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BOND MARKET REVIEW

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A Space Odyssey

The space of time the Fed's spent with 'near zero' stimulus is hard to fathom – especially considering the global volatility, and trillions of Dollars in gains and losses since December 2008. While the target rate's been tethered to zero, the journeys of global rates, equities, currencies, and commodities have been anything but. Since then, the S&P rose 142% – and even after a 10% drop, it's still 118% higher. Since then, the U.S. 10–year note traded from 2.04% to 4.01%, to 1.39%, to 3.04%, to 1.65%, and it's at present only a few bps from where the journey began. Despite the Fed's drive to get off zero, India just had a surprise rate cut, Japanese and German inflation just went negative, and the European Central Bank is entertaining more stimulus (or QE). Central bankers want to say inflation is slowing, transitory, low, or that there's disinflation. Negative inflation or falling prices is deflation, but they are reluctant to use that term. The cash helicopter isn't quite what it was dreamed to be! (Despite adding $7.55 trillion in debt.)

Domestically, members of the Fed are 'talking the hawk', but voting with the doves. As the **B**ond **M**arket **R**eview pointed out last week, FOMC members currently without a vote seem the most vocally hawkish. It reminds us of the Sheriff that had a tussle with a disorderly cowhand. After setting him straight, he also punches the cowboy's friend. The guy screams out: "What'd ya do that for?" The Sheriff explains: "If I hadn't, I'd have left – and you'd have told your friend: 'I wish he'd 'a hit me!' Figured I'd just head that one off at the pass."

A continuous dilemma for the Fed is that they're prone to the optimistic view that they've made a difference and can supposedly safely remove stimulus. The current liftoff probabilities are only 16% for October and just over 36% for December. It's clear the Fed would like to begin tightening in 2015, but the markets are still leaning more to 2016. Many global yields are once again at 3–month lows with stocks falling to their lows for 2015. This at least means there are signs of capitulation. In another 'recalculation', the FOMC is now placing full employment at a 4.9% jobless rate – just .2% below the current 5.1%. It seems the FOMC's full employment measure is as transitory as their stance on inflation.

However, a puzzling space 'oddity' is the chasm between the market's and the Fed's perceptions concerning future inflation. The Treasury market is pricing inflation at its lowest level in 6 years, just as the Fed is ready to hike on what we believe to be suspect 'full employment' and their contention that the lack of inflation is only transitory. Missing either point could lead to an errant first move. This past week, Fed Chair Janet Yellen said: *"Most FOMC participants, including myself, currently anticipate that achieving these conditions will likely entail an initial increase in the federal funds rate later this year, followed by a gradual pace of tightening thereafter."* Gradual is the term also favored by Fed Vice Chairman Stanley Fischer, ostensibly to soothe nervous global markets that are accustomed to the Fed's otherwise (and historical) relentless campaigns of tightening – often beyond the point of no return. Yellen added an 'out' though, explaining (and probably implying global): *"But if the economy surprises us, our judgments about appropriate monetary policy will change."* The one shot seems to be December, and New York's Dudley and San Francisco's Williams made a similar (and gradual) case for 2015. Nevertheless, Chicago's Evans pushed it out with *"in my own projections, where I have mid–2016 (for liftoff), we are getting closer."*

Looking Ahead

- Bond cycles show yields making another low–rate trough in mid–October, and then rising into month end.
- Stock cycles show a rally from a low near 10/06 to a more important high near 10/26.

Treasuries, Agencies, and MBS

Treasuries had their best quarter of 2015, while stocks had their worst since 2011. Bonds rallied as equities faltered, and our expectations of higher yields into the end of September failed to occur. Such is cycle work. It's the best of what we've found, but even though performing with great accuracy at times – there's nothing that remotely approaches the 80 to 90% level.

Yields were higher last week, but it's a different story since! After the drop this week, it's hard to recall last week's rise. Fast markets seem to obscure recent history. Short rates are the most interesting. 2–year notes rose from .58% near the end of August to .85% in anticipation of a Fed move on September 17th. That 'non–event' sent yields tumbling 15 bps within a few hours. After rising from .66% to .73% last Thursday to Friday, 2–year yields have fallen 2 bps a day since – as 5 and 10–year yields fell back to the levels from late April (treating the August 24th low as an 'outlier'). Thus, the 2–year was fooled into believing the Fed's contention that September would mark the liftoff of rates from the near–zero position they've maintained since December 2008, and the first hike since June 2006!

Actually, the first 'liftoff' of the last tightening campaign occurred off a 1.00% funds level in June 2004 under then Fed Chair Alan Greenspan, so it's been over 11 years since the Fed's fired their primary launching rockets. Overall, stocks and bond yields have been falling at a steep pace since the Fed's surprisingly dovish policy statement on September 17th. Last week, yields rose 1.5, 3, 3, and 2 bps for the 2, 5, 10, and 30–year sectors. This week's rally has yields lower by 6.5, 11.5, 12.5, and 10 bps in a strong move for each of those sectors.

MBS spreads (for FNMA 30–year 3.0%) widened by 1 bps into September 25th. Last Thursday's (09/24) $29 billion 7–year note auction brought 1.813% in an offering rated an above–average '4 of 5.' Demand was off to last month, and the yield was the lowest since the March 2015 auction. Foreign buying rose to a stout 62.6% versus 50.8% in August. Next week, the U.S. Treasury will auction $24 billion 3–year notes on Tuesday (10/06), $21 billion 10–year notes on Wednesday (10/07), and $13 billion 30–year bonds on Thursday (10/08).

09/25/15 Treasury Yield Curve	2-Year: 0.694%	5-Year: 1.475%	10-Year: 2.163%	30-Year: 2.956%
Weekly Yield Change:	+.014	+.030	+.029	+.020%
Support:	0.67/ 0.71/ 0.74/ 0.76%	1.41/ 1.44/ 1.47/ 1.53%	2.07/ 2.11/ 2.14/ 2.18%	2.90/ 2.95/ 2.99/ 3.04%
Targets:	0.63/ 0.60/ 0.58/ 0.56%	1.35/ 1.32/ 1.35/ 1.32%	2.00/ 1.96/ 1.93/ 1.89%	2.82/ 2.78/ 2.74/ 2.70%

Economics

The ADP (private payroll) Employment Change for September was 14K ahead of August numbers with a better than expected rise of 200K. That would indicate the economy is still on a gradual pace of adding jobs consistent with the recent trend. Initial Jobless Claims rose only 3K to 267K last week – also supporting that 'steady increase with modest layoffs' view. Continuing Claims fell 1K to 2,242K. GDP for 2Q 2015 continued to be upgraded as it was bumped up .20% to 3.90%. A contributing factor was Personal Consumption being adjusted .50% higher to 3.60%. The GDP Price Index remained at 2.10%, while the core rate was .10% higher to 1.90%. Consumption remains a positive as Personal Spending was up .40% in August. Personal Income grew by .30%. Any income growth is good when inflation is in check, and the PCE deflator for August was flat. That annual pace of Personal Consumption Expenditures measure was unchanged at a modest .30% increase. Core PCE rose .10%, and the annual pace matched that rise with a .10% bump to 1.30% – still well below the Fed's desired 2.0% (or slightly more) target.

University of Michigan Sentiment rose 1.5 to 87.2. Their Current Conditions survey rose .9 to 101.2, and Expectations rose from 76.4 to 78.2. Board Consumer Confidence improved from 101.3 to 103.0. ISM Milwaukee fell from 47.67 to 39.44, Chicago Purchasing fell from 54.4 to 48.7, and the Chicago Fed National Activity Index dropped from .51 to –.41. Kansas City Fed Manufacturing Activity was less negative with a bump from –9 to –8, as was Dallas increasing from –15.8 to –9.5. After two months of gains, Durable Goods Orders fell 2.00% in August. Ex transportation, orders were flat. Orders for Capital Goods fell .20%. August New Home Sales rose 5.75% to 552K (from July's revised 15K–better 522K). That was up 18.45% versus last August. However, Pending Home Sales fell off pace with a 1.40% drop. While metro home prices fell .20% in July, the annual pace for the S&P/Case–Shiller 20–city index was .06% higher to 4.96%. Their Home Price Index rose .37% in July, and the annual increase was .18% higher to 4.69%.

Thursday kicks off October with a few more clues into September payrolls from Challenger Job Cuts and jobless claims data. Also due are August Construction Spending, ISM Manufacturing & Prices Paid, Vehicle Sales for September, and Bloomberg Consumer Comfort (which last week rose from 40.2 to 41.9). Friday reveals the September payroll data and the U.S. Unemployment Rate. These monthly numbers continue to be a heavy influence on the Fed's determination to hike rates before year end. Also due are Average Hourly Earnings and Weeks, Labor Participation, ISM New York, and August Factory Orders. Monday (10/05) gives us the service–sector outlook (ISM Non–Manufacturing Composite) and the September change for the Fed's labor dashboard. Tuesday is set for the release of the August Trade Balance (deficit) and IBD/TIPP Economic Optimism. Wednesday follows with and August Consumer Credit and MBA Mortgage Applications (which fell 6.70% last week).

Equities

Stocks just completed their worst quarter since 3Q 2011. It was also the most volatile quarter since 2011 for stocks, commodities, and currencies! The losses are staggering. Global equity prices have deteriorated by roughly $11 trillion in only 3 months! While it's certainly not the Fed's fault for the plight of equity investors worldwide, they know that their timing issues can lead to a lot of finger pointing – so policy moves are a tough call. With Monday's stock–market drop to retest the 2015 lows, the NYSE composite fell to its lowest close in nearly 2 years.

While the 30th of September is historically one of the worst days for equities, stocks had their best gains in 3 weeks today – offsetting what would have been an even more–dismal month and 3rd–quarter. Into the 25th, the Dow lost 69.91 points or .43% to 16,314.67. The Dow was .18% lower through today. The S&P fell 26.69 points or 1.36% to 1,931.34, and was .59% lower into today. The Nasdaq fell 140.73 points or 2.92% to 4,686.50, and was another 1.42% lower by today's close. The Dow Transports dropped 2.31% last week, and were .83% lower into today. Bank stocks rallied 1.44%, but are .94% lower since Friday.

Resistance:	Dow:	16,330/ 16,458/ 16,585/ 16,721	Nasdaq:	4,625/ 4,678/ 4,760/ 4,817	S&P:	1,917/ 1,938/ 1,960/ 1,979
Support:		16,075/ 15,948/ 15,823/ 15,669		4,488/ 4,423/ 4,357/ 4,291		1,872/ 1,850/ 1,829/ 1,808

Other Markets

Commodities rose .79% last week, but have fallen .99% so far this week. Crude Oil rose 2.28% into the 25th, but is 1.33% lower this week. Gold also rose last week, adding .67%, but is 2.64% lower this week. The U.S. Dollar had a strong week, adding 1.51%. It's .05% higher this week. The Japanese Yen lost .51% last week, but is .59% higher since Friday. The Euro fell .91% last week, and is another .16% lower this week. Corn rose 3.11%, but is .32% lower this week. Cotton fell .35%, and is another .25% lower this week.

"O that a man might know the end of this day's business ere it come!" William Shakespeare (Julius Caesar) [especially on the day of a 'flash crash']

Additional Information is Available on Request
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