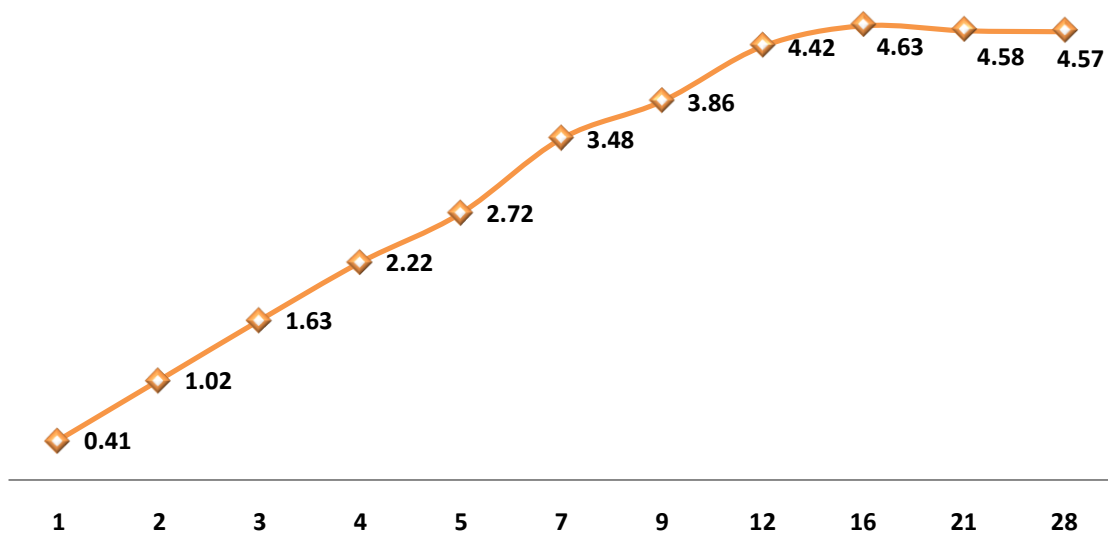


Tuesday, August 25, 2009

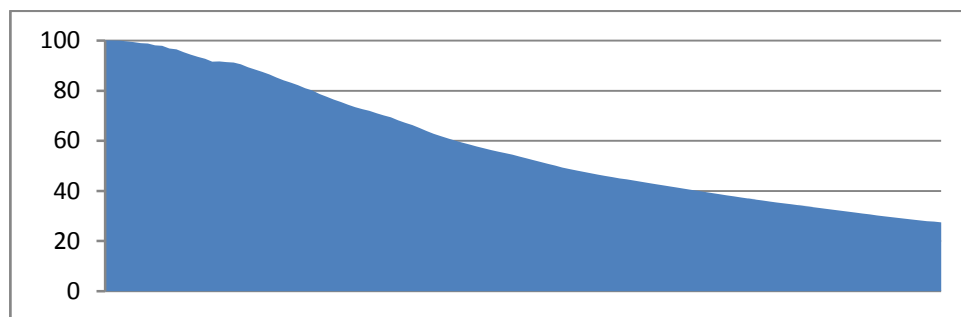
Interest Rates & Bonds

Here is my version of the Treasury yield curve, with each year of maturity being a Padovan Number into the future.

Yield Curve



The data are from Friday's implied yield of zero coupon Treasuries.* I am such a Bond Bull that I expect all the data points on the curve to drop below 1 percent at some point. I do not know when, nor do I know the process by which the curve will get there. Maybe the middle of the curve will get pushed down first, or perhaps the yield on longer dated maturities will make the move first. It does not really matter to me much. I usually suggest playing the Long Bond just because you get more bang for your buck with it. Below is a graph of Treasury zero coupon prices extending out to 2038. The farther out you go, the cheaper the prices.



* "Stripped Coupon Interest" on this WSJ page:
http://online.wsj.com/mdc/public/page/2_3020-tstrips.html?mod=topnav_2_3000

I have been thinking that those who want leverage to higher bond prices (lower yields) but do not wish to trade in the futures market could buy zero coupon bonds instead. If T-Bond yields drop to, say, 2 percent (which I believe is very doable) the value of the Treasury 'Strip' maturing in 2038 will nearly double from its current market value.

I have never tried to buy zero coupons myself, but I pretty sure they are available through most securities brokers. Alternatively, you can trade EDV, an ETF from Vanguard.

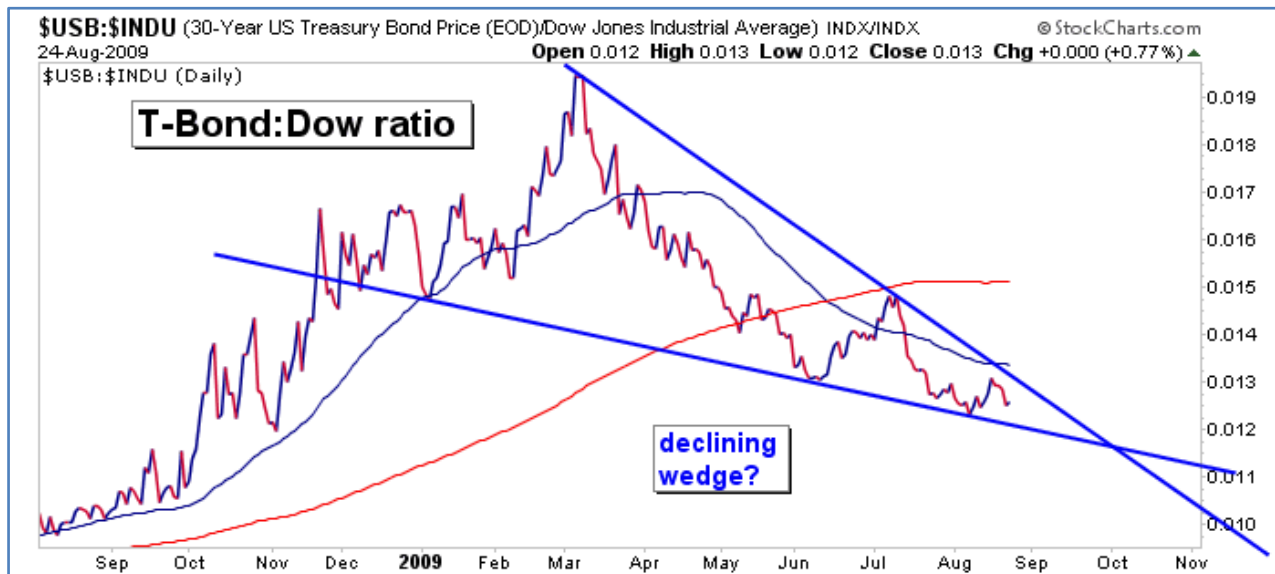


But maybe it would be better to short TBT, the 'ultrashort' T-Bond ETF. It is way more liquid, and because it is a leveraged ETF it is subject to continual price decay. From the looks of the chart shorting it may offer better returns in a Bonds Bull Market than being long EDV. (Though I see that EDV pays out a distribution for some reason, whereas TBT does not, obviously.)



Recently we looked at the Dow:Gold ratio and also the T-Bond:Gold ratio. As forecast, further gains

have since been seen for both ratios. Modest gains, but gains nonetheless. And I think that both Stocks and Bonds should continue to out-perform Bullion. But what are the prospects of Bonds relative to Stocks? Let's have a peek at the T-Bond:Dow ratio.



The potential declining wedge pattern I highlighted looks very promising. I see a good chance that this has bottomed, but if not, I see an excellent chance that the ratio is *forming* a bottom.

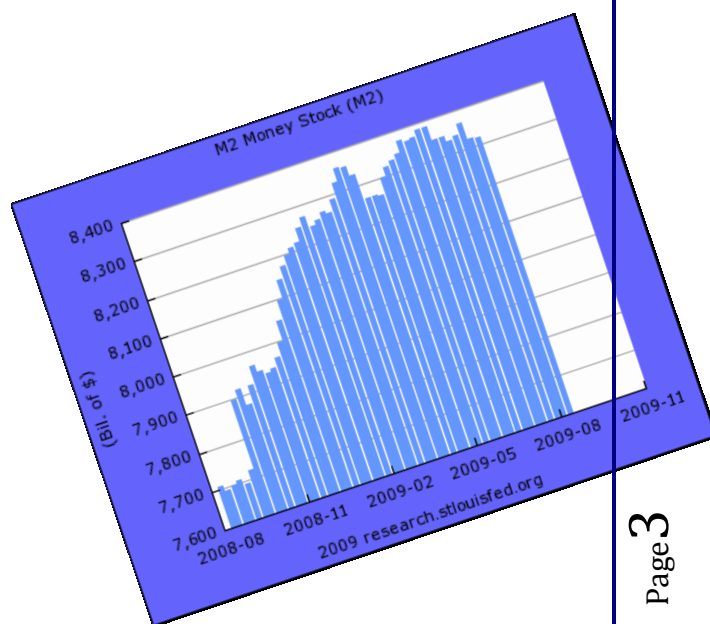
I watched a bunch of Bloomberg TV clips on youtube yesterday and the world is a buzz about what the Company Store's 'exit-strategy' is going to be. Don't worry about it. Official interest rates will not be increased anytime soon, if ever.

Even if we are on the road to Recovery, which appears doubtful to this analyst, it is still unlikely that the Unemployment Rate has topped out. Coming out of the last recession they did not raise the Fed Funds Rate until a full year after Unemployment peaked. And remember, that was a 'mild' recession.

Sure the Fed is worried about Inflation. They are worried that there is not enough of it! Between joblessness near 10 percent, declining wages, the unrelenting overproduction of Goods and Commodities on a global scale, the contraction of consumer credit, and on, and on, there is no risk of Inflation. And obviously I am referring to Price Inflation, in the same sense that the GeldPolitickers concern themselves with.

But what about the Money Supply? Well, if we tilt the graph enough maybe we can get hyperinflation going again.

M2 has increased about 8 percent in the past 52 weeks. Big Whoop. But it has barely increased at all since the



beginning of the year and it is lower than when the Stock Market bottomed in March.

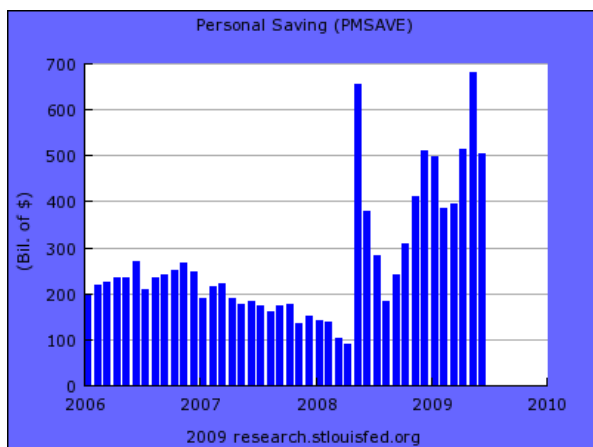
Shit, just occurred to me that that M2 (\$8313 billion as of 8/10/09) is lower than when they announced the Treasury and Agency monetization program on March 18th (M2 release on 3/16 came in at \$8361 billion).

M1 has been a little stronger than M2 recently but still nothing crazy like last last year. Besides, the recent divergence may well be due to a shifting into more immediate forms of money (you know, to pay bills and such).

Believe me, the Money Supply will take off again someday, my point here is simply that despite all the stimulus and such the money aggregates have been tame so far this year. So, the supposedly bearish (for Bonds) argument, that excessive monetary and fiscal excesses will erode the value of the debt (an argument I don't really subscribe to anyway), just does not seem that pressing right now.

The real bearish risk for Treasuries would be if the US Trade Deficit narrows much more, or God forbid, the Balance moves to surplus. The Deficit this year should come to a minimum of \$300 billion less than the average of the previous few years. Back in March on the blog[†] I remarked about the coincidence of the Fed monetizing \$300 billion in longer term Government Debt when the Trade Deficit would be narrowing by about the same amount.

So unless Oil can get pumped back up to \$100+ per barrel (which might not do any good if Americans aren't the ones buying it) and they extend the Cash for Clunkers Scheme to Asian made electronics and assorted junk, the issue is going to arise about who is to buy the next load of surplus Treasury Debt.



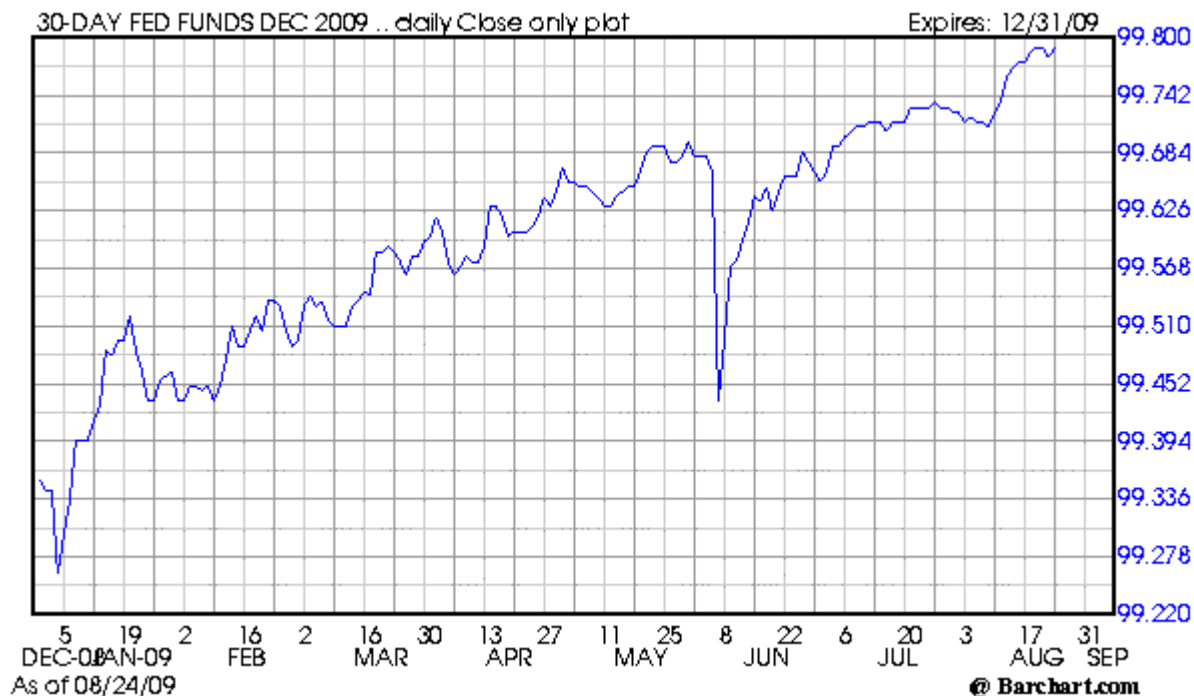
On the left here is a chart of Personal Savings (monthly figures at annualized rate). For the last 12 months (ending 6/09) Personal Savings are up about \$200 billion over the 12 months prior. Not a bad start, and with the Savings Rate still less than 5 percent there is definitely room for improvement.

Additionally, we might look forward to private foreign investors to increase purchases of Treasuries, particularly as uncertainty increases in Emerging Markets and the like.

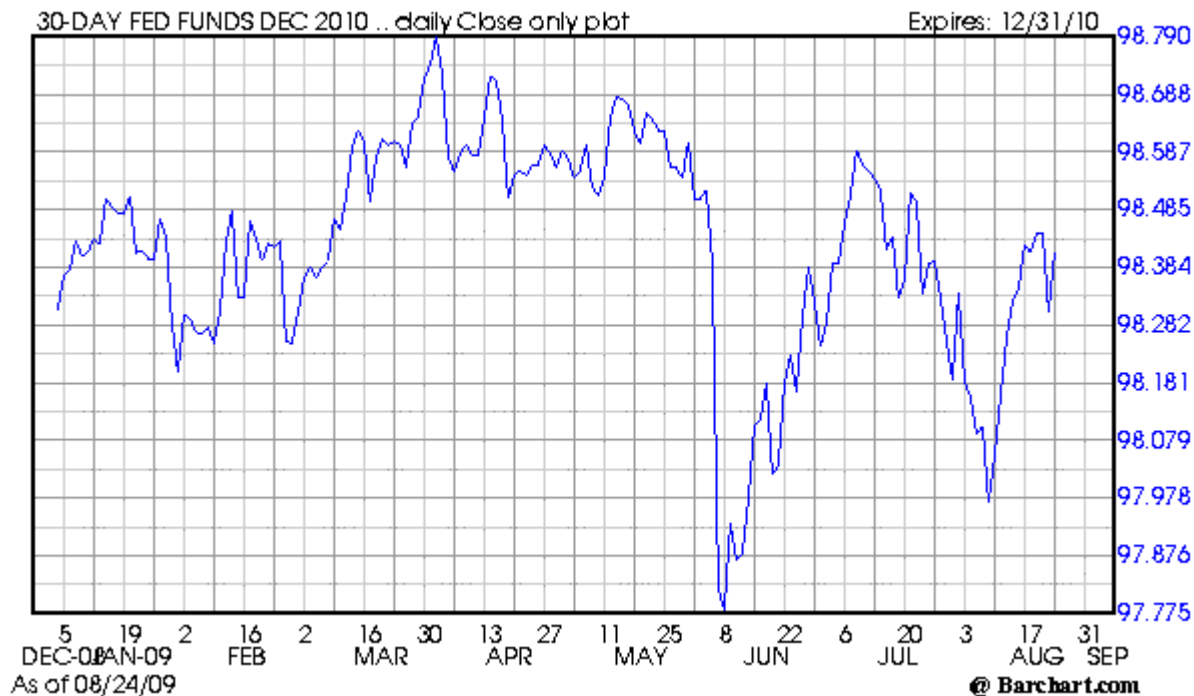
These kind of things may lend support for US Bonds and Notes, but at the end of the day my forecast is for a Bond *Bubble*, and bubbles are inherently driven by Speculation. It is the Speculative Community (hedge funds &c) that will inflate this bubble to its fullest. As I have explained before, the positive carry on Bond and Note futures will prove irresistible to leveraged speculators. The only thing missing from the equation now is the belief that short term interest rates really will stay 'abnormally' low for

[†] *Thursday, March 19, 2009*

an 'extended period'. The next chart shows the Fed Funds December 2009 futures contract. The market has just now actually priced in rates remaining in the 0 to .25 percent target to the end of this year.



But the December 2010 contract is pricing a rate of more than 1.5 percent:



And thus concludes another Bond pumping episode here at Trend & Value. I reiterate my suggestion to be long T-Bonds for major move higher in price. There may be a little downside in the near term, I really don't know, but the next phase of the Bond Bubble should take prices to new highs and yields to new lows.