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

November 03, 2015

Our Brand is Crisis

If we weren't still in crisis–management mode, why would the Fed continue to hold rates near zero? Though there were no great surprises in the FOMC statement last Wednesday (10/28), the Fed was a bit more upbeat than expected. The Fed adopted a more hawkish tone, and was clearly interested in beginning to raise rates during their December meeting. Many Fed members have stated their desire for a 2015 liftoff, and the December meeting is obviously their last chance. With stocks having their best month in 4 years, the committee was empowered to be a little less cautious in crafting the wording for their policy. The core differences between the October 28th statement and the one from September 17th included: *"Household spending and business fixed investment have been increasing at solid rates in recent months …"* The last statement had said increases were *"moderate."* They said they were *"monitoring global economic and financial developments"*, but removed the September contention that those events might *"restrain economic activity"* and put *"downward pressure on inflation."* The **B**ond **M**arket **R**eview would have thought it appropriate to leave those events as still quite possible – and threatening! The big change was from: *"In determining how long"* to maintain current rates near zero, to a more hawkish inclusion of: *"In determining whether it will be appropriate to raise the target range at <u>its next meeting</u> …"* – placing December squarely in the crosshairs. The FOMC said they *"will assess progress, both realized and expected"* towards their goals of maximizing employment and achieving 2% inflation. While we can't see 2 months adding that much confidence, let alone inflation, jobs, or labor participation – the market's probabilities for a December hike have risen from 34.7% pre–meeting to 58.0% today! Richmond's Jeffrey Lacker was the only 'nay' vote, as he was last month – preferring to instead hike 25 bps.

The European Central Bank is also reviewing a move in December, but unlike the Fed, they are keyed on their *"price–stability mandate"* and will determine the degree of accommodation necessary at that time. ECB president Mario Draghi said they were ready to act *"by using all the instruments available"* within their mandate. China just cut rates, and has experienced a third straight month of contraction in manufacturing.

Looking Ahead

- Bond yields should make a high in this first week of November. That should be a buy opportunity.
- Our stock cycles show equities falling from November 5th to a low near the 18th.
- The bond market will observe Veterans Day next Wednesday (11/11), but stocks will trade.

Treasuries, Agencies, and MBS

The 2–year note auction that was delayed from October 27th until the debt ceiling could be raised, is now scheduled for $26 billion on supply to be offered on Wednesday (11/04). Apparently, if you can't decide on a debt ceiling limit, you just suspend it! On Monday, Congress suspended the debt ceiling until March 2017, meaning that, without controls – they can borrow and spend all they want with no limits. Thus, there is no debt ceiling – kind of like the old Dallas Cowboys stadium. It should preserve the credit rating on U.S. debt (unless the ratings agencies decide it's a ridiculous strategy). With the market's assessment that a December FOMC hike is a little better than 50%–50%, 2–year rates have risen around half of the expected 25 bps hike or 12.5 bps from their recent .62% level. (2–year rates had also risen in a similar 'hedge' going into the September meeting.) Yields have risen to 5–week highs.

Into the 23rd, yields rose 3, 6.5, 5.5, and 2 bps for the 2, 5, 10, and 30–year Treasury sectors. That trend continued last week as the FOMC put a December hike very much back on the table. Into month end, yields for those sectors rose 8.5, 10, 5.5, and 2 bps. For these first 2 trading days of November, yields were 4 bps higher at 2–years, and 7 bps higher further out. Nevertheless, yields have risen into our timeframe for a buy opportunity, so we would lighten hedges and extend purchases. The Atlanta Fed's GDP model agrees, as it's projecting a slowdown in GDP growth. MBS spreads (for FNMA 30–year 3.0%) pulled in by 4 bps into the 23rd, and by 1 bps last week. The 5 and 7–year auctions took place as scheduled, and each was rated as average (or '3 of 5'). Last Wednesday, the U.S. Treasury sold $35 billion 5–year notes at 1.415%. Demand was the lowest since August, and foreign buying slipped from 63.5% in September to 58.9%. Thursday's $29 billion 7–year note came at 1.885%, and demand was the best since November (2014). Foreign buying was very close to last month, sliding .3% to 62.3%.

10/30/15 Treasury Yield Curve	2-Year: 0.726%	5-Year: 1.519%	10-Year: 2.143%	30-Year: 2.923%
Weekly Yield Change:	+.083	+.102	+.055	+.022%

10/23/15 Treasury Yield Curve	2-Year: 0.643%	5-Year: 1.417%	10-Year: 2.088%	30-Year: 2.901%
Weekly Yield Change:	+.032	+.064	+.054	+.019%
Support:	0.78/ 0.81/ 0.84/ 0.88%	1.63/ 1.66/ 1.69/ 1.73%	2.22/ 2.26/ 2.30/ 2.34%	3.02/ 3.04/ 3.06/ 3.09%
Targets:	0.75/ 0.71/ 0.65/ 0.61%	1.57/ 1.54/ 1.51/ 1.47%	2.19/ 2.15/ 2.12/ 2.08%	2.97/ 2.95/ 2.93/ 2.90%

Economics

The economy grew at a 1.50% pace in the 3rd quarter. That was .10% less than expected, and slowing quite a bit from 3.90% in the 2nd quarter. The largest correction in inventories since 2011 kept GDP from being closer to 3%. A second estimate will come later this month. Personal Consumption grew 3.20% and the GDP Price Index fell from 2.10% to 1.20% (with the core rate falling .60% to only 1.30%). The Employment Cost Index rose .60%. Initial Jobless Claims rose 1K to 260K (just off the lowest levels in 42 years). Continuing Claims dropped from 2,181K to 2,144K. In September, Personal Income rose .10% and Personal Spending matched that increase. The Personal Consumption Deflator fell .10%, slowing that inflation measure by .10% to an annual .20%. The core pace (ex food & energy) rose .10%, and remained flat annually at 1.30%.

ISM Manufacturing slipped .1 to 50.1 – challenged and stagnating due to weak exports. (50 is the dividing line between expansion and contraction.) Prices Paid rose 1 point to 39. While Dallas Fed Manufacturing Activity fell from –9.5 to –12.7, other areas showed some improvement. Richmond rose from –5 to –1, and ISM Milwaukee rose from 39.44 to 46.66. Chicago Purchasing Managers was promising, rising from 48.7 to 56.2, as was ISM New York, surging from 44.5 to 65.8. University of Michigan Sentiment slipped from 91.1 to 90. Their survey for Current Conditions dropped from 106.7 to 102.3, and Expectations also fell, but only by .6 to 82.1. The Consumer Confidence Index fell from 102.6 to a 3–month low 97.6. IBD/TIPP Economic Optimism fell from 47.3 to 45.5. Factory Orders were .3% lower in August to –2.1%, and then dropped 1.0% in September. Ex transportation, orders fell .60%. Orders for Durable Goods fell 1.20%, and were also revised 1% lower to –3% for August. Ex transportation, orders fell .40%. Vehicle Sales rose .05M to an 18.12M pace for October. Domestic sales fell .22M to 14.14M.

New Home Sales slumped 11.53% in September to 10–month–low 468K units. That was only 2.86% higher to last year. Pending Home Sales fell 2.30%, also confirming some slowing in housing. The S&P/Case–Shiller 20–City Index showed metro home prices rising .11% in August, with the annual pace rising from 4.91% to 5.09%. Their Home Price Index rose .44%, increasing the annual pace .12% to 4.68%. Construction Spending rose .60%.

Wednesday is set for MBA Mortgage Applications (off 3.5% last week), the September Trade Balance (deficit), the service–sector outlook (ISM Non–Manufacturing Composite), and the first look into October payrolls from ADP Employment Change. Thursday gives us jobless claims data, Challenger Job Cuts for October, Nonfarm Productivity, and Bloomberg Consumer Comfort (which last week fell from 43.5 to 42.8). Friday provides September Consumer Credit and the key payroll data for October – including the Unemployment Rate, Hourly Earnings, and Labor Force Participation. Next Monday (11/09) gives us a look at the Fed's jobs dashboard (Labor Market Conditions Index Change), along with 3rd–quarter data for MBA Mortgage Foreclosures and Mortgage Delinquencies.

Equities

While most folks expected a negative October for equities, our cycles pointed up into the 26th. While leaving some of the move on the table, we would've been quite satisfied in using that timing to stand aside. The S&P surged 8.30% in October – marking the best gains in 4 years (to October 2011 – which saw a whopping 10.77% gain)! While the first day of October saw a slight loss, the Dow kicked off November with a 165–point gain on Monday that sent it positive for 2015 (though only by .03%). It was tough reconciling a 26th top in equities when our bond cycles were projecting higher yields into this week, with longer maturities topping throughout the 2nd to the 6th. However, our secondary high cycle (trend–change) for stocks hits around November 5th – matching up the potential much better for a synchronous high in stocks and yields. With bonds dropping and stocks rising, market participants have been warming up to taking on more risk. A rising Dollar based on the perception that the Fed will be tightening soon while other global banks are extending (or adding) stimulus has also been feeding an appetite for U.S. equity assets.

The meat of the equity gains came in the week of the 23rd, with the Dow rising 2.50%. Last week, it rose .10% to 17,663.54, and has added 1.44% into today. The S&P gained 2.07%, and then .20% last week to 2,079.36. It's up 1.46% this week, and is now 2.47% better for 2015. The Nasdaq gained 2.97% into the 23rd, .43% into month end (to 5,053.75), and is 1.81% higher this week. The Transports rose 2.69%, lost 2.02%, and are .97% ahead this week. Bank stocks rose 3.10% into the 23rd, lost .89% last week, and are up 1.80% for the first 2 days of the new month. Our combination of equity cycles projects lower into the 18th – which could represent another buying opportunity.

Resistance:	Dow:	18,064/ 18,201/ 18,337/ 18,473	Nasdaq:	5,192/ 5,228/ 5,264/ 5,300	S&P:	2,116/ 2,127/ 2,139/ 2,151
Support:		17,801/ 17,665/ 17,558/ 17,401		5,120/ 5,084/ 5,054/ 5,012		2,105/ 2,093/ 2,081/ 2,070

Other Markets

Commodities have been mixed. They lost 2.87% into the 23rd, rose .98% last week, and were 1.00% better into today. They were heavily influenced by Crude Oil, which lost 5.63%, gained 4.46% last week, and then surged 2.81% to kick off November. Gold lost 1.72% and another 1.88% over the past 2 weeks. It's already 2.39% lower this week. The U.S. Dollar surged 2.81% into the 23rd on the ECB plans to continue stimulus. Despite the hawkish FOMC reads from last week, the Dollar fell .23%, but it was .23% higher into today. The Euro lost 2.91% into the 23rd, was .11% lower last week, and fell another .38% into today. The Japanese Yen fell 1.70%, rose .70%, and was a similar (to the Euro) .37% lower into today. Corn rose .80% and .66%, but then lost .46% into today. Cotton lost 1.71%, and then rose .89% into month end. It's now 1.18% lower.

"When someone tells you something defies description, you can be pretty sure he's going to have a go at it anyway."
Clyde B. Aster

Additional Information is Available on Request

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