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BOND MARKET REVIEW

February 03, 2016

Less than Zero

The groundhog, Punxsutawney Phil, saw no shadow on Tuesday and forecast an early spring. However, the Fed's hiking forecast has been cooling. We're thinking 6 more weeks of low rates – and then some! When the FOMC began their liftoff in December, 4 hikes in 2016 were a 'lock' and the first was intended for March 16th, 2016. Back in December, and in our subsequent 2016 forecast issue, the **B**ond **M**arket **R**eview was skeptical of those 4 hikes – given our outlook for an economic trough in 2016. The odds of a hike at that March meeting have fallen from a coin toss in December to only 12% today! Additionally, given the global equity selloff and slowing growth data worldwide, the market–driven chances for even one more hike in 2016 now stand at less than 50%.

January turned out to be the worst month for global stocks since last August, and the worst yearly start since 2009. The global selloff erased well over $7 trillion in market value – but it could have been much worse. The Dow gained over 500 points on last two days of January to trim what through last Wednesday was the worst monthly loss for the Dow since February 2009, and the worst for most indices since May 2010. Though the European Central Bank only talked about adding stimulus (around March) at their meeting a few weeks ago, global equities hungry for low–rate fuel got a big boost from the Bank of Japan. Though dismissing the idea earlier in January, late last week the BOJ adopted negative rates, their yields fell to record lows, and stocks had their best one–day gains since September 8th!

One measure of U.S. manufacturing slumped at an annual rate of 5.8% in the 4th quarter of 2015. However, our economy is not an easy read! Nonresidential business investment increased by the least amount since 2010, while consumer spending rose the most since 2005. Another report had service industries growing in January at the slowest rate since April 2014. Every time crude oil tumbles, the Fed tells us the drop and resulting lack of inflation is 'transitory.' If we all had a nickel for every time we've heard that, we might be able to stimulate some inflation!

If the Fed still considers the projected–though–gradual hikes still in play, our economy would have no reason to see lower rates – much less negative ones. So, could we go BOJ on rates? You've got to wonder why the Federal Reserve is now asking banks to run stress tests where the rates of 3–month T–Bills would stay negative for a prolonged period. The central bank said: *"The severely adverse scenario is characterized by a severe global recession, accompanied by a period of heightened corporate financial stress and negative yields for short–term U.S. Treasury securities."*

Recall how 'patient' the FOMC was in projecting stimulus for an extended period during and after the financial crisis. This week, Fed Governor Lael Brainard cautioned: *"Recent developments reinforce the case for watchful waiting."* New York FRB President William Dudley noted that financial conditions have become *"considerably tighter"* than they were in December, and said if they remained so into the March meeting, the FOMC *"would have to take that into consideration in terms of that monetary–policy decision."* Dallas' Robert Kaplan said: *"There is no pre–determined path"* on hikes and said the FOMC would be *"data–dependent."* On the other hand, and clearly across the aisle in thought, Kansas City's Esther George said *"monetary policy cannot respond to every blip in the financial markets."* She also said: *"The recent bout in volatility is not all that unexpected, nor necessarily worrisome"* given the Fed's round of policies *"focused on boosting asset prices as a means of stimulating the real economy."* Not worrisome – unless yours was part of the over $7 trillion up in smoke. Last Friday, San Francisco's John Williams reassured there was little chance of recession, the U.S. could weather some storms abroad, and that he was optimistic.

Looking Ahead

- The bond cycles are mixed, but we expect another push to low yields into February 19th.
- Our equity cycles still show stocks improving from our January 27th/28th trend–change for a low.

Treasuries, Agencies, and MBS

Today, the BOJ said that interest rates could be lowered to –1% if necessary, and that there was no floor for a negative interest rate. Treasuries followed suit, if only as a once–again good–spread alternative. Last week, yields fell by 9.5, 15.5, 13, and 8 bps for the 2, 5, 10, and 30–year Treasury sectors. Into today those sectors were lower by another 5, 5.5, 3.5, and 3 bps. With 2–year yields, the maturity most affected by Fed policy, falling over 37 bps from over 1.09% to .72%, it's clear that bond investors are betting against an imminent FOMC hike or inflation. The U.S. government just raised borrowing estimates for the first quarter by 52%, so it's a good thing for us that rates are still relatively low – for now. We had yields turning back down from a rise into the 2nd or 4th, and yields fell hard on the 2nd. The bond cycles are very mixed, but do indicate that yields should rise from a low near February 19th. Last Thursday's 7–year auction was rated an outstanding '5 of 5' as $29 billion notes were sold at 1.759%. Demand was the best since November 2014, the yield the lowest since last January, and foreign buying rose from 47.1% to 69.4%.

MBS spreads (for FNMA 30–year 3.0%) widened by 1 bps last week. The Treasury will auction $24 billion 3–year notes on Tuesday (02/09), $23 billion 10–year notes on Wednesday, and $15 billion 30–year bonds on Thursday.

01/29/16 Treasury Yield Curve	2-Year: 0.776%	5-Year: 1.329%	10-Year: 1.922%	30-Year: 2.744%
Weekly Yield Change:	–.095	–.153	–.131	–.080%
Support:	0.74/ 0.76/ 0.79/ 0.82%	1.31/ 1.37/ 1.40/ 1.46%	1.91/ 1.94/ 1.98/ 2.02%	2.75/ 2.78/ 2.83/ 2.86%
Targets:	0.70/ 0.67/ 0.65/ 0.63%	1.20/ 1.17/ 1.14/ 1.09%	1.84/ 1.81/ 1.77/ 1.74%	2.67/ 2.63/ 2.59/ 2.55%

Economics

Vehicle Sales increased from a 17.22M pace to 17.46M – for the best January in a decade. Domestic sales rose from 13.46M to 13.79M. Initial Jobless Claims fell from a 6–month high of 294K to 278K. Continuing Claims rose from 2,219K to 2,268K. The preliminary data for Durable Goods Orders showed a 5.10% drop in December, and a .50% fall in November (which was previously unchanged). Ex Transportation, orders fell 1.20%. 4th–quarter GDP slowed to .70%. Personal Consumption, however, rose 2.20%. The GDP Price Index fell from 1.30% to .80%, and Core PCE rose 1.20%. The Employment Cost Index rose .60%. December Personal Income rose .30%, but spending was flat (with real spending set at .10% higher). The PCE Deflator showed a .10% drop in December, leaving the annual pace for that measure of inflation .20% higher to a tame .60%. The core (ex food & energy) was flat, with the annual pace remaining at 1.40%. The service industries sector (ISM Non–Manufacturing) fell from 55.8 to 53.5 – as growth fell to the slowest pace since February 2014. ISM Manufacturing contracted for a 4th month – improving only .2 above December's reading of 48 (which had been the weakest result since June 2009). Prices Paid were flat at 33.5. University of Michigan Sentiment fell from 93.3 to 92 and Expectations dropped from 85.7 to 82.7. However, Current Conditions rose from 105.1 to 106.4. ISM New Orders rose from 48.8 to 51.5. ISM New York fell from 62 to 54.6, but Milwaukee rose from 48.53 to 50.36 and Chicago Purchasing rose from 42.9 to 55.6. Kansas City Fed Manufacturing Activity was flat at –9. IBD/TIPP Economic Optimism was .5 better to 47.8. Construction Spending rose .10% in December, but was revised .20% lower to a .60% drop for November. Pending Home Sales rose .10%, leaving them 3.10% higher versus last December.

The ADP Employment Change data showed a 205K increase in private payrolls. Thursday is set for more clues into January employment from jobless claims data and Challenger Job Cuts. Other data includes Nonfarm Productivity and Unit Labor Costs for 4Q 2015, Bloomberg Consumer Comfort (which last week rose .6 to 44.6), December Factory Orders, and a final update on orders for Durable Goods. Friday supplies January payroll data including job growth and unemployment statistics, the U.S. Trade Balance (deficit) for December, and Consumer Credit. Next Monday (02/08) brings the Fed's jobs dashboard following this Friday's January payroll data (Labor Market Conditions Index). Also due are 4Q Mortgage Delinquencies and MBA Mortgage Foreclosures. Tuesday gives us NFIB Small Business Optimism, JOLTS Job Openings for December, Wholesale Inventories and Wholesale Trade Sales. Wednesday's data includes MBA Mortgage Applications (off 2.60% last week following the previous week's 8.80% surge) and the Monthly Budget Statement for January.

Equities

Stocks have whipsawed, while also trading higher from our January 28th trend–change low. As we said: *"The cycles show stocks generally higher into March 17th – which happens to be the day after the next Fed meeting!"* Last week, the Dow rose 372.79 points or 2.32% to 16,466.30 – climbing for a second week out of the abyss reached on January 20th. It was .79% lower into today. The S&P gained 33.34 points or 1.75% to 1,940.24, but dropped 1.43% into today. The Nasdaq had risen 22.77 points or only .50% to 4,613.95, and was also the weakest since Friday – falling 2.38%. The Transports rose 1.89%, but were 1.04% lower into today. Bank stocks rallied 2.57%, but then fell 3.98%.

Resistance:	Dow:	16,471/ 16,599/ 16,727/ 16,856	Nasdaq:	4,534/ 4,565/ 4,618/ 4,668	S&P:	1,939/ 1,961/ 1,983/ 2,005
Support:		16,212/ 16,086/ 15,961/ 15,834		4,464/ 4,429/ 4,397/ 4,366		1,895/ 1,873/ 1,851/ 1,830

Other Markets

Commodities rose 1.80% last week, but have fallen 1.54% so far this week. Crude Oil rose 4.44%, but then fell 3.99%. Gold rose 1.83%, and tacked on another 2.23% since Friday. The U.S. Dollar was unchanged last week, but tumbled 2.36% into today (helping gold prices). The Japanese Yen lost 1.99% last week on the BOJ negative–rate policy, but it's 2.67% better this week. The Euro gained .32% last week, and powered 2.53% higher into today. Corn rose .47%, but then fell .27%. Cotton lost 2.11%, and then gained 1.33% into today.

"Writing about music is like dancing about architecture." Elvis Costello

Additional Information is Available on Request

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