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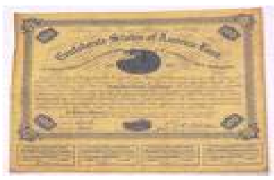

Economics & Financial Markets

United States Fixed Income

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Bond and Equity Markets in Sync Indicating Mid Year Economic Recovery

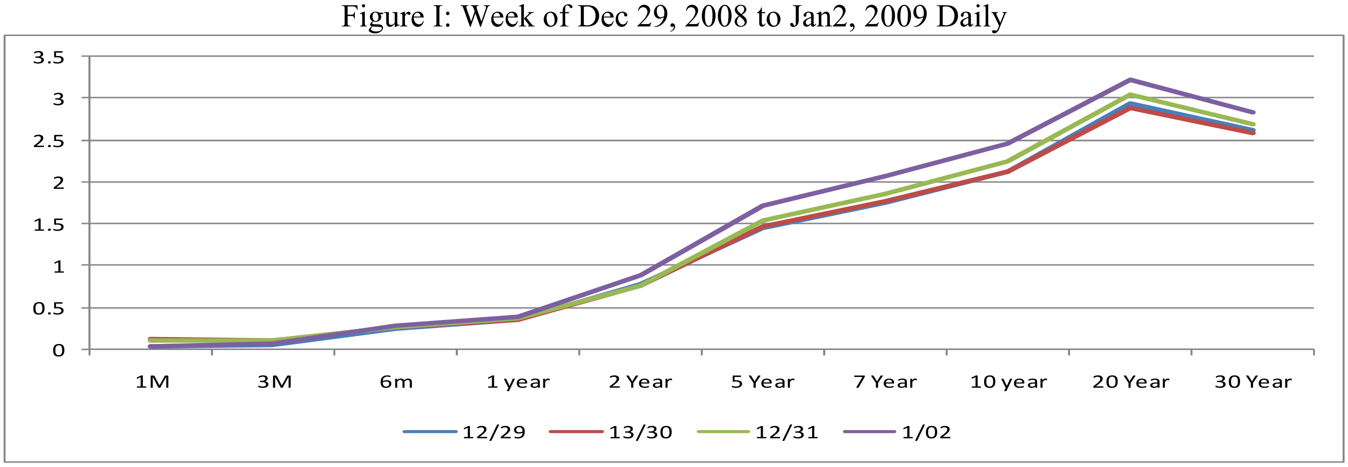
I: Introduction

Last week all the major equities indices were up between 6% and 6.7%, as expectations grew that the economy is likely to recover by midyear. The markets advanced significantly despite some rather terrible economic news, leading us to the obvious distinction between the economy and the markets. It is critically important to distinguish between the markets and the economy, while recognizing that the markets always lead the economy, and the bond markets leads or is in concurrence with the equities.

The bond market is both a leading and coincident indicator to the equity markets, while providing a different perspective on the economy. In many ways it is a truer or almost purer reading of the participant's expectations about the economy. This week the yields on the bond market like the equities began to act as if there was an expectation that the economy would recover by midyear 2009.

II. Yield Curve week of December 29, 2008 to January 2, 2009

Figure I: Week of Dec 29, 2008 to Jan2, 2009 Daily



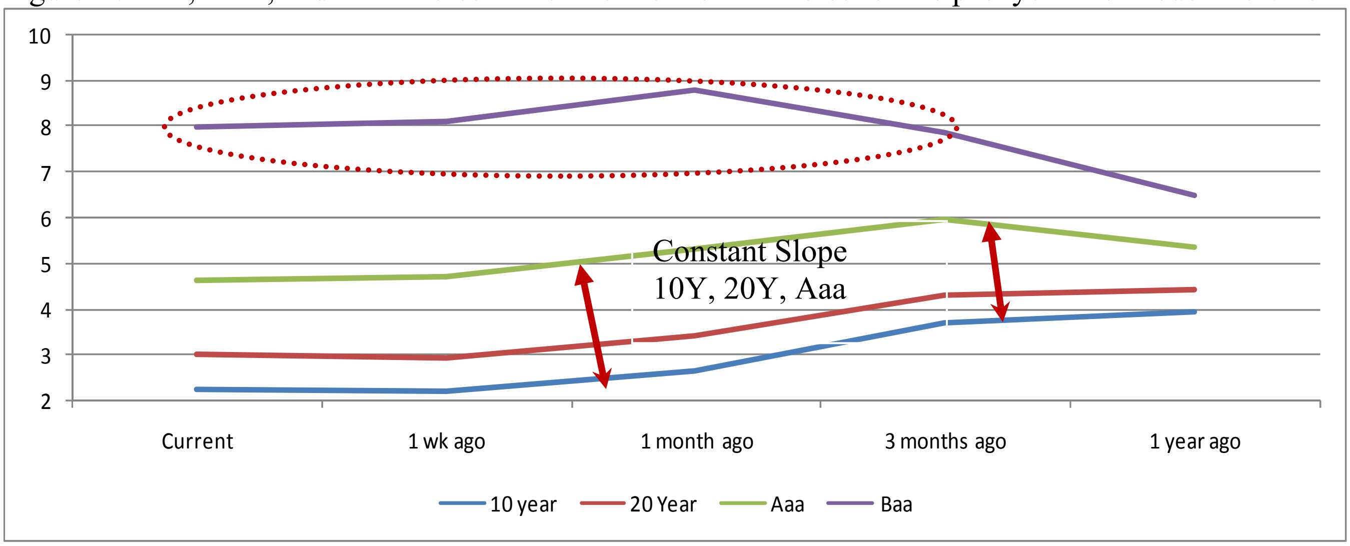
Source: Federal Reserve, U.S. Treasury, SISR

Last week the yields on the 2 year to the 30 year note and bonds increased by approximately 20 basis points. Friday's action was the most aggressive, with the yield on the 10 year rising to 2.46% by mid afternoon, before falling back to a 2.36 yield by the end of the day. Figure I plots the daily change in the yield curve from last week, with the yield on the long end increasing every day.

III. Corporate Bonds as Related to the 10 and 20 Year Treasuries

This is the first week since the failure of Lehman Brothers were both the equity markets and the bond markets were synchronous in indicating that there may be some sunlight ahead. We have seen this expectation over the past month as the Baa corporate bonds, finally began to decline in yield after deviating strongly from the Aaa, 10 year and 20 year Treasuries. Last week was a continuation of this pattern, signaling the first cracks in the flight to safety, and concerns that the economy was in a deep recession or worse.

Figure II: 10Y, 20 Y, and AAA notes in Relation to the Baa Notes for the past year a Various Intervals



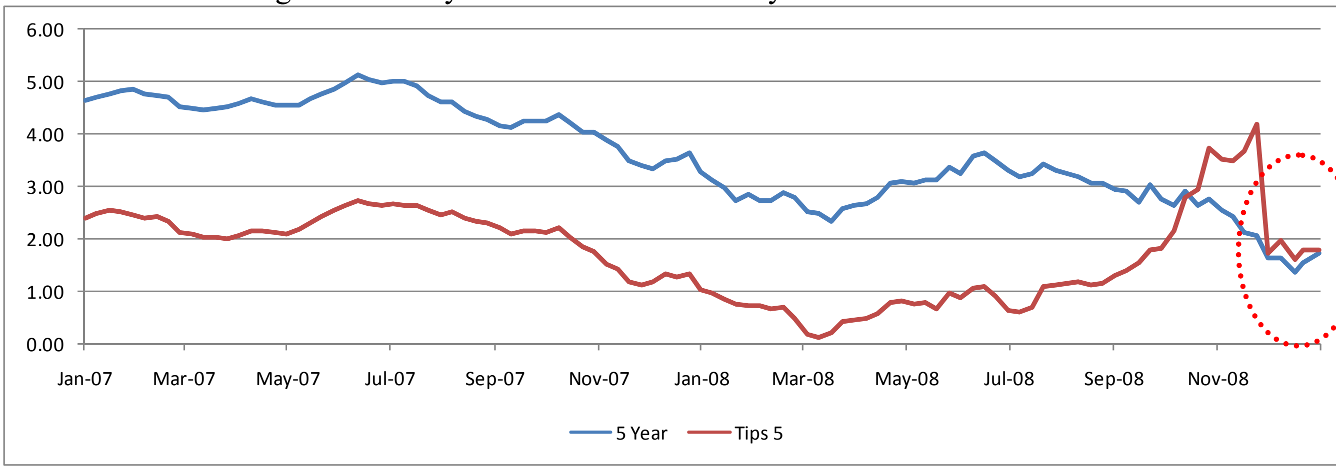
Source: Federal Reserve, DOT, SISR

There is a tremendous amount of work to be done, but the simple fact that the lame duck period is nearly over and the new administration is projecting a major stimulus package, appears to have been giving the markets something to look forward to.

IV. 5 Year and 10 Year TIPS Still Indicating Deflation

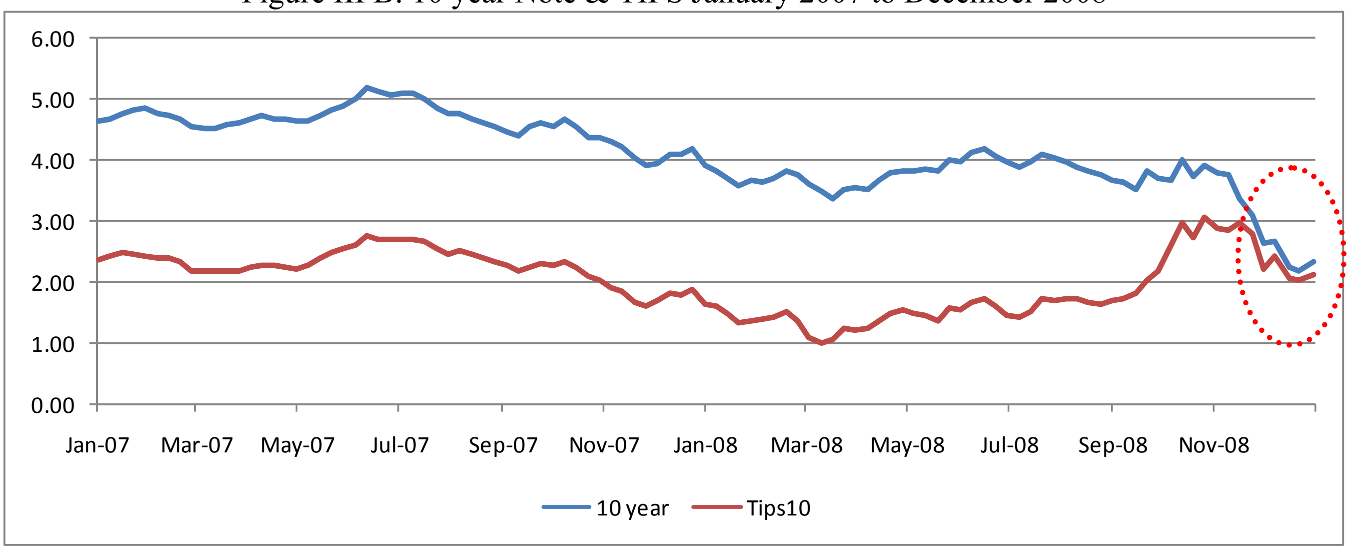
Even the TIPS were moving in this direction. In the past week, the yield on the 5 year TIPS increased by 18 basis points, whereas the 5 year notes were up 27 basis points. Similarly the 10 year TIPS were up 26 basis points and the 10 year notes were up 33 basis points. These are minor movements but at least they are in the correct direction. We expect that as the economy begins to fully that the TIPS will move back to parity with a rate of 2 to 2.5%. Similarly, we expect that inflation will be at or near the long run fed target of 2 to 3 % annually, barring a catastrophe on the other side with runaway inflation resulting from the current rapid expansion of money supply.

Figure III A: 5 year Note & TIPS January 2007 to December 2008



Source: Federal Reserve, DOT, SISR

Figure III B: 10 year Note & TIPS January 2007 to December 2008



Source: Federal Reserve, DOT, SISR

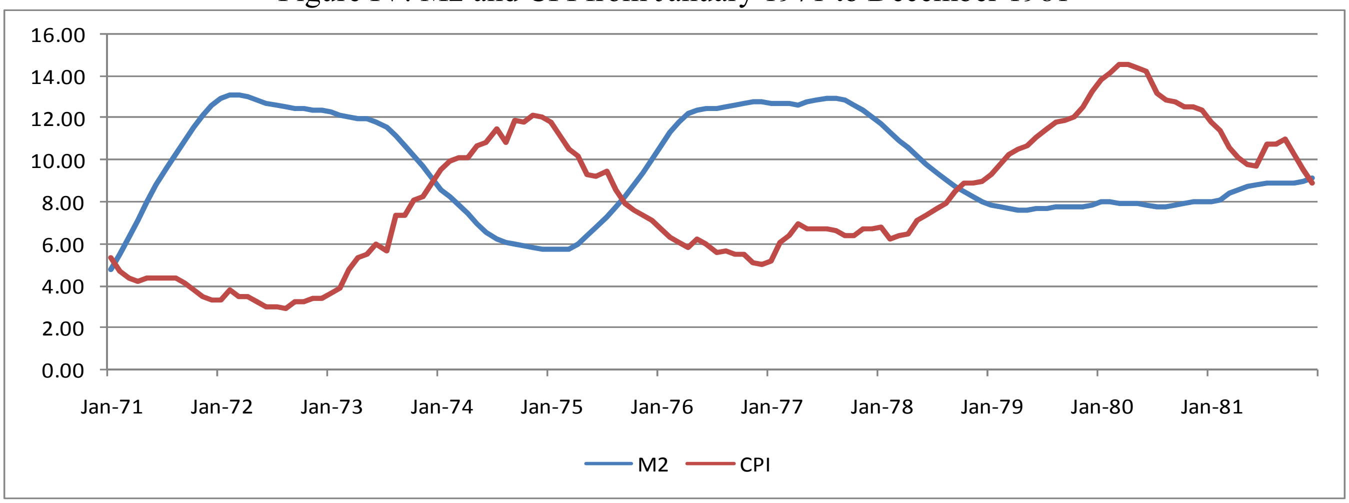
These are not major moves but both the 5 year and the 10 year have been acting like there is an expectation the deflation is likely, within the intermediate terms. We have argued that within the next 2 to 5 years it is unlikely that there will be no inflation, and have argued that the obvious trade is to short the 5 and 10 year notes and to purchase the respective TIPS. We expect that the yields on the 5 and 10 year notes will increase back to historical parity of 2 to 2.5%, as confidence builds that the economy will recover by midyear.

The historical relationship between the TIPS and their respective instruments has been a consistent 200 to 250 basis point spread for both the 5 year and 10 year TIPS, over the past couple of years (Figures IIIA & B respectively). However, beginning in July of 2008 this 200 to 250 basis point gap between the TIPS and their respective instruments closed for the 5 year TIPS, and in September for the 10 year TIPS. The 5 year TIPS are currently still above the 5 year note, whereas the yield on the 10 year TIPS are only slightly below the yield on the 10 year notes, but expanded very slightly this past week (please see circles in Figure IIIA & B). What is troubling is that from these instruments there is no expectation of inflation despite the fact that money supply is growing at unprecedented rates of growth, over the past three months.

V. Money Supply and the Possibility of Inflation

The relationship between the rate of money growth and the level of inflation has been debated since the 1980's with very mixed results. Bernanke has argued that he agrees with the basic contentions that money and inflation are related, but unlike the relationship in the 1970's and the 1980's, he believes one needs to more astute to the international flow of money. Figure V plots the long run relationship showing the 18 month lag between inflation and the high rate of growth of money supply. The only time since 1959 when the U.S. increased money supply at double digit rates for an extended period was in the 1970 to 1980 period and inflation occurred within 18 months.

Figure IV: M2 and CPI from January 1971 to December 1981

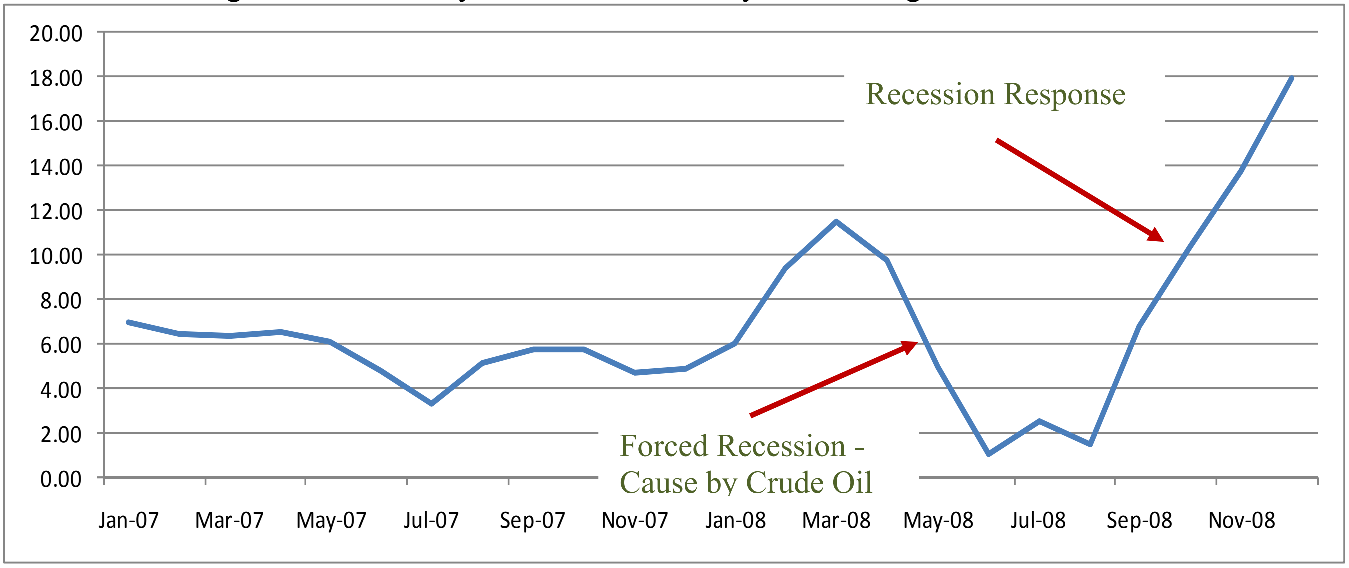


Source: Federal Reserve, Department of Labor, SISR

Since the downfall of Lehman the Federal Reserve has been expanding M2 money supply at an unprecedented rate of growth. Last week the 3 month rate of expansion was nearly 18% annualized, with 4 to 6 % the normal rate of expansion. The same is occurring worldwide. A key question, we believe, is not will there be deflation, but how rapid will the inflation be. The question that concerns us is: will this current rapid rate of M2 growth cause inflation in 1 ½ to 2 years?

Currently no one is concerned about inflation as we have shown with respect to the TIPS, however if theory is correct it may well be that this will be the primary issue of concern in late 2010 and early 2011. Figure V plots M2 money supply with two interesting points to consider: 1) why did the Federal Reserve contracted M2 so strongly after Bear Stearns fell, knowing that the economy was falling into a recession, and as we now know, that it was in the midst of a recession; and 2) why is the Federal Reserve expanding M2 so rapidly, at rates that are more likely than less to cause major inflation in several years.

Figure V: M2 Money Growth from January 2007 through December 2008



Source: Federal Reserve, SISR

The reason that the Federal Reserve was contracting money from the time that Bear Sterns collapsed to the time that Lehman came apart was that they realized that is was essential to bring the economy into a recession in order to break the back of the high price of oil, or that oil would bring the economy into recession. Since then they have been increasing money at a remarkable high historic rate of growth, reminiscent of the 1970's and 1980's. Our fear is that we may be creating the third bubble of the decade, the bond bubble, and when it breaks many of the holder's of these low interest long bonds will be seriously hurt, certainly on a mark to market rate of accounting.

IV: Conclusion

This may have been the first week since the collapse of Lehman that both the equity markets and the bond market acted as if there was some expectation that there will be a recovery by midyear 2009. The bond yield on all maturities increased, the Baa corporate bonds continued their decline in yield, and the TIPS declined relative to their base instrument, if ever so slightly.

Our biggest concern is that once the economy begins to expand, will the Federal Reserve be able to contract M2 growth and maintain a stable economy? Secondly, even if the Federal Reserve is able to perform this magic will the other central banks of the world be as adept in this transaction.

This may not appear to be a relevant concern at this time. It is almost as if a Doctor tells you that you that you have an unusual rare disease, and only have between 10 to 15 years to live on average, unless a cure is discovered, while you are in the trenches of a war and fear that you may not survive the week.

Based on our forecast and expectations we would recommend the purchase of the 5 and 10 year TIPS and the sale of their respective instruments. We find it hard to believe that there will be deflation, and even harder to believe that in 2 years there will be zero inflation. This is why we believe a discussion of M2 was relevant. Also the Corporate low investment grade and junk bonds need to be looked at.

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2 – Overweight – The stock is expected to outperform the equal weighted expected total return of the sector coverage. Our investment horizon is 12 – 18 months except as specified by the reporting analyst.
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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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