

May 3, 2011

Bond Squeeze Nearly Over

Treasury yields fell further today, with the one-year Treasury yield hitting a record low 0.17% and the 10-year yield at 3.25%, down from 3.6% on April 11. We think Treasury yields are being pushed down by temporary factors. These may be misinterpreted as a sign of economic slowdown or risk aversion. We expect U.S. growth expectations for the second half to improve and capital allocation to shift from bonds to stocks as inflation, growth and huge Treasury issuance begin to dominate the post-debt-limit outlook.

10 Yr US Treasury Yield (last obs. May 3, 2011)



Source: Federal Reserve; Encima Global

Our previous pieces explained several factors likely to push Treasury yields down temporarily (see Whipsaw in Bond Yields on 4/18, Treasury Bond Squeeze on 4/26). These include:

- The risk that the debt limit problem would stop Treasury debt issuance temporarily in May or June, creating a shortage of Treasuries while the Fed was still completing its QE2 purchases;

- A major bond fund's two-stage announcement that it was zero-weight on Treasuries and then outright short Treasuries. We think this is the right call for the second half of 2011, but contributed to a temporary squeeze pushing bond yields lower in April;
- Concerns about economic weakness heightened by the first quarter slowdown to 1.8% GDP growth; also the Fed's intent to end its QE2 purchases has caused growth concerns (though we emphasize that QE2 wasn't "money printing", provided very little monetary stimulus and will not cause a monetary tightening when it ends;
- And technical factors in April which disrupted the short end of credit markets. The FDIC changed bank capital requirements forcing banks to reserve against a broader set of liabilities. (See our discussion in Record Gold on April 5.) This disrupted short-term markets including the repo market, pushing the effective fed funds rate down to 9 basis points (from 20bp) and limiting the supply of bonds for sale. We think the downward pressure has rippled through the maturity curve, causing a record low in one-year Treasury bills today and the low yields on 10-year notes.

12 Month T-Bill Rate (last obs. May 3, 2011)



Source: Federal Reserve; Encima Global

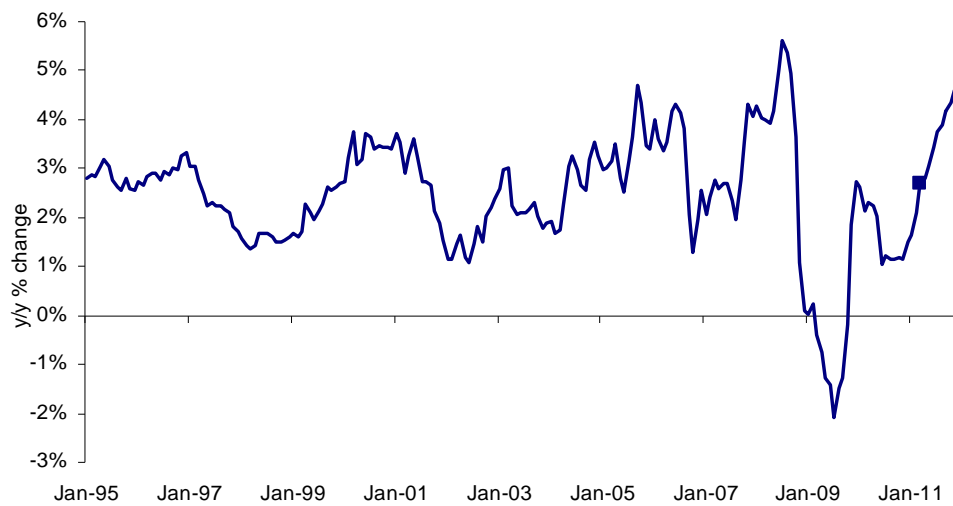
We think the short-squeeze on Treasuries is nearing an end and that the longer-term outlook for higher bond yields in the second half will begin to take over.

- Treasury Secretary Tim Geithner announced plans to disinvest trust funds. This delays the debt limit deadline into August. **Because the disinvestment process increases headroom under the \$14.3 trillion debt ceiling, it means larger Treasury issuance in May, June and July than would have occurred in the absence of disinvesting**

the trust funds. The timing change is critical for the Treasury squeeze because the Fed will have stopped buying Treasury bonds before the debt ceiling crunch hits in August.

- Republicans are having difficulty in forcing substantial spending cuts before the November 2012 election, leaving heavy debt issuance intact as soon as the debt limit is increased.
- Inflation is rising worldwide, with the U.S. likely to pierce 3% year-over-year CPI in May and head toward a possible 4% CPI inflation rate toward year-end.

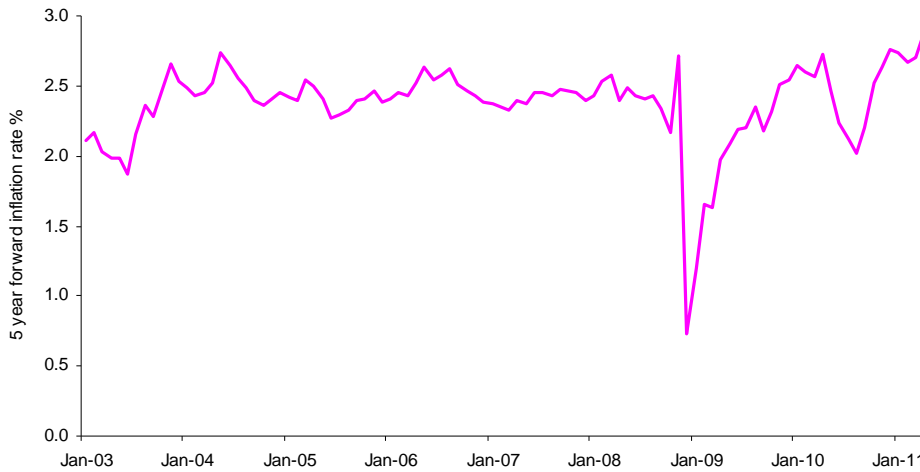
Consumer Price Index Y/Y (last obs. March 2011, estimated through Dec 2011)



Source: Bureau of Labor Statistics; Encima Global

- The five-year forward inflation rate -- an increasingly standard measure of inflation expectations based on the five-year average inflation rate starting in five years derived from the TIPS market -- reached an all-time high of 2.87% for the April average.

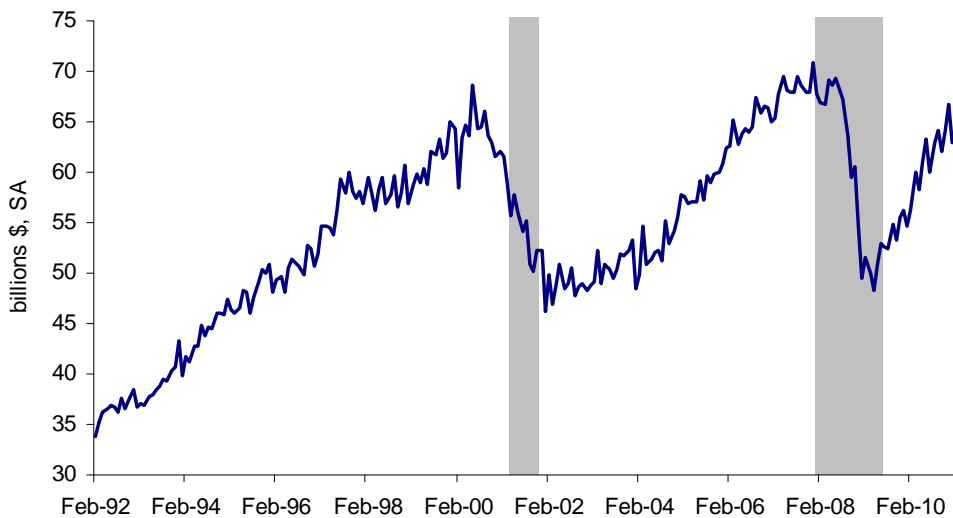
5 Year Forward Inflation Rate (last obs. April 2011)



Source: Haver; Federal Reserve; Encima Global

- **Growth is likely to recover from the first-quarter letdown, as shown in ISM at 60.4, strong April auto sales, especially for domestically-produced vehicles, ADP's first-quarter earnings report and the March improvement in capital goods orders.**

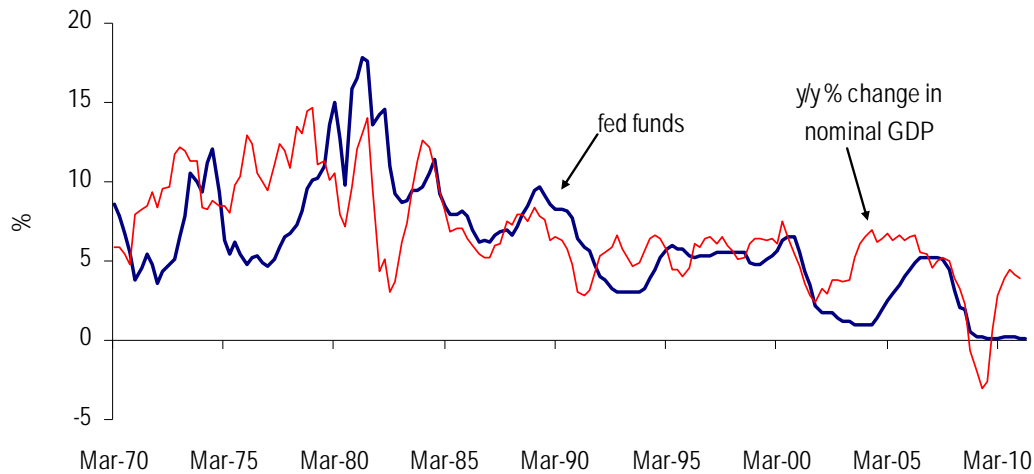
Nondefense New Orders for Capital Goods ex Aircraft (last obs. March 2011)



Source: Census Bureau; Encima Global

- While monetary policy is tightening elsewhere, the U.S. is expected to maintain deeply negative real interest rates for years (Fed funds rate below inflation). This policy undermines confidence in the Fed and the value of the dollar. As in the weak-dollar 1970s and 2000s, the Fed funds rate is also below the nominal GDP growth rate, creating increasing market distortions.

Fed Funds and Nominal GDP Y/Y (last obs. Q1 2011)



Source: Federal Reserve; Bureau of Economic Analysis; Encima Global

As discussed in previous pieces, we think there is a limit to the downward pressure on yields during this squeeze. The debt limit increase will cause pent-up Treasury issuance, which the market will be able to anticipate. In the meantime, there are increasingly robust substitutes for Treasuries as the time-frame of the debt limit problem is extended.

- Aaa and Baa-rated bonds have partially tracked the decline in Treasury yields. Even German bund yields have declined some in recent days despite the first of several ECB rate hikes. These bonds and others are partial substitutes for Treasury bonds. The yield on Aaa has fallen to 5.08%.

Aaa bond yields (last obs. May 2, 2011)



Source: Federal Reserve; Encima Global

- The low bond yields are inconsistent with record gold, which reflects loose Fed monetary policy, the Bush-Obama weak dollar policy, and the resulting shrinkage in the value of the dollar. **We think bond yields will begin to rise with growth and inflation expectations as Treasury delays the debt ceiling problem past the Fed's completion of its QE2 purchases.**

Gold Price (last obs. May 3, 2011)



Source: Wall Street Journal; Encima Global

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