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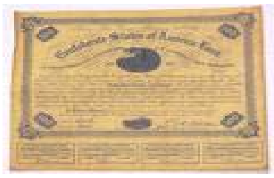

Economics & Financial Markets

United States Fixed Income

Philip L. Miller – 646-415-9141
Chief Strategist
pmiller@sisresearch.com
www.sisresearch.com

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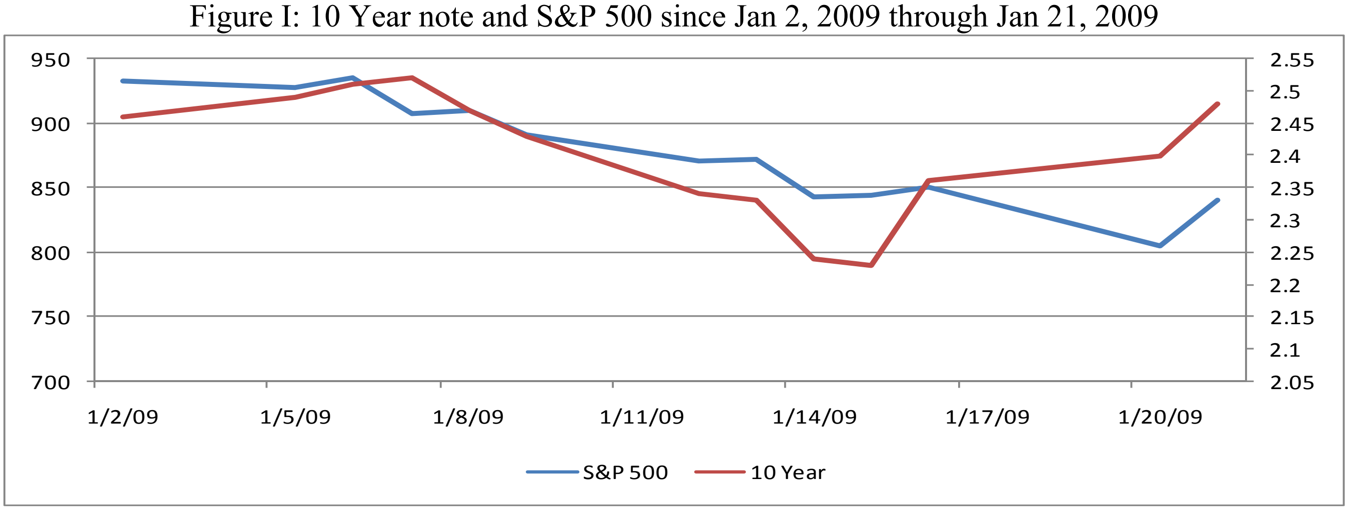
Bond Market Leading Equity Markets: Will Election Transition Optimism Alter Negative Market Sentiment

I: Introduction – Bond Market leads Equities Indicating Growing Stability

Over the last two weeks we observed a good degree of fluctuation in the 10 year notes with yields declining from a high of 2.52% on the 10 year to a low of 2.23 and by today back to 2.56. The markets which had rallied since the announcement of Geithner as Secretary on November 21, 2008 until January 2, 2009 retreated since then with the exception of yesterday Jan 21, 2009. The bond market which was beginning to stabilize in late December began to follow the markets with yields on the 10 year declining. However, by last Thursday Jan 15, 2009 the yields on the 10 year began to improve and yesterday's action was the one of the strongest upward move of the month for both bonds and the equity markets.

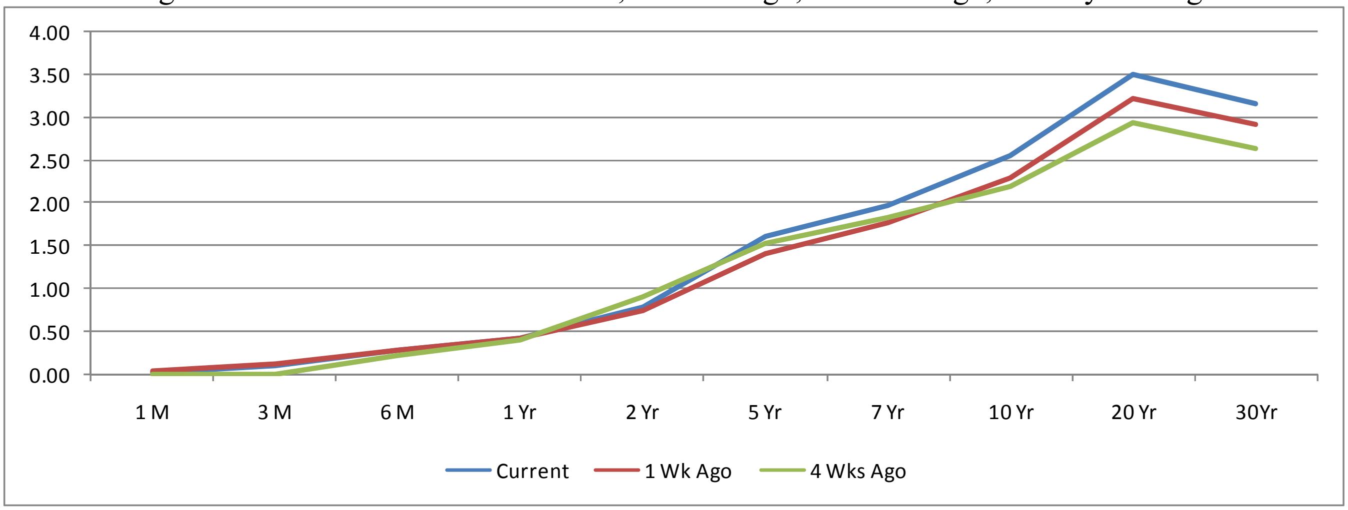
Figure I: 10 Year note and S&P 500 since Jan 2, 2009 through Jan 21, 2009



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

For the past two months since the Geithner announcement we have been arguing that the lame duck period of the Bush Administration was hurting confidence and significantly affecting the markets. In the past couple days since the Obama inaugurations there has been significant signs of greater optimism by Main Street in Contrast To Wall Street. It is our belief that the markets will feed on this optimism as long as the optimism spills over to consumer confidence and ultimately purchases. The last few days with the 10 year increasing in yield indicated that there is growing optimism for the markets. Figure II shows the yield curve over the past month with the long end of the curve beginning to improve somewhat.

Figure II: Yield Curve for the Current, 1 Week Ago, 4 Weeks Ago, Weekly Average



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

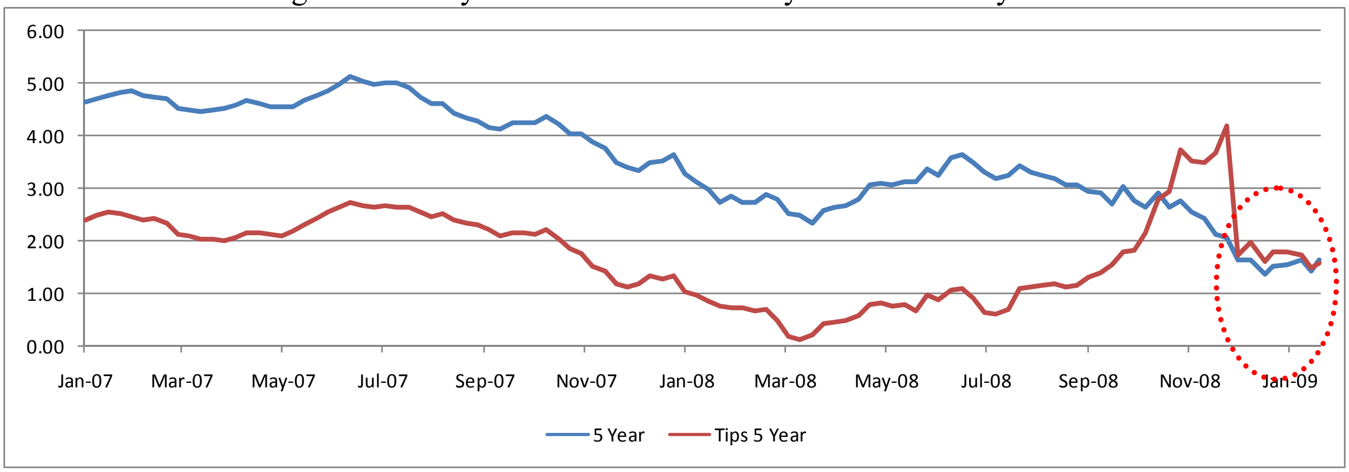
In the past few weeks since the FMOC lowered interest rates on December 16, 2008 the longer end of the yield curve has been increasing, providing a significant sign that there is some expectation that the economy will be getting stronger. We have observed that the longer end of the Treasury yield curve increasing as seen in Figure II. The yield on the 5 year increased from 1.42% to 1.62%, the 10 year went from 2.30% to 2.56%, the twenty and 30 year bonds went from 3.23% to 3.51%, and 2.93% to 3.17% respectively. The yield on the TIPS increased but at a slower rate than their base instrument, with the 5 year TIPS going from 1.49% the prior week to 1.56% this past week and the 10 year went from 1.77 to 1.98 currently. This was the first time since Lehman that the 5 year TIPS were trading below the 5 year notes.

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. Over the past few weeks there was a major reversal in the pattern: with the inflation protected Treasury securities increasing significantly relative to their base bond instrument. Yesterday was the first day in fact that the 5 year TIPS traded below their base instrument, with the 5 year trading at 1.62 and the 5 year TIPS trading at 1.56. These patterns are a continuation of the Treasury market indicating that the economy is beginning to get stronger.

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

Last week the 5 year TIPS for the first time since the fall of Lehman was below the 5 year Treasury notes. The yield on the 5 year Treasuries closed yesterday at 1.56% whereas the yield on the 5 year notes was 1.62%. This has been a long period of abnormal trading patterns which had resulted from the extreme flight to safety. The TIPS have been closing the gap for the past few weeks with the 5 year Treasury moving above the 5 year TIPS (Figure IIIA).

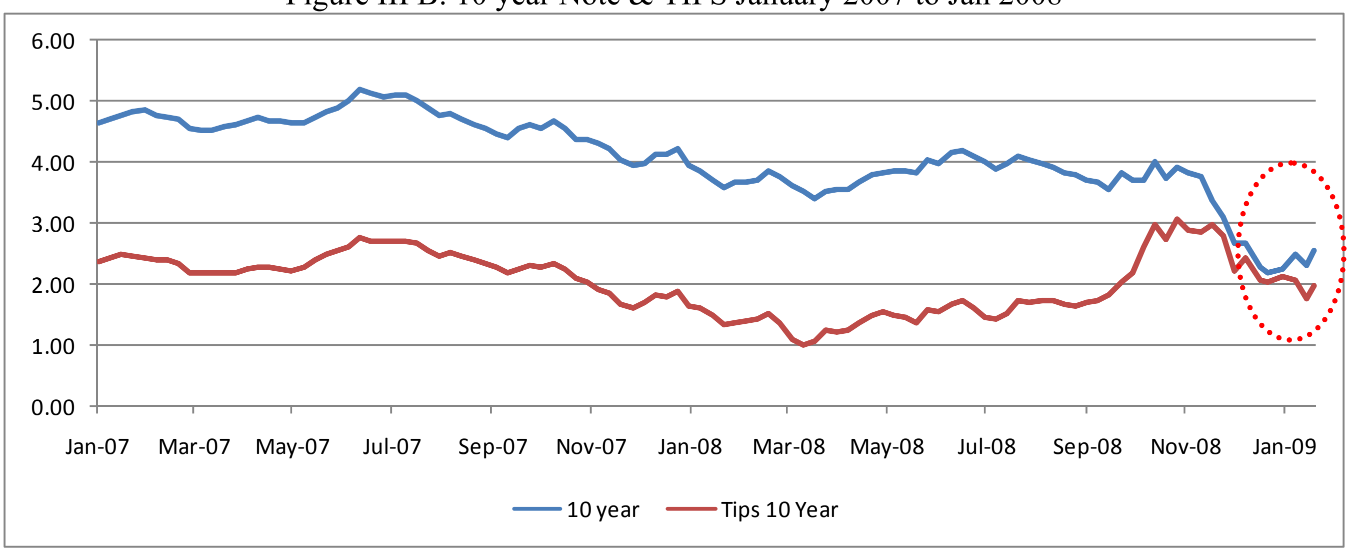
Figure III A: 5 year Note & TIPS January 2007 to January 2009



Source: Federal Reserve, DOT, SISR

The yield on the 10 year TIPS for the week increased to 1.98% from 1.77% with the yield on the 10 year going from 2.30% to 2.56% a 26 basis point increase as opposed to a 19 basis point increase for the TIPS. The 10 year has continued to expand out, with a healthier 58 basis point spread as of yesterday's close.

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



Source: Federal Reserve, DOT, SISR

From Figures IIIA and IIIB, using weekly data, we see how in the past few weeks, the spreads have slowly begun to move back toward a more normal direction. The current moves are still not major moves, but at least they have been moving in the correct direction and are positive relative to the TIPS.

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.

III. SISR Fixed Income Forecast for 2009

Based on our economic expectation we are forecasting the 2009 FF rate and the 10 year notes. We have based our forecast on: 1) an inflation rate of 1 to 1.5% by the end of next year; 2) on GDP in Q109 being negative by greater than 1%; Q209 coming in at near zero; Q309 being slightly positive; and Q409 at a 2.2% growth rate; 3) the price of oil increasing to a range between 55 and 65 dollar by the end of next year; 4) gasoline going back to the $2.10 to $2.30 per gallon range; 5) the dollar stabilizing at $1.20 to $1.40 per Euro, through midyear and 6) initial claims and unemployment peaking in Q109.

Given the current U.S. Fed Funds target interest rates, we believe that the dollar will continue to strengthen again the Euro because it is expected that the U.S. will emerge from this crisis faster than the Euro Zone. Once the FOMC begins to raise interest rates as we expect by midyear, we believe that the dollar will become even stronger relative to the Euro, and eventually trade at parity with the EURO. As the dollar strengthens Crude will fully stabilize in the 50 to 60 dollar per barrel range. We also expect that the U.S. will recover from this recession faster than the EU zone recovers from their recession.

SISR Fixed Inceome Forecast for 2009

	Historical				SISR Forecast			
Rates	Dec 30, 2007	June 30, 2008	Sept 30, 2008	Dec 26, 2008	Jan 31, 2009	Mar 31, 2009	June 31, 2009	Dec 31, 2009
Fed Funds	4.25	2.00	2.00	0.0-0.25	0.0-0.25	0.0-0.25	1.00	1.50
1 Year	3.42	2.36	1.78	0.38				
2 Year	3.23	2.63	2	0.89				
5 Year	3.63	3.34	2.98	1.51				
10 Year	4.21	3.99	3.85	2.16	2.60	2.75	3.00	3.50
10 Yr - FF	-0.04	1.99	1.85	2.16	2.35	2.5	2	2.00

Source: Federal Reserve, SISR

We are forecasting a FF target rate of 1.50% by year end, with a 10 year note at 3.50%. We would expect that the 10 year TIPS will continue to drop relative to their basic instruments and the spread expanding out to at least 100 basis points by year end if not sooner. This would indicate a 1.0% to 1.5% inflation rate by year end. In addition the 10 year note less the Fed Funds rate (FFBond), as show in the table, is projected to remain in the range of 1.5% to 2.5%.

For the past year we have been highlighting this FFBond spread as being perhaps the most important single indicator of the economy's health. It has anticipated every major recession including the 2007 to 2009 recession. During early 2007 this spread had been negative for over 9 months, which was indicating that the economy was heading into a recession. We are projecting that the FOMC will be very cognizant of maintaining the FFBond spread at 1.5 to 2.5% going forward. We similarly will be watching this spread very closely, since the U.S. economic recovery will be dependent on this spread remaining at or above the preferred ratio of greater than 1.5%. If it begins to decline below 1.5%, as it briefly did in November, it is likely that the economy will again be heading into more difficult times. This is why we have been so encouraged over the past week even though the equity markets were telling a different story. We believe that the Treasury Markets may be leading the Equity Market as a leading indicator for the economy beginning to find some sense of footing.

IV: <u>Conclusion</u>

Two weeks ago 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 finally saw the 5 year TIPS move below their basic instrument and the Fixed Income market have begun to show some signs of returning to a more normal pattern.

There is not much to say except today the economic data for claims and housing starts was terrible, the equity markets are down but the bond market yields on the 5, 10, and 30 year notes and bonds today are up again. This is the expected trend with the economy anticipated to show some improvement in the intermediate future. Bonds we believe are a better indicator of expectations than are stocks. Bonds are leading with stocks lagging future economic expectations.

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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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