BOND MARKET REVIEW

September 17, 2015

Failure to Launch

What do you say – after one of the most anticipated financial moves in recent history becomes a 'non–event?' We're OK – you're not? Global markets ate our homework? The FOMC chose to look beyond U.S. growth and job creation, and capitulate to weak global growth and the IMF plea for more time. The Fed reworded the top of their statement to say household and business fixed investment spending were *"increasingly moderately."* While leaving intact their text of expectations for economic activity to expand at a moderate pace *"with appropriate policy accommodation"*, they used a global view to leave rates 'near zero' – where they've been since December 2008. If you were a sophomore in high school at that time, you'd be graduating college with the same prime rate for the entire period. This statement added: "*Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term."* They repeated that they view the *"outlook for economic activity and the labor market as nearly balanced"*, but they added that they're *"monitoring developments abroad."* The vote was 9 to 1 with Richmond's Lacker preferring a 25 bps hike.

What appeared as a 'September lock' earlier in the year moved to 50–50% in recent months. After the July Fed minutes (in mid August), the odds began to drop and fell to only a 26% chance last week (which was correct). We said: *"The **B**ond **M**arket **R**eview is of the opinion that they should hold off for more confirming data."* Given this statement, the odds for liftoff in October are now only around 18%. In the **BMR** (08/20/2015), we noted that a St. Louis Fed member agreed with us that QE had done little to increase inflation. In fact, current measures of inflation are below where they were when the Fed set its 2% goal in 2012. Last week, we said the Fed could use jobs or GDP as justification to hike, but we argued: *"If the Fed hikes now, they're ignoring their own inflation mandate and risking a surprise to already–fragile (and nervous) global equity markets."*

We've also been skeptical of the jobs number, and found yet another insider that shares our concerns. Andrew Levin was an advisor to Ben Bernanke and Janet Yellen from 2010 to 2012. On Tuesday, he said: *"We're not even close to full employment."* Levin said it could take 2 years to reach full employment based on his calculation of around 2.2% 'slack' in the potential labor force. He put the 'real' unemployment rate closer to 7.25% – a number the **BMR** would believe. (That would leave only one solid quarter of GDP as a reason to lift rates, and that's just not enough!) Levin said: *"Initiating monetary tightening at this juncture would be a serious policy error."* For now – they didn't choose that path. Skipping the October meeting, the new liftoff would supposedly be in December, so we've months more modest–to–moderate growth and tame inflation to endure. Fighting deflation or very–low inflation is a tough war. We've seen the EU battle for years, and anticipate the ECB to step up their QE measures in the fight. U.K. inflation is near zero. Japan's been in the battle for decades. While Japan expects a resumption in growth and inflation, S&P is skeptical. Standard & Poor's cut Japan's long–term credit a notch to A+, stating their belief that Japan will not be able to reverse their *"deterioration in the next 2 to 3 years."* Our final observation is that the real problem is the plunge in China's growth and manufacturing. China is once again the largest holder of U.S. debt – a position Japan held for only one month. It would almost seem like a back–door deal: You don't hike – and we won't dump Treasuries! A U.S. hike had been seen as a huge risk for China and emerging 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.

Treasuries, Agencies, and MBS

While the short–end of the curve was unchanged going into the 11th, bond traders began to hedge their bets on the Fed hiking rates on the 17th. Last week, yields rose 4.5, 6.5, and 7 bps for the 5, 10, and 30–year Treasury sectors. That theme continued into the Fed meeting as 2, 5, and 10–year yields jumped 10, 11, and 13 bps – moving halfway towards a potential 25 bps hike. That left 2–year notes at their highest yield since 2011. In fact, global yields such as those on Germany's short notes also rose about 9 bps into the meeting. A hike, after all, would have led to global repricing of short instruments! However, the non–event led to the best 2–year note rally since March 2009. That was when the Fed announced plans to increase QE bond purchases. Today's FOMC statement was read as a bit confusing to those that expected a move given the Fed's stated intentions since early 2015, but also surprisingly dovish in content by traders. With rates this low, a 25 bps move would have caused an instant correlative pricing for nearly all short paper. The unwind of that 'half hedge' led to 2 and 5–year gains overshooting the losses they'd shown since Friday. By the end of the day, yields were lower for the week by 2.5 and 3.5 bps at 2 and 5–years. They were flat at 10–years and 5.5 bps higher for 30–years.

Inasmuch as bondtraders have somewhat correctly played short rates, long maturities are trading well below the 'dot plot' projections further out in time. It's clear that the markets don't believe projections of those 2.5% to 3.5% Fed targets in 2017 and 2018 – as current pricing is assuming roughly half those levels.

MBS spreads (for FNMA 30–year 3.0%) pulled in by 3 bps into September 11th. Next week, the Treasury will auction $26 billion 2–year notes on Tuesday (09/22), $35 billion 5–year notes on Wednesday (09/23), and $29 billion 7–year notes on Thursday (09/24).

09/11/15 Treasury Yield Curve	2-Year: 0.707%	5-Year: 1.514%	10-Year: 2.189%	30-Year: 2.953%
Weekly Yield Change:	–.002	+.047	+.064	+.069%
Support:	0.70/ 0.74/ 0.77/ 0.81%	1.49/ 1.52/ 1.55/ 1.58%	2.20/ 2.23/ 2.27/ 2.31%	2.97/ 3.02/ 3.06/ 3.09%
Targets:	0.70/ 0.67/ 0.65/ 0.62%	1.43/ 1.40 / 1.37/ 1.34%	2.13/ 2.09/ 2.06/ 2.02%	2.93/ 2.88/ 2.84/ 2.80%

Economics

Initial Jobless Claims fell 11K to 264K, into the lower range of recent data. Continuing Claims dropped from 2,263K to 2,237K. Producer Prices showed zero inflation in August, leaving the annual pace with a .80% decline. Ex food & energy, prices rose .30% taking that annual core pace .30% higher to .90%. Consumer Prices fell .10% in August, but were up a slight .10% ex food & energy. Annual CPI remained at only .20%, while the core rate remained at 1.80%. University of Michigan Sentiment fell from 91.9 to 85.7, and Current Conditions dropped from 105.1 to 100.3. Expectations fell from 83.4 to 76.4 as the recent market turmoil probably set in. Bloomberg Consumer Comfort confirmed those results with a drop from 41.4 to 40.2. Bloomberg Economic Expectations fell 1.5 points to 44.5. The Philadelphia Fed Business Outlook dropped from 8.3 to –6, and Empire Manufacturing contracted for a second month (–14.92 and –14.67). August Industrial Production declined by .40%, and Capacity Utilization fell from 78% to 77.60%. U.S. Manufacturing declined the most since January 2014 with a .5% drop.

The Budget deficit was $64.4 billion in August – less than expected, leaving the 11–month fiscal budget 10% lower to 2014. Retail Sales rose .20% in August, and were .40% higher for a 'control group.' Home builder optimism rose 1 point to a 10–year high of 62. In July, foreign entities bought $7.7 billion long Treasuries. Including shorter instruments, purchases netted a $141.9 billion increase. The 2Q Current Account Balance was only $109.7 billion. August Housing Starts fell 3.01% to 1,126K, but were up 17.66% versus August 2014. Building Permits rose 3.54% to 1,170K, and were 16.65% higher to August 2014.

Friday is set for Leading Indicators (August LEI) and Household Change in Net Worth. This Monday (09/21) brings Existing Home Sales for August. Tuesday follows with the FHFA House Price Index and Richmond Manufacturing. Wednesday updates MBA Mortgage Applications (which fell a sharp 7% last week).

Equities

Our equity cycle worked well, with stocks heading straight up into the 16th. They should now be *"lower into a trend change near the 22nd, and then higher into month end."* Every week for the past 10 has been a reversal of direction for the S&P – and last week was up. Last week, into the 11th, the Dow gained 330.71 points or 2.05% to 16,433.09. It's 1.47% better this week. The S&P gained 39.83 points or 2.07% to 1,961.05, and is 1.49% higher this week. The Nasdaq rallied 138.42 points or 2.96% to 4,822.34, and is 1.48% better this week. The Transports rose 3.31%, and are 2.03% higher this week. Bank stocks rose 2.01%, but are .29% lower since Friday.

	Dow:	Nasdaq:	S&P:
Resistance:	16,537/ 16,664/ 16,794/ 16,926	4,890/ 4,969/ 5,039/ 5,111	1,984/ 2,006/ 2,029/ 2,052
Support:	16,405/ 16,276/ 16,153/ 16,026	4,828/ 4,760/ 4,700/ 4,658	1,963/ 1,941/ 1,919/ 1,904

Other Markets

Commodities were up a slight .01% last week, and are .76% better since the 11th. Crude Oil lost 3.08%, but has rallied 5.09% this week. Gold lost 1.57%, but is 1.25% higher this week. The U.S. Dollar fell 1.09% last week, and is .54% lower this week. The Japanese Yen was 1.34% lower, but is up .48% this week. The Euro surged 1.70%, and added .86% into today. The Dollar had been trading higher on expectations of a Fed hike. Corn surged 7.15%, and is 1.40% higher this week. Cotton rose 1.62%, but is 3.53% lower since Friday.

"Take calculated risks. That is quite different from being rash." George S. Patton

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Doug Ingram, Managing Director – Commerce Street Capital Management

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