BOND MARKET REVIEW

September 10, 2015

War Room

What strategy will we see next week from the battle–weary Fed? The FOMC is data dependent at this point, and three questions arise employing various semantics of the word 'lies.' We want to know what data lies ahead? What lies within the data? And, what lies are in the data? The August employment numbers were a little disappointing – or soft, but they continued a recent trend. The economy created jobs, though under expectations at 173K and at the slowest pace since March. The number of Americans out of the labor force grew to a new record (over 94 million) – leaving labor force participation at its lowest levels since the late '70s. The Unemployment Rate dropped .2% to 5.1% – the lowest since April 2008! Thus, according to the data, nearly everyone that wants a job – has one. Though the bar has been moving, the economy once again reached the Fed's goals to satisfy the measure of full employment! That said, for a number of other reasons, even the 'holdouts' are starting to believe there'll be no rate liftoff in September! Since the Fed's release of their minutes for the July meeting (on August 19th), the odds have fallen from a 50–50 chance for a September liftoff to only 26% over the past few days. A survey of economists is still closer to 50-50. The **B**ond **M**arket **R**eview is of the opinion that they should hold off for more confirming data.

During the financial crisis, the Fed's long–term forecasting tools led them to project *"exceptionally low levels for the federal funds rate for an extended period."* Pushed for clarity, they forecasted low rates *"through mid–2013"* beginning with their August 2011 statement. In January 2012, they moved that timeframe to *"late 2014."* In September 2012, that window was changed to what has just past – *"mid 2015!"* In December 2012, they dropped the timeframe and switched from simply extending maturities to purchasing long Treasuries. At that time, they adopted a low–rate stance until unemployment dropped below 6.5% and inflation remained no more than .5% above their 2% long–range goal – something that remains a non–issue! In March 2014, they removed the 6.5% jobless rate because it was nearly accomplished. With the August rate falling to only 5.1% unemployment, we're now beneath levels many Fed members have referred to as having achieving 'full' or 'maximum' employment.

Now what? With global equities in great distress, growth challenges in the EU and China, and warnings of deflation once again present, the ECB just downgraded its outlook. In fact, the ECB and other central banks are adopting fresh stimulus measures. Our FOMC is of course troubled by having no wiggle room to fight future battles as a result of years of QE and near–zero rate stimulus. There are also many external factors at work. As we enter football season, the FOMC has its own set of armchair quarterbacks ready to offer up their backseat–driver type of analysis and opinions. During the G20 meetings in Ankara this past week, the U.S. has been encouraged to make sure the economy is truly ready before taking action. The International Monetary Fund's Christine Lagarde spoke out against the gradual pace option that could even lead to a reversal. She said: *"The Fed has not raised interest rates in such a long time, that it should really do it for good, not give it a try and then have to come back."* Speaking to her more–global outlook, she explained: *"The IMF thinks that it is better to make sure that data are absolutely confirmed, that there is no uncertainty, neither on the front of price stability nor on the employment and unemployment front, before it actually makes that move."* Of course, the IMF likes the low–rate global stimulus!

The question for next Thursday is: Will the FOMC kowtow to external forces, or choose to follow their own path. The FOMC has long held that they'd like to liftoff in September, or at least in 2015, but the unemployment rate and 2Q GDP are among the only factors that would still encourage the Fed to begin that soon. If the Fed hikes now, they're ignoring their own inflation mandate and risking a surprise to already–fragile (and nervous) global equity markets. If the Fed stays, they risk their projections of hiking at a gradual pace. They would be seen as waiting for a more solid footing capable of a campaign of hikes, but also as overly willing to prop up global equity markets!.

Looking Ahead

- Bond cycles show yields generally higher into late September.
- Stock cycles show a trend–change high near 9/30, a low near 10/14, and a more major high near 10/30.
- The much–anticipated September FOMC interest–rate policy announcement is due on Thursday the 17th.

Little Trouble in Big China

Following an August selloff that was their largest in over 3 years, Chinese officials stepped up to say leverage had been decreased and they perceived *"no systemic risk."* Zhu Jun of the People's Bank of China said: *"We think it's pretty close to the end."* The PBOC explained that state intervention would prevent further collapse. The **BMR** would note – such moves didn't work as timely for the U.S. or Japan! It reminded us of numerous comments made during the financial crisis. For instance, on March 28, 2007, Ben Bernanke said: *"The impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained."*

Treasuries, Agencies, and MBS

FOMC action or not, our cycles are showing higher yields into month end. The cycles are too mixed and the markets too volatile to try to fine tune every turn, so we're erring to the larger move. Such a strategy would argue for hedging (or selling) on rallies. With the Dow falling 540 points and equities dropping over 3% last week, yields were lower, but not near as volatile as over the last 2 weeks of August. Into September 4th, yields fell 1, 4.5, 5.5, and 3 bps for the 2, 5, 10, and 30–year Treasury sectors. A snapback in equities this week took away a little of the safe–haven bid for bonds, and yields for those sectors were higher by 2.5, 8, 10, and 10 bps into today.

MBS spreads (for FNMA 30–year 3.0%) widened by 2 bps into September 4th. Tuesday's 3–year note brought 1.056% for $24 billion in supply. Demand was the lowest since July, and the auction was rated an average '3 of 5'. Foreign buyers took 51% of the issue versus 52.8% last month. Yesterday's 10–year note was rated an above–average '4 of 5', and added $21 billion at a 2.235% yield to last month's offering (August 2025 maturity). Demand was the best since July, though foreign buying fell from 60.1% of the issue last month to a still–stout 57.5% for this offering. Today's 30–year bond was also rated above average though the yield was 2.98% – the highest since July. Demand was better than last month, and foreign buyers took 66% of the $13 billion supply versus a 51.9% in August. The supply was added (or reopened) to last month's August 2045 maturity.

09/04/15 Treasury Yield Curve	2-Year: 0.709%	5-Year: 1.467%	10-Year: 2.125%	30-Year: 2.884%
Weekly Yield Change:	–.009	–.046	–.057	–.028%
Support:	0.76/ 0.79/ 0.81/ 0.84%	1.57/ 1.60/ 1.63/ 1.66%	2.25/ 2.27/ 2.31/ 2.35%	3.01/ 3.04/ 3.06/ 3.09%
Targets:	0.70/ 0.67/ 0.65/ 0.62%	1.51/ 1.48/ 1.45/ 1.42%	2.20/ 2.17/ 2.13/ 2.10%	2.96/ 2.92/ 2.89/ 2.86%

Economics

With data released on Thursday (09/03), Initial Jobless Claims rose 11K to 281K, the highest since early July – but still holding below the 300K threshold for every week since March. Continuing Claims dropped from 2,266K to 2,259K. In today's release, Initial Jobless Claims fell 6K back to 275K, and Continuing Claims edged up 1K to 2,260K. Challenger Job Cuts showed little volatility with only 2.90% more layoffs versus August 2014. The economy added 173K jobs versus 217K expected, though 44K more jobs were also added to the results for the past 2 months. Private payrolls grew by 140K versus 201K expected, and manufacturing lost 17K jobs.

Though expected to fall to 5.20% on even better payroll numbers, the Unemployment Rate fell from 5.30% all the way to 5.10%. That result is one FOMC members have associated with 'full employment', though the Labor Force Participation Rate remained at its highest level since the '70s (October 1977) – with a 62.60% reading for a third straight month. That said, the number of Americans not in the labor force grew from 93,770,000 to a record 94,031,000! Job Openings in July had risen from 5,323K to 5,753K. Average Hourly Earnings rose .30% in August, but the annual increase was unchanged at 2.20%. Weekly Hours rose .1 to 34.6, but were unchanged to last month's data pre–revision. The Underemployment Rate fell .10% to 10.30%. The combination of all the jobs data led to the FOMC labor dashboard improving by 2.1 points (Labor Market Conditions Index).

Bloomberg Consumer Comfort dropped .6 to 41.4 last week given increased market turbulence, and maintained that reading today. NFIB Small Business Optimism rose from 95.4 to 95.9. The service–sector outlook is still strong, but pulled back from 60.3 to 59 (ISM Non–Manufacturing Composite).

Americans are spending! Consumer credit was revised nearly $7 billion higher in July to a huge $27.018 billion, and beat expectations with a $19.097 billion increase in August. The Trade Balance deficit was wider ($45.21 billion instead of $43.84 billion) in June, but narrowed to $41.86 billion in July on increased exports and decreased imports. That will be a plus for 3Q GDP. Import Prices fell 1.80% in August, and the annual decline increased from –10.50% to –11.40%! Wholesale Inventories were off .10% in July. Wholesale Trade Sales fell .30%.

Friday is set for Producer Prices (August PPI), University of Michigan Sentiment, and the August Monthly Budget Statement. Next Tuesday (09/15) gives us August Retail Sales, Empire Manufacturing, Industrial Production, Capacity Utilization, and July Business Inventories. Wednesday follows with MBA Mortgage Applications (off 6.2% last week), Consumer Prices (August CPI), home–builder outlook (NAHB Housing Market Index), and net foreign Treasury transactions (TIC flows). The FOMC will release their updated stance on interest–rate policy next Thursday (09/17). Also due are the 2Q Current Account Balance, Housing Starts, and Building Permits.

The **BMR** will 'never forget' 9/11/2001. While we recall and honor the Americans lost in the terrorist attacks, we also thank our nation's first responders then and now – and those whose bravery prevented even more loss of life.

Equities

Since August 26th, stocks have had 4 of their largest gains of the year, but it hasn't been enough to offset the global equity plunge in August. Last week ended up with significant losses again as a 'soft' jobs report on the 4th did little to encourage the bulls. The Dow lost 540.63 points or 3.25% to 16,102.38. It's up 1.42% since Friday, despite another swoon on Wednesday. The S&P lost 67.65 points or 3.40% last week to 1,921.22, but is 1.62% higher this week. The Nasdaq also fell hard – losing 144.41 points or 2.99% to 4,683.92. It's up 2.40% this week. The Dow Transports lost 1.45%, but are 3.04% higher this week. Bank stocks fell 3.79% last week as one of the weaker sectors, but are 2.14% higher this week. Our cycles are showing stocks higher into a trend change near September 16th, lower into a trend change near the 22nd, and then higher into month end.

Resistance:	Dow:	16,437/ 16,658/ 16,943/ 17,206	Nasdaq:	4,829/ 4,898/ 4,969/ 5,038	S&P: 1,971/ 1,993/ 2,015/ 2,038
Support:		16,040/ 15,792/ 15,536/ 15,294		4,758/ 4,703/ 4,657/ 4,622	1,929/ 1,905/ 1,884/ 1,861

Other Markets

Commodities settled down a little last week, losing only .20%. They're .66% higher this week even though Crude Oil is off .28% after rising 1.84% last week. Gold lost 1.11%, and is 1.03% lower this week. The U.S. Dollar gained .11%, but is .83% lower this week. The Japanese Yen rallied 2.23% last week, but is 1.37% lower this week on talks of additional stimulus measures by the Bank of Japan. The Euro lost .32% last week, but is 1.17% higher since Friday. Corn lost 3.79% last week, but has rebounded 3.51% into today. Cotton lost 1.07%, but is .65% higher this week.

"Nothing has an uglier look to us than reason, when it is not on our side." Halifax

"It's all right to have butterflies in your stomach. Just get them to fly in formation." Dr. Rob Gilbert

Happy Birthday Jeffrey!

Additional Information is Available on Request
Doug Ingram, Managing Director – Commerce Street Capital Management