BOND MARKET REVIEW

December 10, 2015

Up the Down Staircase

The last major hurdle to a Fed rate hike this coming week would have been poor payroll numbers. Last week, we said: *"It appears that only dismal November payroll numbers this Friday would be enough to sway the FOMC to delay their liftoff until January or March 2016."* There were no such downside surprises! The Unemployment Rate remained at 5%, payrolls rose more than expected with upside revisions to the last two months, and labor force participation improved. The Beige Book reassured the Fed that growth is still at least moderate in most districts, though there are some challenges within the manufacturing sector. The committee will get a last minute view on inflation forces with producer and consumer price index updates coming before their announcement on Wednesday.

One thing not lately mentioned by apologists for higher rates is that the Fed typically hikes rates to slow the economy. With only modest growth and a recent downturn in manufacturing, that can't be the goal here. Neither are current inflation levels a present threat. It seems the largest argument is that 'it's time', or at the very least to store up ammo for another cut when and if needed. While the chief question for many remains at what pace will the Fed tighten from the liftoff, some of our longer–term work makes us wonder if rates will trip back down the stairs – leading to another cut sometime in 2106? The committee seems to be in a hurry to return to 'policy normalization', as if there's not a global 'new normal' taking place. Fed Chair Janet Yellen said a delay could lead to *"abrupt tightening"* that might even *"inadvertently push the economy into recession."* We would ask, what if this is the abrupt tightening that does just that? Even from where we sit – there's no shortage of armchair quarterbacks and back–seat drivers! In the last **BMR**, we discussed that the incoming FOMC voters for 2016 will most likely be a more hawkish crew. What remains to be seen is, should she choose to go with the launch, whether or not Yellen can persuade a unanimous vote for liftoff with the current Fed vote holders? There are certainly plenty of 'yea' votes standing at the ready.

Last week, with only the few puzzle pieces to come, Atlanta FRB President Dennis Lockhart said: *"Absent information that drastically changes the economic picture and outlook, I feel the case for liftoff is compelling."* He said he *"bought into that view"* that *"much of what's suppressing inflation is transitory in nature."* Countering that view, OPEC just upped production of Crude Oil despite the recent glut of supply. The **B**ond **M**arket **R**eview does believe that low oil prices have been a stimulus to global economies, but prices are now the lowest since 2004 – and this price 'war' could further endanger the U.S. oil industry. With the Fed hiking rates, the Dollar could show continued strength – which would continue to thwart U.S. manufacturing and exports. The Monthly Budget Statement for November showed a $64.6 billion deficit – which is already 12.6% worse (more) than last year's deficit pace. Wait until we factor in higher borrowing costs on our immense and fast growing debt!

Looking Ahead

- Bond cycles are mixed into December 16th. After that, yields should rise steadily into month end.
- Our stock cycles show trend–change highs near the 15th and 21st, with a major low due near January 11th.
- The FOMC will announce their interest rate policy stance on Wednesday, December 16th at 2 pm ET.

Treasuries, Agencies, and MBS

Stocks and bonds had large swings over the past week – as the markets not only focused on the upcoming Fed meeting and good payroll numbers, but also with domestic terrorism in California within three weeks of the Paris attacks. As we've noted, short rates have priced in a December rate hike. Short Treasury instruments are trading at the highest yields since the financial crisis. Over the past week, the odds for a rate hike coming on the December 16th FOMC meeting have risen from 72%, to 74% after Friday's payrolls, to 78% earlier this week, and then to 76% today. Rates spiked up into last Thursday, but have since traded by down with the cycle. Into December 4th, yields rose 2, 6, 5, and 1.5 bps for the 2, 5, 10, and 30–year Treasury sectors. Into today 2–year note yields rose .5 bps, but yields for the 5, 10, and 30–year sectors fell 3, 4, and 4 bps. Our bond–yield cycles are bottoming out and mixed into the Fed meeting. After that, we expect a steady rise into the end of the month. We would sell and/or place hedges back on.

MBS spreads (for FNMA 30–year 3.0%) pulled in by 2 bps last week. On Tuesday (12/08), the U.S. Treasury sold $24 billion 3–year notes at a 1.255% yield. The auction was rated 'above average' and demand rose versus last month. Foreign buyers accounted for 47.4% of this issue versus 40.8% in November. Wednesday's 10–year sale was rated average and brought 2.233% for $21 billion in supply. Demand was the highest since September and foreign accounts bought 62% versus 60.5% last month. The Treasury reopened the November 2025 issue for the sale. Today's 30–year bond was also rated average and brought 2.978% for $13 billion. Demand was again better to the previous sale, and foreign buying rose to 63.9% from 60.3% last month.

12/04/15 Treasury Yield Curve	2-Year: 0.941%	5-Year: 1.706%	10-Year: 2.270%	30-Year: 3.010%
Weekly Yield Change:	+.021	+.061	+.049	+.013%
Support:	0.94/ 0.96/ 0.99/ 1.02%	1.62/ 1.65/ 1.68/ 1.71%	2.18/ 2.22/ 2.25/ 2.29%	2.96/ 3.00/ 3.04/ 3.08%
Targets:	0.91/ 0.89/ 0.86/ 0.83%	1.59/ 1.56/ 1.53/ 1.50%	2.15/ 2.11/ 2.08/ 2.04%	2.88/ 2.86/ 2.83/ 2.79%

Economics

ADP Employment Change was 'spot on' as an early read for November payrolls. 217K jobs were added in the private sector and previous data was bumped 14K higher. Another positive came in Challenger Job Cuts showing 13.90% less announced layoffs versus November 2014. Nonfarm payrolls rose 211K in November (versus 200K expected), and data for October was revised 27K higher. The 2–month revision was 35K higher. Private payrolls rose 197K, and 36K were added in revisions to previous months. Manufacturing jobs were adjusted from flat to up 1K for October, but then fell 1K last month – leaving that slowing sector unchanged for the last 2 months. Given that result, we can repeat from the **BMR (10/08/2015)** that manufacturing jobs are *still "stagnant with no net improvement since January!"* There was a positive with the Labor Force Participation Rate improving from 62.40% to 62.50%. Government data showed 67K less in the 'not in the labor force' bracket, a partial reason for the U.S. Unemployment Rate remaining at 5.0% instead of improving – given the pickup in jobs.

The Underemployment Rate actually rose .10% to 9.90%. Average Hourly Earnings rose .20%, but the annual pace slowed from 2.50% to 2.30%. Another negative came in Average Weekly Hours falling from 34.6 to 34.5, so overall the report was good, but not great. The Fed's job dashboard agreed with that assessment as it rose 2.2 points in October, but only .5 points for November (Labor Market Conditions Index). Initial Jobless Claims rose 9K to a still–low 269K last week, but rose to 282K today. Continuing Claims were 6K higher to 2,161K, and then sharply higher to 2,243K for the following week. JOLTS Job Openings for October showed available situations falling from 5,534K to 5,383K. Nonfarm Productivity rose 2.20% in the third quarter, and Unit Labor Costs were up 1.80%.

Last week, Bloomberg Consumer Comfort fell for the 5th time in 6 weeks. It dropped from 40.9 to 39.6. However, it rose to 40.1 with today's release. IBD/TIPP Economic Optimism rose from 45.5 to 47.2, but NFIB Small Business Optimism fell from 96.1 to 94.8. ISM New York fell from 65.8 to 60.7. Durable Goods Orders rose 2.90% in October. Ex transportation, they were up only .50%. Orders for Capital Goods rose 1.30%. Factory Orders rose 1.50% (after falling .80% in September). Ex transportation they rose only .20%. The service sector outlook is still positive at 55.9, but less optimistic than last month's 59.1 reading (ISM Non–Manufacturing Composite). The Trade Balance deficit for October was $43.89 billion, up from September's $42.46 billion. Consumer Credit expanded by $15.982 billion, well off September's $28.566 billion increase. Wholesale Inventories fell .10%, and Trade Sales were flat. Import Prices fell .40% in November, and the annual pace slowed to a 9.40% drop from –10.70%.

Friday is set for November Retail Sales, Producer Prices (November PPI), Business Inventories, and the University of Michigan confidence surveys. Next Tuesday (12/15) gives us Empire Manufacturing, November Consumer Prices (CPI), homebuilder outlook NAHB Housing Market Index, and net foreign Treasury transactions (TIC Flows). Wednesday follows with MBA Mortgage Applications (which fell .20% and then rose 1.20% over the past 2 weeks), November Housing Starts & Building Permits, Industrial Production, and the much–anticipated FOMC interest rate decision for December.

Equities

The stock cycles are performing as expected. Stocks did move lower in the middle of last week, but the Dow gained nearly 370 points on Friday – making what should be an important high with our trend–change that was due on the 4th. We had repeated: *"We would not want to be long after the 4th!"* The next two high turns, which we would treat as additional opportunities to sell, are due near December 15th and the 21st. For now, our work is showing the next important low (one we would treat as a buying opportunity) near January 11th.

Last week, on the strength of Friday's rally, the Dow closed 49.14 points or .28% higher to 17,847.63. It's 1.53% lower this week and Euro stocks were off sharply tonight. The S&P gained 1.58 points or .08% to 2,091.69, but is 1.89% lower this week. The Nasdaq rose 14.75 points or .29% to 5,142.27, but is also 1.89% lower so far this week. The Transports lost 3.17% last week and are 3.56% lower this week. The divergence between the Industrials and the Transports, combined with the weakness in the latter, have a Dow Theory signal in place for a bear market. Nothing's near 100% but, given our cycles, there are some negatives stacking up. Bank stocks rose 1.15% last week, but were 3.86% lower into today.

Resistance:	Dow:	17,428/ 17,562/ 17,695/ 17,827	Nasdaq:	5,001/ 5,037/ 5,074/ 5,110	S&P:	2,025/ 2,037/ 2,050/ 2,067
Support:		17,227/ 17,166/ 17,038/ 16,906		4,933/ 4,897/ 4,862/ 4,828		2,014/ 2,003/ 1,992/ 1,981

Other Markets

With Crude Oil tumbling to 14–year lows, inflation may indeed be a bit more entrenched rather than transitory. Crude fell 4.17% last week, and has plunged 8.03% this week. Commodities were unchanged last week, but are a stout 3.39% lower already this week – tumbling to their lowest levels in over 2 decades. Another anti–inflation notch! Gold rose 2.68% last week, but is 1.05% lower this week. The U.S. Dollar was hit hard last week with a 1.73% drop. It's another .39% lower this week – despite expectations that the Fed will hike this month (even as other central banks are providing additional stimulus). The Japanese Yen fell .25% last week, but rallied 1.26% into today. The Euro surged 2.72%, and is .55% higher this week. Corn rose 4.73%, and added .27% into today. Cotton rose .96%, and is .85% better this week.

"Our bodies are our gardens to which our wills are gardeners."
William Shakespeare

"When I was younger, I could remember anything, whether it had happened or not."
Mark Twain

"Asking a working writer what he thinks about critics is like asking a lamppost how it feels about dogs."
Christopher Hampton

Additional Information is Available on Request
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