

Bond Market Review

August 25, 2009

The Counterfeiter

In the **Bond Market Review (06/02/08)**, we had just seen ‘The Counterfeiters’ and said it was a “*compelling foreign film (with subtitles) that illustrates the true story of the largest counterfeiting operation in history, set up by the Nazis in 1936.*” We observed the plot as a key strategy “*to produce enough fake British currency to throw the English economy into chaos.*” We warned: “*We’re doing the same with real currency. The Fed’s solution under current Chairman Ben Bernanke (and somewhat under Alan Greenspan – though he didn’t flaunt it as much) is to operate the largest money-making printing press in history.*” Is ‘counterfeiters’ an unfair term? What else would you call printing what you know is nothing much more than an IOU. The Dollar had ‘silver certificate’ removed from the top a long time ago. U.S. currency now just reads “Federal Reserve Note”. A note??? It’s more like a hall pass that at least does have a little power towards the menus at Taco Bell and McDonalds.

Bernanke has now been re-nominated, and to be fair, negotiating the past few years would have been tough on anyone – regardless of their stance on monetary and interest-rate policy. The Fed has also been operating short-handed and needs to add 2 governors and then replace 2 that plan to retire shortly. Those folks will have to be on board or drink the printing-press Kool-Aid. This crisis was the closest possible to a no-win situation. The Fed was stubborn in holding rates high for so long – and we contend they played no small role in forcing the magnitude of the subprime crisis upon us. No doubt it would have happened anyway, but resets hundreds of bps above the initial financing rates forced the issue and gave us less time to react. We hold the Fed responsible for that. And they want *more* authority? So how did studying the Great Depression and using that printing press pan out? If the idea was to avoid recession, it didn’t work. If it was to foresee the financial crisis – that didn’t happen either. If the strategy was to forestall the worst stock market sell off in decades, that definitely didn’t work. Everyone seems focused on the great stock market rally since March and the fact that some economic data is falling at a reduced pace or showing a modest increase. This may actually be the best possible time *to* instead retire from the Fed!

Looking Ahead

- Bonds appear to have made seasonal high yields. The 10-year could now revisit the lower 3% zone.
- We continue to expect further weakness in the economy. Stocks may be making important highs.

Tree Hugging

When this government goes green, it’s not *green* friendly. How long can the Bernanke Guttenberg strategy work? It came at a cost of losing many great financial institutions, banks, auto companies, and amassing trillions of dollars in debt by using an out-of-control printing press to mortgage our future beyond our ability to pay. Additionally, the government *used* that printing press to wrestle control of the banking and auto sectors. At the end of this deflation cycle, the looming inflation scenario may make our debt unmanageable. A few weeks ago, Geithner requested a new debt ceiling. It *was* set at \$12100000000000 (that’s how \$12.1 trillion really looks), but will soon shoot far beyond that. After all, once you’re printing, what’s a few zeroes??? Most of the budget forecasts are using the current-low and artificially-engineered rates to predict that we will cut deficits at some future year. Among others, the Bank of Tokyo was negative on giving Bernanke another term. They said it would be negative for the U.S. Dollar, and that’s tough to refute. Reports from the Fed’s annual Jackson Hole, Wyoming conference had them seeming less likely to be a part of a global coordinated effort to recover from the financial crisis. That is seen as thwarting global growth, adding to volatility, and another potential negative for the U.S. Dollar.

That said, the government’s newest longer-term budget is now roughly \$2 trillion more than previously forecast. Keep in mind the Fed has purchased 22.9% of the Treasuries issued in 2009 and plans to stop that phase of quantitative measures in October. In this case, we think ‘quantitative measures’ are no different than getting a new credit card with which to pay the others. You can transfer the debt for 2.99% or so, but ultimately it turns to 19.99% — and there’s a point where you are powerless to do anything about it. That’s where we are headed at the government level. Can we continue to attempt to lend to ourselves and pretend that’s a viable plan? And, what happens when our government has to borrow at 5 to 8% (or more) instead of zero to 4%? What will *that* do for commercial and residential real estate investors? The inflation part of that equation might sound good, but the financing part won’t!

We’ve been bond bulls (and rightly so) for a long time given this large deflation trend that last topped with a cycle high in 1980. Reckless currency printing is disturbing our cave. We’re sharpening our claws and thinking about coming out of hibernation. The only thing holding us back (and hitting the snooze button) for now is the capacious potential for another large downwave in stocks, housing, and commercial real estate.

Departures

While we recognize that governments need to assure the public that things are often better than they really are, this week’s reassurances from freshly–renominated Fed Chairman Bernanke may not pan out as he hopes. On Friday, prior to his nomination, Bernanke said: *“Economic activity appears to be leveling out, both in the United States and abroad, and the prospects for a return to growth in the near term appear good.”* The day before, Treasury Secretary Geithner said: *“We have a long way to go, but we are starting to see signs of stability, and these signs mark the first steps to recovery.”*

We certainly hope so, but Treasury Secretaries and Fed Chairs aren’t always right. We’re including a few ‘gems’ from the past few years to make that point. In March 2007, then Treasury Secretary Paulson said: *“The fallout in subprime mortgages is going to be painful to some lenders, but it is largely contained.”* That March, Bernanke said: *“The impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained.”* In February 2008, Bernanke said: *“I don’t anticipate any serious problems of that sort among the large internationally active banks that make up a very substantial part of our banking system.”* In May 2008, Paulson said: *“The worst is likely to be behind us.”* Bernanke followed with this in June 2008: *“Despite a recent spike in the nation’s unemployment rate, the danger that the economy has fallen into a ‘substantial downturn’ appears to have waned.”* Pardon our skepticism, but could they be presently wrong as well?

Treasuries, Agencies, and MBS

For the week, yields were lower by .5 and 1 bps at 6–months and 1–year while also dropping .5 and 4.5 bps at 10 and 30–years. Yields rose in the middle of the curve with 2, 3, 5, and 7–year Treasury rates higher by 4, 4, 6, and 3 bps. Since Friday, we’ve rallied back to the lower end of the 3–month trading range with 3 to 30–year yields dropping 10 to 15 bps. The accumulation zone for the **(08/11/09) BMR** was 3.72 to 3.82%. We rose to 3.76% on the 13th before a rally to 3.38% (the best levels in more than a month). Last week’s accumulation zone was 3.49 to 3.58%. Yields rose to 3.60% yesterday before a rally sent us once again back to the lower end of the range (with the 30–year following suite). We contend we’re seeing confirmation of our analysis from the **BMR (08/11/09)** where we said: *“One technique we use indicates bonds are making a ‘W’ bottom. That would project the 10–year yield falling near 3.20% by the second week of September.”* Last week, we said with the *“follow through, we could hit the 3.16 to 3.26% zone by our August 28 trend–change date. We would certainly take profits and/or set portfolio hedges at those levels”*. This week’s accumulation zone is 3.47 to 3.65%.

MBS spreads were flat for the week and Agencies were 3 bps wider at 2–years, 10 bps wider at 5–years, and 8 bps wider at 10–years. The Treasury brought a record–equaling \$42 billion 2–year notes today at 1.119% (the highest since June and with weaker demand). Foreign bidding accounted for almost half the issue. The Treasury will auction \$39 billion 5–year notes on Wednesday and \$28 billion 7–years on Thursday (08/27).

<u>08/21/09 Treasury Yield Curve</u>	<u>2-Year: 1.090%</u>	<u>5-Year: 2.564%</u>	<u>10-Year: 3.565%</u>	<u>30-Year: 4.375%</u>
Weekly Yield Change:	+0.0414	+0.0570	–0.0039	–0.0457%
Support:	1.08/ 1.15/ 1.23/ 1.28%	2.52/ 2.60/ 2.65/ 2.73%	3.48/ 3.54/ 3.61/ 3.69%	4.27/ 4.32/ 4.37/ 4.43%
Targets:	0.97/ 0.93/ 0.88/ 0.81%	2.40/ 2.35/ 2.28/ 2.23%	3.40/ 3.33/ 3.26/ 3.16%	4.15/ 4.10/ 4.06/ 3.99%

Equities

Last week, we said: *“There could still be a rally to 1,035 to 1,042 after this correction (and before a larger one). However, breaking 930 would be extremely negative at this point.”* We got our trip to 1,037.75 today – fulfilling that objective and making new 2009 highs. As we also wrote, this timeframe has been heavily marked with seasonal tops in equities. If we trade lower into September 2 to 4, we could hit an upward cycle into the 23rd followed by a fall into October 29th. For the week, the Dow rallied 184.56 points or 1.98% to 9,505.96. The Nasdaq added 35.98 points or 1.78% to 2,020.90 and the S&P rose 22.04 points or 2.20% to 1,026.13. Bank stocks were 2.84% higher. Traders can sell S&P 1,030 and 1,044. Place buy stops at 1,063 and 1,091.

Resistance:	Dow:	9,620/ 9,794/ 9,903/ 10,124	Nasdaq:	2,046/ 2,070/ 2,083/ 2,152	S&P:	1,038/ 1,044/ 1,087/ 1,122
Support:		9,441/ 9,283/ 9,006/ 8,856		1,993/ 1,961/ 1,929/ 1,917		1,013/ 1,000/ 976/ 953

Other Markets

Crude Oil hit a new 2009 high today of \$75/barrel. That’s 131.48% over the December low and the highest level since October 21 (2008). The 9.45% weekly increase led Commodities .75% higher. Gold rose .65% and the Dollar slipped 1.15%. The Japanese Yen added .59% and the Euro rallied .87%.

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Economics

Leading Indicators for July rose .6%, marking the fourth consecutive increase. Initial Jobless Claims rose 15K to 576K and Continuing Claims were 2K higher to 6,241K. Philadelphia Fed (manufacturing) improved from -7.5 to +4.2. Mortgage Delinquencies for 2Q 2009 rose by 9.24%. July Existing Home Sales jumped 7.2% to 5.24M (the highest since August 2007 and the biggest gain since records began in 1999) and that marked the first annual improvement (with a 5.01% increase) since November 2005. Other good news? German service industries had their first growth in nearly a year and the Japanese economy grew for the first quarter in the last five. Other bad news? 12 states now have negative outlooks from at least one of the major 3 credit-rating agencies. The Chicago Fed National Activity Index for July was 1.08 higher to -.74. The S&P/CaseShiller Home Price Index rose 1.39% in June (the first *increase* in 3 years), but was still off 15.44% to last year (the least drop since April 2008). There was a 2.87% improvement in the second quarter for the index based on 10 metro areas (instead of 20) though prices slipped 14.92% year over year. The RPX Composite (metro home prices) fell 14.61% to last June. June's House Price Index rose .5% trimming the quarterly loss to only .7%. Consumer Confidence rose 6.7 to 54.1 (the first gain since May) and the Richmond Fed Manufacturing Index was flat at 14.

Wednesday is set for MBA Mortgage Applications (which were 5.6% higher last week), July Durable Goods Orders, and New Home Sales. Thursday updates 2nd-quarter GDP, Personal Consumption, and jobless claims data. Friday brings Personal Income, Personal Spending, the PCE Deflator, and University of Michigan Confidence. Monday closes out August with Chicago Purchasing Managers, NAPM-Milwaukee, Dallas Fed Manufacturing Activity, and the Bloomberg Financial Conditions Index. Tuesday leads off September with ISM Manufacturing, Pending Home Sales (July), Construction Spending, Vehicle Sales, and ABC Consumer Confidence (which improved one point to -45 this week).

Cold Turkey

John Lennon said: *"Temperatures rising; Fever is high; Can't see no future; Can't see no sky. Cold turkey has got me on the run!"* Warren Buffet commented on the *"gusher of federal money"* that was used to address the financial crisis and the *"uncharted territory"* it has placed us in fiscally. Buffet, now 78, said: *"Enormous dosages of monetary medicine continue to be administered and, before long, we will need to deal with their side effects."* He said: *"For now, most of those effects are invisible and could indeed remain latent for a long time. Still, their threat may be as ominous as that posed by the financial crisis itself."* That's our position as well. Michael Jackson's death has now been ruled a homicide by drugging. The American economy has sustained so much *"monetary medicine"* that a cold turkey phase or additional overdose could be devastating.

Additional Information is Available on Request

Doug Ingram, Independent Financial Economist

"If you can find a path with no obstacles, it probably doesn't lead anywhere." Frank A. Clark

Why not just legislate that no one can have health problems? Then, if your body starts to have problems, you can just be fired as its CEO – and the government can take over.

It's as Otto von Bismarck said: *"Laws are like sausages. It's better not to see them being made."*