *"This is a first in what we believe will be broad defaults on commonwealth debt."*

Into July 24th, the curve flattened with 2–year yields rising 1.5 bps, while yields for the 5, 10, and 30–year sectors fell by 5, 8.5, and 12 bps. There was further flattening last week as yields fell 1.5, 9, 8, and 5.5 bps for the 2, 5, 10, and 30–year sectors. The short–rate markets seem convinced that the Fed is going to raise rates in 2015, while long rates are tuned into global difficulties, sluggish growth, and other data showing modest inflation and mixed economic performance. Bond cycles remained mixed, making it difficult to hone in on trend–change dates. We're leaning to August 5th/7th as being more important for selling rallies or adding hedges. Into today, yields were higher by 6.5, 11.5, 9, and 3.5 bps for the 2, 5, 10, and 30–year sectors.

MBS spreads (for FNMA 30–year 3.0%) widened by 4 bps into July 24th (reversing the previous weeks tightening), but narrowed by 2 bps last week. The 2 and 5–year auctions on Tuesday and Wednesday (July 28th and 29th) were rated above average ('4 of 5'), while Thursday's (07/30) 7–year offering was rated only average. On Tuesday (07/28), the U.S. Treasury sold $26 billion 2–year notes at .69%. Demand improved to the last sale, and foreign bidding increased to accept 54.4% of the sale versus 52.6% in June. Wednesday's (07/29) $35 billion 5–year note brought 1.625% with the best demand since November 2014. Foreign accounts stepped up to take 67.5% of the issue versus 56.6% last month. Today's $29 billion 7–year note auction came at 2.021%. Demand was the best since May, though foreign buying fell from 56.6% last month to 49.1% of this issue. Next week, the U.S. Treasury will auction 3–year notes on Tuesday (08/11), 10–year notes on Wednesday (08/12), and 30–year bonds on Thursday (08/13).

07/31/15 Treasury Yield Curve	2-Year: 0.663%	5-Year: 1.530%	10-Year: 2.181%	30-Year: 2.907%
Weekly Yield Change:	–.017	–.089	–.082	–.056
07/24/15 Treasury Yield Curve	**2-Year: 0.680%**	**5-Year: 1.619%**	**10-Year: 2.263%**	**30-Year: 2.963%**
Weekly Yield Change:	+.013	–.051	–.085	–.120
Support:	0.73/ 0.75/ 0.78/ 0.80%	1.66/ 1.69/ 1.72/ 1.76%	2.28/ 2.32/ 2.35/ 2.40%	2.96/ 3.02/ 3.07/ 3.12%
Targets:	0.69/ 0.67/ 0.63/ 0.59%	1.60/ 1.57/ 1.54/ 1.51%	2.21/ 2.17/ 2.14/ 2.10%	2.86/ 2.82/ 2.77/ 2.73%

Economics

GDP for the second quarter improved to 2.30%, and the first quarter's performance was revised from a contraction of .20% to instead show growth of .60%! That data supports Fed Chair Janet Yellen's position that the first quarter weakness was possibly transitory. Personal Consumption was 2.90%, while Q1 data was revised .30% lower from 2.10% to 1.80%. The GDP Price Index rose by 2% in Q2, while Q1 was revised from unchanged to a rise of .10%. Ex food & energy (core) PCE for Q2 2015 was adjusted .20% higher to 1.80%, and Q1 data was revised .20% higher to 1.00%. While it's very encouraging that U.S. service providers expanded in July with the biggest jump in 10 years, it's a continued sign that the U.S. is continuing to expand as a services–based economy. The ISM Non–Manufacturing Composite surged from 56 to 60.3. The service sector now makes up nearly 90% of our economy, and while expansion is promising, wages are nearly stagnant and the U.S. economy used to have a much larger manufacturing component. We would have deemed that 'more balanced', and all those jobs and production have been relocated or lost to other countries. At only .20%, the Employment Cost Index for 2Q 2015 showed the smallest wage increases since data began in 1982. A Chinese manufacturing gauge just fell to a 5–month low. We've contended that's a negative indicator for U.S. retail, as most of our goods are now imported. ISM Manufacturing slipped from 53.5 to 52.7, and Prices Paid fell from 49.5 to 44. Factory Orders rose 1.80% in June, somewhat offsetting the 1.10% drop in May. Ex transportation, they grew by .50%. Orders for Durable Goods rose 3.40% in June. May's drop was revised .30% lower to 2.10%. Ex transportation, orders rose .80%, while May data was revised from a .50% gain to a .10% drop. Capital Goods Orders rose .90%.

The first look into Friday's jobs data for July came today with ADP Employment Change showing private payrolls growing by 185K in July versus 215K expected. Initial Jobless Claims were under 300K for a 21st week. They rose slightly last week, but only 12K higher to 267K versus the previous week's 42–year low of 255K. Continuing Claims were unchanged the previous week at 2,216K, but 46K higher last week to 2,262K. Personal Income rose .40% in June, while Spending increased by only .20%. Real Personal Spending was flat. Bloomberg Consumer Comfort fell from 43.2 to 42.4 into July 23rd, and then 1.9 points to 40.5 last week. The Leading Index for June was higher by .70%. Kansas City Fed Manufacturing Activity was 2 better to –7, while Dallas rose from –7 to a still–negative –4.6. The Richmond Fed Manufacturing Index rose from 7 to 13. The Chicago Fed National Activity Index rose from –.08 to +.08. ISM Milwaukee improved from 46.55 to 47.12 and Chicago Purchasing Managers rose from 49.4 to 54.7. ISM New York rose from 63.1 to 68.8. University of Michigan Sentiment fell .2 to 93.1. Their Current Conditions measure rose 1.2 points to 107.2, but Expectations fell from 85.2 to 84.1. Board Consumer Confidence Index fell hard in July, with a decline from 99.8 to 90.9. IBD/TIPP Economic Optimism fell from 48 to 46.9.

Personal Consumption Expenditures increased by .20% in June, but this favored inflation indicator for the Fed showed only an annual .30% increase. The core rate rose only .10%, leaving annual core PCE unchanged at 1.30%. Construction Spending rose .10% in June. July Vehicle Sales rose from 16.95M to an annual 17.46M pace. Domestic sales rose from 13.21M to 13.92M. The June Trade Balance deficit widened from $40.94 billion to $43.84 billion. May New Home Sales were revised from 546K down to 517K. June sales dropped 6.77% to 482K. Though Pending Home Sales are up 11.10% versus last year, the June data showed a 1.80% decline. MBA Mortgage Applications rose .80% into the week ending July 24th, and were 4.70% higher last week. May data for metro home prices showed a decline of .18%. The annual price rise dropped .01% to 4.94%. Overall, the S&P/Case–Shiller Home Price Index rose only .04%, with the annual pace .09% higher to 4.39%.

Thursday gives us a second look into July jobs from Challenger Job Cuts and another week of jobless claims data. Friday (08/07) reveals the July Unemployment Rate and other July payroll data. Economy watchers would like to see the Labor Force Participation Rate experience at least an uptick off the lowest levels since the late '70s. June Consumer Credit is also due. Next Monday's data (08/10) includes the Fed's jobs dashboard (Labor Market Conditions Index Change), and second–quarter data for MBA Mortgage Foreclosures and Mortgage Delinquencies.

Equities

We had expected another upturn near July 29th, and stocks turned higher on the 28th – following a fairly brutal selloff from the 20th to the 27th that saw the Dow drop 738 points or 4.07% and the S&P tumble 3.25%. Our equity cycle is positive into August 5th/6th, but then turns down again. Into July 24th, the Dow plunged 517.92 points or 2.86% to 17,586.52. It rose 121.33 points last week to 17,689.86 – ahead only .40% for the month. The first week of August has it .84% lower. The S&P lost 46.99 points or 2.21% into the 24th to close at 2,079.65, and gained 1.16% last week to 2,103.84. It's off .19% to kick off August. Into the 24th, the Nasdaq dropped 121.51 points or 2.33% to 5,088.63. It gained .78% last week to 5,128.28, and is .23% better this week. The Dow Transports fell 2.67% into the 24th, surged 3.96% higher last week, and are up .54% this week. Bank stocks lost 1.00% into the 24th, and another .11% last week. They're .61% higher this week.

Resistance:	Dow:	17,519/ 17,658/ 17,658/ 17,784	Nasdaq:	5,105/ 5,142/ 5,177/ 5,205	S&P:	2,101/ 2,112/ 2,120/ 2,133
Support:		17,391/ 17,324/ 17,196/ 17,062		5,030/ 5,005/ 4,967/ 4,935		2,077/ 2,066/ 2,055/ 2,044

Other Markets

Crude Oil fell right into its cycle for a low on the 28th, had a short rally, and then fell near 4–month lows this week. Those lows back in March were the lowest since 2009. This drop is once again reducing forward inflation estimates. Crude Oil fell 5.40% into the 24th, 2.12% last week, and is 4.18% lower this week – for a potential 6th weekly loss! Commodities dropped 4.43%, 1.20% last week, and are 1.38% lower this week. Gold lost 4.10% into the 24th, gained .87% last week, and is .84% lower this week.

The U.S. Dollar lost .66% into July 24th coming off a 1.89% surge the week of the 17th. It gained .10% last week, and is .61% higher this week. The Japanese Yen rose .23% into the 24th, fell .06% last week, and has fallen .79% already this week. The Euro gained 1.42% into July 24th, was unchanged last week, and then off .71% into today. Corn fell 6.60% and 5.48% over the past 2 weeks, but is .47% better this week. Cotton lost .05% and 2.78%, but is 1.16% better this week.

"Talent hits a target no one else can hit; Genius hits a target no one else can see." Arthur Schopenhauer

Additional Information is Available on Request

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