

BondWorks

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The bond market put in a strong performance in spite of another record volume of Treasury Note auctions last week. As discussed in this here column last week, Treasury supply has been an ongoing theme in the market for a while. It has been front page news for months now and it is pretty much fully discounted for that reason. The demand from both domestic and foreign market participants has been ridiculously high in all three tranches auctioned last week. Even the 7 Year Note – which is considered to be a bit of an odd duck – was oversubscribed to a record level and foreign Central Banks took the highest percentage ever for this particular maturity. World capital markets are highly interconnected. If the yields on Treasury bonds increase, that will cause funding costs to rise for the Russians, Chinese, Japanese, etc. – all those parties that are highly critical of the way the US continues to ramp up its borrowing needs. Officials in those countries are fully aware of that, so they continue to show up in size at all the Treasury auctions – which is really what matters at the end of the day.

The Fed decision at their policy meeting was pretty much as expected. The Funds rate is already near zero and the committee reaffirmed that they plan to keep it there for the foreseeable future. Financial markets were slightly disappointed that there was no mention of increased securities purchases, but the reaction was muted.

Meanwhile in the real world, we had 5 more banks shut down by the authorities this weekend. That takes the count up to 45 and counting for this year. So subtract another 4-5 organizations from the private sector and add them to the public sector. It is not just the banking sector that is transferring operations to the government umbrella. The approximately 6 Million jobs that were eliminated – mostly by the private sector - have joined the public payroll through government insurance benefits. The auto sector is certainly becoming closer supervised by the government as their operations are curtailed by strings attached to bailout packages. Lawmakers are even going as far as taking Fed Chief Ben Bernanke to task in his role during the financial bailouts last fall. That would have been unheard of during the Greenspan era – who was viewed as infallible. Big Brother taking over increasing chunks of the economy is not likely to return us to prosperity, but it will cost more to operate.

NOTEWORTHY: The economic calendar was another mixed bag last week. The housing front is going nowhere fast. Existing Home Sales increased a couple of percentage points to 4.77 Million units. The figure was lower than consensus forecast and the previous month's data was revised down from 4.68 to 4.66 Million. New Home Sales declined marginally from 344k to 342k. This data point was also below expectations and the old data was revised down. New Home Sales have declined over 75% from the peak in 2005 and there is not much relief in sight on this front. Durable Goods Orders increased by 1.8% for the second month in a row, exceeding expectations of a small decline in May. Weekly Initial Jobless Claims ticked up 15k to 627k, while Continued Benefits jumped 29k to 6.74 Million. Personal Income increased 1.4% in May, while Personal Spending was up a modest 0.3%. In case you are wondering how

Incomes can possibly be increasing while record numbers of folks continue to lose their jobs, the answer is government help. If we deducted government subsidies and reduced taxes, Personal Income actually declined last month. Consumer Confidence – as measured by the Michigan Survey – ticked up 2 points to a still disappointing 71 (100 is neutral). In Canada, there were no major economic releases last week. This week's schedule will include the ISM Purchasing Managers' surveys as well as the monthly Employment report one day early on Thursday.

INFLUENCES: Trader sentiment surveys moved noticeably higher but stayed in bear territory this week. This is supportive from a contrarian perspective. The Commitment of Traders reports showed that Commercial traders were net long 343k 10 year Treasury Note futures equivalents – a slight increase of 7k from last week. This is still somewhat positive. Seasonal influences are quite positive heading into month/quarter end. The technical picture is improving as bonds had a nice follow through higher last week. One headwind that bonds face at this point comes from the positions in the Rydex group of funds. There are some analysts that watch investment flows into the various sectors of these funds from a contrarian perspective. Purchases of Rydex bond funds went off the charts during the past 2 weeks, indicating that most of the money available in this space have been spent. In spite of this obstacle, I expect that we should get further follow through to higher prices in the long bond during the weeks ahead.

RATES: The US Long Bond future moved up close to 4 points to 118-17, while the yield on the US 10-year note decreased 24 basis points to 3.54% during the past week. The Canadian 10 year yield was 11 basis points lower at 3.40%. The Canada-US 10 year spread shrank 13 basis points to 14. The US yield curve was flatter as the difference between the 2 year and 10 year Treasury yield decreased 15 basis points to 243.

BOTTOM LINE: Bond yields declined last week, while the yield curve became flatter. The fundamental backdrop remains weak, which is supportive for bonds. Trader sentiment turned more positive, but remained in bearish territory – which is positive; Commitment of Traders positions are slightly supportive and seasonal influences are bullish. I recommend keeping the long bonds that were purchased the other week.

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