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# BOND MARKET REVIEW

June 30, 2016

## Independence Day: Resurgence

As we come into the long holiday weekend for July 4th, we'd note the largest 'Brexit' was not necessarily last week's vote by the United Kingdom to leave the European Union, but rather the Declaration of Independence of the 13 colonies to leave the British Empire in 1776. A state of war had existed since 1775, and the colonists were tired of heavy taxes levied on them by British Parliament – in which they had no representation. 40 years of war followed that 'Brexit'. An increasing number of tax acts were implemented in the interest of having the colonies pay their 'fair share' of the costs to keep them in the British Empire. It's interesting that even then, higher taxes were viewed as a 'fair share' by the government that sought to raise them. These collective tax laws were known as the 'Coercive Acts' by Parliament, but became known as the 'Intolerable Acts' in the Colonies. In November 1775, Thomas Jefferson said: *"Believe me, dear Sir: there is not in the British empire a man who more cordially loves a union with Great Britain than I do. But, by the God that made me, I will cease to exist before I yield to a connection on such terms as the British Parliament propose; and in this, I think I speak the sentiments of America."* It was obvious last week that modern Britain saw the 'levy' required to be in the EU as a burden, and was weary of the ability to protect its borders.

Peace eluded the new United States and Great Britain for years, and wasn't settled until the War of 1812 (which also involved Britain's conflict with Napoleon Bonaparte in France – and his conquests within Europe and into Russia). Solomon Short said: *"The only winner of the War of 1812 was Tchaikovsky."* – as that musical overture celebrated Russia's defense against Napoleon's forces in 1812. In the Atlantic, American sailors were being captured from merchant vessels and impressed into the British Navy which ruled the waters in that day – and was restricting our abilities to trade. America declared war against Britain in 1812, though fighting had been going on since 1811. The early stages didn't go well for the states. Following their defeat of Napoleon in April 1814, they were able to focus on America. Britain managed to capture and burn much of Washington D.C. in August. When their attack on Baltimore failed, Britain devised a major campaign against New Orleans. The attack commenced in 1815, with British forces not knowing a peace treaty had already been reached – establishing the modern Canadian borders. They were defeated by American forces led by General Andrew Jackson – who is scheduled shortly to lose his place on the $20 bill. The War of 1812 was viewed as a second revolutionary war, but it took from 1775 to 1815 to achieve peace.

A partial reason for the formation of the European Union was to emulate the single currency, open border, free trade that made the United States an economic juggernaut. While the EU sought that goal, the United States sought to become more 'European' in health care and the movement to a new world order. So far, the new world order is cheap – in terms of borrowing costs! While many economies have inflated away the debt of their citizens, low rates are encouraging debt. Shortly after last week's vote, a number of other EU countries called for their own referendums to remain or exit. EU finance ministers said the U.K. should exit quickly, while Scotland said they might resist the move – or even renew independence efforts from the U.K. German Chancellor Angela Merkel said there was no way back from the vote and that it was time to *"grasp reality."* Many U.S. states view Washington D.C. as out of touch with state's rights – while also imposing onerous taxes and legislation. Numerous U.S. states rallied to the Brexit with their own calls for Calexit, Alaskexit, and Texit. Is such a vote legal? While previous Supreme Courts ruled that states were an indestructible part of the union, who knows what today's anything–goes Supreme Court would rule?

## Looking Ahead

- Bond yields have trend–change lows due around July 14th.
- Equities have trend–change highs due around July 6th/7th.
- Happy Independence Day! The bond market will close at 2 p.m. EDT on Friday, and all day on the 4th!

## Treasuries, Agencies, and MBS

The FOMC hiked rates in December – if only to get the 2015 liftoff they desired, to show their policies were working and that their goals were being met. The coming hikes were to be gradual. However, gradual was not intended to be 'one and done' – but that's now what the trading odds are showing. The **B**ond **M**arket **R**eview was suspect of the timing of the first hike – after which global markets tumbled into early February. Whether that first rate increase was deemed part of the cause or not, in their January statement the Fed began to include the monitoring of global risks to their outlook. In April and June, they changed their statement to reflect their ongoing monitoring of *"inflation indicators and global economic and financial developments."* Earlier this month, Fed Chair Janet Yellen had said another hike in the coming months might be appropriate. July was instantly viewed as a possibility. After the anemic May payrolls, July fell from over 50% to less than a 30% chance – and the next odds on potential for a hike moved once again to December. The June 'dot plots' backed off a little, but still projected one to two possible hikes in 2016.

That said, over the past week, the probabilities for a cut rose above those for a hike for the rest of 2016! Two weeks ago, we noted that former Minneapolis FRB President Narayana Kocherlakota said the Fed has been too one dimensional lately – considering only hikes. Though a lot of things can change very quickly, as of today the market odds argue for no more rate increases until 2018. Fed Governor Jerome Powell noted an increased global risk. He said: *"The Brexit vote has the potential to create new headwinds for economies around the world, including our own."*

As we said 2 weeks ago, the Treasury had altered the auction calendar for last week to hold its offerings ahead of the Brexit vote. It turns out they could have saved millions of dollars in borrowing costs by waiting until after the event! Yields were steadily higher into the vote, and then fell sharply. Into Thursday, 10–year Treasury yields had risen 13 bps. They fell 22 bps into Friday's close as yields ended the week lower by 6.5, 4, 5, and 1 bps for the 2, 5, 10, and 30–year sectors. Into today, they were off another 4.5, 7.5, 9, and 12.5 bps – ending the month with yields lower by 29.5, 37.5, 37.5, and 36.5 bps! That put 10–year yields just off the multi–decade lows of July/August 2012. 30–year yields were just above the multi–decade lows of early 2015 and 5–year yields fell to the lowest levels since June 2013. The 2 to 10–year spread was the flattest since November 2007, and 2–year yields the lowest since last October. MBS spreads (FNMA 30–year 2.5%) pulled in by 3 bps last week. The Treasury will auction 3–year notes on Monday (07/11), 10–year notes on Tuesday (07/12), and 30–year bonds on Wednesday (07/13).

| **06/24/16 Treasury Yield Curve** | **2-Year: 0.629%** | **5-Year: 1.074%** | **10-Year: 1.561%** | **30-Year: 2.410%** |
|---|---|---|---|---|
| Weekly Yield Change: | –.066 | –.040 | –.048 | –.010% |
| Support: | 0.61/ 0.64/ 0.67/ 0.75% | 1.05/ 1.10/ 1.15/ 1.20% | 1.52/ 1.59/ 1.65/ 1.71% | 2.28/ 2.32/ 2.39/ 2.44% |
| Targets: | 0.57/ 0.55/ 0.52/ 0.50% | 0.97/ 0.95/ 0.90/ 0.85% | 1.42/ 1.38/ 1.35/ 1.29% | 2.21/ 2.17/ 2.14/ 2.10% |

## Economics

Initial Jobless Claims rose 10K to 268K, but remain very tame. Continuing Claims fell 20K to 2,120K. The University of Michigan confidence surveys fell a bit, but weren't taken in time to observe the aftermath of the Brexit. Sentiment dropped from 94.3 to 93.5 and Current Conditions fell from 111.7 to 110.8. Expectations dropped from 83.2 to 82.4. Bloomberg Consumer Comfort fell from 44.2 to 43.9. However, board Consumer Confidence rose from 92.4 to 98 – the highest reading since October. The Chicago Purchasing Managers outlook rose from 49.3 to 56.8, while Dallas was a little less negative, rising from –20.8 to –18.3. The Richmond Fed Manufacturing Index fell from –1 to –7.

In May, Personal Income rose .20%, but Personal Spending rose .40%! Those numbers for April were revised .10% higher to .50% and 1.10%, so we've not been savers in recent months. 1st–quarter U.S. GDP was revised .30% better from the second estimate to 1.10%. Personal Consumption was revised .40% lower to 1.50%, and the GDP Price Index came in .20% lower to .40%. The PCE Deflator rose .20%, though the annual pace fell from 1.10% to .90%. The Core PCE (Personal Consumption Expenditures – ex food & energy) also rose .20%, though the annual core pace was unchanged at 1.60%. Core PCE for Q1 2016 fell from .10% to 2.00%. In May, Orders for Durable Goods fell 2.20%, which was far more than the anticipated .50% drop. Ex transportation, they fell .30%. Orders for Capital Goods fell .70%.

Pending Home Sales surprised to the downside as they dropped 3.70% in May. They were, however, up 2.40% versus May 2015. The S&P/Case–Shiller Home Price Index rose .07% in April, slowing .08% to a 5.03% annual increase. Metro prices (20–city index) were .45% higher, only slowing .04% to a 5.44% annual pace.

Friday kicks off July (and the 3rd quarter) with Vehicle Sales for June), ISM Manufacturing, Prices Paid, New Orders, and Construction Spending. Following the July 4th holiday on Monday, Tuesday (07/05) is set for ISM New York, IBD/TIPP Economic Optimism, May Factory Orders, and orders for Durable Goods and Capital Goods. Wednesday brings MBA Mortgage Applications (which fell by 2.60% last week), the May Trade Balance, the service sector outlook (ISM Non–Manufacturing Composite), and the minutes from the Fed's June meeting (which are now very dated considering global events following the Brexit). Thursday provides the early reads on June payrolls from Challenger Job Cuts and ADP Employment Change. Also due are jobless claims data and Bloomberg Consumer Comfort. With a delay until the 8th, Friday reveals the June jobs numbers as late as payrolls can come as the results can be as early as the 2nd, but are usually not ready on the 1st (and traditionally are released on Fridays). That Friday brings June payrolls, the Unemployment Rate, and other job statistics. Consumer Credit is also due. The following Monday (07/11) reveals the variance in the Fed's jobs dashboard (Labor Market Conditions Index Change). The next **BMR** is scheduled for the week following the 4th.

## Equities

On Friday, the Dow lost 610 points – which was the largest loss for it and the S&P since August 2015. In that one day, following a nice start for the week – all the gains for 2016 were gone. The Nasdaq and financials had their worst losses since August 2011. On Monday, there was follow through to the downside. However, based on our equity cycles, which are higher into July 6th/7th, we made this assumption last week – which so far is holding true. We said: *"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."* We also said we were in the window for a low through the 29th, so: *"There could be some value purchases between now and then."* Since Monday, the Dow has risen nearly 800 points! We still expect another selloff into the end of July, so we view July 6th/7th as a hedge and/or take–profit opportunity. It's worth noting that much of the incoming EU economic data was improving prior to the Brexit vote.

Though the Dow lost over 600 points on Friday, equities had been off to a good start. The week's loss was 274.41 points or 1.55% to 17,400.75. It's 3.04% higher this week – wiping out nearly all of the selloff. The S&P lost 33.81 points or 1.63% to 2,037.41, but is 3.02% higher this week. The Nasdaq fell 92.36 points or 1.92% to 4,707.98, but is 2.86% better since Friday. The Dow Transports lost 3.55%, and have since risen 2.25%. Bank stocks tumbled 3.83%, and have only recovered 2.13% this week.

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|---|---|---|---|---|---|---|
| Resistance: | Dow: | 18,004/ 18,145/ 18,278/ 18,414 | Nasdaq: | 4,881/ 4,916/ 4,942/ 4,964 | S&P: | 2,109/ 2,120/ 2,132/ 2,143 |
| Support: | | 17,875/ 17,738/ 17,612/ 17,406 | | 4,811/ 4,742/ 4,693/ 4,648 | | 2,086/ 2,075/ 2,063/ 2,036 |

## Other Markets

One of the cycles that turned out nicely was in the Gold market. In the **BMR (05/17/16)**, we said: *"We show Gold making a low near June 3rd."* It shot up on the 3rd, and had risen over 12% following the Brexit vote. Gold rose 2.13% last week, and is .05% higher this week. It rose 8.71% in June. Crude Oil lost .71% last week, but is 1.45% higher since Friday. Commodities were 1.92% lower, but 2.06% higher this week. The U.S. Dollar gained 1.33%, and is .66% better this week. The British Pound fell 4.76%, and is another 2.68% lower (versus the Dollar) this week. The Japanese Yen rallied 1.86%, but is .96% lower this week. The Euro lost 1.42%, and is .10% lower this week. Corn tumbled 12.16% last week, and is 6.70% lower this week. Cotton fell .11%, and is off another 2.60% this week.

*"It's wonderful what we can do – if we're always doing." George Washington*

*"Thomas Jefferson once said, 'We should never judge a president by his age, only by his works.' And ever since he told me that, I stopped worrying." Ronald Reagan*

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