1445 ROSS AVENUE, SUITE 2700
DALLAS, TEXAS 75202 · 214-545-6800

BOND MARKET REVIEW

December 29, 2015

Point Break

With the Fed's first rate hike since June 2006, the tether holding short rates down has been removed – and the loosening stakes are allowing the economic winds to now lift rates. Over the past week, U.S. 2–year Treasury yields broke above 1% for the first time since April 2010. However, the spread between 2 and 30–year yields just fell to the lowest level since this past April. As we contended in the last **B**ond **M**arket **R**eview (12/17/15): *"With the first FOMC hike behind us, we think short–term instruments will continue to price in the 4 anticipated 25 bps hikes over the coming year, while long rates will rise a bit, but be driven more by inflation expectations – which we don't currently view as 'transitory'."* Transitory is no longer the only FOMC buzzword. Fed Chair Janet Yellen chose to give us a new spin on inflation this week. She said: *"There are various idiosyncratic factors that affect core inflation."* That idiosyncrasy is due to just a few candidates. One being falling health–care prices, and another certainly lower Crude Oil. However, countering the 'transitory' viewpoint, OPEC said it expected to see Crude Oil demand slide into 2020.

We said the Fed would choose to leave rates unchanged in January in order to confirm their plan to increase the target at a *"gradual pace."* A hike would shock the markets, as the Fed would be going off script and opting for a surprise move. If they move as signaled, every other meeting would lead to 4 hikes – one each in March, June, September, and December. Last week, FRB Atlanta President Dennis Lockhart confirmed that expected time line, explaining: *"Moving up gradually means not every meeting, in all likelihood. … The rate of rising interest rates will be more like every other meeting."* The Fed's overall forecast was for 1.375% at the end of 2016 – squarely in the 1.25% to 1.50% boundaries that would result following 4 hikes from the current .25% to .50% (or .375% average). The votes should be there. We already said the incoming FOMC voters should be more hawkish. One review we saw had it this way: There will be 3 hawks and a dove replacing a hawk, a dove and 2 neutral voters. In other words, the 2 swing votes will soon be hawks. Treasury Secretary Jacob Lew said there's *"a lot to feel good about"* the progress of the U.S. economy (though it's rare his office or a Fed member would talk about how bad they expected things to be).

Breakeven Analysis

The Dow had risen 2.96% into May 19th. From that high, it lost 16.42% into August 24th to go 13.76% negative for the year. Since early November the Dow has struggled to go ahead for the year. After a 1.10% rally today it was .57% lower to the end of 2014, but within striking distance of an annual gain. The S&P was .12% lower for 2015 yesterday, but rallied to go .95% ahead today. The Nasdaq was ahead by 7.85% for 2015 today, and looks to be the clear winner. On the other side, the Dow Transports were 16.63% lower for 2015 as of today's close. Bank stocks had wide swings this year, but moved to the plus side by .36% today after being lower for the year only yesterday (like the S&P). As of the 21st, 5–year yields were flat for the year, but they're 13 bps higher as of today. On the other hand, 2–year yields have risen 43 bps (up 64% since the end of 2014). The S&P and Dow are too close to call for 2015, and there are only two trading days left. The Dow won't touch its past 3 yearly gains of 7.26%, 26.50%, and 7.52%.

Looking Ahead

- Bond yields should rise into January 4th. After the 8th, they should trade lower into the 25th.
- Our stock cycles now show a down trend from December 30th to January 11th.
- Stocks will trade normal hours on New Year's Eve, but the bond market will close at 2 pm ET.
- All markets will close on New Year's Day (Friday). We wish you a Happy and Prosperous New Year.

Treasuries, Agencies, and MBS

Yields are rising with our cycles into month end. Today the 5–year note hit its highest yield since early June, and the 2–year note hit its highest yield since April 2010. The cycle for rates peaks on January 4th. After January 8th, our bond cycles become very constructive into the 25th. That would line up with expected cyclic weakness in stocks from December 30th to January 11th (or possibly the 14th). We would cover bond hedging positions near the 4th, and buy bonds for an expected rally. Into the week of the 18th, yields rose 7.5, 12.5, 7.5 and 5 bps for the 2, 5, 10, and 30–year Treasury sectors. Those sector yields continued higher by 4.5, 3.5, 3.5, and 4 bps last week (into the 24th). Into today, that trend continued with yields increasing by 9.5, 7, 6.5, and 7.5 bps.

MBS spreads (for FNMA 30–year 3.0%) pulled in 4 bps into the 18th, and then widened 1 bps last week. On Monday (12/28), the Treasury Department sold $26 billion 2–year notes at 1.056% (the highest since the December 2009 auction). Demand was the lowest since the August 2009 offering. Foreign buyers took only 37.5% compared to 45.7% last month. No matter what long rates do, and how much they might resist rising due to inflation concerns, the Fed has signaled 4 more hikes over the 8 meetings in 2016. With a 25 bps bump presumably coming every 3 months (or so), demand might stay a little soft. Through October, foreign buying has softened every month in 2015 in what could end up the largest decline since 1978.

Today's $35 billion 5–year note offering brought 1.785%. Demand was the lowest since July 2009, and the yield was the highest since September 2014. Foreign buying came in at 52.5% versus 56.7% in November. The U.S. Treasury will auction $29 billion 7–year notes on Wednesday (12/30).

12/24/15 Treasury Yield Curve	**2-Year: 1.000%**	**5-Year: 1.714%**	**10-Year: 2.242%**	**30-Year: 2.961%**
Weekly Yield Change:	+.046	+.037	+.037	+.039%
12/18/15 Treasury Yield Curve	**2-Year: 0.954%**	**5-Year: 1.677%**	**10-Year: 2.205%**	**30-Year: 2.922%**
Weekly Yield Change:	+.077	+.123	+.077	+.051%
Support:	1.10/ 1.13/ 1.17/ 1.21%	1.84/ 1.91/ 1.98/ 2.05%	2.32/ 2.36/ 2.40/ 2.44%	3.06/ 3.10/ 3.15/ 3.19%
Targets:	1.07/ 1.04/ 1.01/ 0.97%	1.70/ 1.65/ 1.58/ 1.52%	2.28/ 2.24/ 2.21/ 2.17%	3.02/ 2.97/ 2.93/ 2.88%

Economics

Initial Jobless Claims fell 5K to a 4–week low 267K. Continuing Claims fell from 2,242K to 2,195K. A downward revision in inventories took 3rd–quarter GDP down .10% to 2.00%. Personal Consumption remained at 3.00% and the GDP Price Index was unchanged at 1.30%. 3Q Core PCE was .10% higher to 1.40%. Consumer Confidence rose from 92.6 to 96.5. University of Michigan Sentiment also improved (from 91.8 to 92.6), and their measure of Current Conditions was 1.1 better to 108.1. Expectations rose from 82 to 82.7. Richmond Fed Manufacturing rose from –3 to 6, but Kansas City fell from 1 to –9, Chicago dropped from –.17 to –.30, and Dallas fell from –4.9 to –20.1.

The PCE Deflator was flat, but raised the annual pace from .20% to .40%. The core Personal Consumption Expenditures rate rose .10%, but that ex food & energy annual pace remained at 1.30%. Personal Spending rose .30% in November, as did Personal Income. Durable Goods Orders were flat in November, but fell .10% ex transportation. Capital Goods Orders dropped .40% (their first fall in 3 months). Sales of Existing Homes fell in November back to the levels of April 2014 as new rules were making loans harder to close. Sales fell 10.53% to 4.76M, and were off 3.25% versus last year. New Home Sales rose 20K or 4.26% to 490K (still weaker than expected). They were 13.69% higher versus last year. In October, the FHFA House Price Index rose .50%. Metro home prices rose .84% in October (S&P/Case–Shiller 20 City Index). The yearly pace quickened from 5.36% to 5.54%. The Home Price Index rose .88%, raising the annual pace from 4.85% to 5.17%. The November Goods Trade Balance deficit was $60.5 billion (–$1.276b).

Wednesday is set for November Pending Home Sales. Thursday wraps up 2015 with jobless claims data, Chicago Purchasing, ISM Milwaukee, and Bloomberg Consumer Comfort (which last week rose from 40.9 to 42.2 – nearly a 2–month high). Monday (01/04) kicks off 2016 data with Construction Spending, ISM Manufacturing, and ISM Prices Paid. Tuesday follows with ISM New York and Vehicle Sales for December. Wednesday is loaded up with MBA Mortgage Applications (which rose 7.30% last week), the November Trade Balance (deficit), Factory Orders, Durable Goods Orders, and the service–sector outlook (ISM Non–Manufacturing Composite). Key data also due on Wednesday includes the minutes from the December FOMC meeting and the first clue into next Friday's December payroll release from the ADP Employment Change report.

Equities

The Dow lost .79% into the 18th, but had a big Santa Claus rally with a 423.62–point 2.47% gain last week to 17,552.17. It's up .96% this week. The S&P lost .34%, gained 55.44 points or 2.76% to 2,060.99 last week, and was then .84% better into today to put it back ahead for 2015. The Nasdaq lost .21%, then gained 125.41 points or 2.55% to 5,048.49 last week, and is 1.18% better this week. The Transports lost 2.13%, gained 3.51%, and are off .04% so far this week. Bank stocks lost .07%, gained 3.02%, and are .54% ahead so far this week.

Resistance:	Dow:	17,741/ 17,875/ 18,011/ 18,143	Nasdaq:	5,115/ 5,151/ 5,188/ 5,223	S&P:	2,081/ 2,092/ 2,104/ 2,116
Support:		17,609/ 17,478/ 17,344/ 17,213		5,043/ 5,008/ 4,973/ 4,938		2,058/ 2,046/ 2,035/ 2,024

Other Markets

Commodities have traded higher since the 17th (the day after the Fed decision). Many global equity markets have been generally higher as well. Commodities were 1.54% lower the week of the 18th, but 2.29% better last week and .71% higher into today. Crude Oil lost 2.50%, surged 9.70% last week, and then eased back .60% into today. Gold lost .99%, gained 1.03%, and is a slight .03% better this week. The U.S. Dollar rose 1.21%, lost .72% last week, but then rose .16% into today. The Japanese Yen lost .12%, gained .60%, and was then .02% lower into today. The Euro lost 1.07% into the 18th, rose .87% last week, and was .39% lower into today. Corn gained .40%, lost 2.67%, and was .55% lower into today. Cotton fell .03%, lost another .05%, but is .33% higher so far this week.

"Real success is finding your lifework in the work that you love." David McCullough

Additional Information is Available on Request

Doug Ingram, Managing Director – Commerce Street Capital Management