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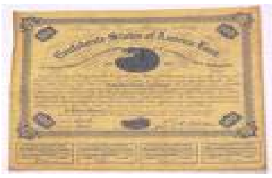

# Economics & Financial Markets

## United States Fixed Income


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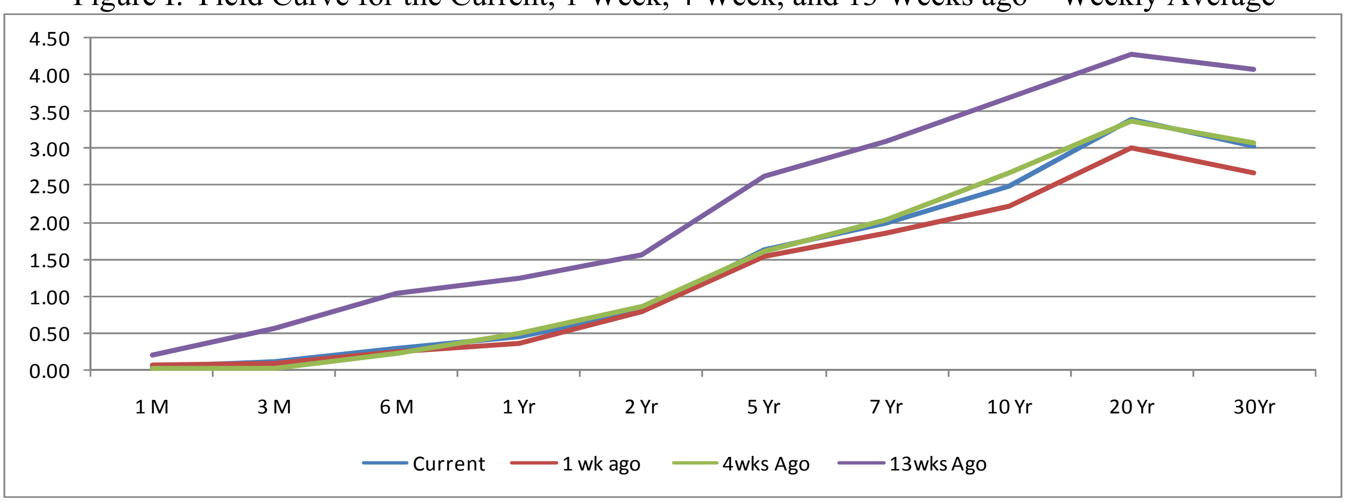
## TIPS Yields and Bond Yields Move in Opposite Directions

### I: Introduction

Last week we observed that the longer end of the Treasury yield curve increasing as seen in Figure I. The yield on the 5 year increased from 1.55% to 1.62%, the 10 year went from 2.24% to 2.48%, the twenty and 30 year bonds went from 3.02% to 3.40%, and 2.68% to 3.03% respectively. The yield on the TIPS went in the opposite direction and actually declined, with the 5 year TIPS going from 1.79% the prior week to 1.60% this past week and the 10 year went from 2.12 to 2.06 on average for the week, with the 10 year going from 2.34 on Monday to 1.87% on Friday.

Figure I: Yield Curve for the Current, 1 Week, 4 Week, and 13 Weeks ago – Weekly Average




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

The FOMC in their minutes released this week on Tuesday Jan 6, 2008, from the meeting Dec 15-16, argued that there may actually be disinflation and that the risk of inflation may be too low for economic growth. For the past month we have argued against this contention and believe that there is greater risk of inflation within the next few years than the risk of disinflation or deflation as some believe. However, this belief, that we may be entering into a period of deflation, may well be one of the main reasons that there has been the imbalance between the TIPS and their respective instruments. The FOMC argued in their published minutes that:

> Looking forward, participants agreed that inflationary pressures looked set to moderate further in coming quarters, reflecting recent declines in commodity prices and rising slack in resource markets, and several saw risks that inflation could drop for a time below rates they viewed as most consistent over time with the Federal Reserve's dual mandate for maximum employment and price stability…Several participants observed that monitoring measures of inflation expectations for signs of disinflationary dynamics would be especially important going forward.

This has been the trading pattern over the past several months, as seen in Figure 1, with almost an accordion like movements from compression to slight expansion in the past week, and back to the level of 4 weeks ago. The FOMC minutes described this trading pattern aptly in recognizing that:

> Yields on nominal Treasury coupon securities declined significantly over the intermeeting period in response to safe-haven demands as well as the downward revisions in the economic outlook and the expected policy path.

They continued to comment on the TIPS by arguing that this flight to safety may have pushed the Treasuries below the TIPS because of the greater liquidity of the underlying notes and bonds instruments.

> Meanwhile, yields on inflation-indexed Treasury securities declined by smaller amounts, leaving inflation compensation lower. Although the decline in inflation compensation occurred amid sharp decrease in inflation measures and energy prices, it was likely amplified by increased investor preference for the greater liquidity of nominal treasury securities relative to that of inflation-protected Treasury securities.

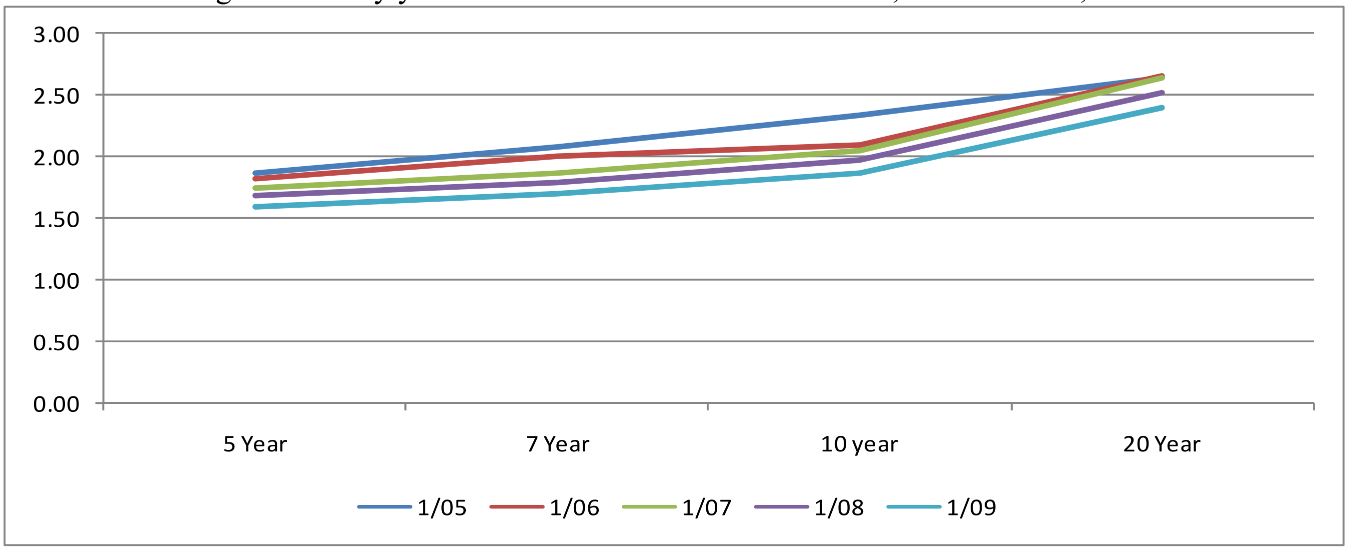
This has been our argument for the past several weeks that the inflation protected Treasury securities were significantly undervalued and that the Treasury securities were significantly oversold. Last week there was a major reversal in the pattern: with the inflation protected Treasury securities increasing significantly relative to their base bond instrument. We believe that there is a growing sense that with crude oil beginning to stabilize, that it is unlikely that there will be deflation. Our concern is not that there will be no deflation but our concern is that there may be inflation if the Federal Reserve is not careful.

## II. 5 Year and 10 Year TIPS Begin to Adjust to Limited Inflation Expectation

Last week we saw that each day, the yield on the TIPS went in the opposite direction of their base instrument. The yield on the TIPS declined during a week, while the long end of the yield curve increased in yield. The 5, 7, 10 and 20 year yields on the notes all increased while their respective base instruments all declined.

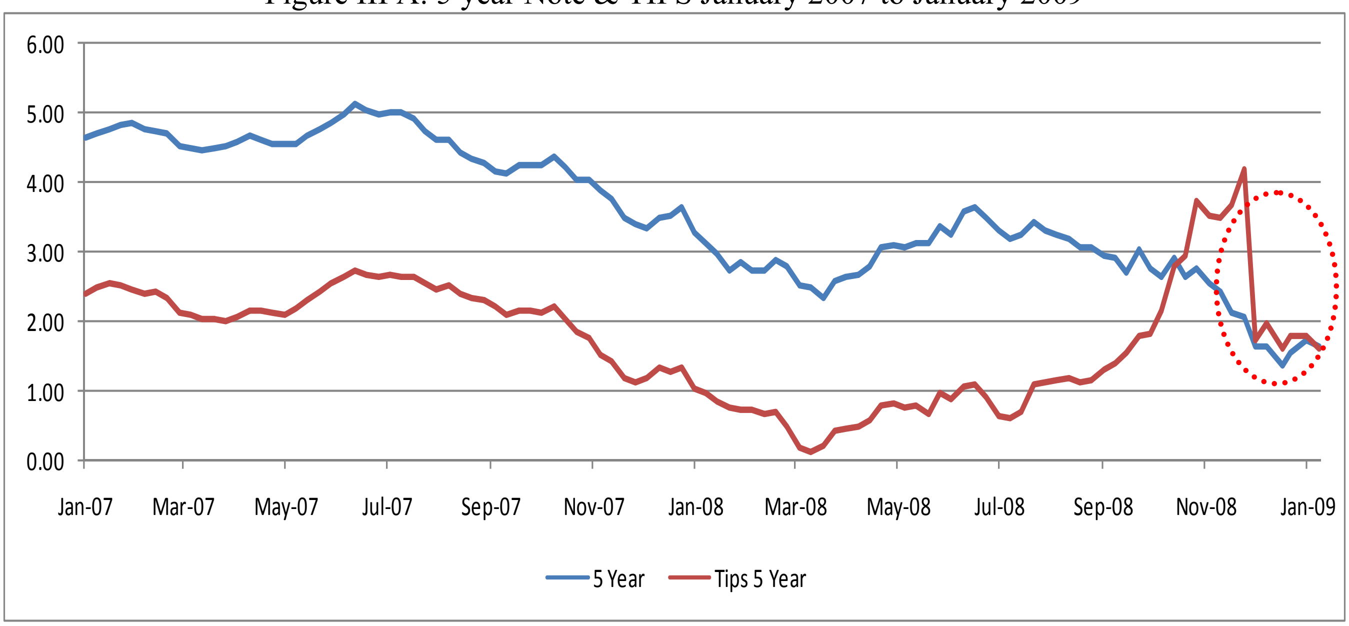
Figure II: Daily yield curve for the TIPS week of Jan 5, 2009 to Jan 9, 2009




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

The TIPS moved in the opposite direction of the 5 and 10 year notes. The 5 year note began to close the gap and is now only a few basis points below the 5 year TIPPS (Figure IIIA).

Figure III A: 5 year Note & TIPS January 2007 to January 2009

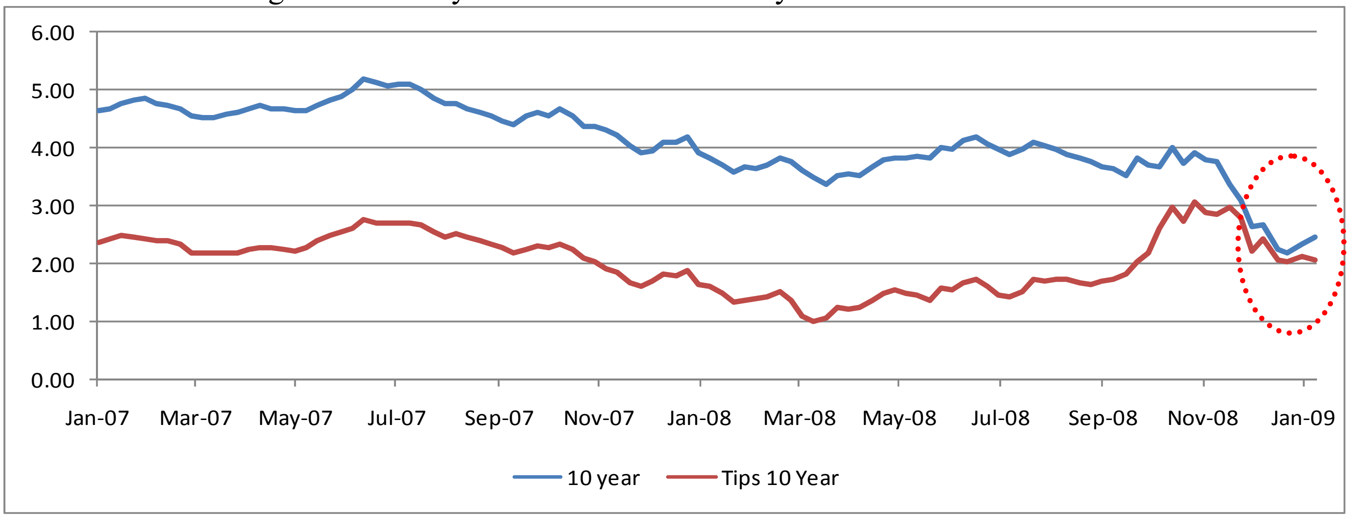



Source: Federal Reserve, DOT, SISR

The 10 year alternatively expanded out, with a healthier 50 basis point spread as of Friday's close. From Figures IIIA and IIB, using weekly data, we see how in the past few weeks, the spread have slowly begun to move back toward a more normal direction with the Treasuries being 2 to 2.5% higher than the TIPS. These are still not major moves, but at least both the 5 year and the 10 year have been moving in the correct direction. Perhaps as the FOMC minutes had suggested, that they the flight to safety is abating, and that the liquidity issues of the TIPPS and their respective instruments is becoming less of an issue.

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



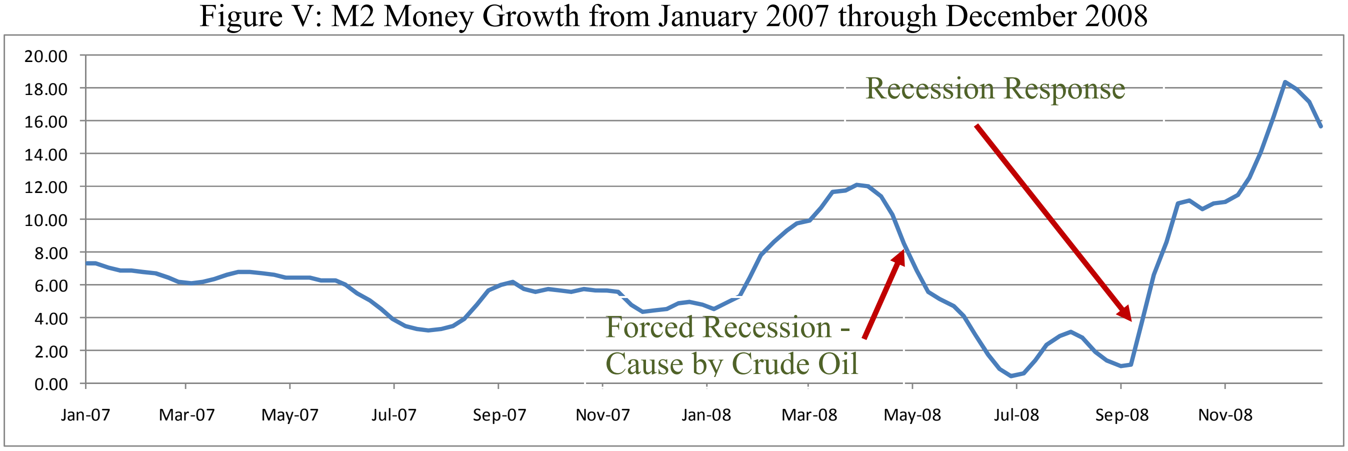

Source: Federal Reserve, DOT, SISR

The historical relationship between the TIPS and their respective instruments have 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.

## V. Money Supply

Last week was the first week since the collapse of Lehman that we saw any decline in the extremely rapid growth of money supply (Figure IV). Money supply has been growing at a 16 to 18% annualized rate of growth for the past 4 months.

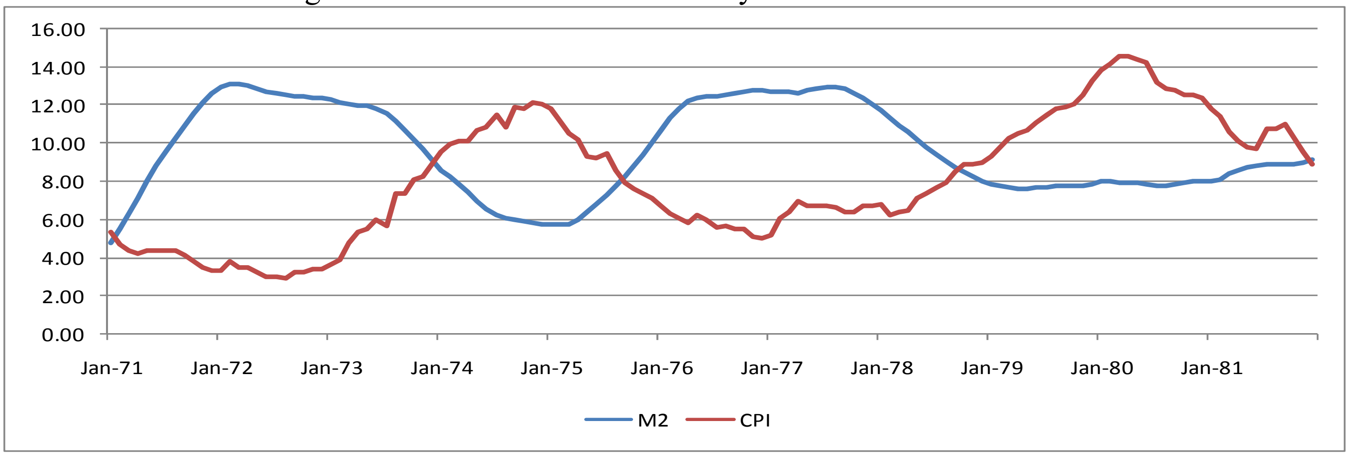
Figure V: M2 Money Growth from January 2007 through December 2008




Source: Federal Reserve, SISR

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 IV 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

Currently no one is concerned about inflation, but we need to watch to see how the Federal Reserve deals with money growth over the next few months, because if M2 growth continues at this double digit rate into summer, it is likely that inflation will begin to show up within the economy by the end of 2009.

## IV: Conclusion

Last week we concluded with the following statement:

> 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.

This week we began to see the TIPS move in the projected direction. Concerns about Inflation/deflation, and how quickly the economy will return to health are all major issues confronting the bond market. The fact that the TIPS began to move in the desired direction we believe is another sign that there is the beginnings of some semblance of economic stability on the horizon.

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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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