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

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BOND MARKET REVIEW

June *08, 2016*

Reversal of Fortune

In the **BMR** (04/28/16), we asked: *"How would the Fed see enough evidence of a pickup by June – especially after a first quarter GDP just plodding along in low gear?"* We followed that skepticism in the **BMR (05/04/16)**, making our case: *"By June, we'll know the results for April and May payrolls. … However, it will be too early to get a really good read on 2nd–quarter GDP, and through today there hasn't been enough promising data to push us into the June–hike camp."* Last week, we said: *"The bond market had been trading as if the Fed wouldn't touch rates again until very late in 2016 – if then. Various Fed members had been making the case that one or more hikes could occur in 2016, but bond–traders had been calling that supposed bluff – that was seen as making the case that things were better than they seemed. Though many said the data was indeed strong enough for the next move, the markets ignored the 'noise'."* However, the minutes from the FOMC's April meeting revealed that a good number of participants were leaning to a June hike – if the economy remained on course. When Fed Chair Janet Yellen said: *"Probably in the coming months such a move would be appropriate."*, it seemed the deal for a hike was all but sealed! The **B**ond **M**arket **R**eview then made the case: *"By Friday, the Fed will have May payroll data to add to that equation."*

It was like a scene from 'Peanuts!' As bond traders were about to kick the football, Lucy (in the form of Janet Yellen) pulled it away – tripping them up. Yet, as Yellen went to kick the other way, Snoopy (in the form of May payroll numbers) left her also kicking air. Until last week, December was the next month with market–driven odds over 50% for the next Fed hike. After Yellen's comments last week, the July odds soared from near 20% to over 50%, and June's rose from single digits to 30%. With May's lowest payroll additions since 2010, June quickly dropped to near 0% and July fell below 30%. December once again became the first month with better than 50–50% odds for the next hike. Clearly, most Fed members want to hike, if only to get rates back to what they would call 'normal', but many have also stated that incoming data must continue to show some improvement. We view the next 2 months as off the table for any hikes given our earlier reasoning. We know June is out, and July will only let us see one more payroll number. September would give us 3, as results for June, July, and August would give the Fed a much better read.

The May jobs report saw data improve, but the internal numbers suffered from trends that continue to be a cause for concern. The Unemployment Rate dropped from 5.0% to 4.7%. While 4.7% is within the range that many Fed members have associated with full employment, and the lowest since November 2007, the drop was unfortunately due to an exodus of workers out of the labor force! While ADP Employment Change showed 173K jobs added in May, only 38K were added – with a modest 25K in the private sector. That was the fewest jobs added since September 2010, and 59K jobs were subtracted from gains reported over the previous 2 months. A record number of Americans were out of the labor force in May, as there were 664K more than in April – bringing the total to 94,708,000! That put the labor force participation rate down .2% to 62.6% – very close to its 38–year low. Also, 468K more workers were added to the category of those working part time that would rather be full time – as that total rose from 6M to 6.4M. The part time status continues to be driven by health care mandates that require employer–provided insurance for those working over 30 hours. That had been for companies with over 100 workers, but dropped to 50 beginning in 2016 – further pressing cut backs in hours for some small companies.

Looking Ahead

- Bond yields have trend–change lows due June 27th and July 14th.
- Equities have trend–change lows due June 13th and June 22nd.
- The FOMC will announce June's interest–rate policy stance on Wednesday the 15th at 2 p.m. EDT.
- The United Kingdom will vote to exit (termed Brexit) or remain in the European Union on June 23rd.

Treasuries, Agencies, and MBS

The Fed's Beige Book did report that: *"Employment grew modestly since the last report, but tight labor markets were widely noted."* In keeping with the reports of recent years, growth was described with nearly 2 dozen references using *"modest"* or *"moderate"*, so still nothing stellar or robust! It's not only FOMC policy helping Treasury rates stay low. Under European Central Bank President Mario Draghi, the ECB is even buying junk bonds. Those asset purchases combined with worry over a potential exit from the European Union by British voters in a referendum set for June 23rd, long foreign debt fell to record lows this week. 10–year German debt hit .043%, Japan's fell to –.146%, and Swiss dropped to –.476%. Numerous EU countries and Japan had negative 2–year yields – with most riding fresh lows. German levels hit –.548%. With the next Fed rate hike seen as possibly September, but more likely December, selling pressure waned – and U.S. debt once again got a 'value bid' versus quality foreign alternatives.

We thought long yields would rise into the end of May. They did, and we said: *"Reduce hedges and buy bonds."* 10–year yields peaked the next day (on May 31st), and today fell to their lowest lows since early April! Using term–premium valuation, 10–year notes are showing the highest demand in over 50 years. Into Friday, yields fell 13.5, 15.5, 15, and 13.5 bps for the 2, 5, 10, and 30–year sectors. Into today yields were very little changed versus Friday. MBS spreads (FNMA 30–year 2.5%) widened by 4 bps last week.

On Tuesday, the U.S. Treasury sold $24 billion 3–year notes at .93% in an average–rated auction. Demand fell versus May, and foreign buying dropped to 48.1% from 61.5% in that previous auction. Today's 10–year note brought 1.702% for $20 billion in an auction rated an above–average '4 of 5'. The May 2026 note was reopened and demand rose to that auction. Foreign buying was also better, rising from 73.5% to 73.5% this month.

06/03/16 Treasury Yield Curve	**2-Year: 0.774%**	**5-Year: 1.232%**	**10-Year: 1.701%**	**30-Year: 2.510%**
Weekly Yield Change:	–.137	–.154	–.151	–.137%
Support:	0.78/ 0.81/ 0.86/ 0.91%	1.29/ 1.32/ 1.35/ 1.39%	1.70/ 1.73/ 1.77/ 1.80%	2.52/ 2.55/ 2.60/ 2.64%
Targets:	0.75/ 0.73/ 0.71/ 0.69%	1.20/ 1.18/ 1.15/ 1.12%	1.66/ 1.63/ 1.61/ 1.57%	2.44/ 2.40/ 2.36/ 2.33%

Economics

Despite dismal payroll numbers, the other data is a 'hard read'! Bloomberg Consumer Confidence rose from 42 to 43.2 – the highest reading for that measure of confidence in 5 weeks. However, Consumer Confidence fell from 94.7 in April to 92.6 – the lowest reading in 6 months! Consumer Spending rose the most in almost 7 years, while the service industry grew at its slowest pace since early 2014. Initial Jobless Claims fell for a 3rd week, dropping 1K to 267K. Continuing Claims rose 12K to 2,172K.

Early data showed May jobs not looking too bad. Challenger Job Cuts reported 26.50% less cuts versus May 2015, and ADP Employment Change came in at 173K jobs added. The net result turned out to be 25K private sector jobs added, and only 38K total – versus 160K expected. 59K jobs were removed from the totals of the past 2 months. Manufacturing lost 10K jobs, and the U.S. Unemployment Rate fell from 5.00% to 4.70%. The Underemployment Rate remained at 9.70% and the Labor Force Participation Rate fell .20% to 62.60% (near 38–year lows). Average Hourly Earnings rose .20%, leaving the annual pace at 2.50%. Average Weekly Hours remained at 34.4. The key indicator was probably the Fed's jobs dashboard. Not only did that Labor Market Conditions Index drop 4.8 points, but it was also revised from a .9 drop in April to a 3.4–point decline in May. Nonfarm Productivity fell .60% in the 1st quarter, though Unit Labor Costs rose 4.50%. JOLTS Job Openings rose to a record 5,788K, so it would seem there are plenty of positions available! Personal Income rose .40% in April, while Personal Spending was up by 1.00%!

IBD/TIPP Economic Optimism dropped .5 to 48.2. Chicago Purchasing Managers dropped 1.1 to 49.3, Dallas Fed Manufacturing Activity fell from –13.9 to –20.8, and ISM New York fell from 57 to 37.2. ISM Manufacturing expanded from 50.8 to 51.3, and Prices Paid rose from 59 to 63.5. New Orders fell .1 to 55.7. The Service Sector (ISM Non–Manufacturing Composite) dropped from 55.7 to 52.9.

The PCE deflator rose .30% in April, increasing that annual inflation reading from .80% to 1.10%. Ex food & energy, prices rose .20%, leaving the annual core pace at 1.60%. The S&P/Case–Shiller Home Price Index rose .09% in March, as the annual increase slowed from 5.32% to 5.15%. Their 20–city index was .85% higher – maintaining an annual gain rate of 5.43%. Construction Spending fell 1.80% in April. Factory Orders rose 1.90% in April, but were only .50% higher ex transportation. Durable Goods Orders rose by 3.40% in April, but were also only .50% ex transportation. Capital Goods Orders fell .60%. Vehicle Sales improved in May from a 17.32M pace to 17.37M. Domestic Vehicle Sales fell from a 13.48M pace to 13.33M. The Trade Balance deficit widened from $35.5 billion to $37.4 billion in April (though the March deficit was revised down from a previous $40.4 billion). Consumer Credit expanded by $13.416 billion in April (far off the $28.384 billion spending spree in March).

Thursday is set for jobless claims data, Bloomberg Consumer Comfort, and April Wholesale Inventories & Trade Sales. Friday brings the University of Michigan consumer sentiment surveys and the Monthly Budget Statement for May. Next Tuesday (06/14) gives us NFIB Small Business Optimism, May Import Prices, Retail Sales, and April Business Inventories. Wednesday brings MBA Mortgage Applications (which fell 4.10% and then rose 9.30% over the last 2 weeks), Producer Prices (May PPI), Empire Manufacturing, Industrial Production, Capacity Utilization, TIC Flows (net foreign Treasury operations), and the FOMC interest rate policy statement for their June meeting.

Equities

While the bond cycles did well, our equity cycles call for a pullback into June 8th that never happened. The Dow lost ground the first 3 weeks of May, but finished well. May is statistically a losing month, so even a 13.56–point net gain of .08% is a winner. The S&P gained 1.53% and the Nasdaq rose 3.62%. Last week, the Dow fell 66.16 points or .37% to 17,807.06. It closed above 18,000 today for the first time since late April, up 1.11% for the week. The S&P was up .07 points (statistically 0%) to 2,099.13, and was .95% higher into today – hitting a new 2016 high. The Nasdaq gained 9.01 points or .18% to 4,942.52. It's up .65% this week. The Dow Transports lost .54% last week, but are 2.21% better since Friday. Bank stocks fell 1.75%, but are .62% better this week. June 13th could be a low.

Resistance:	Dow:	18,016/ 18,083/ 18,150/ 18,217	Nasdaq:	4,980/ 5,015/ 5,050/ 5,086	S&P:	2,120/ 2,131/ 2,143/ 2,154
Support:		17,883/ 17,815/ 17,683/ 17,552		4,909/ 4,864/ 4,840/ 4,805		2,097/ 2,085/ 2,074/ 2,062

Other Markets

Once again, Crude Oil continued to improve out of our May 16th cycle low – which rises into June 21st/23rd. Crude is up 11.85% since the 16th. We also had a Gold low due near June 3rd, and it's surged from a trading channel low since that date. Crude Oil lost 1.44% last week, but is 5.37% higher this week. Gold rose 2.17%, and added 1.59% into today. Those markets helped Commodities rise 1.36% and then another 3.79% this week. The U.S. Dollar tanked after the poor May payroll numbers signaled a delay in FOMC rate hikes. The Dollar fell 1.54%, and is since .48% lower. The Japanese Yen surged 3.43%, but is off .43% this week. The Euro also jumped by 2.27%, and is .25% better this week. Corn rose 1.33%, and is 3.11% higher this week. Cotton fell .56%, but is 2.91% better this week.

"It's not the will to win that matters ... everyone has that. It's the will to prepare to win that matters."
Paul 'Bear' Bryant

Additional Information is Available on Request
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