Profitis Capital Services LLC

BOND MARKET YIELDS, EQUITY PRICES AND "QE"

NOVEMBER 10, 2010

Executive Summary

In late June of this year, the yield of the 10 year U.S. Treasury Note dipped below 3% for the first time since the depths of the current financial crisis. This also marked only the second trading range below that mark in the last 48 years.

It may seem reasonable that the increased issuance of Treasury debt would serve as the catalyst for moving bond market yields higher. However, the overall *decline* in marketable debt outstanding (including corporate, municipal, mortgage, etc.) has mitigated this supply issue. In addition, the longer the government replaces private industry as the major spender in the economy, the longer it will take any potential rebound to occur.

The flight to quality bid for Treasury debt has masked a pervasive, underlying trend: real GDP growth is slowing down. This rate is reflected in real Treasury yields in that it represents a minimum investment return rate for investing in the entire U.S. economy.

In addition, long term inflation trends reflect a deceleration of price increases. Absent marked real economic growth and muted money supply growth, market participants are accepting of lower and lower bond market yields.

Executive Summary (cont.)

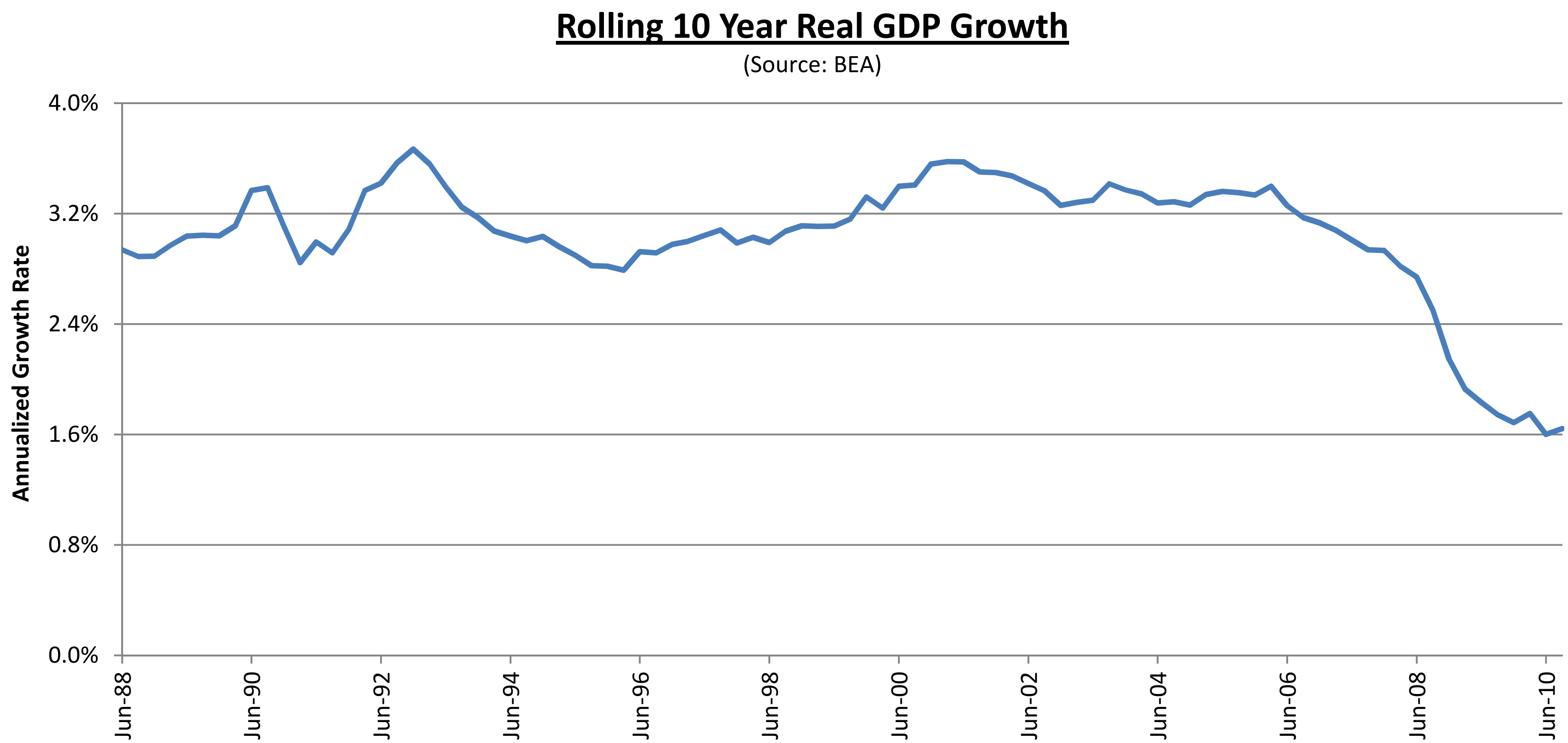
At issue is the Federal Open Markets Committee's (FOMC) intervention in the U.S. fixed income markets. Broker / dealers do not have the same motives as the FOMC. The "buyer of last resort" profile of the FOMC creates a unique opportunity for private industry to profit. Telegraphing trades allows banks to acquire inventory to sell to the FOMC at a later date. The FOMC is acting as a price taker, their motives are to promote monetary policy. We observe a buyer (FOMC) that does not have to act rationally because it can withstand losses that other market players would not (could not) tolerate. This serves to distort market yields and complicate inter-market analysis.

Such "quantitative easing" has included GSE debt, Treasury debt and GSE/Agency mortgage backed securities (mbs). The initial program (1/09 – 3/10) absorbed $1.2 trillion of 30 year mbs. In addition, the Fed added $300 billion in Treasury debt to their horde of assets. The economy improved negligibly, but equity markets responded smartly. What will the impact of "Round 2" be?

The Big Picture....Literally

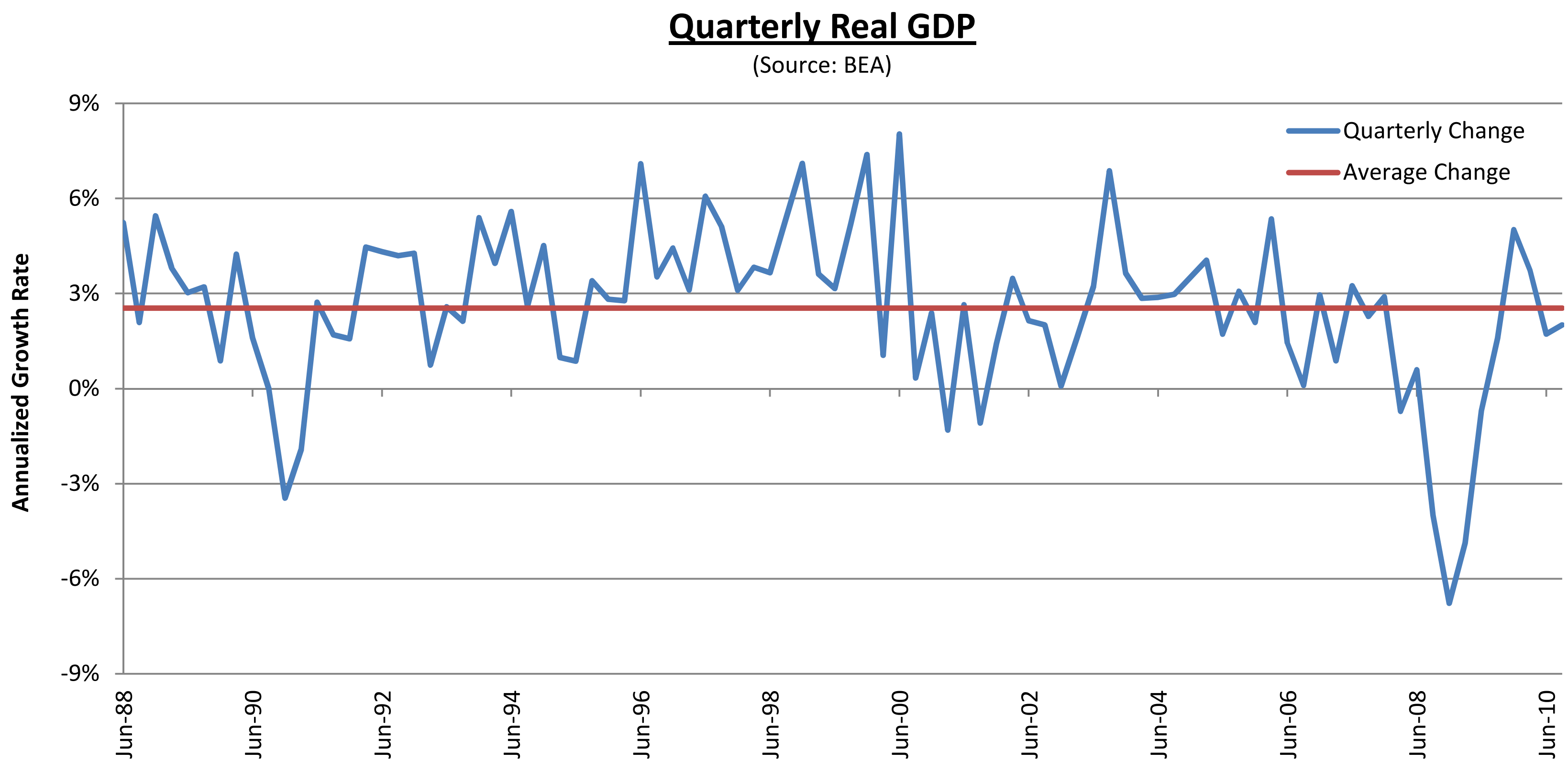
- High: 15.68% (Oct-81)
- Low: 2.18% (Dec-08)
- Median: 6.46%
- Mean: 6.86%
- Standard Deviation: 2.59%

Real GDP I



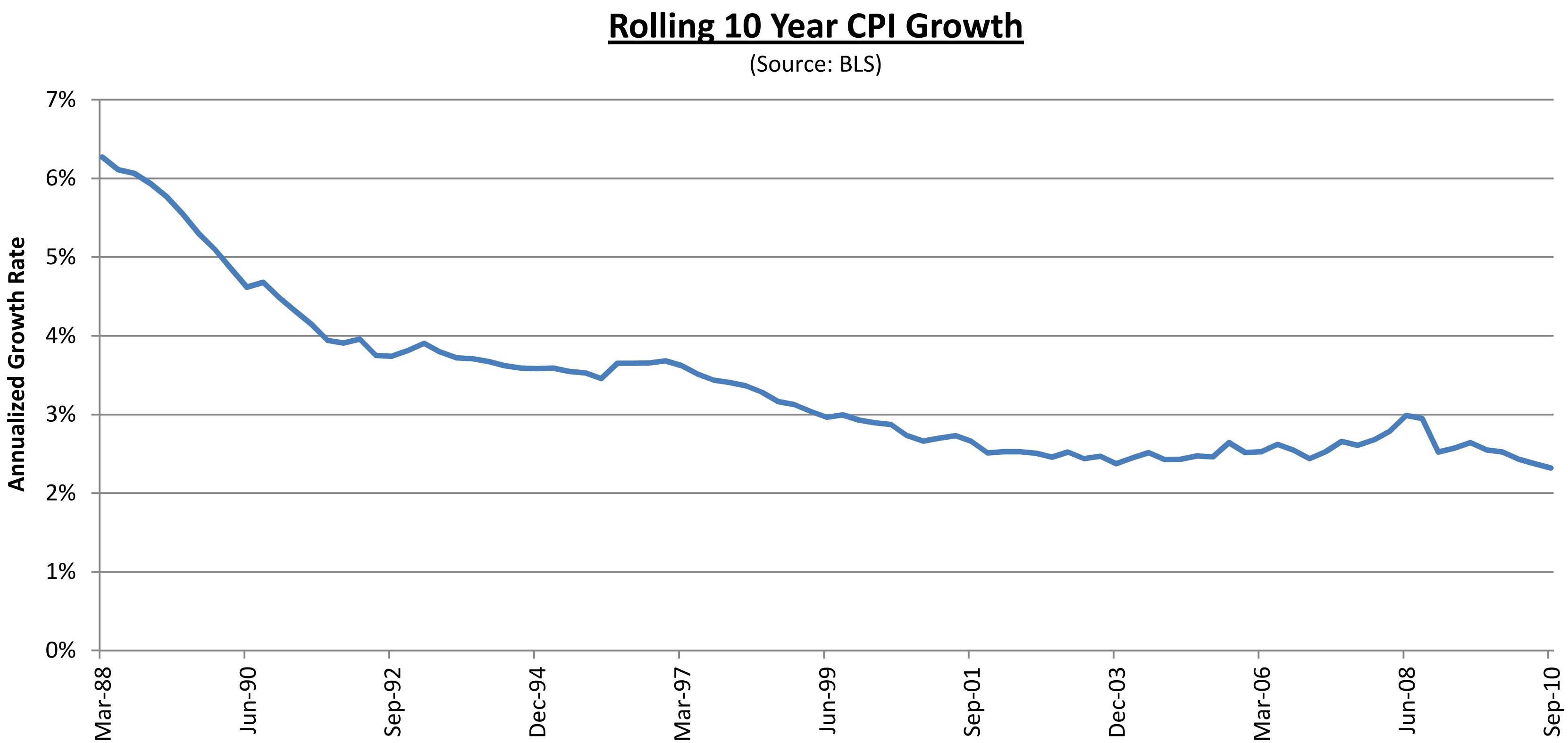
- Recent observations below 2%: 3rd time in last 71 years (late '30s & mid '50s)
- Implications for job growth: are structural deficiencies to blame?

Real GDP II



- Since Q1 1988: average growth rate of 2.54%
- Current slowdown has underlined the trend of declining growth

U.S. Inflation



- Aggressive monetary policy has not counteracted consumer retrenchment
- "Inflation is always and everywhere a monetary phenomenon"

<u>Is The Market Yield Way Off Target?</u>

- Fisher Equation: Nominal Yield = Real Yield + Inflation + (Real Yield * Inflation)
  In practice, the last term is usually ignored since it is typically of little impact in calculating the Real Yield.

- Federal government revenue is closely correlated to GDP. Its ability to generate tax receipts depends on the production of the economy[1]. In this sense, investing in U.S. Treasury debt is the broadest possible investment in the U.S. economy. Therefore, the real GDP growth rate and real U.S. Treasury yields are interrelated.

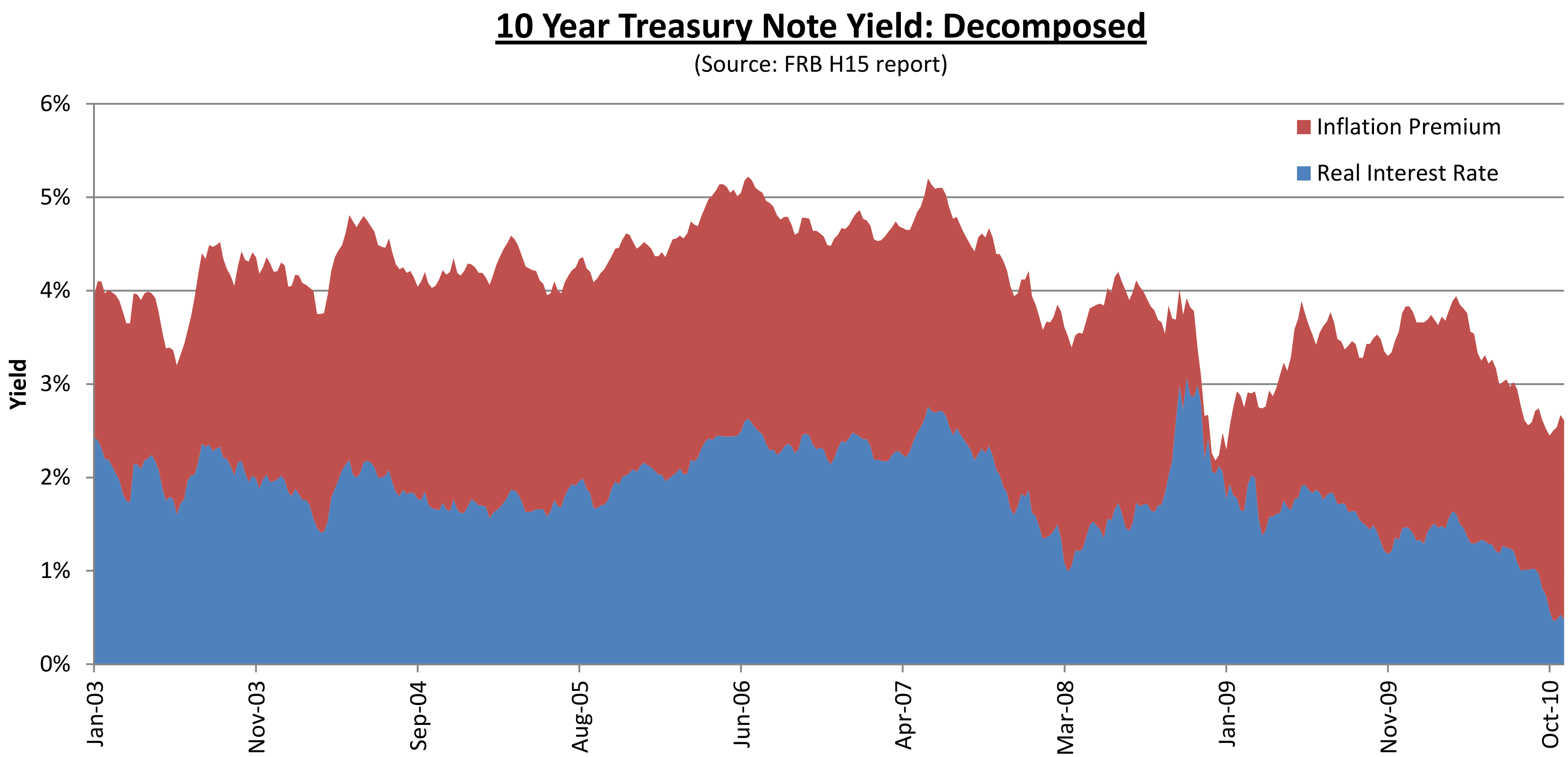
- Recent observations: Nominal 10 year U.S. Treasury yield = 2.61%
  Inflation expectation (TIPS market) = 2.13%

  Difference = real yield = 0.48%

Is the "new normal" <u>that</u> subdued?

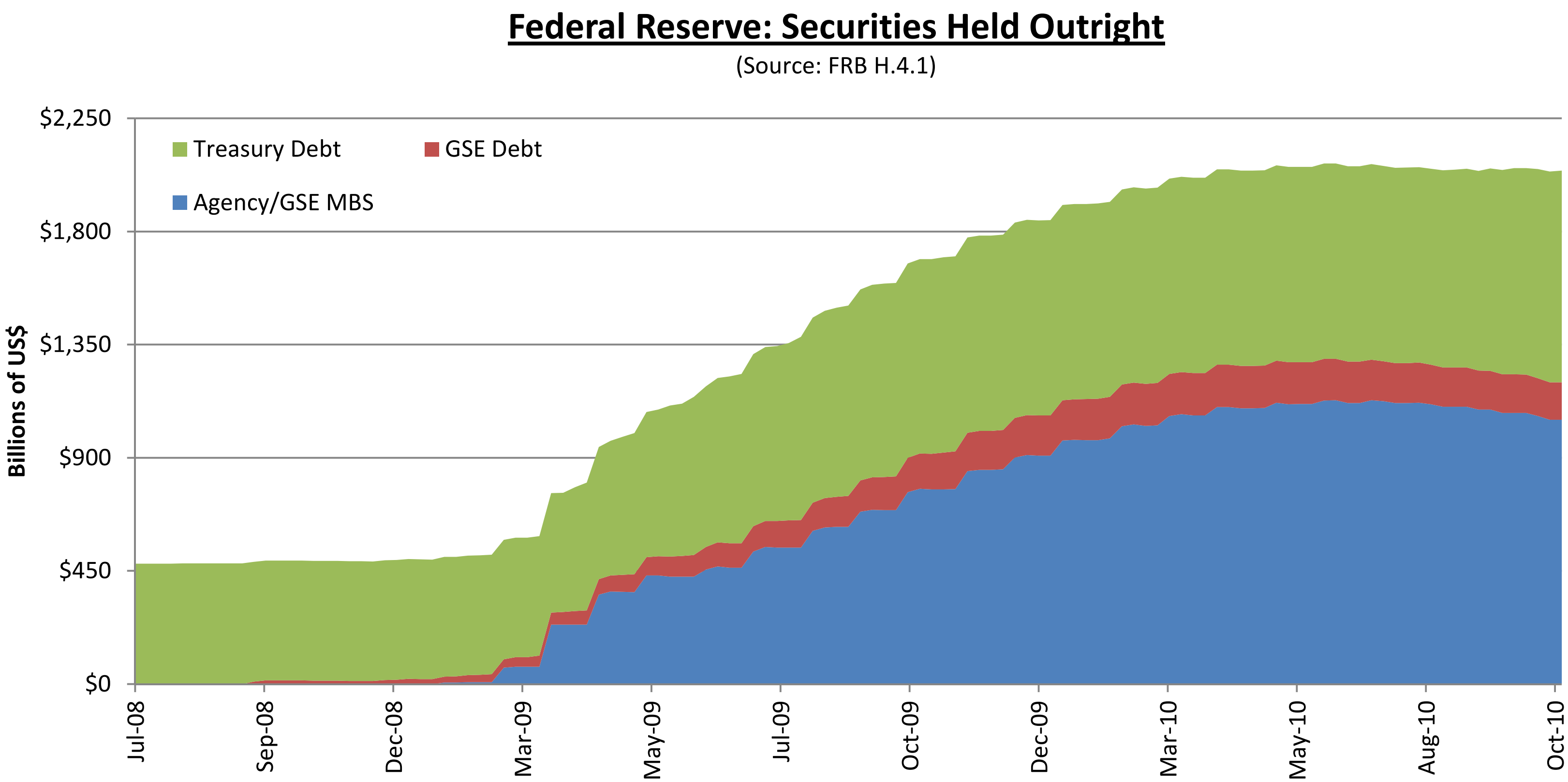
[1] See appendix

Decomposition



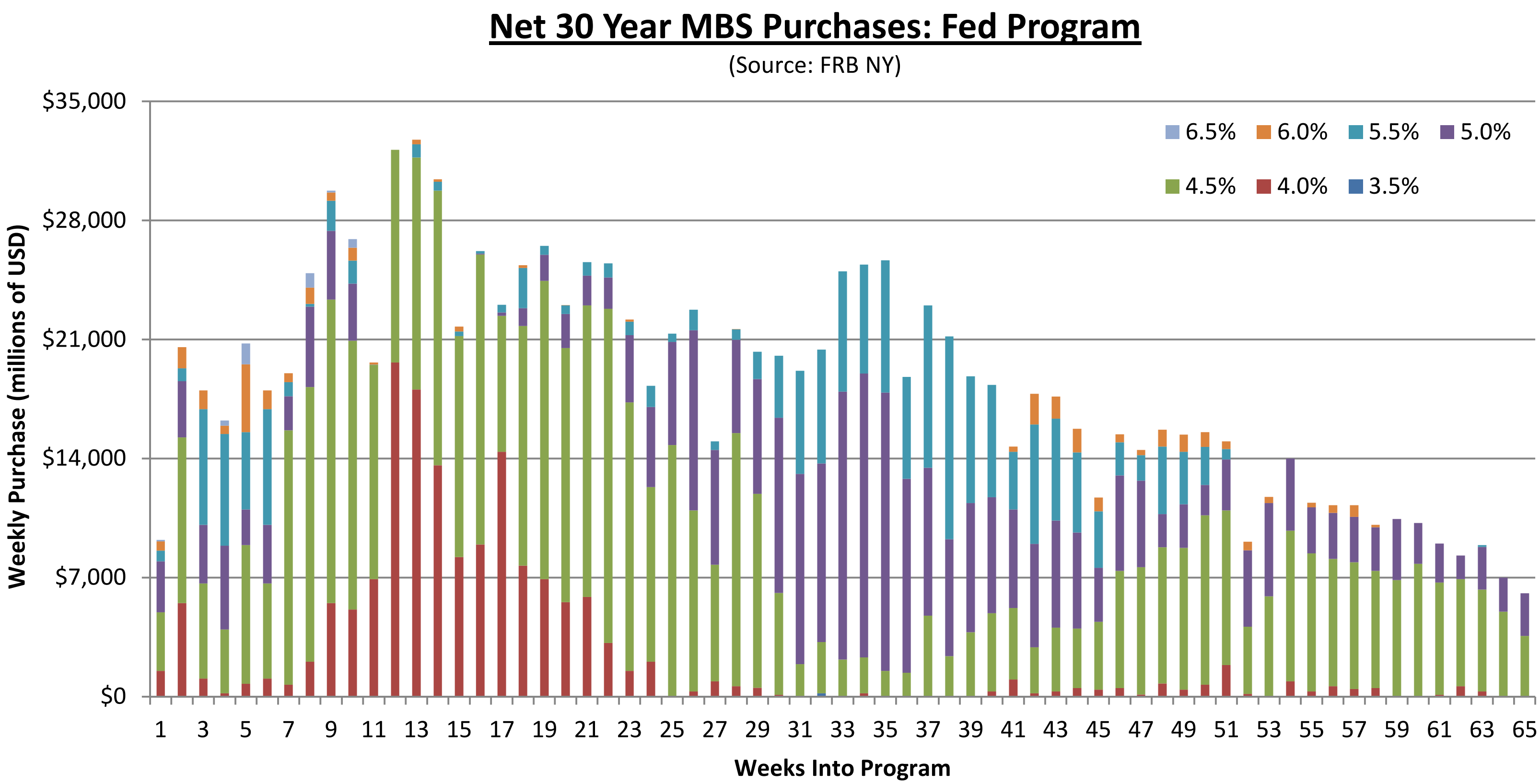
- The issuance of TIPS has created an easily observable market for trading the real interest rate
- Both components seem to reflect a lingering economic malaise

The Fed's Balance Sheet I



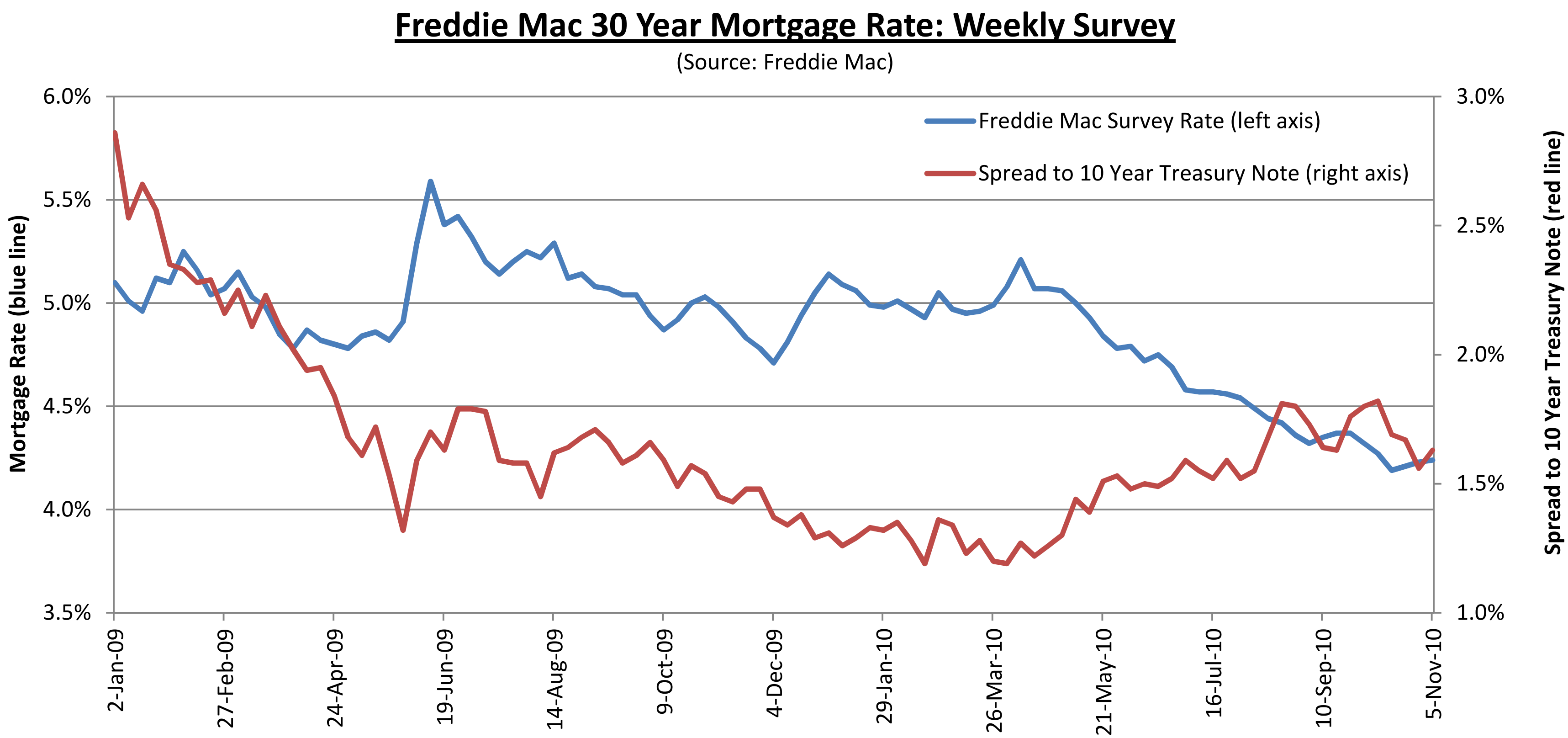
- Size and composition of the Fed's holdings has changed dramatically
- Leading buyer of GSE/Agency mbs issuance during 2009

The Fed's Balance Sheet II



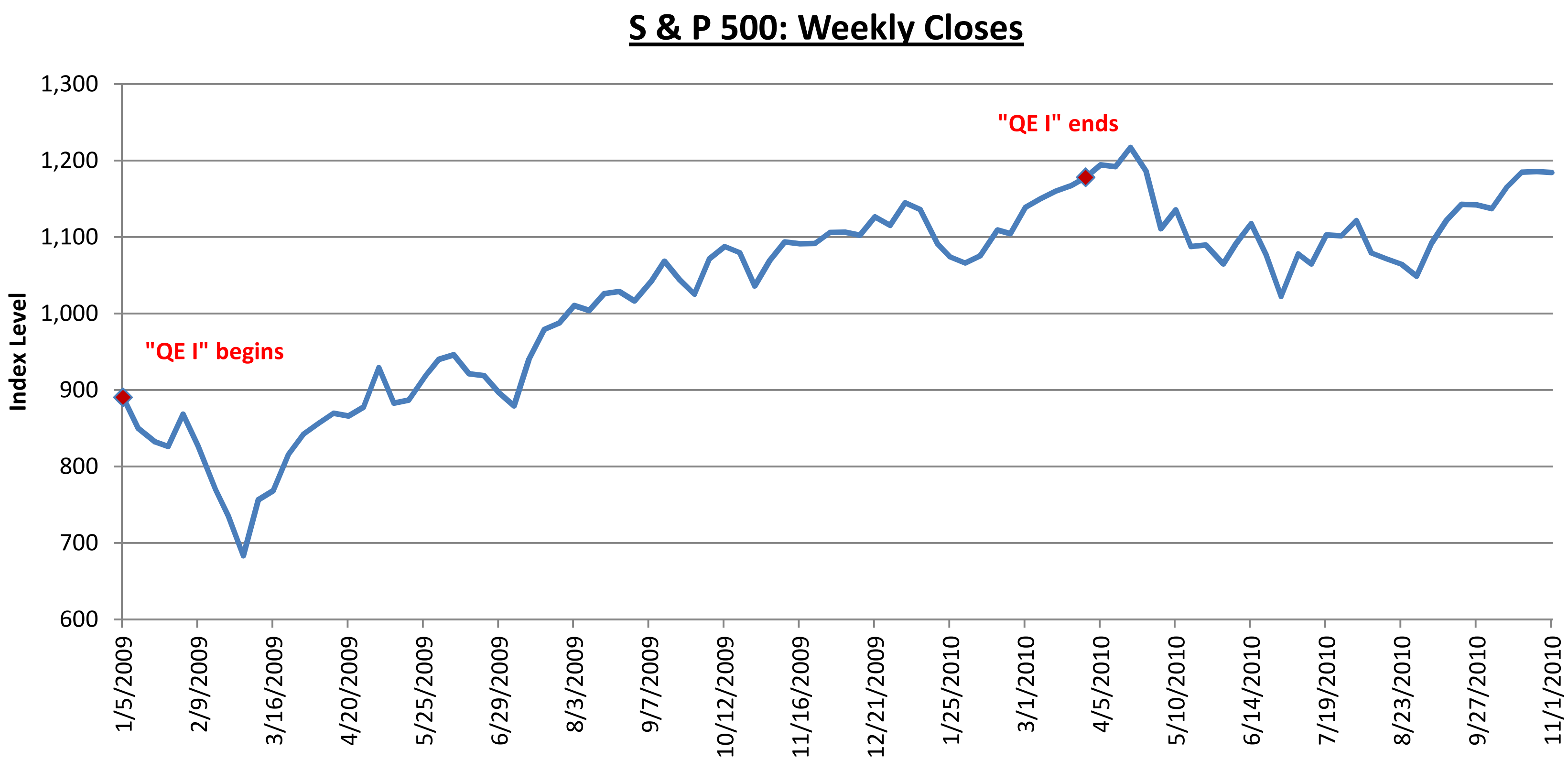
- QE I: 1/2009 – 3/2010
- Purchases totaled $1.2 trillion: 4.73% weighted average coupon

The Fed's Impact: Interest Rates



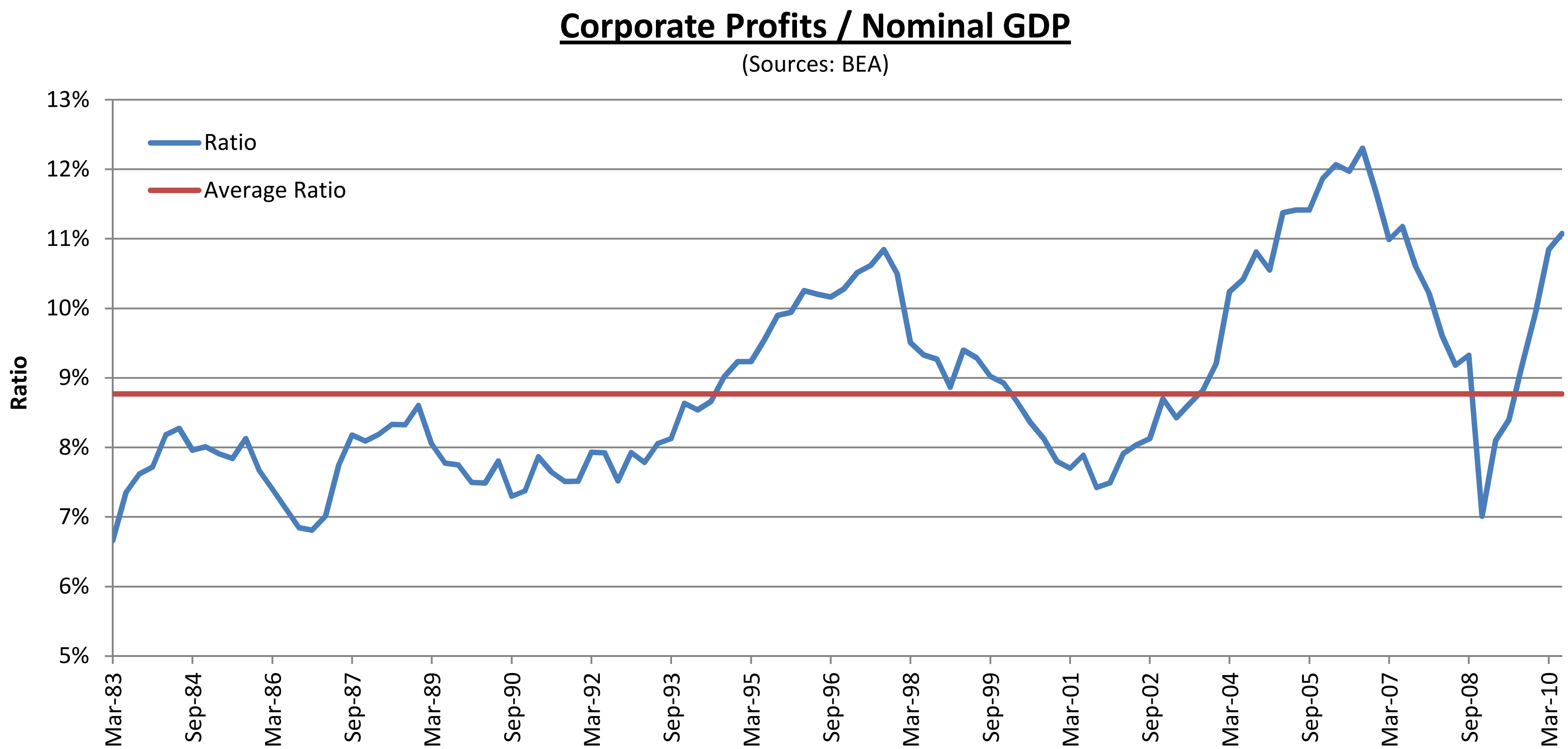
- Multi-generational lows in mortgage rates
- Spreads seemed to have bottomed during the 1st quarter of 2010

The Fed's Impact: Equity Market



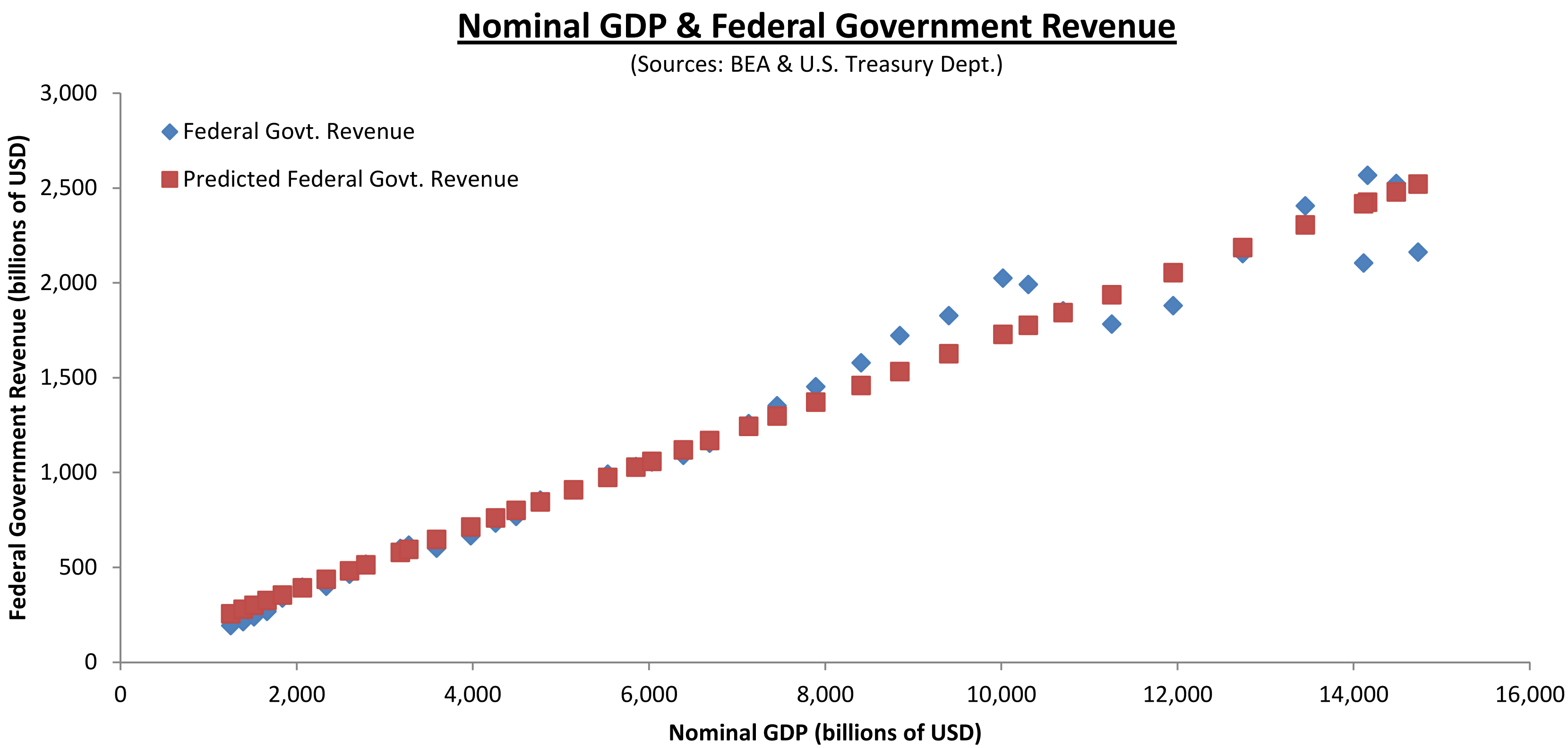
- 32.3% gain (25.1% annualized) from 1/2009 – 3/2010
- 0.53% gain (0.87% annualized) from 3/2010 – 10/2010
- 8/31/10: FOMC minutes released detailing economic difficulties

Equity Market: Have Earnings Peaked?



- The equity market has responded to the dramatic return of earnings growth
- Is the course maintainable absent top line growth?

Appendix



- Simple regression: Federal Govt. Revenue = 45.184 + (0.1681 * Nominal GDP)
- Adjusted R^2 = .971
- Observations: Fiscal 1972 – Fiscal 2009

Appendix (cont.)

"..the Committee intends to purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about $75 billion per month."

Statement of the FOMC: 11/3/2010
http://www.federalreserve.gov/newsevents/press/monetary/20101103a.htm

Nominal Coupon Securities by Maturity Range*							TIPS**
1½ -2½ Years	2½-4 Years	4-5½ Years	5½-7 Years	7-10 Years	10-17 Years	17-30 Years	1½-30 Years
5%	20%	20%	23%	23%	2%	4%	3%

**The on-the-run 7-year note will be considered part of the 5½- to 7-year sector, and the on-the-run 10-year note will be considered part of the 7- to 10-year sector.*
***TIPS weights are based on unadjusted par amounts*

The above table is an excerpt of the Federal Reserve Bank of New York's announcement of 11/3/10.
http://www.newyorkfed.org/markets/opolicy/operating_policy_101103.html

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