FIXED INCOME: "WAITIN' ON A SUNNY DAY"

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While the monthly employment report is a primary focus for the money and bond markets, this month's release was not necessarily being viewed as a potential game changer. Indeed, recent Fed rhetoric, combined with the tenor of the April FOMC meeting minutes, had shifted market sentiment to the point where a rate hike at either the June or July policy gathering was being viewed as likely. What investors were not expecting was the surprisingly soft jobs report the Bureau of Labor Statistics released for May. Needless to say, the conversation has shifted yet again, with the markets now essentially removing any chance of the Fed raising rates next week. While there have been economic reports suggesting that the U.S. economy has been improving from the Q1 pace of only +0.8%, don't put the jobs numbers in that category. One should never make too much of one month's worth of data, but the May Employment Situation Summary revealed that job growth for the April/May period has definitely decelerated at a noticeable clip (even when adding back the striking Verizon workers). To illustrate, after registering their weakest showing since 2010 (+38,000, or +73,000 including the Verizon workers) in May, total nonfarm payrolls have now expanded by a monthly average of only +81,000 (or +98,000 including Verizon) thus far in Q2. This compares to an average monthly gain of +195,000 in Q1 and a far more solid showing of +239,000 during the October– March period. The unemployment rate did fall 0.3 percentage points to 4.7%, the lowest reading in almost nine years, but that was primarily due to a plunge of 458,000 in the civilian labor force, certainly not an indication of overly robust conditions. Back to our initial point: The money and bond markets have largely "priced out" any chance the Fed will raise rates at this month's meeting. Let's put this in some perspective. Prior to the May jobs report, the implied probability for an increase in the Fed Funds Rate for June was placed at roughly 30%, but as of this writing, that number had shrunk to a paltry 4%. Even the outlook for the July FOMC meeting has visibly changed, as Fed Funds Futures now show only a 29% chance of a rate hike against a more than 50% chance less than a week ago. It is important to keep in mind that this statistic is subjective in nature and does not necessarily have the greatest track record for predicting actual Fed rate moves. The U.S. Treasury (UST) market got into the act as well. The first place to look at is the Two-Year note, the maturity that is more closely tied to Fed rate actions. After hitting a 2½-month high point of 0.92% in late May, the Two-Year note yield plummeted down to 0.78% in the wake of the jobs report, back to the level that existed pre-FOMC minutes. Further out along the yield curve, the 10-Year yield dropped back down to just above the 1.70% threshold, or more than 15 basis points (bps) below its late May peak. In other words, the UST arena has returned to a setting where a June rate hike is off the table. **Conclusion** Given the current rate backdrop, the Fed would have to do a lot of heavy lifting if it were contemplating a move next week without wanting to surprise the markets. If, as expected, the FOMC forgoes a rate hike next week, it could use the June meeting and Fed chair Janet Yellen's upcoming Semiannual Monetary Policy Report to the Congress on June 21 and 22 as a means of communicating its intentions for July. While concerns regarding global economic and financial developments have seemingly been eased, a data-dependent Fed can't be pleased with the latest employment figures. The policy makers will most likely not overreact to one month's data, but the shadow the jobs report is casting over the labor market setting won't be ignored either. Yellen's speech earlier this week highlighted this point, and seemed to remove the June meeting from consideration, while keeping options open for the future.That leaves the Fed in a position where data watching becomes a heightened priority as it looks for improvement, or "Waitin' on a Sunny Day."

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the "policy rate" of the U.S. Federal Reserve.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Maturity : The amount of time until a loan is repai.

Two-Year note : a debt obligation of the U.S. government with an original maturity of two year.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Basis point : 1/100th of 1 percent.