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BOND MARKET REVIEW

February 17, 2016

Downshifting

Though not saying the economy had reversed, the Fed's January minutes showed their hiking foot was off the accelerator and their forecasted expectations had downshifted. The most obvious headwind has been the global selloff in equities that had erased over $8 trillion in market value through last week. Fed Chair Janet Yellen said the Fed was not to blame for what they've termed 'market turmoil.' While widely expected to stand pat on rate policy with their January statement, today's minutes offered additional input into the views of the committee as stocks were headed for their worst January since 2009, and commodities continued to plunge to new multi–decade lows. Clearly the Fed was anticipating inflation to begin to approach their 2% target, but falling prices began to appear more entrenched than 'transitory.' The minutes said: *"Participants judged that the overall implications of these developments for the outlook for domestic economic activity was unclear, but they agreed that uncertainty had increased."*

The downshifting in the economy has the Fed tapping the brakes on tightening (what members have termed as 'normalization'). Clearly the FOMC's collective December forecast had been good enough to allow the Fed to hike rates for the first time in a decade – and layout a plan to continue hikes at every other meeting in 2016. The **B**ond **M**arket **R**eview doubted that campaign would unfold in that manner at that time, and we still do. A major difference is that we now have company – even on the committee. While the December vote had been unanimous, enough doubt has arisen among committee members to rule out March – and to question an April hike as well. As of last week, the odds for a hike were less than 2% all the way out to the September meeting. As stocks were plummeting in January, the minutes revealed: *"Many saw these developments as increasing the downside risks to the outlook."*

While some FOMC policy makers spoke up for a temporary delay, others were more conditional. On Tuesday, Philadelphia FRB President Patrick Harker said he was *"data dependent,"* leading him to approach *"near–term policy a bit more cautiously"* than he did a few months ago. He said he didn't feel the stock market selloff would *"overwhelm"* the committee, and that he expected equity markets to *"calm down and reverse direction."* His key point was that *"it might prove prudent to wait until the inflation data are stronger before we undertake a second hike."* We read that as conditions for an additional move down the road, and not for multiple 2016 hikes. Minneapolis' Neel Kashkari was focused on the labor force, and said getting wages up would get inflation moving towards their goal. Today, he said there's probably been *"a bit more downside"* in the data following the Fed's January meeting. The **BMR** would note that a "bit" is merely a "smidgen", so the Fed is downplaying the severity of the data.

We think St. Louis' James Bullard put it best. He said: *"I regard it as unwise to continue a normalization strategy in an environment of declining market–based inflation expectations."* 10–year bond yields had dropped 77 bps since the Fed's December meeting, and the Dow lost over 2,300 points. The markets finally provided a relief rally, and the S&P had its first 3–day win streak for 2016. Over the past 3 trading sessions (starting Friday), stocks had their best 3–day rally since last August. Since Thursday's lows, the Dow has risen nearly 1,000 points! 10–year yields popped back 28 bps higher. Last Friday, Crude Oil had its best rally in seven years, and bank stocks surged the most since 2011. That's changed the FOMC hike outlook, but only a "bit." The market–driven odds for the next hike have risen to 4%, 9.8%, 18.8%, 20.4%, and 26.8%, for the next 5 meetings (3/16, 4/27, 6/15, 7/27, and 9/21). Even after the snapback rally in equities, the expectations for even one additional hike by September are still barely above 1 in 4.

Looking Ahead

- The bond cycles are mixed, but we expect yields to rise after dropping into a low near February 19th.
- Our equity cycles show stocks turning again lower from trend change highs due March 1st and 17th.

Treasuries, Agencies, and MBS

As of last Thursday, 10–year note yields had plunged 28 bps as equities were selling off and many global interest rates were trading increasingly negative. New York FRB President William Dudley said the Fed was *"definitely aware of what's been going on internationally"*, but he said the talk of the U.S. employing negative rates was *"an extraordinarily premature conversation to be having."* Yields traded back up off their lows as crude oil and equities rallied. 10–year yields ended only 9 bps lower, while the 2, 5, and 30–year sectors were down by 1, 3, and 6.5 bps for the week. All had been significantly lower. Into today, yields were 3, 5.5, 7, and 8.5 bps higher for the 2, 5, 10, and 30–year sectors.

MBS spreads (for FNMA 30–year 3.0%) widened 2 bps last week. The Treasury will auction $26 billion 2–year notes on Tuesday (02/23), $34 billion 5–year notes on Wednesday, and $25 billion 7–year notes on Thursday.

02/12/16 Treasury Yield Curve	2-Year: 0.716%	5-Year: 1.211%	10-Year: 1.749%	30-Year: 2.605%
Weekly Yield Change:	–.008	–.030	–.088	–.064%
Support:	0.74/ 0.76/ 0.79/ 0.81%	1.24/ 1.29/ 1.34/ 1.40%	1.81/ 1.85/ 1.89/ 1.95%	2.67/ 2.71/ 2.75/ 2.78%
Targets:	0.69/ 0.67/ 0.65/ 0.62%	1.18/ 1.13/ 1.08/ 1.03%	1.70/ 1.65/ 1.58/ 1.52%	2.59/ 2.55/ 2.51/ 2.47%

Economics

January Retail Sales were better than expectations in rising .20%, showing some resilience through the stock market drop. December's were revised from a .10% drop to instead rise by an equal .20%. Ex autos, they rose .10%, and likewise increased .10% in December – reversing a previously reported .10% drop. The 'control group' rose .60%. Import Prices fell 1.10% in January. The slowed annually to a 6.20% drop from December's 8.10% fall. Producer Prices rose .10% in January (after falling .20% in December). Ex food & energy, prices rose .40%. The Annual PPI slowed to a .20% drop from 1.00%, and the core annual pace rose from .30% to .60%. University of Michigan Sentiment fell from 92 to 90.7. Their Current Conditions survey dropped from 106.4 to 105.8 and Expectations fell from 82.7 to 81. Empire Manufacturing data improved from –19.37 to –16.64. In January, Industrial Production rose .90% and Capacity Utilization increased from 76.40% to 77.10%. December Business Inventories rose .10%.

Home–builder optimism faded 3 points to 58 in February (NAHB Housing Market Index). Housing Starts fell 44K or 3.85% to a 1,099K pace in January. Building Permits were off only 2K or .17% to a 1,202K pace, but that was after a 28K downward revision to December's data. Foreign entities withdrew a net $114 billion out of U.S. Treasury investments in December. Longer–term holdings fell by $29.4 billion. China's holdings dropped to a 10–month low (down $18.4 billion in December), and Japan reduced holdings by $22.4 billion. For the year, foreign holdings rose only $.01 trillion to a still–hefty $6.17 trillion.

Thursday is set for the Philadelphia Fed business outlook, jobless claims data, Bloomberg Economic Expectations, Bloomberg Consumer Comfort (which last week rose .3 to 44.5), January's Leading Index, and 4Q data for Mortgage Delinquencies and MBA Mortgage Foreclosures. Friday reveals Consumer Prices (January CPI) and Real Average Weekly Earnings. Next Monday (02/22) gives us the Chicago Fed National Activity Index. Tuesday follows with home price data from the S&P/Case–Shiller indexes, Consumer Confidence, the Richmond Fed Manufacturing Index, and Existing Home Sales for January. Wednesday brings MBA Mortgage Applications (which rose 8.20% last week), and New Home Sales for January.

Equities

Stocks surged Friday, and completed their best 3–day rally since last August into today. Friday's 313.66–point rally left the Dow still 231.13 points or 1.43% lower for the week to 15,973.84, but obviously things had been looking much worse. By today, the Dow was 3.00% higher and very near the close of 2 weeks ago (01/29). The S&P lost 15.27 points or .81% to 1,864.78, but surged 3.33% into today. The Nasdaq fell 25.63 points or .59% to 4,337.51, but outperformed the group with a 4.53% rise since Friday. The Dow Transports gained 1.52%, and added another 3.94% into today. Bank stocks fell 3.00% last week, even after a 5.36% rally on Friday. They rose 3.48% into today.

	Dow:	Nasdaq:	S&P:
Resistance:	16,522/ 16,649/ 16,780/ 16,911	4,535/ 4,570/ 4,605/ 4,638	1,931/ 1,942/ 1,953/ 1,964
Support:	16,267/ 16,139/ 16,013/ 15,887	4,467/ 4,437/ 4,403/ 4,339	1,909/ 1,896/ 1,887/ 1,876

Other Markets

Oil stockpiles were reported near an 86–year high, and drilling rigs across the U.S. continued to be shut down from being unprofitable. Over 1,000 rigs have ceased operations over the past year and a half. This domestic capability could serve as a 'cap', as rigs and other oil producing methods would come back on line and increase supply when and if higher prices allow. Commodities fell .97% last week, but are 1.36% better this week. Crude Oil fell 4.69%, despite a 6.30% rally on Friday. Crude is 4.14% higher this week. Gold surged 7.02% last week, but was 2.26% lower into today. The U.S. Dollar lost 1.10%, but rose .85% into today. The Japanese Yen surged 3.10% last week, but has fallen .75% this week. The Euro gained .88%, but is off 1.14% since Friday. Corn lost 1.91%, but is 2.37% better this week. Cotton fell 1.78%, but is 1.65% higher this week.

"As long as judges tinker with the Constitution to 'do what the people want,' instead of what the document actually commands, politicians who pick and confirm new federal judges will naturally want only those who agree with them politically." Antonin Scalia

"A Bill of Rights that means what the majority wants it to mean is worthless." Antonin Scalia

Additional Information is Available on Request

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