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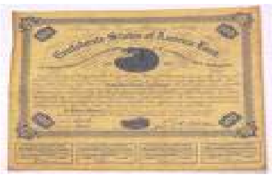

Economics & Financial Markets

United States Fixed Income

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

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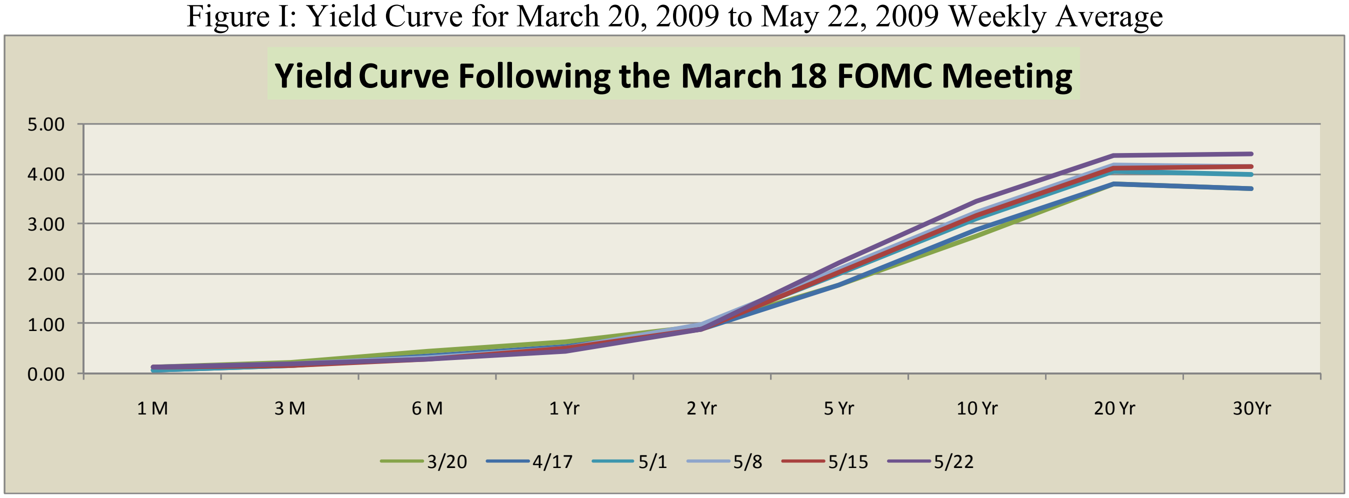
10 Year Should Begin to Force Mortgage Rate Higher, But Other Risks Appear to be Festering

I: **Introduction**

From the middle of January to the middle of February 2009 the Treasury weekly average yield has been higher with each passing week. Since then the Treasury yields have been essentially flat until the FOMC meeting on March 18, 2009, when the long bond yield declined significantly. From the FOMC meeting of March 18 to the meeting on April 29, 2009 the yield curve had returned to it prior levels and since the meeting it has continued it gradual accent. This past week the 10 year yield of 3.45% was the highest yield since the Federal Reserve lowered the fed funds rate to 0 to 25 basis points.

Figure I: Yield Curve for March 20, 2009 to May 22, 2009 Weekly Average

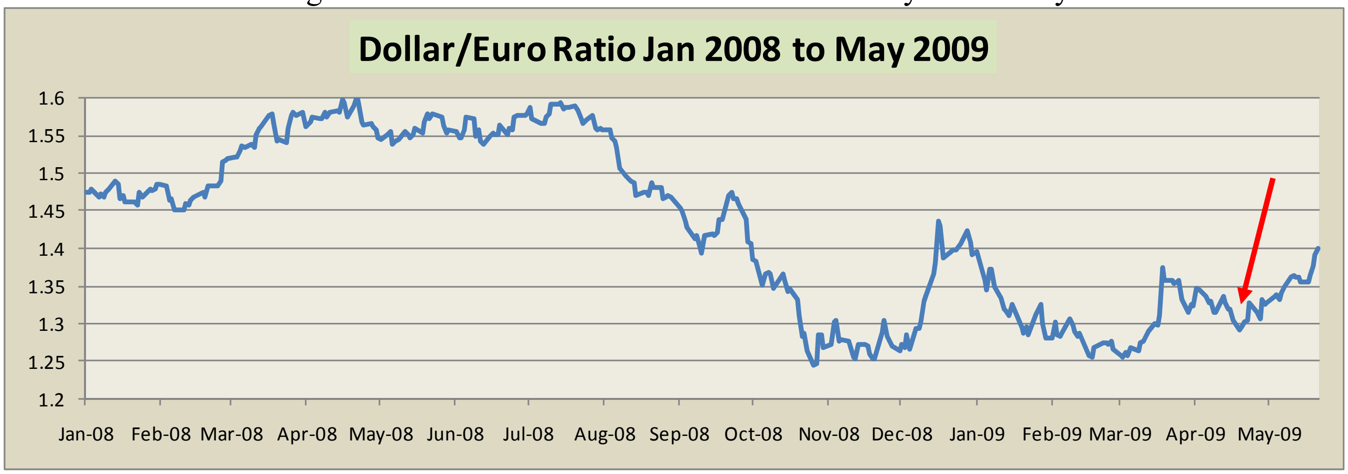


Source: Federal Reserve, U.S. Treasury, SISR

The last two week we have seen an increase in the long bond with the 10 year increasing 35 basis point, while the equity markets have become somewhat stretched and have declined nearly 5% from their recent highs.

While yields are going up interestingly the Dollar/Euro ratio is going up with the dollar instead of getting stronger, it is getting weaker, somewhat inconsistent with higher yields.

Figure II: The Dollar/Euro Ratio Jan 2008 to May 2009 Daily



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

The markets are telling us as is the FOMC in their recent minutes, that the U.S. economic recovery is likely to be somewhat delayed. We are finding that the yields are going up which in this instance would indicate that the demand for these instruments is declining for one of two reasons:

1. That money is going into equities where the likely risk/return is improved and/or
2. Demand for these instruments is slacking off for other reasons, which would logically also cause an increase in the bond yields.

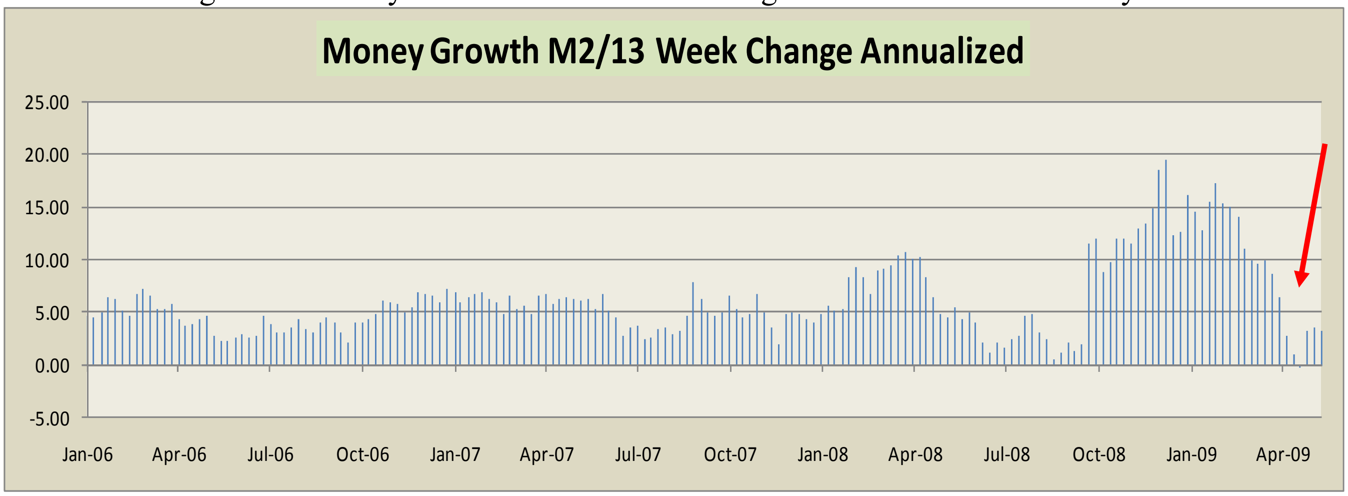
The first reason would be highly logical and well positioned, if it were not for the fact that the dollar was getting weaker. The fact that the dollar is getting weaker indicates that there is a problem in the U.S. economy, which is the likely for the recent correction, leading us to the second explanation that there is a growing disinterest and or risk in owning U.S. Treasuries, causing the yields to increase. This brings us to the question is California an isolated instance or it is the sign that foretells the future, that the public financial structure is beginning to crack.

II. Money Supply Collapses in Past Month

Beginning in March as seen in Figure I the rate of expansion of money growth fell below 10% on a 3 month change basis, annualized. We use the 3 M change because y/y changes are not sensitive enough to the changes in the rate of growth of money and one loses the intent of the FOMC policy committee. Late last year the entire discussion of M2 growth revolved around the very rapid increase in money growth which was accelerating at nearly 18% for a period of time. This had lead to an extensive discussion within the markets regarding inflation in the 12 to 18 month forward period.

Yesterday, for the first time in 7 month the M2 indicator in the leading economic indicators measure was negative and was the largest single item of the 10 to be negative, even more so than permits. For some reason the Federal Reserve has significantly slowed money growth to a rate of change well under the target of 4 to 6% growth over the past few months.

Figure III: Money Growth M2/13 Week Change Annualized Jan 06 to May 09



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

This rate of contraction should be alarming to the extent that a contraction means that there is less liquidity in the system, which is what occurs when the FOMC raises the fed funds target to contract growth. Since the rate of M2 growth fell below 10%, the dollar has been sinking relative to the Euro. We expect that in large part this is based on the expectation that the U.S. economy may have a greater than expected period of recovery. We are confused about why when the economy is so fragile, would the fed, if they had control, be contracting money supply at this critical juncture. Our only explanation is with the fed funds rate at near zero they may have few options.

The pattern that is being displayed of rising interest rates and declining money supply is very consistent with the pattern when the Federal Reserve is attempting to tighten during the business cycle. Traditionally when the fed funds target rate is increased we find that M2 growth slows and that interest rates increase. This would explain why the bond yield is increasing during a period of time that money supply rate of increase has gone from 18% annualized to only 3% annualized. This would also explain why the dollar is getting weaker during a period of time when interest rates are increasing, because there is concern about when the economic recovery in the United States will actually occur prior to bankruptcy of the nation (still an unlikely event, but so was it two years ago, that City Groups (C) shares would be trading at less than it cost to pull money out of an ATM).

II. FOMC Meeting of March 18, 2009

On the afternoon of March 18, 2009 the FOMC committee made major news with their press release of the events of the meeting. There were 5 key points to the press release.

1. Maintaining the target range for the federal funds rate at 0 to 1/4%.
2. To support mortgage lending and the housing markets, the Committee this year will direct the purchase up and additional 750 Billion of agency mortgage-backed securities bring the total to $1.25 Trillion.

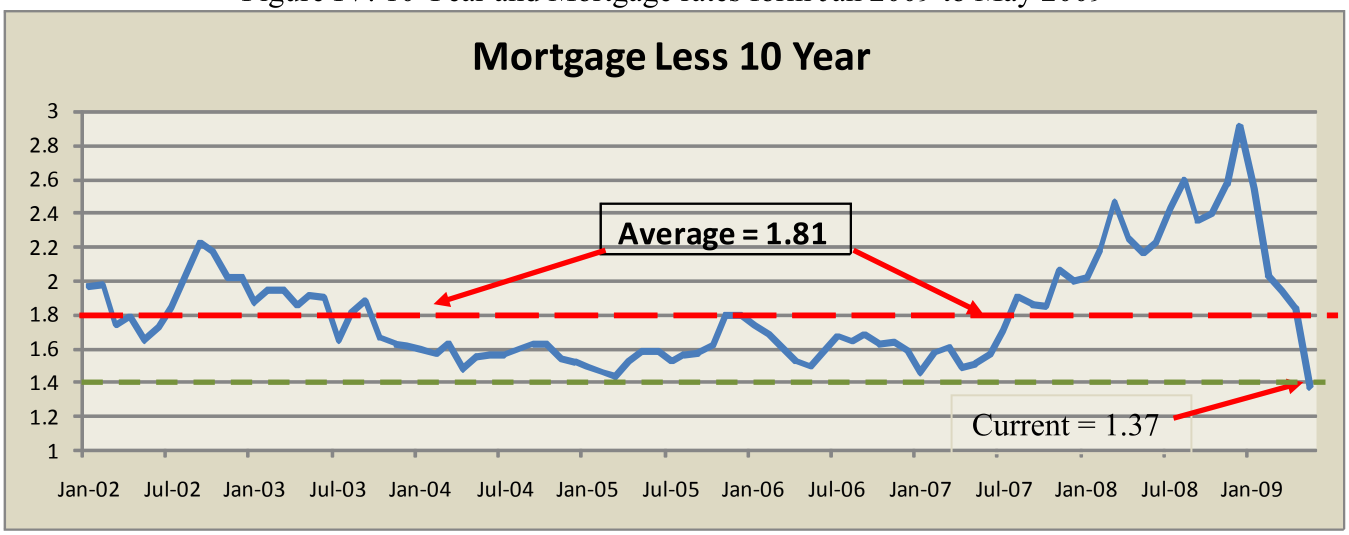
3. Will increase its purchase of other agency debt by $100B to a total of $200B.
4. Will direct the purchase of $300B of longer term Treasury Securities over the next 6 months.
5. TALF was launched to extend credit to extend credit to households, student loans, credit cards, small businesses and the real estate market.

One of the objectives of the FOMC committee's aggressive action during that meeting was to reduce mortgage rates.

III. Mortgage rates before and After the FOMC Meeting

The desired effect occurred in that the mortgage rate did in fact decline, however the 10 year note which mortgage rates normally mimic, have been rising since the meeting (Figure I).

Figure IV: 10 Year and Mortgage rates form Jan 2009 to May 2009



Source: Department of Treasury, SISR

The 10 year initially declined from 3.02% on March 17, 2008 the day before the meeting, to close at 2.51% on March 18 the day of the announcement. In the next 8 weeks, however, it continued to increase well past the 3.02% level just prior to the April 29th meeting. By Friday May 22, 2009 the 10 year was trading at 3.45.

However, in contrast to the 10 year the mortgage rates declined and stabilized around 4.8% going from 5.15% prior to the meeting to 4.82% last Thursday May 21st. The 10 year had been increasing on demand issues we believe and the mortgage rate has remained constant most likely assisted by Fed Policy.

The net effect of this action also has been that the mortgage rate less the 10 year spread is now tighter than it had been at 1.37% in contrast to 2.15% before the March 18th meeting. More significantly the spread is now not only completely normalized with no risk premium, a risk premium that began in mid 2007 (Figure III). The most surprising aspect of this mortgage rate less the 10 year spread is that it is currently at near historic lows, which should now cause the banks to be even more cautious than they had been with a larger risk premium, given that the economy is far from what one would consider stable.

The decade long relationship for this spread is 1.81%. Historically over several decades since 1980 it has been a bit lower, closer to 1.6 to 1.7%. This would indicate that the banks are taking a lower premium on this rate since December of 2008 when it reached its high of 2.91%. The FOMC has been conscious and trying to bring this rate down for several months now, but with the rates where they currently are only two things can happen:

1. That the mortgage rate will rise with the 10 year and function in lock step with it, if the rates rise and or
2. The banks will simply stop mortgage lending, both of which are likely.

Conclusion and Implication

Since the mortgage rate has reached a historical low relationship with the 10 year it is likely that going forward the mortgage will mimic the 10 year much more closely indicating that mortgage rates likely will be going higher. This report should be rather disconcerting to the reader as it is to us, in that everyone appears to be seeing that the financial sector again is are beginning to have various distortions now not caused by risk taking but because of monetary and fiscal policy.

Money supply is growing slower than we would have expected, the 10 year is increasing faster than we would have expected, the mortgage rate appears vulnerable to increasing because banks cannot lend in this environment with the 10 year/mortgage spread where it currently is, and the economy appearing to be stalled in its tracks.

The only place that this is not completely evident is in the equity markets and the reason is that money is flowing from fixed income into the equity markets, but the equity markets despite this flow is in the process of a minor to a more major correction following its rapid increase over the past few months, with the likely cause being problems in the financial markets as represented in this report.

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