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Capital Management

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Bond Market Review

The Hangover

That Congress is drunk with uncontrolled spending is not lost on Fed Chairman Bernanke. He testified: *"Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy economic growth."* He said confidence in financial markets *"requires that we, as a nation, begin planning now for the restoration of fiscal balance."* ECB President Jean–Claude Trichet echoed those comments, saying *"any failure by governments to ultimately rebalance budgets would hamper economic recovery."* We think if we've learned anything, it's that we've learned little. This government will *not* check spending and is instead focused on ways to increase tax revenue. They even suggested taxing employer–provided benefits – a tax hike that would hit lower–income Americans incredibly hard. The government still plans to have a pay 'czar' to limit compensation. (Someone said this administration has more 'Czars' than Russia.) Because of that, TARP recipients have been scrambling to repay stimulus funds. As with the lore of other blood–sucking vampires, once the government has been 'invited' in, they won't leave. Ten of our largest banks just gained U.S. Treasury approval to buy back $68 billion of government shares, which *hypothetically* would release them from some oversight on hiring, compensation, and lending. Geithner said: *"These repayments are an encouraging sign of financial repair."* Obama said the repayment of government aid was a *"positive sign"*. Of course, there are conditions! The banks may have to purchase an additional $5.1 billion in government–held warrants to free themselves from government controls. Even then, we expect no end to the meddling since the inception of the *'Troubling'* Asset Relief Program.

Looking Ahead

- 10–year yields could top near June 17th. There is support at 3.95% and then 4.05 to 4.22%.
- We continue to expect further weakness in the economy. Stocks should peak between now and mid–July.

Land of the Lost

Treasuries fell sharply on the belief that improving conditions and the surge in commodity prices might lead the Fed to raise rates this year. While they *will* at some point, we don't recall the Fed ever tightening while there was a *rising* Unemployment Rate. The Fed Funds target *is* exceptionally low, but the Fed is still buying longer maturities in their attempt to drive rates down (with little recent success). This week, the Fed bought $7.5 billion of Treasuries maturing between May 2014 and April 2016. Since March 25, the Fed has purchased $153.028 billion in U.S. debt. However, 10–year yields have risen to 3.92% after trading as low as 2.46% – just after the Fed's announcement of the plan to buy U.S debt on March 18. **They say 'Don't fight the Fed' and, if ever a fight could be 'fixed', this should have been it!** This new 'conundrum' must be frustrating and confusing to the FOMC. (As with most government programs – so much for good intentions!) Nevertheless, it just confirms that the Fed can't control *longer* rates any more *now* than they could when they were inverting the curve trying to drive longer rates higher! It's like Congress trying to reduce the deficit through increased spending. It's also troubling that rates on Fannie Mae and Freddie Mac mortgage securities have been driven back to the highest levels since the day before the Fed announced plans to purchase U.S. debt (11/24/08). They are now over 5% after being under 4% a few weeks ago. 30–year fixed rate mortgages just surged to 5.45% after a recent low 4.85% percent in April. On a positive note, yields tend to overshoot targets into the seasonal highs in May and June and we are here! The **B**ond **M**arket **R**eview has a trend–change date of June 17th that we have been expecting to mark a reversal to lower yields. For now, 4.05 to 4.22% are upper targets (support) for the 10–year.

Treasuries, Agencies, and MBS

For the week, 6–month yields were 5 bps higher, but the 1, 2, 3, 5, 7, 10, and 30–year sectors saw *steep* increases of 16, 38, 43, 49, 48, 37, and 30 bps. Since Friday, yields haven't changed much (and were mixed), although 3, 5, and 10–year notes followed through with 3 bps yield increases. The spread between the 2 and 10–year sectors reached a record 281 bps before pulling back to 248 bps. Investors pulled out of shorter issues on bets the Fed will begin to consider raising rates if the economic outlook continues to improve. MBS spreads widened by 6 to 12 bps. Agencies were 1 bps wider at 2–years, 6 bps better at 5–years, and 3 bps better at 10–years. Supply continues to weigh heavily on the markets. $35 billion 3–year notes came today at 1.96% (the highest since May 2007). Foreign demand is still good with their central banks buying 48.3% of that issue. The Treasury will auction $19 billion 10–year notes Wednesday (06/10) and $11 billion 30–year bonds on Thursday (06/11). Chinese banking officials argued for more Yuan–denominated debt and said the U.S. should issue some 'Yuan' bonds. We hope that doesn't get considered! An unforeseen currency reevaluation could greatly multiply our interest–borrowing costs.

06/05/09 Treasury Yield Curve	2-Year: 1.292%	5-Year: 2.833%	10-Year: 3.828%	30-Year: 4.633%
Weekly Yield Change:	+.3777	+.4926	+.3685	+.2970%
Support:	1.37/ 1.43/ 1.51/ 1.59%	2.91/ 2.97/ 3.06/ 3.13%	3.92/ 4.05/ 4.13/ 4.22%	4.71/ 4.86/ 4.97/ 5.05%
Targets:	1.27/ 1.20/ 1.09/ 0.96%	2.82/ 2.72/ 2.61/ 2.43%	3.79/ 3.67/ 3.53/ 3.59%	4.57/ 4.51/ 4.43/ 4.32%

Economics

Challenger Job Cuts for May were up 7.4% to last year, but that was far better than April's 47%, March's 180.7%, and December's 274.5%! The ADP Employment Change data for May revealed a 532K drop in jobs, and April's losses were bumped up by 54K (to 545K net job cuts). Stocks may be gaining, but the loss in jobs is still troubling. Housing has yet to turn and rising mortgage rates won't help. Additionally, higher rates spell trouble here for another wave of resets which will escalate payments on outstanding variable rate mortgages. Bankruptcy filings were 9.7% higher in the first quarter (with business filings up 11%). Chapter 7 bankruptcy filings rose 15.5% while Chapter 13 filings (which require installment payments to settle some debt) were *down* 2.8%. (Why not just rub *all* the debt!) The ISM Non–Manufacturing Composite (service sector) outlook for May bumped a less–than–expected .3 higher to 44. April Factory Orders rose .7%, but that was from data that was revised 1% lower for March (to –1.9%). Nonfarm Productivity for Q1 was 1.6% higher. Initial Jobless Claims fell 4K to 621K and Continuing Claims dropped 15K to 6,735K (the first drop this year). ICSC Chain Store Sales were off 4.6% in May. The economy lost far less jobs than expected in May. April losses were revised 35K lower and May's came in 175K below expectations at 345K. (Because of that, politicians were saying the economy *gained* 150,000 jobs. It's sort of like how they call a smaller increase in spending a budget *cut*.) Still, the 345K drop was the smallest in 8 months. Notwithstanding, the economy lost jobs for the 17th straight month and the U.S. Unemployment Rate rose from 8.9% to 9.4% (the highest since September 1983 at 9.5%). Manufacturing lost jobs for the 35th month with a 156K drop. Consumer Credit was expected to fall by $6 billion in April, but instead contracted a whopping $15.7 billion (the second worst monthly decline on record). Additionally, March data was revised $5.5 billion lower to –$16.6 billion. Not only were consumers spending less, their ability to borrow to do so was increasingly limited. Wholesale Inventories fell 1.4% in April. IBD/TIPP Economic Optimism was 2.2 higher to 50.8.

Wednesday is set for Bloomberg Global Confidence (June), MBA Mortgage Applications (which fell 16.2% last week), April's Trade Balance (deficit), the Monthly Budget Statement for May, and the Fed's Beige Book. Thursday brings May Retail Sales, jobless claims data, and April Business Inventories. Friday gives us the Import Price Index for May and University of Michigan Confidence. Next Monday (06/15) brings Empire Manufacturing, April TIC Flows, and the NAHB Housing Market Index. Tuesday is set for the May Producer Price Index (PPI), Housing Starts, Building Permits, Industrial Production, and ABC Consumer Confidence (which edged up 2 points to –47 this week).

Equities

Stocks gained for the 11th week of the last 13 — extending the rally that began in March. The Transports and Nasdaq have seen 12 winners, and both outpaced the Dow and S&P last week. For the week, the Dow rose 262.90 points or 3.09% to 8,763.13. Through today, the Dow was a mere .07 lower to Friday. The S&P was 20.95 points or 2.28% higher to 940.09. The Nasdaq rallied 75.09 points or 4.23% to 1,849.42 and the Transports were 4.61% higher. Our work **(BMR 05/26/09)** led us to conclude that: *"The sideways volatility may indicate that stocks are determined hold up until early next week or mid July. (If so, our best guess is for a move into the 951 to 970 target zone.)"* We said: *"Traders can sell 50% at S&P 951 and 970 with an initial buy stop at 1,008."* We are 50% short after we traded above 951 and there's still a chance for strength this week that might fill the other part of our short. Our next key trend–change dates per the **BMR (01/06/09)** are 06/26/06, and 07/15/09. Even though we think things could be getting overdone in here, stocks could hold up until the mid–July date. Most global indexes are trading back to their October 2008 levels. Bank stocks fell .94%.

Resistance:	Dow:	8,839/	9,040/	9,285/	9,654	Nasdaq:	1,870/	1,895/	1,916/	1,951	S&P:	956/	976/	984/ 989
Support:		8,700/	8,599/	8,462/	8,221		1,817/	1,774/	1,714/	1,677		936/	924/	913/ 887

Other Markets

Commodities rose again as Crude Oil gained 3.21% (and traded above $70/barrel for the first time since early November). Commodities were 1.92% higher (also back to early November levels). Gold fell 1.75% as the beleaguered Dollar had a 1.64% rally. The Japanese Yen fell 3.46% and the Euro lost 1.34%.

"The man who is swimming against the stream knows the strength of it." Woodrow Wilson

"Nothing is easy to the unwilling." Nikki Giovanni

Additional Information is Available on Request

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