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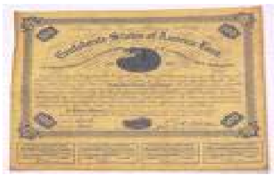

Economics & Financial Markets

United States Fixed Income

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

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Bonds, Oil, Equities Signaling Economic Stabilization

I: Introduction –Indications of Growing Market Stability

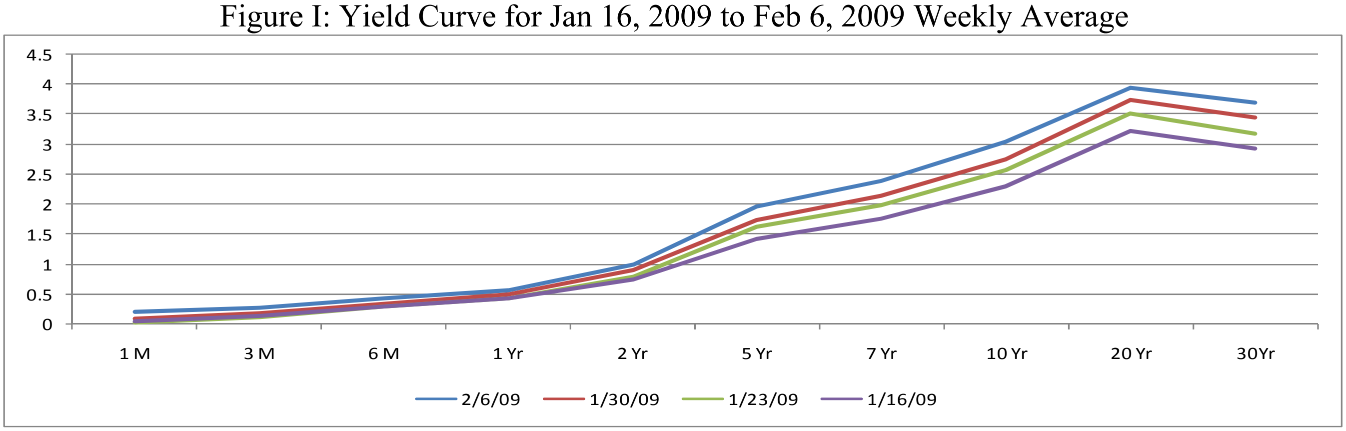
Since the middle of January we have seen the Treasury market move back to some semblance of continuity. We have seen the same pattern with respect to the commodity markets best represented by the price of crude and its relationship to gasoline, diesel, and jet fuels. Over the past week we have also seen the equity markets rally with the expectation that TARP and the Stimulus package will kick into the equation. Bonds led, commodities followed, with equities are lagging slightly behind.

II. Treasuries, Oil leads Equities Indicating Growing Stability in the Markets

A. Treasuries

Since the middle of January the Treasury yields weekly average has been higher with each passing week. We have been arguing for the past month that this is a clear indication that the financial markets are beginning to stabilize.

Figure I: Yield Curve for Jan 16, 2009 to Feb 6, 2009 Weekly Average

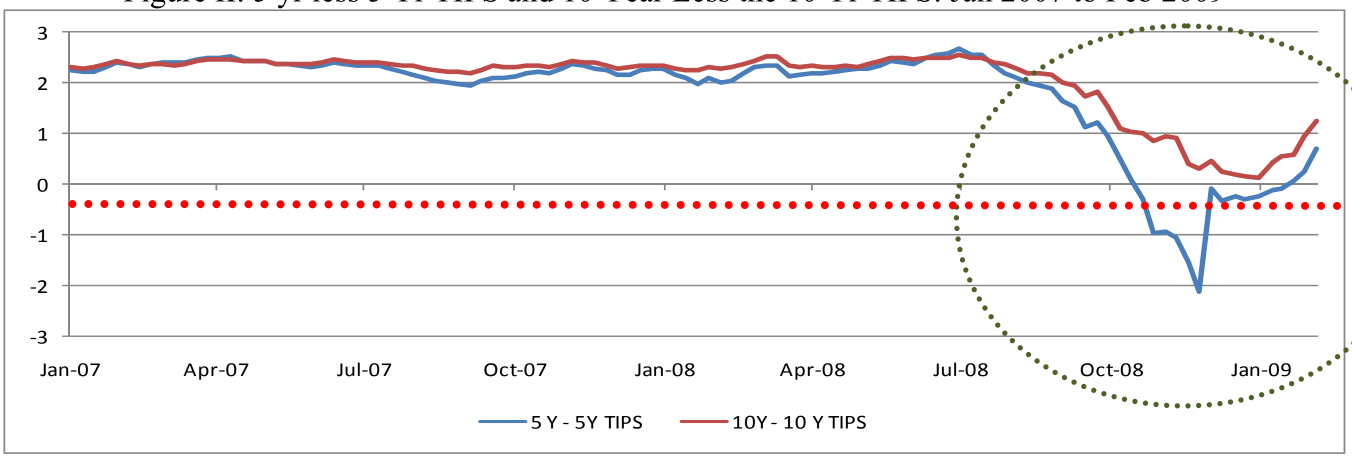


Source: Federal Reserve, U.S. Treasury, SISR

B. TIPS

We are seeing the same pattern with respect to the TIPS as seen in Figure II. Historically the 5 year TIPS and the 10 year TIPS traded in near parity around the expectation of inflation. Since the fall of Lehman and the freezing up of the financial markets, we can see the large drop in both the 5 year and 10 Year TIPS. This would indicate that any expectation of inflation was gone for the 10 year, with the 5 year indicating deflation. The spreads even diverged with the 5 year indicating the extreme case of deflation. In recent weeks we can see how the 5 year and the 10 year are now approaching parity again with the inflation expectation now nearing 1%.

Figure II: 5 yr less 5 Yr TIPS and 10 Year Less the 10 Yr TIPS: Jan 2007 to Feb 2009

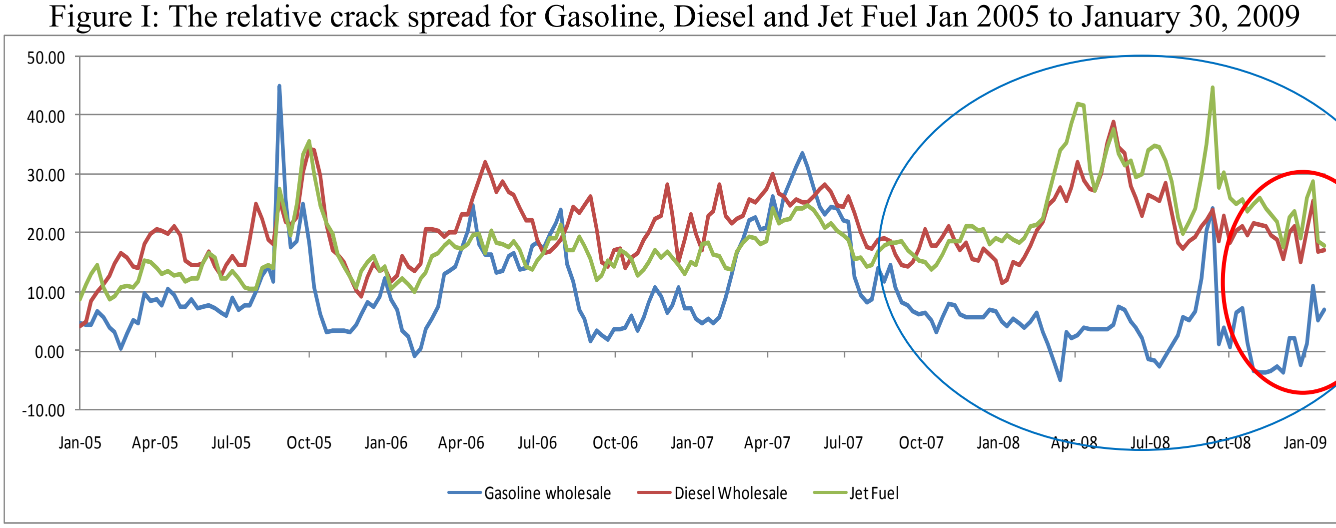


Source: Federal Reserve, U.S. Treasury, SISR

This is a second indication that the Treasury markets are indicating a return to stability. Over this same period we have been observing a similar trend within the important commodity area of Crude, Gasoline, Diesel and Jet Fuel.

C. Crack Spread returning to Historical Parity

Figure I: The relative crack spread for Gasoline, Diesel and Jet Fuel Jan 2005 to January 30, 2009



Source: EIA, SISR

Figure III plots the changing relationship between the crack spread for wholesale jet, diesel, and gasoline. In the Figure we can observe that the large gap created in early 2008 between diesel/jet and gasoline beginning to close over the past two to three weeks. This is a significant improvement in the gasoline crack spread which only a month ago had been negative.

This is also an indication of stability in that the refiners were keeping diesel and Jet fuels components, with less elasticity of demand, at record high crack spreads; while they were selling gasoline at a net loss after refining expenses, because there was so much demand destruction in gasoline. The fact that the gasoline crack is improving is a real sign that the level of demand destruction is abating and that more normal patterns are returning.

D. Equities

Equities have lagged both the Treasuries and the Energy commodities, with the past week showing some signs of a rally as the stimulus package began to appear that it would be passed, and the announcement by Treasury that they are about to announce their program for the remaining TARP money. We have argued for the past year now that the necessary and sufficient conditions for the markets to rebound were that the markets must perceive that the conditions are in place to resolve the cause of the recession. With (1) the TARP program working and averting a crisis for CITI Group, Bank of America, and the auto industry, (2) the stimulus program addressing the job losses caused by the recession, and (3) low gasoline prices for the consumer and programs being to fall into place to help the home owner; we can say with confidence that the necessary and sufficient conditions for the markets to rebound are in place. We must recognize that the markets always rebound prior to the rebound of the economy.

III. Conclusion

It is an interesting time and we believe a very positive time for equities to begin to appreciate. Each of the markets are showing clear signs that there is growing stability in the markets, and we believe that this is a clear sign that baring some catastrophe that the markets have seen their lows and the economy will by midyear to late summer be in a clear rebound. We need to focus on all three markets because they all need to be in synchrony for clear evidence that we have seen a bottom to the equity disaster. These past two weeks have been very positive.

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