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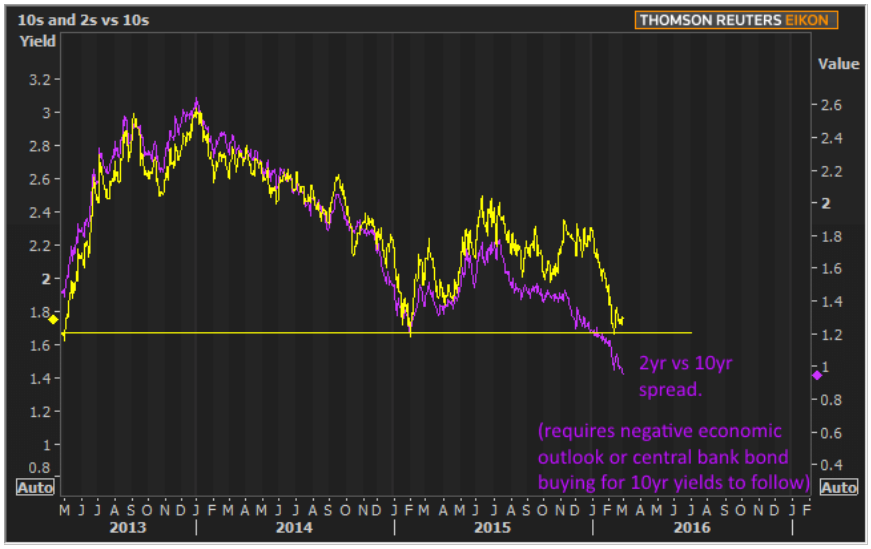
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The Day Ahead: 2 Warnings in Short Term Bond Markets

The **relationship between short and long term yields** is an important indicator for bond markets and the broader economy. 10yr yields are almost always higher than 2yr yields, but when they become much closer together, or when 2yr yields actually rise above 10yr yields, conventional wisdom holds that recession is in store.

With 10's trading around 1.75 and 2's around 0.8, we're **nowhere close** to a so-called "inverted yield curve," but the gap has grown relentlessly narrower since the beginning of 2014. Any time the yield curve is narrowing this much, and especially when it's breaking below 1% (as it is now), investors begin wondering how far away the next recession might be.

This yield curve flattening is the **first warning** in the short term bond market, and one that's worked largely to the advantage of longer term rates. After all, impending recessions generally aren't good for long term rates. A tightening yield curve has also been consistent with falling longer term yields over the past few years.



The second warning cuts the opposite direction. It stems from the fact that a 10yr yields don't historically track the shape of the yield curve like they have been in the chart above. In fact, the "QE era" beginning in 2009 is the only great example of such a strong correlation. It requires a combination of an uncertain economic outlook along with central bank policies that keep short term rates depressed. In other words, if 2yr yields are held near zero (as they

MBS and Treasury

	Price / Yield	Change
MBS UMBS 6.0	99.43	-0.62
10 YR Treasury	4.9860	+0.0952
30 YR Treasury	5.3557	+0.0737

Pricing as of: 11/10 5:59PM EST



Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30YR Fixed	7.30%	+0.12	0.00
15YR Fixed	6.92%	+0.09	0.00
30YR FHA	6.89%	+0.07	0.00
30YR Jumbo	7.40%	+0.03	0.00
7/6 SOFR	6.80%	+0.31	0.00
30YR VA	6.90%	+0.07	0.00

Rates as of: 11/10

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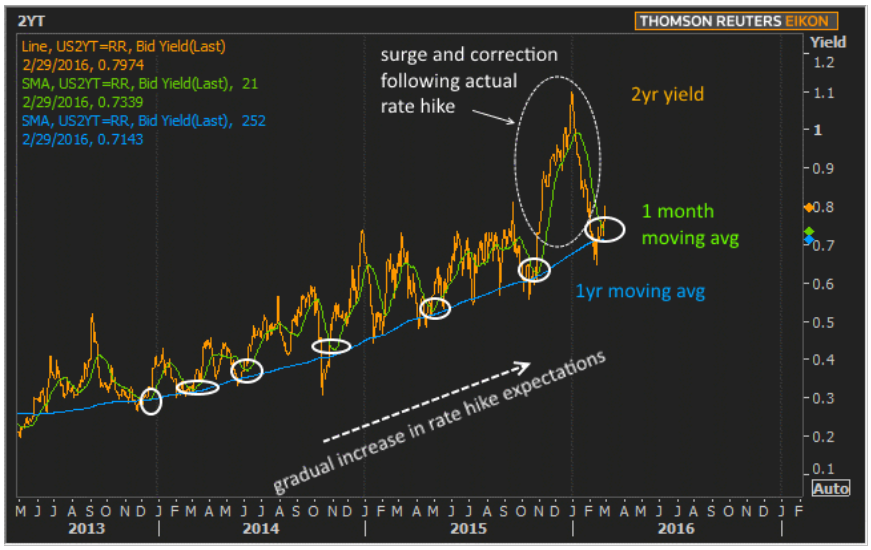
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had been for the past 5 years, the yield curve (relationship between 2s and 10s) will correlate **almost perfectly** with 10yr yields because 10yr yields are the only thing moving.

Now that 2's are moving again, **the risk** is that further upward movement can create upward pressure for 10yr yields as well. This has always been the case in the past, although ahead of recessions the impact of rising 2yr yields is limited (obviously, if they've actually risen to higher yields than 10's). Still, from a shorter-term standpoint, we may have just witnessed a mere correction in the trajectory of 2yr yields following the December rate hike.

In other words, 2yr yields spiked higher than their previous trend would suggest and the first part of 2016 runs the risk of merely being the time when 2yr yields returned to that trend. If that's the case AND, importantly, if we're **not** on the doorstep of a recession (a big "if," depending whom you ask), that upward pressure can still translate to upward pressure on longer-term rates like 10's and mortgages. If it does, the following chart is a bit scary.



Of course the bullish case for rates is that the world is screwed, economically, and that these historical correlations **tend to break down** at such times. Central bank QE (in Europe, particularly) has already led to such a breakdown in 2014 (the year the world priced in the ECB QE that was ultimately enacted at the beginning of 2015). At this point though, it takes more QE to keep the traditional correlation from presenting challenges for the 2016 rally.

With all of the above in mind, anticipation over next week's ECB announcement could overshadow domestic economic data this week, to some extent. Don't expect markets to completely tune out though. This is the biggest week of any given month, with the ISM manufacturing and non manufacturing reports, as well as **ADP Wednesday and NFP Friday**.

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