

F.I.R.S.T

Fixed Income Research and Strategy Trends



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Is That All You Get for Your Money?

How long does this one-way trade continue, this set-up for higher interest rates? Because, well, yields HAVE to go higher, right?

The sentiment for higher rates is strong. The decline in the U.S. fiscal standing — whether measured by the bleak budget, the medium-term funding requirements or the longer-term unfunded mandates — likely demands higher yield premiums.

Yields have also climbed for other reasons. As the economy transitions from recession to recovery, there is anticipation that payrolls are about to move from negative to mildly positive. Worries about a fiscal calamity in Europe (which had helped to maintain a flight to quality bid that was supportive of Treasuries) have started to recede, as Greece has been able to access funding markets. The end of the Fed's mortgage-backed security purchase program may be playing a role here, too, as a large securities purchaser exits the market. Further, uneasiness persists concerning the investment community's desire and ability to continue to absorb the relentless supply of Treasuries. Private debt, of which there is a relative shortage, is looking more attractive.

But the critical element is that we are amidst a move from recession to recovery. We are not yet in an expansion. There are simply too many things that remain too broken or too fragile. Higher rates

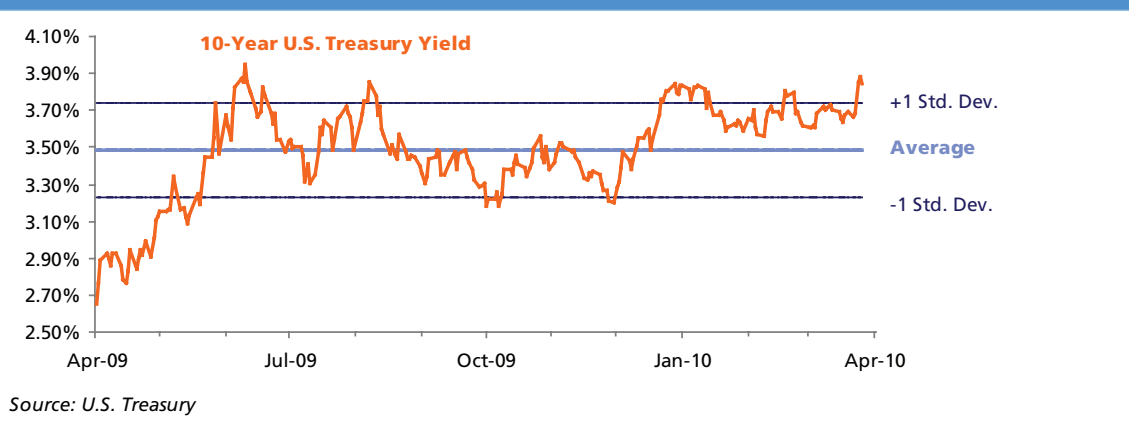
would put pressure on bank credit costs and the housing market, neither of which is prepared. Further, inflationary pressures are not threatening.

This is why near-term fears for rates will be unfounded and why the famous bond market vigilantes have not really sprung into action. We are not willing to bet the ranch that the Fed is about to start tightening, nor are we convinced that longer rates will go much higher of their own accord. But we do expect a period of instability, and we, too, have set up our portfolios for some near-term drift higher in yield of longer maturities.

Investors often call attention to the decades-long downward movement in real interest rates and claim that there are limited prospects for this trend to continue. This conveniently ignores the growing asset allocation needs of pension plans, banks, insurance companies and aging Americans, all of whom desire to put income on their books.

Beyond the U.S. budget and the supply of private credit, the need for savings and investment to be balanced globally is also driving interest rates. Importantly, this has to take account of the worldwide imbalances of the past decade or so, during which the high savings propensities of the newly emerging Asian economies fed an inexorable demand for funding in the West. And while we have both private and public

Range of the 10-year Treasury yield over the last year. The average has been 3.5% with a 25 basis point standard deviation.



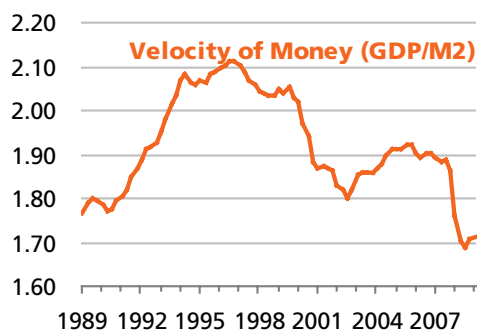
spats with China, their demand for U.S. financial assets has not and is not likely to go away. They don't want to sell the dollars they gain in trade. Reinvesting the dollars into U.S. securities helps maintain China's exchange rate target. Blips of stronger savings rates in the U.S. or more domestic demand in China have made very little dent on the global disparity.

Closer to home, literally, housing prices have stayed near the trend bottom put in some months ago. But these prices cannot rally with the overhanging supply, including foreclosures yet to come. Housing took down a lot of leverage with it, as well as the banks, and none of this is getting fixed very quickly.

Turning employment losses into gains is great. Hopefully, there will be some evidence of that by the time you read this, at least with the kicker of hires to perform the census. But we need millions of jobs to close our output gap. Unemployment is likely to hang high for an uncomfortably long period of time, with a concurrent drag on consumer discretionary spending. Fiscal policy, in full force, is inefficient, expensive and has produced limited new jobs. Unfortunately, it's one of the few things pumping away in what is looking to be a weak recovery.

Lastly, the Fed's mortgage-backed security purchase program built the Fed's balance sheet, while placing reserves at banks. As the banks have been shrinking and writing down bad debts, their desire and ability to lend has been anemic. It is deleveraging time for the banks and even with massive government intervention, it takes years to unwind a balance sheet. What results is a classic liquidity trap in which banks have cash that is not being lent out. Velocity of money, the money multiplier, private sector credit creation: these things are not clicking. Money is not efficiently being put to work. With the end of the mortgage securities purchase program, we are looking to see if money supply measures tumble, exacerbating the problem, and how the Fed may react to that. ■

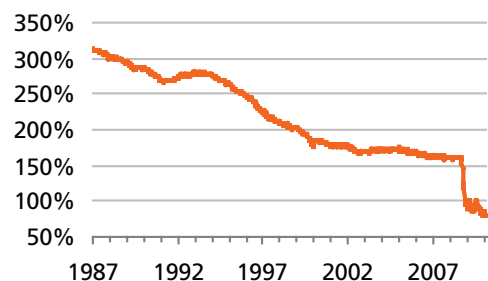
Velocity of money is at a 20-year low, as cash balances remain hoarded.



Source: Bureau of Economic Analysis, Federal Reserve

St. Louis Federal Reserve's measure of the money multiplier exhibits the liquidity trap.

Federal Reserve Bank of St. Louis Money Multiplier Ratio



Source: Federal Reserve

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