

BondWorks

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The bond market was slightly higher last week. The pressure early in the week came from slightly better than expected economic data and supply concerns. However, as we moved along and the risk trade came under pressure again, quite predictably bonds and the US Dollar bounced back with some vigour. The US Dollar is quite overbought now and the Commitment of Traders positions are telling us that it is time for a correction.

The central banks were busy grabbing the headlines again last week. First it was the Reserve Bank of Australia that shocked the market by keeping its benchmark short term rate unchanged at 3.75% versus expectations of another rate hike to 4%. Needless to say the Australian Dollar sold off heavily in reaction to the news. The Bank of England and the European Central Bank did not have any expectations of rate hikes built into their currencies (they stayed put as expected), but those currencies were substantially weaker last week as well.

On the government deficits front, it is quite remarkable how the officialdom – especially in the US - continues to believe that the current debt bubble can be re-inflated by throwing more debt at it. The US announced a projected \$1.6 Trillion deficit for the next fiscal year. Look for further records on this front going forward.

NOTEWORTHY: The economic calendar was busy again. Corporate Earnings took a backseat to economic data as the week moved along. Personal Income and Spending increased by 0.4 and 0.2% respectively in December – pretty much in line with expectations. Construction Spending declined a disappointing 1.2% and the November data was revised down from -0.6 to -1.2% as well. The ISM Manufacturing Index moved up another 3+ points to a robust 58.4, while the more significant ISM Service Sector index remained stuck in the mud at a thoroughly neutral 50.5. Pending Home sales bounced back a massive 1% after a somewhat larger than massive decline of 16.4% the previous month. Auto Sales drifted down from 11.2 Million to 10.8 Million annualized units in January. The Weekly Initial Jobless Claims increased a slight 8k from 472k to 480k. Consensus was looking for a drop to 450k. Productivity continues to soar as a result of ongoing belt tightening. During the last quarter of 2009 Productivity jumped 6.2% as Unit Labour Costs declined 4.4%. One has to wonder how much more is left to squeeze on this front. The Monthly Employment report was actually better than expectations in spite of the slight decline of 20k in Non-Farm Payrolls. The Unemployment Rate fell from 10% to 9.7% even as the labour force increased somewhat for the first time in months. The employment scene is far from rosy but at least the January data has exceeded the mild expectations on a number of fronts including the Average Workweek increasing from 33.2 to 33.3 hours. The back revisions were pathetic though as the government discovered that an additional 900k+ jobs (NOT A TYPO!) were lost during the year ended in March 2009. In Canada, the Unemployment Rate ticked down from 8.4 to 8.3% as 43k new jobs were created in January. Unfortunately pretty much all the new jobs were of the part time, low paying variety. This week's economic schedule will be highlighted by the Trade Balance and Retail Sales reports.

INFLUENCES: Trader sentiment surveys ticked up last week. On a scale of 0-10, the surveys I follow are just above 5.5, which is a decent move from the previous week. We shall see if we get any follow through during the weeks ahead. The Commitment of Traders report showed that Commercial traders were net long 388k 10 year Treasury Note futures equivalents – a decrease of 77k from the previous week. This metric is supportive. Seasonal influences are leaning negative. This metric will start February as a gentle breeze, but will be an increasing headwind from the middle of the month through to the end of May. The technical picture is improving as the Long Bond managed to hold above support at 118. We sold some puts again on the temporary weakness below 118 and will be looking to sell some calls on strength above 120. It is a sign of strength that bonds were able to hold their gains on Friday in spite of the best Unemployment report in well over a year. It is also encouraging to see that after a feeble early week attempt to sell the market into next week's long bond auction cycle, traders had to scramble to cover their shorts later in the week. Next week's auction results at possibly higher prices will provide a further clue about the health of the Treasury market. We remain mildly constructive here.

RATES: The US Long Bond future was up almost a point to 119-16, while the yield on the US 10-year note decreased 5 basis points to 3.56% last week. The Canadian 10 year yield increased 1 basis point to 3.36%. The Canada-US 10 year spread moved in 6 bps as the Canadian 10 Year yield was 20 basis points below the US 10 Year Treasury yield. The US yield curve was pretty much unchanged with the difference between the 2 year and 10 year Treasury yield increasing 1 basis point to 279.

BOTTOM LINE: Bond yields were somewhat lower across all maturities last week, while the yield curve was stable. The fundamental backdrop remains supportive for bonds. Trader sentiment is neutral; support provided by the Commitment of Traders data is positive and seasonal influences are leaning negative. While most of our indicators are in neutral territory, the positive fundamental backdrop and positive COT data support our slightly positive bias for the bond market in the short term.

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