

Bond Yields Rise as Market Nerves Steady

Early Monday morning, panic in the Japanese equity markets ignited a broad selloff in U.S. stocks and a corresponding flight-to-safety that drove Treasury yields to their lowest levels in more than a year. Since then, a sharp rebound in the Japanese market, signs of improved economic data and reassurance by Fed officials have combined to calm market panic and silence talk of an intermeeting rate cut.

Over the past two sessions, the Nikkei 225 has regained +11.5% of its value following the largest single day drop in 37 years. Monday's -12.4% plunge in the benchmark Japanese stock index was initially thought to have sparked by recession fears following Friday's disappointing employment report, but analysts now point to a rapid strengthening of the yen as the trigger point. As was the case Monday and Tuesday, the Nikkei performance set the tone for the U.S. stock market, which has rebounded from Monday's lows.

Economic data releases were light both yesterday and today. On Monday, as investors watched the market turmoil, the July service sector survey from the Institute for Supply Management (ISM) indicated purchasing managers in the largest sector of the economy are doing much better than in June. The composite ISM Service Index climbed from 48.8 (the lowest point in four years) back into expansion territory at 51.4.

Several key sub-indexes also moved from contraction to expansion, suggesting future improvement. The forward-looking new orders index jumped from 47.3 to 52.4, well above the median forecast, while the employment index rose five points from 46.1 to 51.1. The improvement in demand has also stoked price pressure as the prices paid index rose from 56.3 to 57.0.

The service sector represents about 70% of the U.S. economy. The rise in the ISM Services Index from mild contraction back to expansion signals a healthier economy than last Friday's labor market report had suggested, while a slightly greater percentage of purchasing managers experiencing higher prices argue the inflation battle isn't yet over.

Also on Monday, Chicago Fed President Austan Goolsbee shrugged off recession fears while cautioning against putting too much emphasis on last Friday's disappointing employment report. Goolsbee acknowledged July payroll weakness, but noted the smaller job gain was still within the margin of error. He also pointed out that the rise in the unemployment rate resulted from an increase in the labor force rather than a rise in layoffs. At the same time, the Chicago Fed President laid the groundwork for rate cuts by saying restrictive monetary policy isn't required if the economy is no longer overheating.

That same day, San Francisco Fed President Mary Daly said she believes rate adjustments will be necessary in the coming quarter, but the timing and degree of easing will depend on the incoming data. Daly's comments were on script and didn't add much, but her lack of urgency did not suggest Fed officials believe they've suddenly fallen behind the curve.

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This morning, the futures market is indicating just over 100 basis points of easing this year, down from 125 on Monday, with a 50 basis point cut likely at the September FOMC meeting. However, the market picture is continually evolving. Next week's PPI, CPI and retail sales reports are all capable of reconfiguring the outlook.

Market Indications as of 9:14 A.M. Central Time

DOW	Up 390 to 39,388 (HIGH: 41,198)
NASDAQ	Up 304 to 16,670 (HIGH: 18,647)
S&P 500	Up 84 to 5,324 (HIGH: 5,667)
1-Yr T-bill	current yield 4.47%; opening yield 4.43%
2-Yr T-note	current yield 4.02%; opening yield 3.97%
3-Yr T-note	current yield 3.84%; opening yield 3.78%
5-Yr T-note	current yield 3.78%; opening yield 3.72%
10-Yr T-note	current yield 3.94%; opening yield 3.88%
30-Yr T-bond	current yield 4.23%; opening yield 4.18%

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