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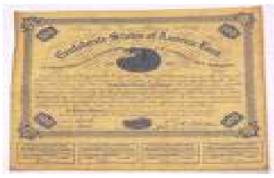

Economics & Financial Markets

United States Fixed Income

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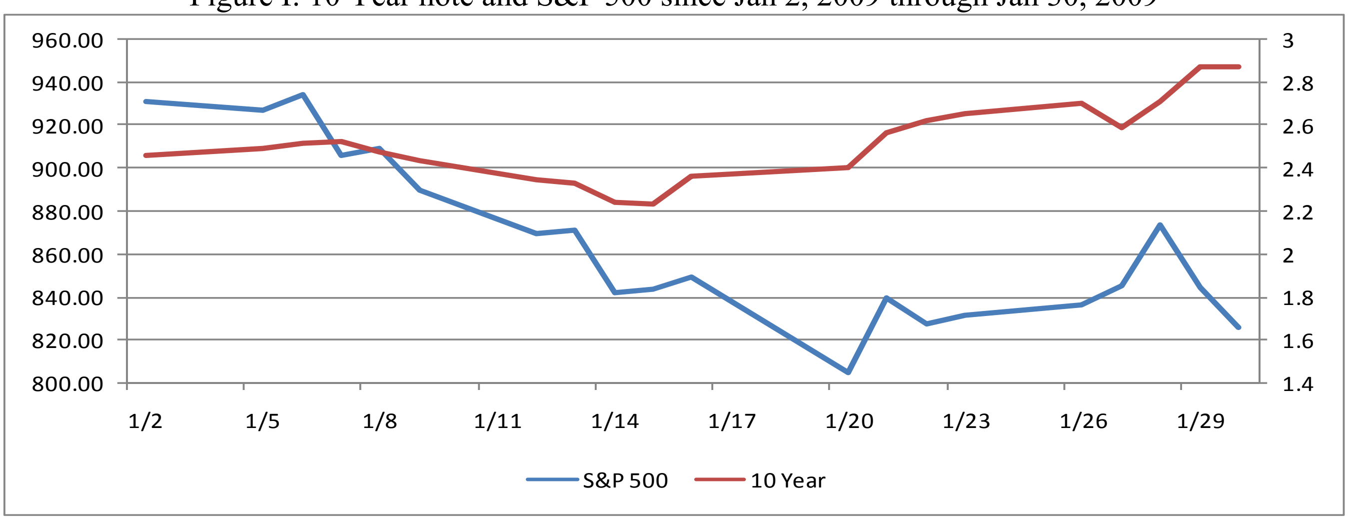
Discontinuity between Treasury Markets and Equity Markets

I: Introduction – Bond Market leads Equities Indicating Growing Stability

Throughout the month of January we have seen a clear dichotomy between the equity markets and the Treasury markets. All January the Treasury yields on the long bonds have been appreciating. The plausible reasons for this movement are: 1) that there is greater stability in the economy, 2) the markets are returning to some sense of equilibrium, with the extreme flight to safety abating, and/or 3) the possibility of inflation. The equity markets in contrast have been struggling all month and in fact the Dow and the S&P 500 had the largest January decline in history

Figure I: 10 Year note and S&P 500 since Jan 2, 2009 through Jan 30, 2009



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

Last week we argued that it is likely that the Treasury market may be leading the equity markets. However, there may be other explanations for the improvement in the yield curve. While Treasury yields have been going up, the 5 year TIPS, for the first time since the decline of Lehman, went below their base instrument. The 5 year note to TIPS spread increased to 0.38% from a low of -2.12% in late November, and the 10 year went from the lows of 0.12% in late December to 1.14% on Friday.

On Wednesday January 28, 2008 this past week the FOMC committee in their statement contended that:

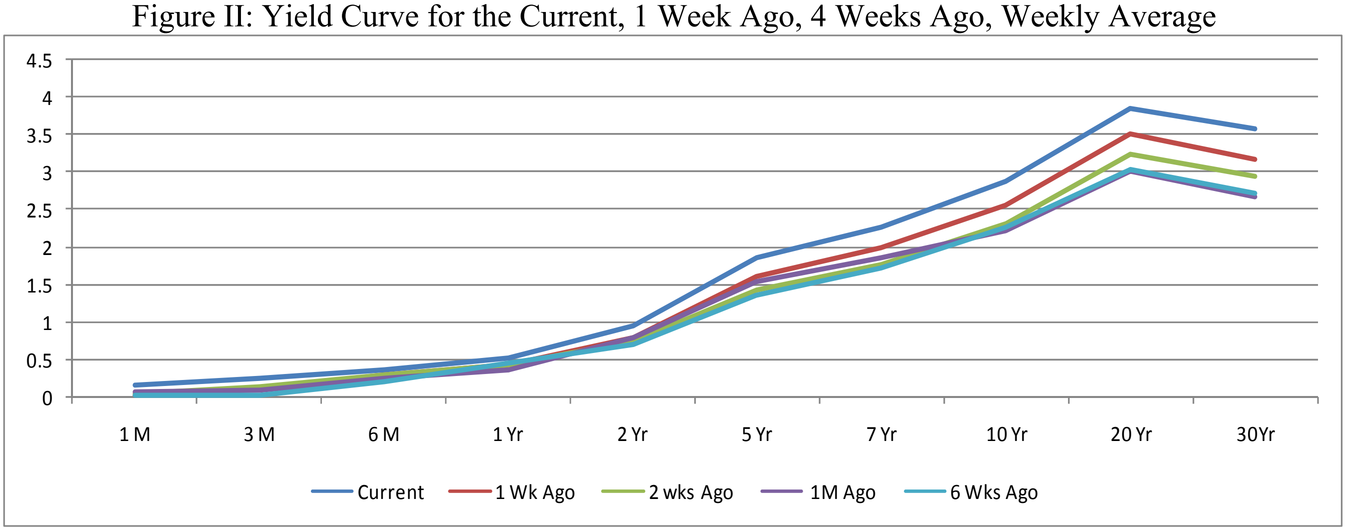
> "In light of the decline in prices of energy and other commodities in recent months and the prospects for considerable economic slack, the Committee expects that inflation pressures will remain subdued in coming quarters. Moreover, the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term."

It is correct that energy prices have come down strongly, with crude oil having come down from $147 to $30 per barrel. However, in the intermediate future with cutbacks from OPEC and the international economies stabilizing, it is likely that both crude oil and gasoline will be increasing in price, equalizing the downward cycle in headline PPI and CPI. Over the past two weeks alone the price of crude has gone from a low of $30 per barrel to 49 per barrel, and wholesale gasoline has gone from $0.84 per gallon to $1.27 per gallon. Through November 2008, the latest data available from IEA, demand destruction of oil has been extensive in the U.S. by about 1.8 million barrels per day. HOWEVER, worldwide there has been no demand destruction with oil demand down only 200 thousand barrels per day, from the highs of mid 2008. India and China are still increasing their use of oil, while Europe is stable, as is Latin America. Much of the perception of demand destruction is coming from the U.S. where participants in the oil markets are way too U.S. phobic or centric, causing many to misunderstand the world dynamics of international oil and its pricing.

This report will argue that it is a combination of a stronger economy with the bond market having a different set of metrics for success than the equity markets, and the expectation of some very slight headline inflation resulting from the price of gasoline and crude oil increasing.

II. The Yield Curve has been expanding out over the past few weeks

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



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

For the past 6 weeks since the FMOC lowered the target Fed Funds rate to 0 to 25 basis points the yield curve for the longer maternities have all increased, and beginning a couple of weeks ago even the short maturities have been increasing. In theory, rates would be going up when there is an expectation of the economy getting stronger, and the likelihood that the FOMC would begin to tighten. Under those assumptions one would expect that the equity markets would be showing the same indication for growth, and not be sitting at or near their cycle lows.

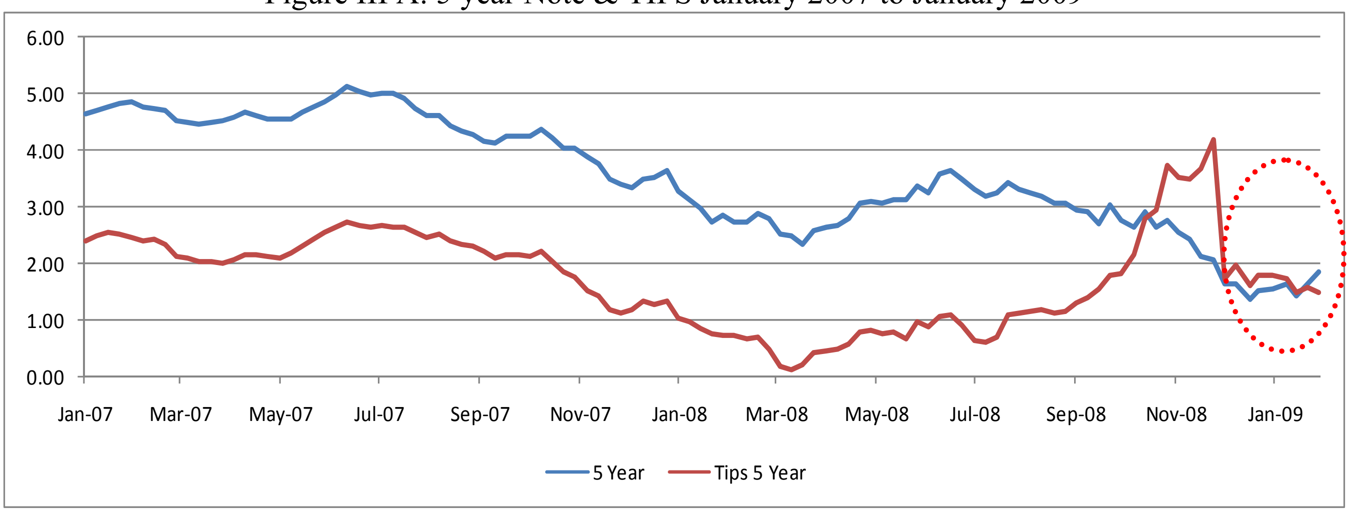
In the past few weeks since the FMOC lowered interest rates on December 16, 2008 the longer end of the yield curve has been increasing, providing a significant sign that there is some expectation that the economy will be getting stronger. We have observed that the longer end of the Treasury yield curve has been increasing as seen in Figure II. The yield on the 5 year appreciated from 1.36% to 1.85%, the 10 year went from 2.26% to 2.87%, and the twenty and 30 year bonds went from 2.72% to 3.59%.

The yield on the TIPS since their recent highs has been going down as their respective instruments have been going up. The 5 year TIPS in recent weeks have gone from a high of 1.80% to 1.47% and the 10 year went from 2.12% to its current 1.73%. Two weeks ago 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. These patterns are a continuation of the Treasury markets indication that one of the factors: economic stability, adjustments post flight to safety, and/or some inflation concerns.

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

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

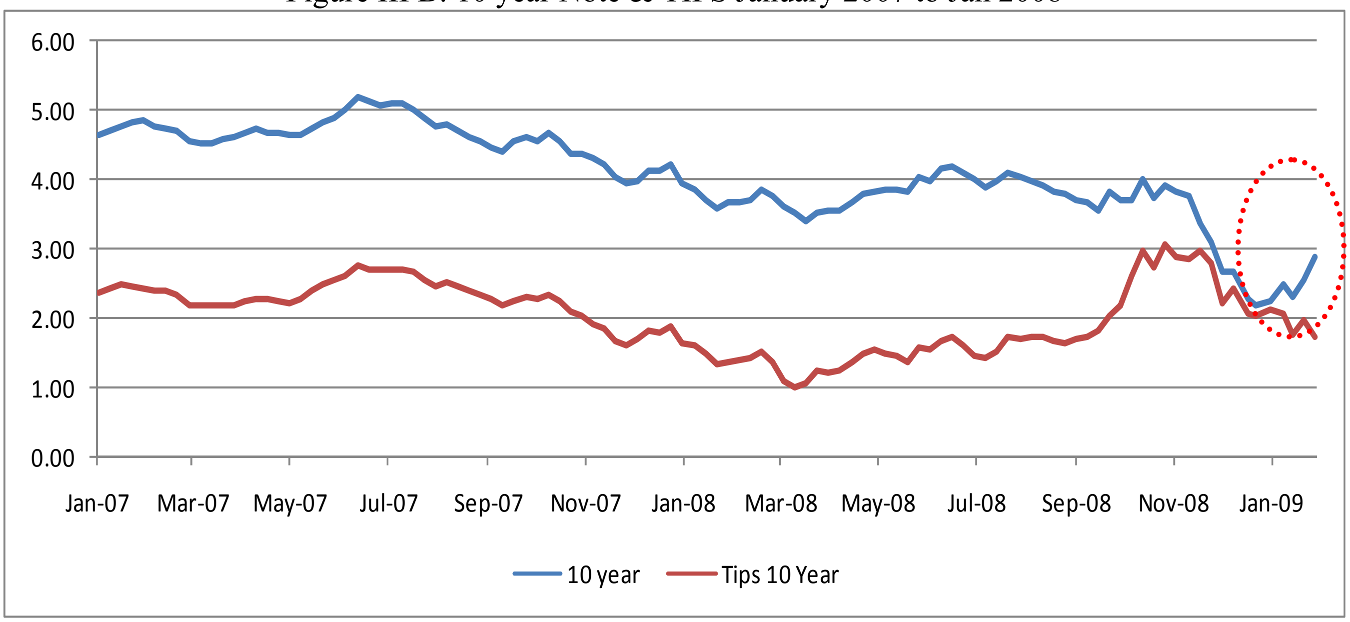


Source: Federal Reserve, DOT, SISR

Two weeks ago the 5 year TIPS for the first time since the fall of Lehman were below the 5 year Treasury notes. The yield on the 5 year Treasuries closed yesterday at 1.85% whereas the yield on the 5 year notes was 1.47%, a 38 basis point difference. There 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). The historical relationship is that the 5 year notes and the TIPS have had a spread near or at the expected rate of inflation. Currently there is little expectation of inflation, at least according to the FOMC as stated above. It was in part the fear of deflation that caused the TIPS to go below their underlying instruments.

The yield on the 10 year TIPS for the week decreased to 1.73% from 1.98% with the yield on the 10 year going from 2.56% to 2.87%. The 10 year has continued to expand out, with now a healthier 114 basis point spread, in contrast to the 12 basis point difference only 4 weeks ago.

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.

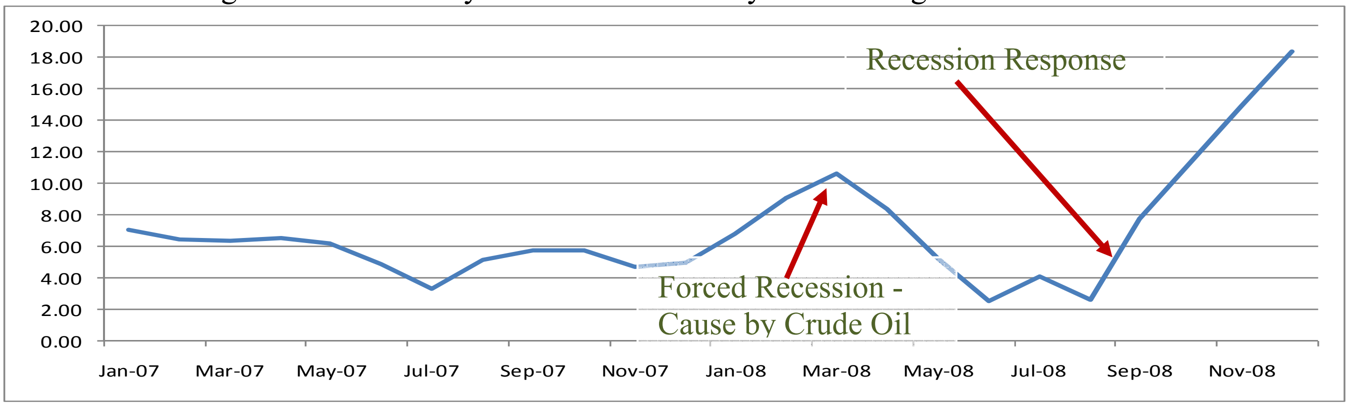
The historical relationship between the TIPS and their respective instruments have been a consistent 200 to 250 basis point spread for both the 5 year and 10 year TIPS, over the past couple of years (Figures IIIA & B respectively). However, beginning in July of 2008 this 200 to 250 basis point gap between the TIPS and their respective instruments closed for the 5 year TIPS, and in September for the 10 year TIPS.

IV. Causes of Possible Inflation

A. Money Growth and added Liquidity to the Economy

Since the collapse of Lehman we have seen an extremely rapid growth of money supply (Figure IV). Money supply has been growing at an 18% annualized rate of growth for the past 4 months. This continued rate of money growth for such an extended period of time is almost unprecedented.

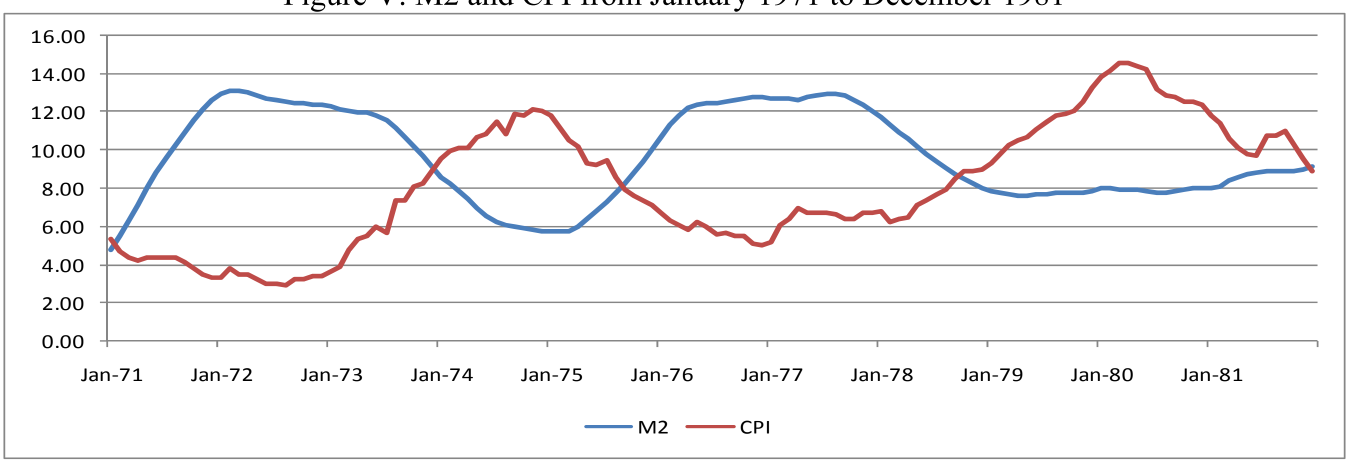
Figure IV: M2 Money Growth from January 2007 through December 2008



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 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 V: M2 and CPI from January 1971 to December 1981



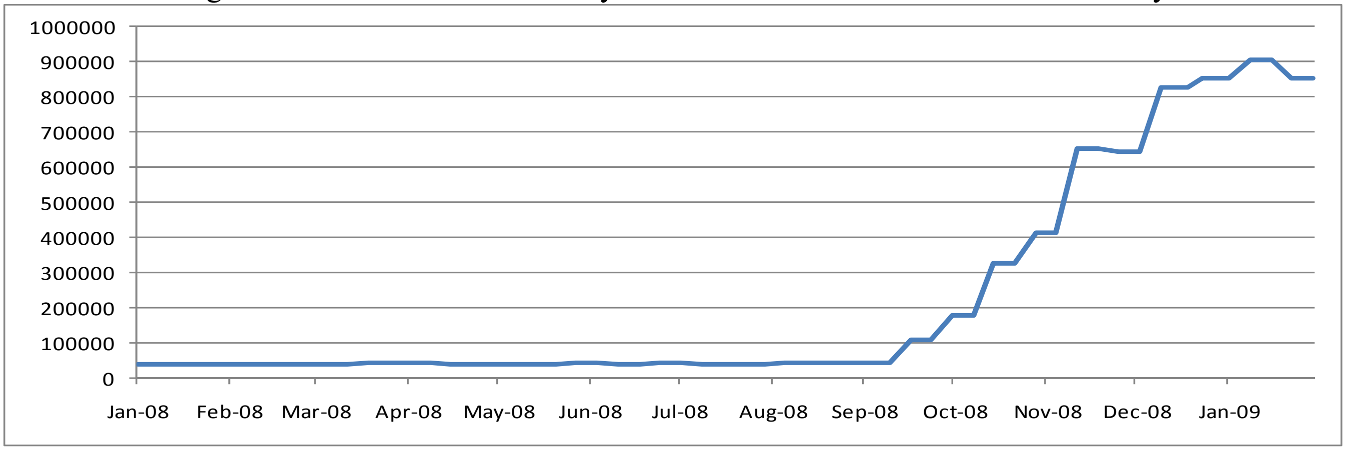
Source: Federal Reserve, Department of Labor, SISR

Given the rapid rate of money growth and liquidity provided into the financial system there must be some recognition that some inflation one to two year out is a distinct possibility, unless the Federal Reserve can effectively figure out how to control this influx of liquidity, once the economy becomes stronger.

B. <u>Total Reserves Held at Banks well above normal and will Impact Multiplier Effect</u>

The rapid rate of growth of Money supply is one factor that should concern the markets, for some possible future rapid increase in inflation. However, there is an even more unsettling phenomenon that has occurred over the last 4 months. Total reserves held by banks have been increasing at an unprecedented rate of increase. From Figure VI we see that the reserved that are held in U.S. banks since September have literally exploded.

Figure VI: Total Reserves held by Banks from Jan 2008 to Dec 2008 Weekly



Source: Federal Reserve, SISR

Reserves within the banking system have gone from a fairly constant 40 billion or thereabouts to over \$820B by the end of December, and \$905B by mid January. Since mid January the reserves have fallen back a bit to \$852B which was the first decline since the Lehman failure.

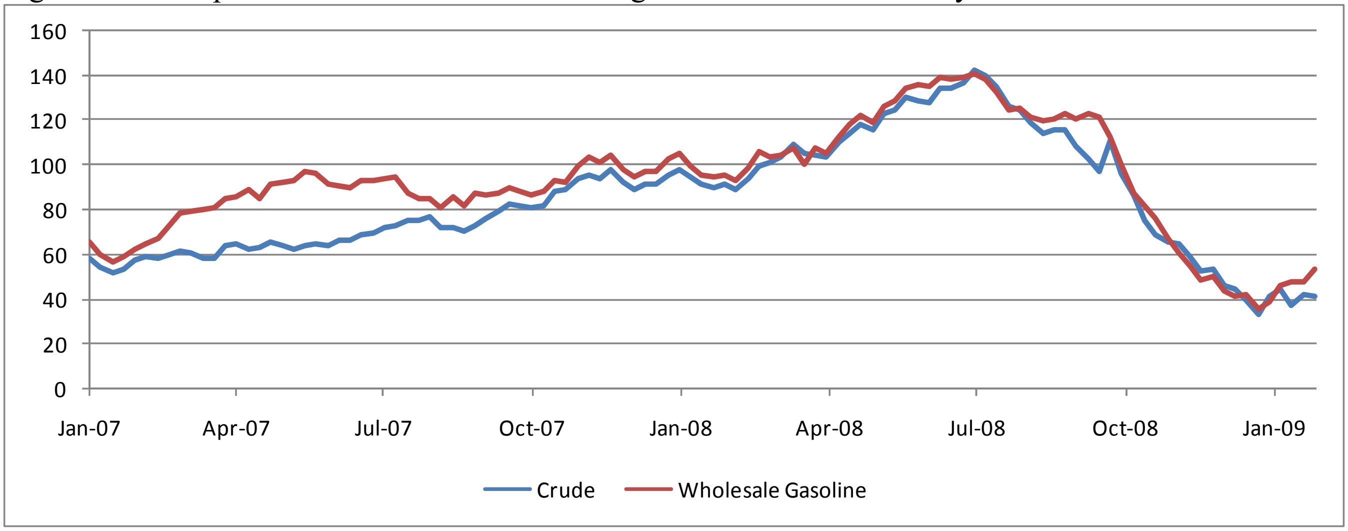
If and when the banking system begins to recover, and banks again feel free to lend, there will be a rush of additional money entering the system, with a strong multiplier effect of 7.5 to 1 for each dollar lent. As that process begins to occur we would need for the Federal Reserve to be contracting money as the velocity of money begins to expand, so that expansionary money growth, even greater than what we are currently seeing, does not fully engulf the economy.

Taking the simple equation MV=PT (Money times velocity equals price time transactions), we currently have velocity at an extremely low level. What will happen when velocity returns to normal if M is not reduced sufficiently? This problem is further complicated by the fact that this same process is going on worldwide, with massive liquidity being entered into the financial system both in the U.S. and internationally (For a fuller discussion of this point please see some of our work on the Federal Reserve).

C. The Rising Price of Crude Oil

The price of crude is likely to increase in the intermediate future, if for no other reason that at the current rate of consumption, the marginal barrel of crude likely costs between \$60 and \$70 per barrel. Looking at Figure IV above we find a rather unusual occurrence. We find not only that money growth has been expanding at an unprecedented rate of growth recently, but that when Bear Stearns collapsed the rate of money growth or additional liquidity added to the financial system, actually contracted. It is our speculation that the reason for this was that the Federal Reserve decided that the economy was going to collapse if the price of oil did not come down. We have for a long period argued that the price of oil was a codependent reason for the financial crisis. In every instance where oil was at extremely elevated levels it was only with a recession that the price of oil has been brought down.

Figure VII: The price of crude oil and wholesale gasoline in Barrels weekly from Jan 2007 to Jan 2008



Source: EIA, SISR

One of the problems that caused the economy to come to its knees in 2008 was the high price of crude oil and gasoline. Oil and gasoline were causing elevated levels of headline inflation but the Federal Reserve in speeches contend that their mandate is to deal with core inflation, because they cannot handle the externalities of the world commodity markets, in adjusting for inflation.

Looking at Figure IV again we see that the Fed acted aggressively in midsummer 2008, to bring the country into a recession to break the back of oil. This is a highly complex problem, and EVERY RECESSION SINCE 1970 WAS CAUSED BY THE HIGH PRICE OF OIL. We are in a period now when the U.S. has also lost much of its control over OPEC, and to put things bluntly the battle for international dominance my well go though the oil fields in the Middle East (for a fuller analysis of these comments please consult our work on international oil markets).

The SISR projection is for gasoline and crude to increase over the next few years heading back to the 70 to $90 range or higher by the beginning of the next decade. This is a real problem for the Federal Reserve and we at SISR do not believe that the Fed has a good handle on how to handle headline inflation in contrast to core inflation. Once the economies of the world begin to stabilize we will see a fairly rapid increase in the price of crude, if for no other reason that the marginal price of producing the quantity that is currently for supply to meet demand is in the 60 to 70 dollar per barrel range. Therefore $80 would appear to be a good estimate for where the price of crude will end up. That will translate into a mid $3 price of gasoline at the pump. From Figure VII we are already seeing wholesale gasoline increasing and the refining spreads expanding out (please see our energy weekly for a fuller analysis of this trend).

IV: Conclusion

Three weeks ago we concluded this weekly fixed income report 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 well below their basic instrument and the Fixed Income market have begun to show some signs of returning to a more normal yield curve pattern.

However, we are seeing the equity markets act very weakly and in fact this January 2009 had the largest decline on record for both the Dow and the S&P 500 Indices for any prior month of January. Interest rates are rising, and the equity markets are falling. There are three plausible reasons for that to occur:

1. The Treasury market is leading the equity market with the expectation that equities will follow the increase in the yield curve.
2. That the improvement in the yield is simply the unwinding of the extreme flight to safety.
3. That despite what the Fed believes and contrary to the fact that economy is extremely weak, inflation does not necessarily occur from cost push or demand pull, but from excess liquidity within the system in the long run.

The first explanation is plausible but not the sole reason for the recent movements. It is true that the Treasury markets look at different metrics for the health of the economy, than do the equity markets. However given the magnitude of the decline in the major market indices, this explanation does not appear all that satisfying. If we do not see a major rally in equities within the next few weeks, while long rates remain at these elevated levels, this explanation will appear even less likely. Markets move is a more highly rational direction, and there are reasons for defined movements. This can at best be a partial explanation, but not a complete explanation.

The Second explanation has some validity also; there has been an extreme push downward on rates from a protracted period of excessive flight to safety. The TIPS were misprices additionally because there was not as much liquidity in those instruments as in the notes and bonds, causing those entities to increase in rates even further, due to excess demand. The unwinding of this excessive flight to safety is plausible, but similarly not very satisfying intellectually.

We believe that more is going on than the simple unwinding of the flight to safety. For example, what is the reason for an unwinding of the flight to safety? An unwinding to the flight to safety by definition would indicate greater stability in the markets, which would signify an improvement in the economy, which we are not seeing in the equity markets. This explanation has some intuitive validity but again is not a complete explanation.

The first two parts of the third explanation also appears unfulfilling in that inflation caused by the excessive flood of liquidity is more than a year to a year to a year and one half away, if then. There are no signs that this will even be a problem and the markets move on expectations and even the expectations are not there yet. The explanation that we provided is way to theoretical for the markets to react too, and that theory is still too untested, and even if it were well established, this explanation would not to have the kind of impact that we have seen on yields in the last few weeks.

The multiplier expansion has some validity, but it will be tied into a reduction of money into the system. Those issues are way too complex to be a cause for this recent dichotomy with the equity markets and the Treasury markets, without other factors signaling their impact.

Inflation, however, can come from someplace else, basically the return of higher prices of oil. This is completely plausible and is compatible with our projections for the price of gasoline and crude oil. We as noted have forecast that gasoline and crude is likely to increasing over the next few years heading back to the 70 to $90 range or higher by the beginning of the next decade. This is a real problem for the Federal Reserve and we at SISR do not believe that the Fed has a good handle on how to handle headline inflation as opposed to core inflation. We also noted that world demand for crude has not contracted in any significant manner, that OPEC has been contracting output, and the marginal barrel of crude most likely costs at least $60 to $70 per barrel to produce.

Treasuries on the surface are a very simple instrument to understand. They identify the expected rate of inflation and the expected cost of lending, with the expectation that there would be some real rate of return to lending over the course of the loan. The cost of lending has been going up, which usually indicates that the underlying factors: the cost of money to the banks has changed, or the expectation of inflation has changed. In this instance the underlying cost of funds to the banks has not increased so there must be some inflation concern in the future.

The expectation of inflation coming from anywhere other than oil appears illogical given the weakness of the economies worldwide. The FOMC statement is more logical, but something is happening within the Treasury markets that are signaling some changes in the economy, that needs to be understood. We believe all this will be unpacked within the next few months. Our best guess is that it is a combination of a better economy with the Treasury markets functioning from a different set of metrics of improvement than the equity markets, and some level of headline inflation from higher energy costs is also a likelihood.

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