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

October 22, 2015

Back to the Future

As most are aware by now, October 21st, 2015, was the date set for Doc Brown's flux–capacitor modified DeLorean to time warp back to the future from 1985. When Marty McFly stepped out into 2015, there were hovercraft, realistic 3–D movies, drones, video–conferencing, and the Cubs had just swept the World Series (in 5 – so it was to be a 9 game series?). As forecasting goes, '4 out of 5 ain't bad'! Maybe the fact that their 2015 still had a wide usage of fax machines disrupted the whole space–time continuum – leading the New York Mets to instead sweep the Cubbies. The Japanese Nikkei is roughly where is was in 1986, so they only wish they could go 'to an alternate future'.

Super Mario

Also in 1985, in September – Super Mario was released by Nintendo. Mario would hit blocks to receive coins or 'power ups.' This week European Central Bank President Mario Draghi acknowledged faltering growth in the EU, and announced that their QE would probably extend to September 2016 – and possibly beyond. EU stocks loved the news – as QE is the stuff of rallies, and U.S. equities shared the energy to propel higher into our cycle. It was like 'reverse taper' talk for the ECB, and they're expected to possibly cut rates in December – at a time when the FOMC could potentially hike! Every time this 'Super Mario' steps on a block, he releases 60 billion Euro for asset purchases!

The Green Inferno

I have two friends with a unique take on meetings. When it was quite obvious that something couldn't be true (or we were being hoodwinked – even if it was by him), one would say: *"What are you going to believe – me or your eyes?"* So, are we supposed to believe a 2015 FOMC hike – or the data? When a vote was approaching, and it was clear the agenda was being moved quickly to an affirmative vote, the other would signal we were being railroaded with subtle train whistles – or locomotive arm motions! The **B**ond **M**arket **R**eview would suppose we'll see a little of both next week as the Fed holds their October meeting concluding with their interest–rate policy statement on Wednesday. As we said last week, no one seems to be expecting any surprises or news in the October statement. It's another chance for FOMC members to tell us there are global concerns, transitory inflation, strength in housing, some slowing in manufacturing, and that jobs are on track.

However, the greenback is on fire! It's been given a huge boost as the ECB and FOMC are now seen on diverging tracks, with Draghi speaking to slow growth and too–low inflation. The ECB seems to be racing the Fed to expand their balance sheet, while the U.S. will shortly again raise its debt ceiling. One would think that out–of–control printing presses would lead to inflation, but the global economy's effect on price pressures has the central banks of Japan, the U.S., and the EU scratching their collective crania. After all, flooding the markets with cash while still borrowing at low or even negative rates – what could go wrong?

Looking Ahead

- Bond yields should make a high in the first week of November. That should be a buy opportunity.
- Our stock cycles still show equities falling from an important and tradable high near October 26th.
- The FOMC will next announce interest–rate policy on Wednesday, October 28th, at 2 p.m. EDT.

Treasuries, Agencies, and MBS

A large drop in U.S. Leading Indicators, and renewed projections for EU (and some global) weakness reduced what was a small chance for a FOMC October hike to one even more remote. The Leading Index fell .20% in September – its largest drop in 7 months. August LEI was revised from up .10% to flat. Though the FOMC will announce policy next Wednesday, it's becoming more evident that even those members clinging to a December 2015 hike might be swayed to a delay into 2016. FRB New York's William Dudley is holding on to 2015 – if the data stays on track with his outlook. We think it won't! Our cycles had yields *"making another low–rate trough in mid–October, and then rising into month end."* Yields began to rise on the 15th (from a low on the 14th), and should make a high in the first week of November. We would remove hedges and accumulate long positions in that November 2nd–to–6th window.

Last week, yields fell 3, 4.5, 5.5, and 3.5 bps for the 2, 5, 10, and 30–year Treasury sectors. Into today, they were flat for the front end, but 2 bps better at 30–years. MBS spreads (for FNMA 30–year 3.0%) pulled in by 1 bps into October 16th. The U.S. Treasury will auction $35 billion 5–year notes on Wednesday (10/28), and $29 billion 7–year notes on Thursday (10/29). The 2–year note auction which was scheduled for Tuesday (10/27) is now listed as 'TBA' – as the Treasury is waiting on the debt ceiling to be raised to accommodate additional borrowing (or it couldn't settle!).

10/16/15 Treasury Yield Curve	2-Year: 0.611%	5-Year: 1.353%	10-Year: 2.034%	30-Year: 2.882%
Weekly Yield Change:	–.028	–.046	–.055	–.036%
Support:	0.64/ 0.66/ 0.70/ 0.74%	1.43/ 1.46/ 1.49/ 1.52%	2.09/ 2.12/ 2.16/ 2.19%	2.92/ 2.97/ 3.01/ 3.06%
Targets:	0.58/ 0.55/ 0.53/ 0.50%	1.35/ 1.31/ 1.28/ 1.25%	2.03/ 1.98/ 1.95/ 1.92%	2.86/ 2.84/ 2.80/ 2.76%

Economics

Over the past two weeks, Bloomberg Consumer Comfort rose .6 to 45.2, but then fell 1.7 back to 43.5. The previous week's University of Michigan survey on Sentiment rose from 87.2 to 92.1, and their Current Conditions result rose from 101.2 to 106.7. Expectations improved from 78.2 to 82.7, but data since then has lost ground like a mishandled punt. Today, Bloomberg Economic Expectations fell 2.5 points to a 13–month low of 42. September Manufacturing Production fell .10%, and the sector remains challenged as Empire Manufacturing was higher – but still negative, moving from –14.67 to –11.36. The Philadelphia Fed Business Outlook rose from –4.5 to –2. Chicago Fed National Activity was .02 better to –.037 and Kansas City Fed Manufacturing Activity rose 8 points to –1. Industrial Production fell .20% and Capacity Utilization dropped .30% to 77.50% in September. Initial Jobless Claims fell from 262K to 256K last week. That was at the lowest levels since 1973. They rose only slightly to 259K with today's data. Continuing Claims fell from 2,208K to 2,164K, and then rose a modest 6K higher to 2,170K. JOLTS Job Openings for August were a little lower to July, falling from a record 5,668K to 5,370K (still the second highest only to July). September Consumer Prices fell .20%, but were .20% higher ex food & energy. The annual pace fell from a .20% rise to flat or 0%, though the core rose .10% to 1.90%. Real Average Weekly Earnings slowed from a 2.30% rise to 2.20%. The Monthly Budget Statement for September revealed a $91.1 billion surplus versus $105.8 billion last year. That closed out fiscal 2015 with a deficit gap of $438.9 billion, 9.2% less than for 2014 – and the smallest since 2007. Though lengthening longer–term holdings of U.S. Treasuries by $20.4 billion, foreign holders were net sellers in August – reducing overall holdings by $9.2 billion.

U.S. homebuilder outlook rose to a 10–year high on expectations of improving sales (NAHB Housing Market Index up from 61 to 64). Though Building Permits fell 5% to 1,103K, they were up 6.98% to last year. However, Housing Starts rose 6.54% to 1,206K (up 16.18% year–over–year) – to their second highest level in 8 years. The housing sector outlook was also boosted with Existing Home Sales rising 4.72% to a 5.55M pace (the second highest level since February 2007). The FHFA House Price Index rose .30% in August.

Friday is set for Manufacturing PMI. Next Monday (10/26) brings September New Home Sales and Dallas Fed Manufacturing Activity. Tuesday yields Durable Goods Orders, S&P/Case–Shiller home price data, board Consumer Confidence, and Richmond Fed Manufacturing. Wednesday gives us MBA Mortgage Applications (which rose 11.80% last week), September's Advance Good Trade Balance, and the FOMC interest–rate policy stance for October.

Equities

Our stock market cycles have been performing quite well. Equities completed a 3–week rally last week and are headed for a 4th! As we updated last week: *"The **BMR** equity cycles continue to show a top near October 26th. After that, the short and medium cycles fall sharply into November 18th. While it's obvious that no techniques are anywhere near perfect, we wouldn't want to be long after the 26th. The short cycles show a high near October 19th and a low near the 21st, before the convergence into the 26th."* We even got the strength into the 19th, and the pullback into the 21st! Into the 16th, the Dow rose 131.48 points or .77% to 17,215.97. It's 1.59% higher this week as we draw nigh to Monday the 26th. The S&P gained 18.22 points or .90% to 2,033.11, and is .95% higher this week. The Nasdaq rallied 56.22 points or 1.16% to 4,886.69, and is .68% higher since Friday. The Transports lost 2.11% last week, but are 1.98% higher this week. Bank stocks gained .25%, and are .92% better this week.

Resistance:	Dow:	17,690/ 17,823/ 17,956/ 18,093	Nasdaq:	5,026/ 5,062/ 5,132/ 5,205	S&P:	2,076/ 2,088/ 2,111/ 2,134
Support:		17,425/ 17,295/ 17,159/ 17,031		4,921/ 4,851/ 4,778/ 4,714		2,054/ 2,042/ 2,019/ 1,997

Other Markets

Following strength into the 9th, Commodities have now resumed their weakness with a 1.60% loss last week, and a 1.92% drop so far this week. Falling prices continue to thwart global growth. Crude Oil tumbled 4.78% last week, and has dropped 3.98% this week. Gold rose 2.36% last week, but was 1.44% lower into today. While a delay in FOMC tightening should be challenging the U.S. Dollar, it's instead thriving on extended stimulus by global central banks. The Dollar lost .31% last week, but has surged 1.97% this week (on news that the ECB is expecting to provide QE through September 2016 – and possibly beyond). The Euro, in turn, fell .09% last week and has plummeted 2.11% this week. The Japanese Yen rose .69%, but is 1.05% lower this week. Corn fell 1.57% last week, and is .40% higher this week. Cotton gained 3.64%, but is off 2.08% this week.

Never mind the DeLorean! Ferrari went public this week, so I can finally own one … share.

Additional Information is Available on Request

Doug Ingram, Managing Director – Commerce Street Capital Management