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# BOND MARKET REVIEW

June 23, 2016

**State of Fear**

Despite the way the polls appeared to be leaning, voters in the U.K. elected to exit the European Union. While we last week listed a 'who's who' of global central bankers and others warning about the consequences of an exit vote, we're again reminded of the power of collective individual voters. As we said last week, open borders are heavy on the minds of voters both here in the U.S. and abroad. The dozens of stories we read leading into the vote contended that the British exit (termed 'Brexit') from the EU would be disastrous for the U.K., the EU, and the rest of the globe. While it does shake the landscape quite a bit, there is much to happen between now and the actual exit. In a 72% voter turnout, the choice was 52%–48% to leave, though Northern Ireland (by 55.8%) and Scotland (by 62%) voted to stay. One of the warnings we read was that Scotland might push again to exit the U.K. if the vote was to indeed leave the EU. The folks in Stoke–on–Trent voted nearly 70% to leave. In defeat, U.K. Prime Minister David Cameron said he would resign and let his successor invoke Article 50 (to exit the EU).

Our early read is that this may be one of those 'buy the rumor sell the fact' events. In this case the rumor was that the 'stays' would have it – so after a much–anticipated market shakeout, the markets could recover better than anticipated. In the U.S., we know that polls are often misleading. However, no one knows whether or not the U.K. exit from the European Union will be near as negative as feared. We do know the early ramifications, as futures on the Dow traded off more than 800 points, the U.S. Dollar had its largest one–day gain since 1978, and the British Pound fell to a 31–year low. Euro stocks (indexes and leading countries) were off 4 to 12% and the Japanese Nikkei fell around 8%. Obviously, there will be huge volatility in market prices, news, and conditions over the coming days – as in this kind of situation, changes can be drastic from minute to minute. Anything we (or others) write will be dated quickly! The late George Carlin once said: *"There's no present. There's only the immediate future and the recent past."*

We've been constantly reminded that the world was ending since World War II. If it wasn't from nuclear proliferation, it would be a total financial collapse from heavy debt, the Y2K computer issue, the melting of the polar ice caps, or even the end of the Mayan calendar in 2012. Michael Crichton's novel 'State of Fear' basically made the case that governments need to keep their citizens 'worried' about some coming cataclysm that consumes us more than what the lawmakers and leaders are doing. Some in the global warming camp are seeking to make it a crime to be a denier! For the record, the **B**ond **M**arket **R**eview is most happy there are still polar bears with ice caps on which to thrive. Recall they were projected to have been greatly endangered by now, with much of the U.S. under water years ago.

**Looking Ahead**

- Bond yields have trend–change lows due June 27th and July 14th. A trend–change high is due on July 1st.
- Equities have trend–change lows due June 24th and then June 29th.

**Treasuries, Agencies, and MBS**

Post–Brexit trading has stocks plunging, the U.S. Dollar surging, and U.S. Treasury yields dropping hard. Bonds love uncertainty – and there's more than enough to draw fright and flight to quality. The **BMR**'s downside yield goals will no doubt be met tomorrow – unless the markets can manage to 'normalize' in less than a day. That's highly unlikely! Since we're still in *"reduce hedges and buy bonds"* mode, hopefully our readers have seen a little windfall as well. Last week, yields dropped by 3.5, 5.5, 3, and 3 bps for the 2, 5, 10, and 30–year Treasury sectors. While yields were higher by 8.5, 14.5, 14, and 13.5 bps into today, by tonight they were lower by 10.5, 9.5, 8, and 3 bps (having reversed 19, 24, 22, and 16.5 bps lower post Brexit). Between now and Monday may be the best time to lock in some profits and replace some hedges – though we still expect another 'rate trough' in late August. Even before the Brexit, the International Monetary Fund lowered U.S. GDP forecasts from 2.4% to 2.2%, and urged the Fed to be *"very gradual"* with any rate increases! Knowing our jobs rate is low, the IMF even said the Fed should accept some overshooting on inflation. This week, Fed Chair Janet Yellen had already cooled expectations for an imminent hike with concerns that: *"It is a very serious matter that productivity growth is so slow."* (That would normally call for stimulus!) Dallas FRB President Robert Kaplan said accommodation should only be removed *"based on a realistic assessment of economic conditions"* – citing shorter–term cyclical challenges. Those are also on the **BMR** radar!

MBS spreads (FNMA 30–year 2.5%) widened by 2 bps last week. The 2 and 5–year note auctions were rated below average, while the 7–year was above average. Monday's sale of $26 billion 2–year notes brought .745% (compared to trading tonight below .50%!). Demand was the lowest since the April offering, and the yield the lowest since September. Foreign buying fell from 49.8% in May to 47.4%. Tuesday's $34 billion 5–year note brought 1.218%. Demand was the lowest since July 2009, possibly as bidders were reluctant to take positions ahead of the Brexit vote.

Foreign buying fell to 57.2% from 66.6% last month. Tonight, 5–year yields dropped below .90%! Wednesday's $28 billion 7–year note auction brought 1.497% with demand the lowest since March, and the yield the lowest since May 2013. Foreign buying rose from 64.6% in May to 65.6%. Overnight, 7–year yields fell to 1.16%!

| 06/17/16 Treasury Yield Curve | 2-Year: 0.695% | 5-Year: 1.114% | 10-Year: 1.609% | 30-Year: 2.420% |
|---|---|---|---|---|
| Weekly Yield Change: | –.034 | –.054 | –.032 | –.031% |
| Support: | 0.62/ 0.67/ 0.73/ 0.76% | 1.08/ 1.13/ 1.15/ 1.20% | 1.58/ 1.62/ 1.66/ 1.71% | 2.43/ 2.47/ 2.51/ 2.55% |
| Targets: | 0.58/ 0.55/ 0.53/ 0.50% | 1.02/ 1.00/ 0.97/ 0.92% | 1.53/ 1.50/ 1.47/ 1.44% | 2.39/ 2.36/ 2.32/ 2.28% |

## Economics

Initial Jobless Claims fell the most since February with a drop from 277K to 259K. Continuing Claims fell 20K to 2,142K. Bloomberg Consumer Comfort rose to a 3–month high 44.2 with its largest weekly increase since January 2015. Kansas City Fed Manufacturing Activity rose from –5 to +2, though the Chicago Fed National Activity Index fell from +.05 to –.051. The Leading Index for May fell .20%. The 6–month annualized LEI was unchanged (0%).

Sales of Existing Homes in May rose 1.84% to a 5.53M pace, which was the highest since 2007 – and a 3.95% increase to May 2015. However, New Homes Sales declined from an 8–year high in April that was revised 34K lower to 586K – and fell 5.97% to 551K. That was still up 6.58% versus last May. In April, the FHFA House Price Index increased by .20%, to an annual pace of 5.9%. Housing Starts fell .26% in May to 1,164K. That was an increase of 8.89% versus May 2015. While Building Permits rose .71% to 1,138K (from a revised 14K higher 1,130K), they were off 8.96% versus last year's pace.

Friday is set for May Durable Goods Orders, Capital Goods Orders, and the University of Michigan Sentiment surveys. Next Monday (06/27) brings the Advance Goods Trade Balance for May and Dallas Fed Manufacturing Activity. Tuesday gives us an update on 1Q GDP, Personal Consumption, Consumer Confidence, Richmond Fed Manufacturing, and S&P/Case–Shiller home price data. Wednesday provides MBA Mortgage Applications (up 2.90% last week), May Personal Income & Personal Spending, the PCE (Personal Consumption Expenditures) Deflator, and Pending Home Sales for May. Next Thursday closes out June trading with jobless claims data, Chicago Purchasing Managers, and Bloomberg Consumer Comfort.

## Equities

By next week, we'll better know the aftermath numbers as a result of the Brexit vote. We know now they'll be ugly, but things can change a lot in a week – for better or worse. We do know that overnight global equity markets fell as much as 8 to 12%. Curiously, U.K. markets were off less than 5% while most (even leading) EU nations dropped much more. An index of Euro stocks was down nearly 9%. U.S. futures markets were off nearly 5%, but narrowed to 3% as trading evolved.

Last week, the Dow fell 190.18 points or 1.06% to 17,675.16. It was 1.90% better into today – having closed above 18K for only the second time since April. However, as we said earlier, Dow futures fell more than 800 points just after the Brexit results were conclusive. We are in another window for a low that extends to June 29th. There could be some value purchases between now and then. The S&P lost 24.85 points or 1.19% to 2,071.22, but was 2.03% higher into today. The Nasdaq dropped 94.21 points or 1.92% to 4,800.34, and had risen 2.29% into today. The Dow Transports fell 2.25%, but were 1.08% better into today. Bank stocks dropped 3.20%, and had recovered 3.76%.

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|---|---|---|---|---|---|---|
| Resistance: | Dow: | 17,602/ 17,708/ 17,771/ 17,926 | Nasdaq: | 4,812/ 4,831/ 4,852/ 4,888 | S&P: | 2,063/ 2,075/ 2,084/ 2,099 |
| Support: | | 17,406/ 17,338/ 17,274/ 17,207 | | 4,761/ 4,743/ 4,709/ 4,675 | | 2,041/ 2,030/ 2,018/ 2,007 |

## Other Markets

Commodities fell .27% last week, but were .60% higher into today. Crude Oil had pulled back 2.22%, but was 4.44% better since Friday. Gold surged over $100 to the highest levels since March 2014 on the Brexit news. Gold rose 1.50% last week, and was off 2.42% into today (before tonight's rally). The U.S. Dollar fell .23%, and was off another .86% this week. However, it rose over 3% to the best levels since March post–Brexit. The Japanese Yen rallied 2.63% last week, but was 1.92% lower into today. The Euro rose .23%, and had risen another .96% before the U.K. vote. Corn gained 3.49%, but tumbled 11.54% into today. Cotton fell .28%, but was .48% better so far this week.

*"What we anticipate seldom occurs; what we least expected generally happens." Benjamin Disraeli*

***Additional Information is Available on Request***

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