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BOND MARKET REVIEW

January 27, 2016

The Break Up

Until December, stocks loved the Fed and other global central banks. The Fed hiked, and equities were dumped! The January FOMC statement came in very much as we expected, but stocks were clearly disappointed. Equities wanted a little more dovish 'love' from the FOMC, but didn't get it as the committee kept a March hike on the table. Last week, we said: *"For now, the market–indicated chance for a rate hike in January is a big '0%', and next Wednesday's FOMC meeting should be a huge non–event – at least for talk of raising rates. The Fed will note continued improvements in growth as reported in the Beige Book, but will no doubt voice concern over the market turmoil and growth challenges in global markets."* The FOMC noted continued improvements in labor market conditions, and moderate improvements in household spending and business fixed investment. They satisfied the other part of our hunch by saying: *"The Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook."* China's Shanghai Composite Index has fallen to a 13–month low. While many global market are well off their highs, the Fed is focused on China as a trading partner and supplier. To paraphrase a book title, the FOMC said to global stocks: 'I'm O.K., you're not!' The Fed was dissing foreign markets with a reversal of the classic break–up line: 'It's not me – it's you!'

The Fed has held the position over the past year that the drop in energy prices, and the resulting low inflation from that and other factors, was most likely *"transitory."* They expected that if they swatted a few times at the gnat of inflation, it would bug off. It hasn't! Last week, we once again made the case that low inflation is more entrenched – more like the gnat that opts to remain a nuisance. The **B**ond **M**arket **R**eview posed: "*Just how 'transitory' is inflation?"* If there was a surprise (to us) in the statement, the FOMC said: *"Inflation is expected to remain low in the near term, in part because of the further declines in energy prices …"* However, they still said it would rise to 2% *"over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further."* We agree with that – if those three conditions actually pan out over the 'medium term.'

While the vote on the policy statement was unanimous, the FOMC separately announced they *"would be concerned if inflation were running persistently above or below"* their 2% objective. FRB St. Louis President James Bullard dissented from approving that change within the statement as he didn't think the language *"focused on expected future deviations"* from that goal. We took that to indicate he considered the statement as too broad – with no action plan on either side.

Looking Ahead

- Bond yields should rise into next week, but we expect another push to low yields into February 19th.
- Our equity cycles still show stocks improving from our January 27th/28th trend–change for a low.

Treasuries, Agencies, and MBS

As we said last week, the market–driven chances for a Fed hike today were essentially '0%' – as that was also what the FOMC had signaled. They maintained their outlook for a 'gradual pace' of increases, even though the markets were expecting a little relief given the global selloff in equities. The odds for a March hike were only 22.1% last week, and fell to 21.1% today. 4 out of 5 dentists are still not expecting a March hike, even though the Fed held firm! (That infamous 5th dentist is still holding out for a root canal.) Last week, yields rose by 2, 3, 1.5, and 1 bps for the 2, 5, 10, and 30–year Treasury sectors. The 10–year note made its low yield right with our January 20th trend–change, and yields fell again into our other maturity cycles due the 26th. Into today, those sector yields fell 3.5, 7, 1.5, and 1 bps. Our cycles have yields up into February 2nd to 4th, but then back down with a rally into a 19th to 24th window.

MBS spreads (for FNMA 30–year 3.0%) pulled in by 1 bps last week. On Tuesday, the Treasury sold $26 billion 2–year notes at .86%. Demand was the best since November 24th, and the yield was the lowest since the auction that took place on November 4th (as the Treasury doubled up on 2–year note auctions that month). Foreign buying jumped to 57.9% of this issue versus only 37.5% in December. Today's 5–year auction was rated below average ('2 of 5') as $35 billion came at a 1.496% yield. Demand was the strongest since November, while the yield was the lowest since October. Clearly, the global stock selloff has given bonds a nice rally. Foreign participation bumped up 1% from last month to 53.5% of this offering. The U.S. Treasury will auction $29 billion 7–year notes on Thursday.

01/22/16 Treasury Yield Curve	2-Year: 0.871%	5-Year: 1.482%	10-Year: 2.053%	30-Year: 2.824%
Weekly Yield Change:	+.019	+.028	+.017	+.010%
Support:	0.85/ 0.87/ 0.89/ 0.93%	1.49/ 1.54/ 1.62/ 1.66%	2.05/ 2.08/ 2.12/ 2.19%	2.83/ 2.86/ 2.91/ 2.96%
Targets:	0.80/ 0.77/ 0.75/ 0.72%	1.37/ 1.31/ 1.25/ 1.19%	1.98/ 1.94/ 1.91/ 1.87%	2.75/ 2.71/ 2.67/ 2.63%

Economics

Either being correct in their outlook, or potentially out–of–touch with stocks and other global developments, Consumer Confidence rose from 96.3 to a 3–month high of 98.1. Consumers are siding with the Fed, even if investors and some data are not! December's Leading Index fell .20%. While the Chicago Fed National Activity Index was a little less negative in rising from –.36 to –.22, Dallas fell from –21.6 to –34.6 and Richmond dropped from 6 to 2. In a nice–weather December, Existing Home Sales jumped 14.71% to hit a 5.46M pace and give that sector its best performance since 2006. Sales were 7.69% higher versus last December (2014). Sales of New Homes rose 10.79% to a 544K annual pace. That was up 12.86% to last December. Home sales rose despite healthy price increases in November. The FHFA House Price Index was .50% higher in November and the S&P/Case–Shiller home price index rose .87%. Metro home prices rose .94%, boosting the annual pace of increase from 5.50% to 5.83%.

Initial Jobless Claims hit a 6–month high last week. Thursday is set for the next jobless claims data, Durable Goods Orders for December, Pending Home Sales, Kansas City Manufacturing, and Bloomberg Consumer Comfort (which last week fell .4 to 44). Friday brings 4th–quarter GDP and Personal Consumption, the Employment Cost Index, University of Michigan sentiment surveys, ISM Milwaukee, and the Chicago Purchasing Manager report. Next Monday (02/01), kicks off February with Personal Income & Personal Spending for December, the PCE Deflator, ISM Manufacturing, and Construction Spending. Tuesday follows with ISM New York, IBD/TIPP Economic Optimism, and January Vehicle Sales. Wednesday gives MBA Mortgage Applications (which rose 8.80% last week), the service–sector outlook (ISM Non–Manufacturing Composite), and a first key look into the January jobs reports from ADP Employment Change private–payroll data.

Equities

Stocks satisfied cyclic forecasts by trading up into January 22nd with their best 2–day rally in 3 months – and then trading off into today. It was also a positive that bond–yield cycles matched the downward equity forecasts into this current window. Our 9–week negative–cycle wave pointed down from December 4th, where we had suggested exiting long positions (or hedging). The **BMR** equity cycles are now turning up from the 28th. Downside momentum has been heavy, and no trading methods even approach being 100%, but we'll defer to our cycle work – albeit cautiously. The cycles show stocks generally higher into March 17th – which happens to be the day after the next Fed meeting! Believe it or not, last week stocks had their first gains in 4 weeks. Of course, the week did end on that January 22nd trend change for a high. The Dow rose 105.43 points or .66% to 16,093.51. It's off .93% since Friday. The S&P gained 26.57 points or 1.41% to 1,906.90. It's off 1.26% this week. The Nasdaq added 102.76 points or 2.29% to reach 4,591.18. It's 2.68% lower this week. The Dow Transports rose 1.34% last week, but are .33% lower this week. Bank stocks had fallen 2.17%, and are down another .79% since Friday.

Resistance:	Dow:	16,212/ 16,474/ 16,725/ 16,987	Nasdaq:	4,592/ 4,649/ 4,712/ 4,806	S&P:	1,917/ 1,933/ 1,950/ 1,961
Support:		15,710/ 15,464/ 15,213/ 14,969		4,457/ 4,391/ 4,325/ 4,260		1,873/ 1,851/ 1,830/ 1,809

Other Markets

Commodities rose 2.42% last week, and are .23% better this week. Crude Oil surged 9.42% and is .34% higher this week. Gold rose .51%, and is up 1.78% since Friday. The U.S. Dollar gained .64%, but then dropped .70% into today. The Japanese Yen fell 1.54%, and was a slight .08% better into today. The Euro fell 1.10%, but has gained .90% so far this week. Corn rose 1.93%, but fell .27% into today. Cotton gained 1.69%, but has fallen 2.55% so far this week.

"Give a man a fish, and he'll eat for a day. Give a fish a man, and he'll eat for weeks!"
Takayuki Ikkaku, Arisa Hosaka and Toshihiro Kawabata

"We cannot fail to win unless we fail to try."
Tom Clancy

Additional Information is Available on Request
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