

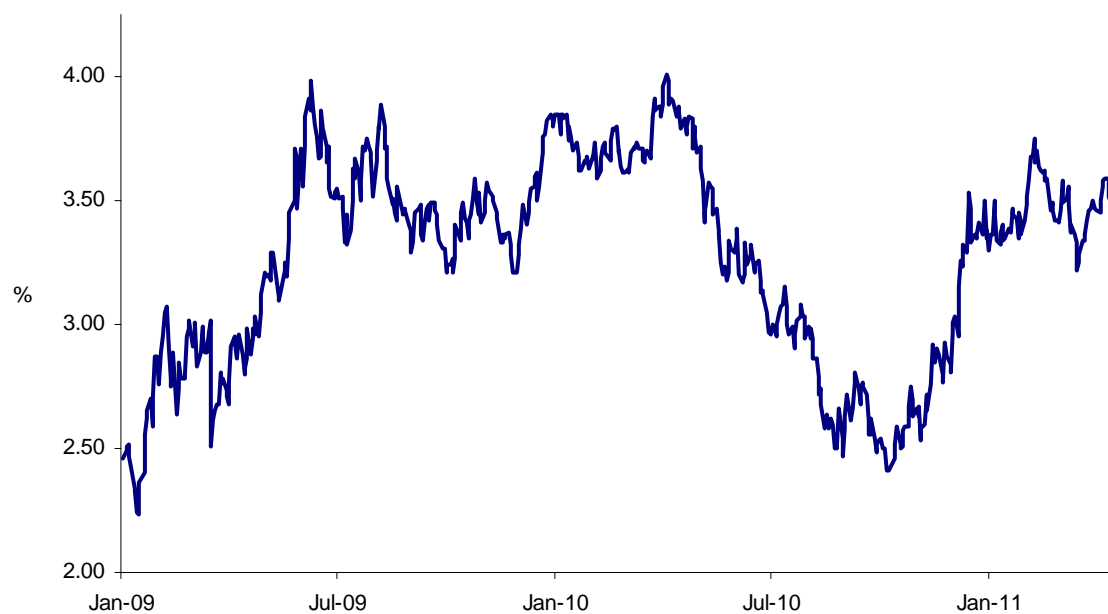
April 18, 2011

Whipsaw in Bond Yields

We think bond yields may go down during the debt limit debate, then up once it is resolved. The swing in perceptions of U.S. and global growth will probably get overdone on the negative side, depressing bond yields. Equities should be able to see through it, but bonds have several other factors also pushing yields down including the likelihood of a short-term cut-off in the supply of Treasuries due to the statutory debt limit.

- The 2010 soft patch pushed the 10-year yield down to 2.5% from 4%. We don't expect growth to slow as much or bond yields to decline as much, but note stronger non-growth pressures on bond yields in 2011 than in 2010.
- By the second half of 2011, we think Treasury issuance will resume in earnest and economic growth will turn out to be a moderate 3% run rate in the U.S. and 4.5% globally, causing bond yields to resume the uptrend that began early in 2009.

10 Year U.S. Treasury Yields (last obs. April 18, 2011)



Source: Federal Reserve Board; Encima Global

Several factors should push Treasury yields down in the near-term:

The supply of Treasuries will decline temporarily. The Congressional fight over increasing the statutory debt limit should cause at least some reduction in Treasury issuance in May. Treasury Secretary Geithner outlined several techniques Treasury may use once it exhausts the headroom in the current \$14.294 trillion debt ceiling. Some of these techniques hold down both marketable and statutory debt and cause less Treasury issuance. (Other techniques are already being used but only reduce statutory debt while allowing bond issuance to continue and marketable debt to go up.) For example, the Federal Financing Bank can issue up to \$15 billion which can be applied to the fiscal deficit but not count as statutory debt or marketable debt. Also, Treasury can raise cash by selling assets (like General Motors shares after the lock-up expires in May.)

Some demand for Treasuries is inelastic. 1) Fed minutes have indicated that the Fed is likely to complete its \$600 billion QE2 purchases in May and June. The Fed has acted indifferently to price and yield throughout its post-Lehman balance sheet expansion. 2) Mortgage pools often buy Treasuries automatically when mortgage refinancings accelerate (in order to make up for the lost duration caused by mortgage pre-payments.) This is pro-cyclical, meaning a decline in bond yields causes refinancings which cause more Treasury purchases and a further decline in yield. 3) Bill Gross said that Pimco was heavily underweight Treasuries and, later, that it had shorted Treasuries. We think this is the right long-term call but might look like a squeeze opportunity for Treasury note and bond buyers.

The perception of systemic risk may go up, lowering Treasury yields. Though counterintuitive, a cliff-hanger on raising the debt ceiling would temporarily increase the safe-haven value of Treasuries.

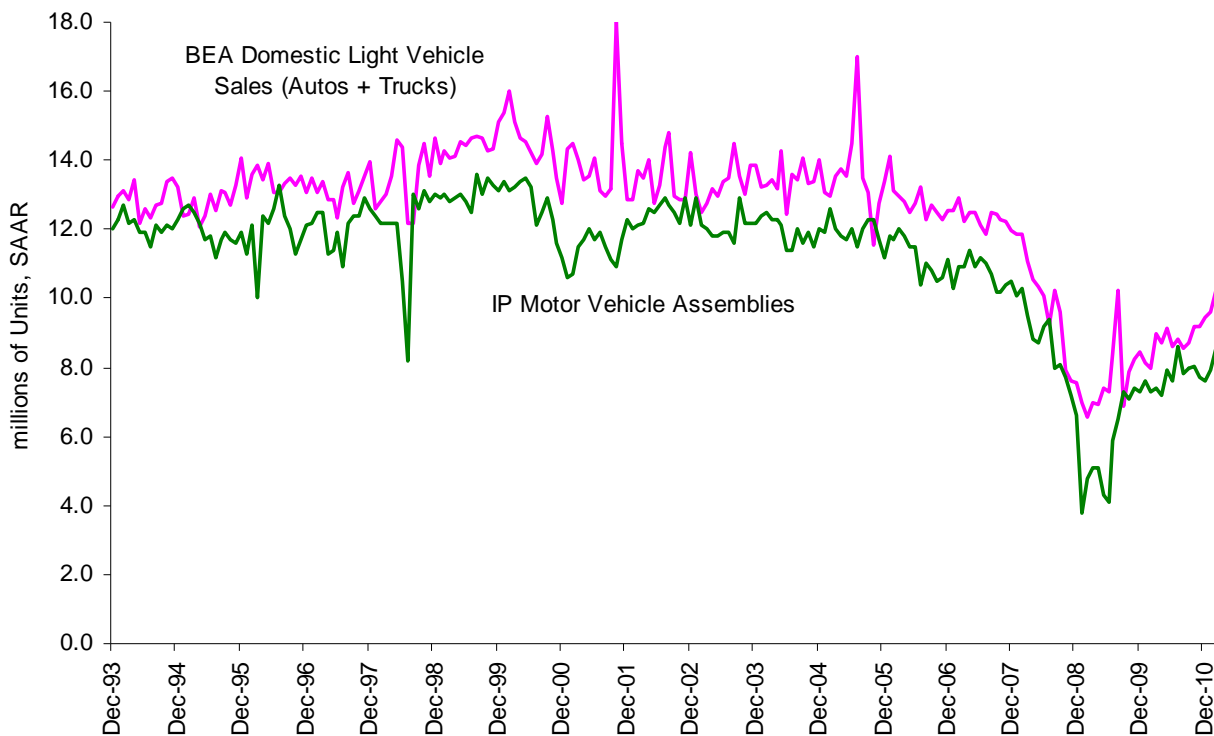
April changes in bank capital regulations have pushed down short-term yields. We think markets will adjust quickly, but for now this downward pressure is rippling into longer maturities.

The end of QE2 may be perceived as a “tightening” of monetary policy. We don’t think this perception will last long, but some will use it as a reason to buy bonds. We expect Fed Chairman Bernanke to emphasize the Fed monetary accommodation. Further, we think the Fed funds rate is the more powerful monetary policy tool and will remain deeply negative in real terms through the second half of 2011 and into 2012. QE2 has had less monetary policy effect – and removal of it won’t be a true tightening -- because the Fed pays above-market rates for excess reserves and the banks haven’t transmitted the excess liquidity by expanding private sector credit.

Talk of fiscal tightening. The perception of a bipartisan shift toward deficit reduction (either through spending cuts or the proposed tax increases) may add temporarily to downward pressure on bond yields. We think U.S. bond yields are primarily linked to Fed decisions, growth, inflation, and demographics, but a May-June fight to reduce the deficit fits in with the other factors putting downward pressure on yields.

Economic letdown. Consensus forecasts for first quarter GDP are declining sharply. We lowered our forecast to 2.2% in March, and the government's first estimate of GDP might be even weaker. There were strong growth indicators from ISM, the household employment survey, ADP job gains and auto sales (up 31% annualized in Q1 from Q4 2010.) However, first quarter retail sales suffered from bad weather and higher oil prices. Many economic models subtract imports from GDP, so the increase in oil imports causes weaker estimated GDP. We think the government's first estimate (due April 28) will be revised upward in subsequent revisions, but may initially encourage the same barbell trade as in 2010 (buy gold to protect against inflation, bonds to protect against deflation). Second quarter estimates will be more important for bond yields. Consumer confidence has held up, but domestic auto production is reportedly being reduced due to Japan's supply-chain disruption and earlier-than-usual seasonal shutdowns. Our view is that the 2011 letdown will be milder than the 2010 soft patch, leaving second quarter GDP at 3% and setting the stage for an above 3% second half.

Auto Sales and Production (last obs. March 2011)



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

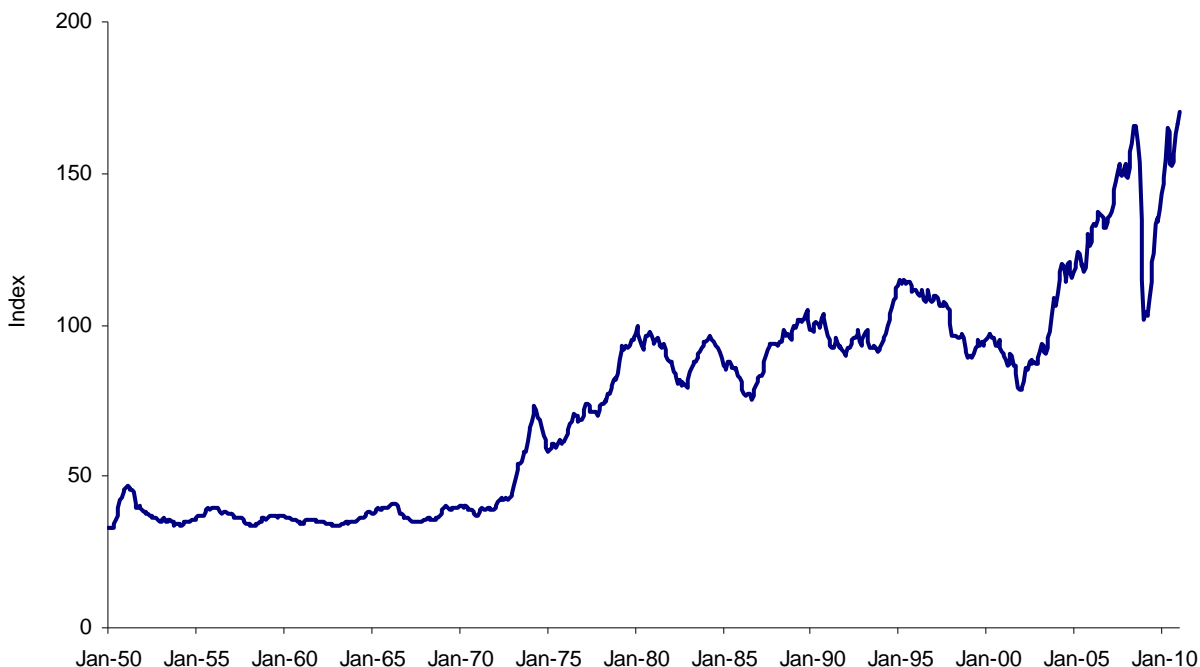
Several factors should push Treasury yields back up in the second half of 2011:

- Once the statutory debt ceiling is increased, Treasury will add to issuance.
- We think Fed Chairman Bernanke will make clear the Fed's intention to conduct a stimulative monetary policy, maintaining the expanded balance sheet and leaving the

door open to QE3. In a detailed April 11 speech, Fed Vice Chairman Janet Yellen explained the Fed view that “recent increases in commodity prices are likely to have only transitory effects on headline inflation.”

- S&P put the U.S. on long-term negative credit watch today based on the fiscal situation, which we think is going to get worse before it gets better.
- With commodity prices very high and dollar weakness creeping gradually into core prices, we think bond yields will rise with the inflation rate (we expect headline CPI to rise well above 3% year-over-year for June.)

FIBER Industrial Materials Prices (last obs. April 14, 2011)



Source: FIBER; Encima Global

- We don't think China will slow down very much. Retail sales grew 17.4% year-over-year in March. China's GDP grew 9.7% year-over-year in the first quarter. For the first time, China also reported a quarter-over-quarter growth rate – a slowdown to 8.7% annualized growth for the first quarter. We think China is working toward a soft landing at 8% GDP growth and will use top-down regulatory constraints, price controls and subsidies to keep inflation down.

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