

BondWorks

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The bond market remained in the 140-145 trading range on the bond futures. The market closed at the top of the recent trading range, but it appears to lack the conviction needed to break through. The Fed's stock/bond yield model showed stocks close to 1 standard deviation expensive to bonds for the better part of the week before the rally in bonds on Friday. The long bond auction cycle this past week was well received. While the rest of the world struggles with lack of demand for various sovereign bond auctions, the 3 year and 10 year Treasury Notes were close to 3.5 times oversubscribed and the market appeared to be somewhat disappointed as the 30 year issue was "only" 2.6 times oversubscribed. However, once the supply was out of the way on Thursday, the bonds were able to mount a sustained attack on the upper boundary of the recent trading range.

We had some interesting news and market action on the European front again last week. The troublesome Italian and Spanish bond markets managed to stage a spirited recovery even in the face of some hefty bond auctions. Just as the stormy climate was set to settle down, the Standard and Poor's rating agency announced a slew of downgrades for a number of European sovereigns, including lowering France from AAA to AA+ and Italy from A- to BBB. As per usual, after some early morning jitters, most markets just treated the wholesale downgrade announcement as a non-event. The PIGS have been trading like medium grade junk for months, everyone knows Greece is completely bankrupt, so taking Italy down from A to a still investment grade BBB was hardly earth shattering news.

NOTEWORTHY: The economic news seems to be running out of the "positive surprise" tone it retained for the better part of the past quarter. Consumer Credit increased \$20.4 Billion in November – its largest jump in a decade. This is a minor data series, but this was a number of great significance in a number of ways. First, just the sheer size of the move was shocking. After spending the better part of 2008 through 2010 in negative territory, this series started creeping back into growth of \$3-8 Billion for the past 15 months. The growth in the series was mostly driven by steady increases in the Student Loan component as revolving credit (i.e. credit cards) continued to lag. Intuitively that made sense. The great deleveraging cycle was on, so consumers made an effort to tighten their belt by working off credit card debt and perhaps taking on some student loans as it made sense to go back to school to obtain further credentials, when it was difficult to get a job. Although one month's data a trend does not make, seeing the kind of credit explosion that we had in November is just unreal. This single data point took the year over year consumer credit figure from 3% to 10% growth. Credit Card debt was up \$5.6 Billion alone. Student Loans, Auto Loans, Line of Credit, you name it, it all sky rocketed. This is anything but de-leveraging! President Obama just put in a request to the legislators to raise the debt ceiling another \$1.2 trillion. I suppose as long as the 10 year yield sits comfortably under 2%, pass me another bottle of Tequila, Sheila and let's have another party! Meanwhile, Weekly Initial Jobless Claims remained range bound under 400k level - barely, with the latest figure registered at 399k - an increase of 24k last week from an again upwardly revised previous number. Retail Sales were also disappointing in spite of great fanfare of a successful holiday shopping season. The headline figure barely increased 0.1%, while the core figure actually declined 0.2%. The US Trade deficit jumped \$4.3 Billion to \$47.8 Billion mainly influenced by

a declining export component (especially to Europe). In Canada, the recent string of Trade Deficits turned into a \$1.1 Billion surplus in November. This week's economic schedule will include data mainly from the housing sector and on the inflation front.

INFLUENCES: Our trader sentiment surveys drifted slightly lower last week. On a scale of 0-10, the survey average is just above 6.5, which is in overbought territory and therefore a slight headwind. The Commitment of Traders report showed that Commercial traders were net long 55k 10 year Treasury Note futures equivalents – up 12k from last week. This metric is barely neutral. Seasonal influences are neutral for another week before turning more sustained negative. The longer term technical picture is positive, as bonds remain in a strong uptrend. The recent 140-145 range remains the focus of our trading. The fundamental outlook remains massively supportive, but trading may become more challenging during the first few months of the New Year.

RATES: The US Long Bond future was up 2 points to 145-00, while the yield on the US 10-year note decreased 10 bps to 1.86% during the last week. The Canadian 10 year yield decreased 2 basis points to 1.92%. The Canada-US 10 year spread moved 8 basis points in the US market's favour last week. The US 10 year yield is trading 6 bps lower than the Canadian 10 Year yield. The US yield curve was 6 basis points flatter, with the difference between the 2 year and 10 year Treasury yield falling to 164 basis points.

BOTTOM LINE: Bond yields were lower in the long end, while the yield curve was flatter. The fundamental backdrop remains supportive for bonds. Trader sentiment is a tad overbought and the Commitment of Traders data is leaning negative, while seasonal influences are neutral. I am positive on the bond market longer term but I am looking for range trading to continue for now. We covered our shorts coming out of the auctions, but re-established at a slightly negative position for now as we continue to dance around the fire.

Summary:

Sector	US	Canada	Comments
Short term rates	Neutral	Neutral	Both the Fed and the BOC made it clear recently that they don't have immediate plans to hike rates
Long term rates	Neutral	Neutral	2% is the happy spot on the 10 year yield – for now.
Corporate spreads	Negative	Negative	Spreads are moving wider again
Canada-US 10 year spread	Range	Bound	Trading 25 bps either side of even yield.

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