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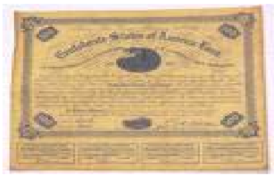

Economics & Financial Markets

United States Fixed Income

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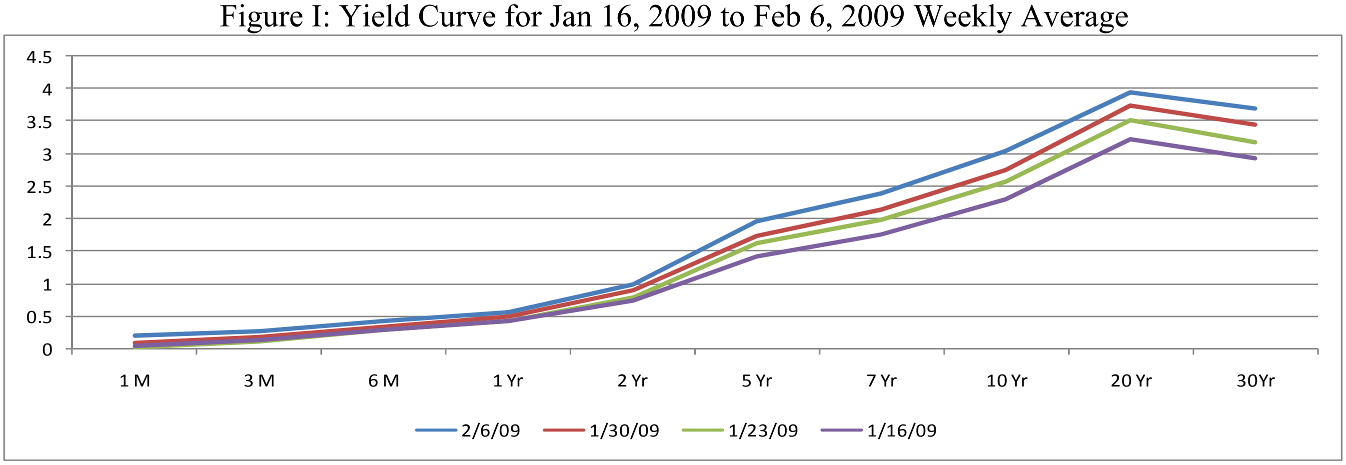
Bonds Lead Equities but Yields Have been in Holding Pattern Waiting for Greater Economic Clarity

I: Yields essentially unchanged from Prior Month

From the middle of January to the middle of February the Treasury weekly average yield has been higher with each passing week (Figure I). Since then the Treasury yields have been essentially flat (Figure II). In February we argued that this was a clear indication that the financial markets are beginning to stabilize, with Figure I indicating the progressive improvement in each week over the past 4 weeks through the end of the week ending Feb. 6, 2009.

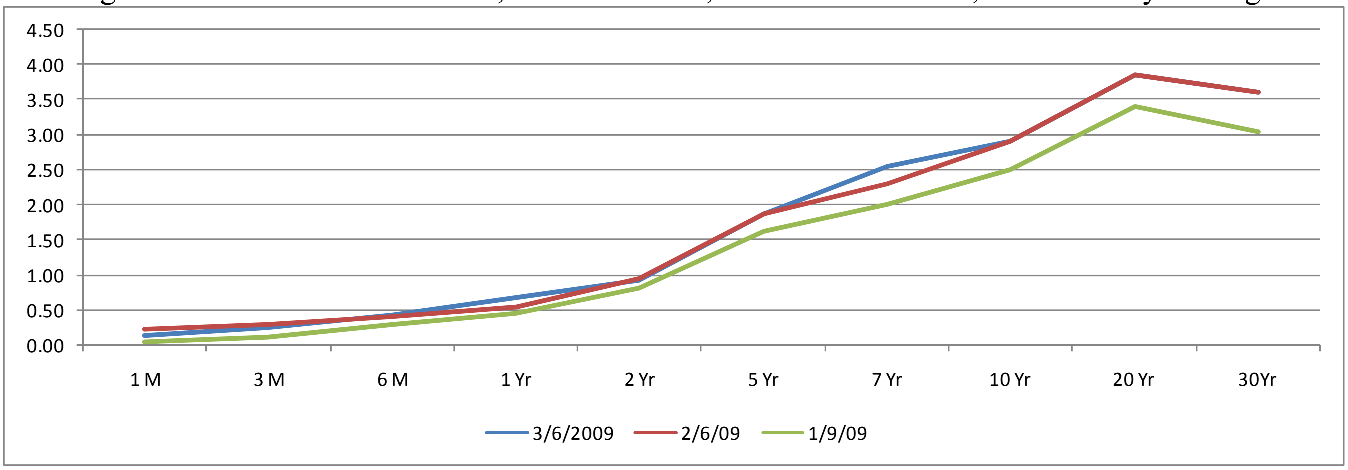
Figure I: Yield Curve for Jan 16, 2009 to Feb 6, 2009 Weekly Average



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

Since then the equity Markets have essentially come apart but interestingly the yield curve has remained fundamentally unchanged (Figure II). Given the uncertainty in the equity markets over the past month one would have expected that the yields may have come in somewhat which is the traditional pattern, but they have not, indicating that the Treasury markets may expect that the depth of the recession is beginning to find some footing. Certainty in the bond markets things have improved from the collapse of Lehman when there was mass panic and an extreme flight to safety.

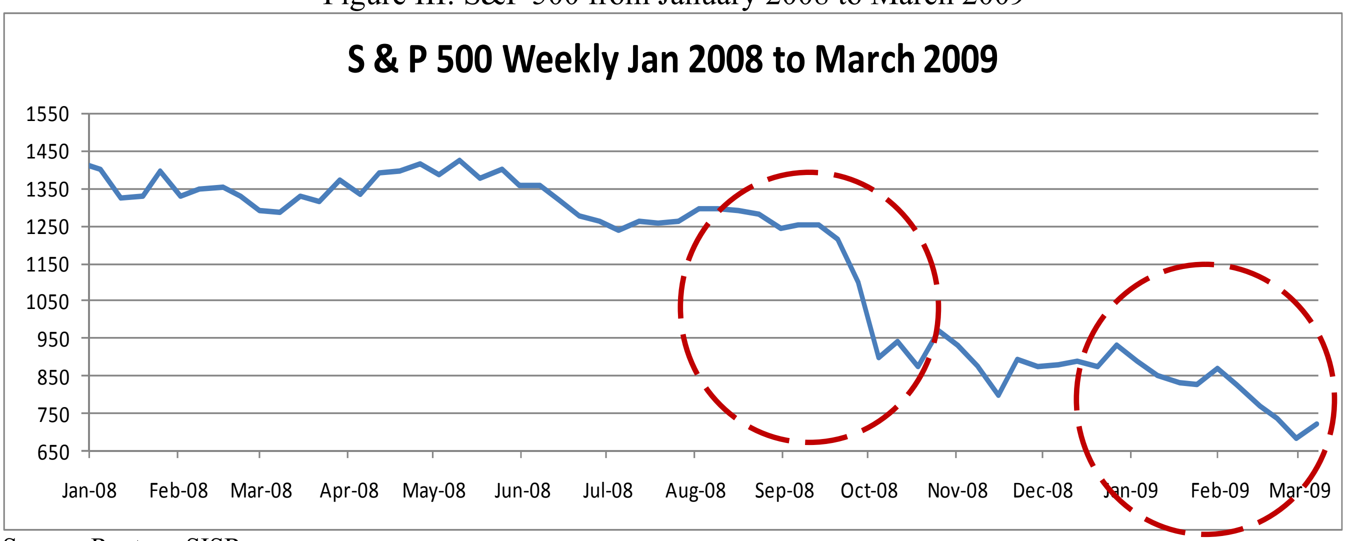
Figure II: Yield Curve for Jan 09, 2009 to Feb 06, 2009 and March 06, 2009 Weekly Average



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

The clear irony is that despite the fact that the S & P 500 has had another major leg down since January (Figure III) the bonds have been holding up quite strongly. If bonds lead why are the bonds holding so strongly with equities indicating more trouble ahead? In addition, we have found the same pattern of stabilization for the commodities as we had with Treasuries, and particularly with respect to crude oil, but the pattern is similar for other commodities.

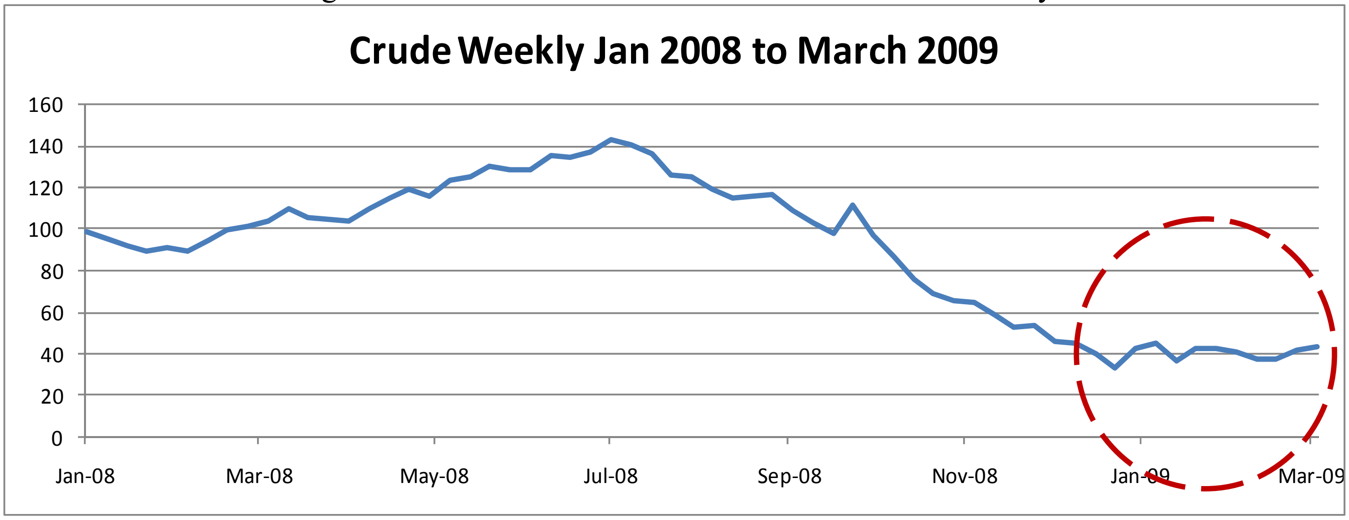
Figure III: S&P 500 from January 2008 to March 2009



Source: Reuters, SISR

Crude hit its lows in late December of 2008 and has gradually been creeping higher (Figure IV). What we are seeing is that bonds and commodities are indicating one set of expectations and the equity markets are indicating another set of expectations.

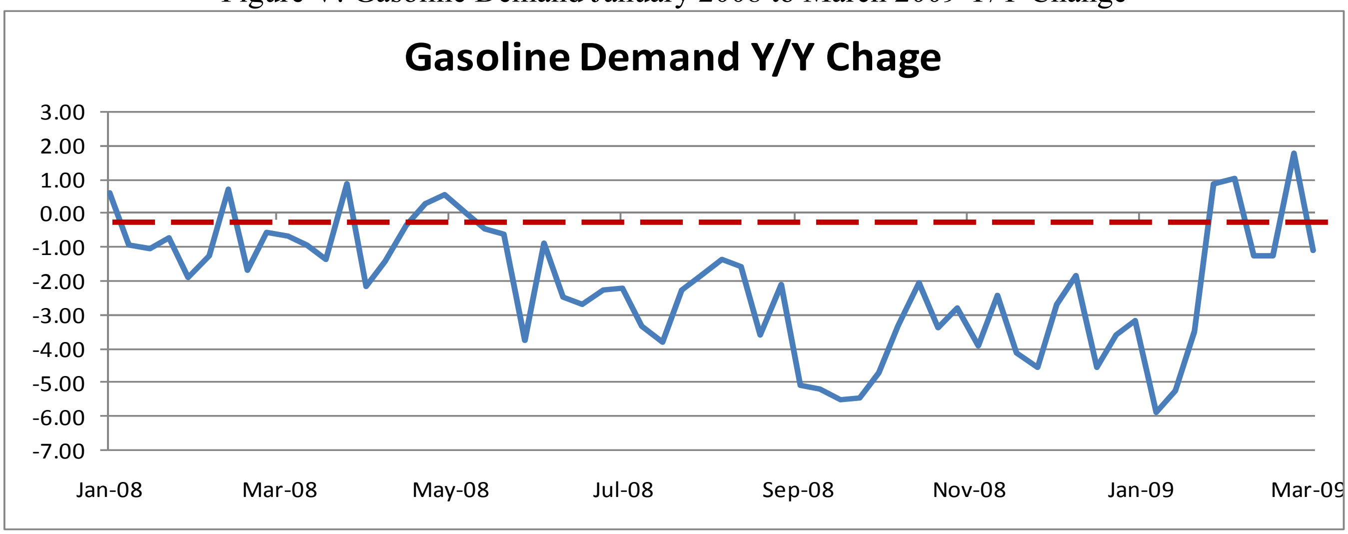
Figure IV: Crude oil from Jan 2008 to March 2009 Weekly



Source: EIA, SISR

In fact even gasoline demand which had been down as much as 6% y/y from September to January is actually essentially unchanged since February on a y/y basis, indicating that the demand falloff has returned to normal demand for gasoline, again indicating economic stability in this component.

Figure V: Gasoline Demand January 2008 to March 2009 Y/Y Change



Source: EIA, SISR

Plausible Explanation for Equities Being out of Synchrony with Treasuries

The most logical explanation for the dichotomy between the equity markets and the Treasury markets is that the equity markets and Treasury markets are focusing on different valuation metrics. The TARP and the TALF programs were designed to stabilize the banking system. Every bank interest rate is derived from various Federal Reserve rates of interest which influence the bank's reserves, their prime interest rates, their borrowing and lending capacity, and all other lending rates, with the Treasury rates serving as further guidance for mortgage rates, commercial paper, and the like.

Equities on the other hand are more focused on profits and the expectation of future profits. With the economic data still coming in rather grim, and at best negatively mixed, it is not surprising that equities are still struggling. The financial structure, however, is clearly improved from the bleakest days following the collapse of Lehman, and certainly in comparison to the expected profitability of major corporations, which are seeing very little clarity going forward.

Bonds always lead equities and this is likely to be the case in this instance also, but equities it appears must first work through the process of future profit expectations going forward, before there will be significant stabilization in the equity markets. In this respect there is the expected lag between the financial markets improving and equities following. Of course the financial will not hold up or get too far ahead of the equity markets, but right now Treasuries appears to be in a holding pattern, to see where equities and the economy will ultimately end up.

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