

April 5, 2011

## Record Gold; Bond Yields to Rise

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We expect U.S. monetary and fiscal policy to remain very loose. On the monetary side, the Fed will complete its \$600 billion QE2 purchases, state its intention to continue monetary accommodation, maintain an enlarged balance sheet, hold the Fed funds rate near zero, and ignore the weakening value of the dollar (see Fed Exit Strategies – Too Slow on April 1).

- Gold reached a new all-time high today at \$1457 per ounce despite last night's hike in China's one-year lending rate to 6.25% and the expected 0.25% ECB rate hike to 1.25% on Thursday.

### Gold Price (last obs. April 5, 2011)

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Source: Wall Street Journal; Encima Global

- We think the latest gold surge, like the previous ones, is primarily a reflection of loose Fed monetary policy, the Bush-Obama weak dollar policy, and the resulting shrinkage in the value of the dollar, which has been hitting all-time lows in real terms.

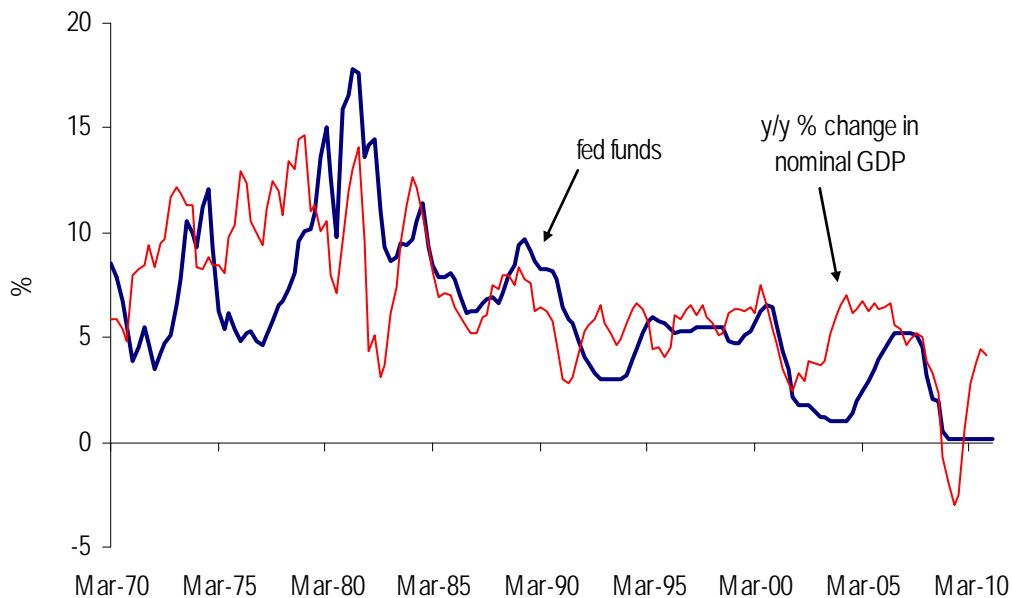
## Record Low for Real Broad Trade-Weighted Dollar (last obs. March 2011)



Source: Federal Reserve; 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. April 5, 2011)



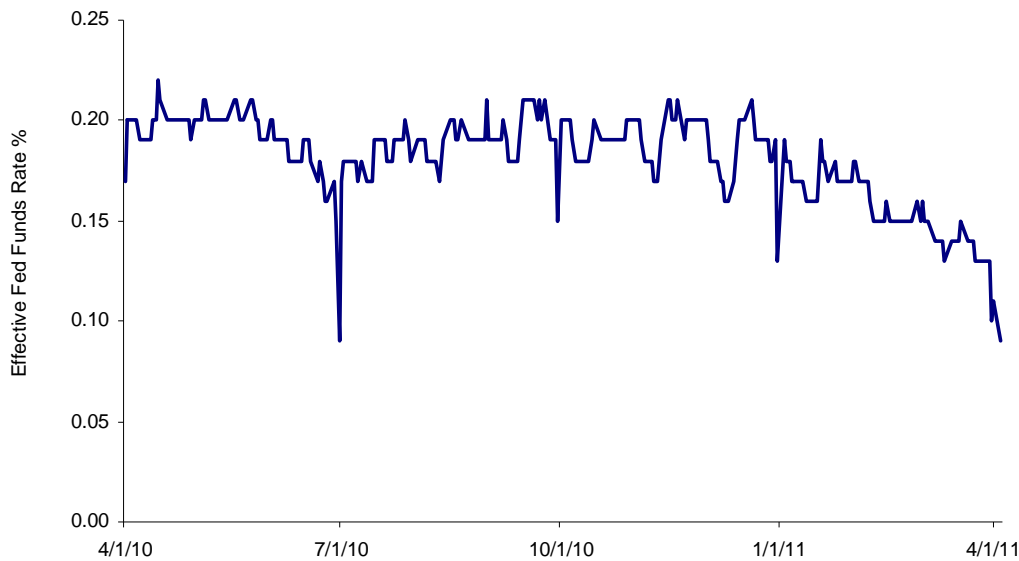
Source: Federal Reserve; Bureau of Economic Analysis; Encima Global

A combination of factors is putting increasing strain on short-term interbank credit markets, which have traditionally been an important part of the financial system.

- The Fed funds rate (where banks borrow and lend to each other, with the Fed as a counterparty) has declined sharply in recent weeks. The FDIC is increasing the charge for repos used to underpin this market (see today's WSJ story on this.) As noted in our April 1 piece, the Fed sharply increased its bank borrowing through excess reserves in February and March in order to repay its Treasury loan facility (helping Treasury stay below the debt ceiling.)

### Effective Fed Funds Rate (last obs. April 5, 2011)

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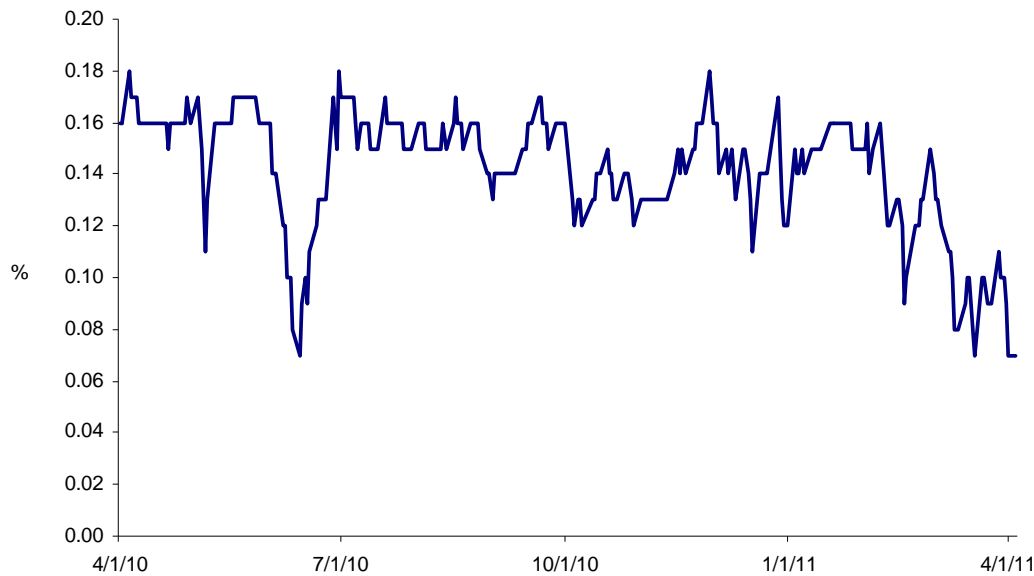


Source: Federal Reserve; Encima Global

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- Similarly, the three-month Treasury yield has fallen sharply in recent weeks, reflecting the strains in short-term credit markets.

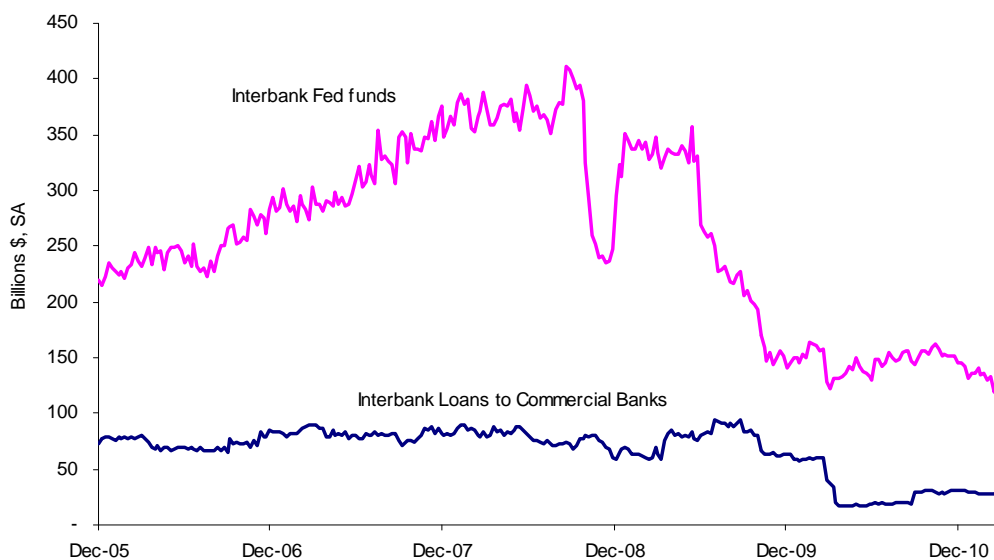
### Three Month T-Bill Rate (last obs. April 5, 2011)



Source: Federal Reserve; Encima Global

- With the Fed funds rate near zero and the Fed paying 0.25% to borrow from banks (well above the rate available in the Fed funds market), there's little incentive for banks to lend to each other. Lending volumes have declined sharply in both the Fed funds market and the direct interbank market.

### Interbank Lending: top line through Fed Funds, bottom line direct interbank market (last obs. March 23, 2011)



Source: Federal Reserve; Encima Global

## Bond Yields Should Rise

Bond yields have stayed very low despite rising gold and inflation risks. In 2009 and 2010, we highlighted the “barbell trade” in which investors bought both gold and Treasury bonds to protect against simultaneous concerns about inflation and deflation.

- We think the bond side of the investment allocation makes little sense under current monetary (and fiscal) policies.

### 10 Yr US Treasury Yield (last obs. April 5, 2011)

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Source: Federal Reserve; Encima Global

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We think dollar-denominated bond yields will resume their uptrend, especially after the debt limit increase, factoring in:

- U.S. and global growth -- we expect second quarter U.S. growth to reaccelerate from the first quarter letdown apparent in the March non-manufacturing ISM; a portion of the letdown was weather-related;
- rapidly rising U.S. headline inflation, which will top 3% by June; and the expected uptrend in core inflation measures (which have a deep lag from dollar weakness, commodities increases and headline inflation);
- negative real interest rates from the Fed;
- increased Treasury issuance once the statutory debt limit is raised in May or June along with the completion of QE2; we think the increase in the debt limit (which must happen

before large payments due in the second half of June) will mark a clear upward turning point in bond yields.

### Baa bond yields (last obs. April 4, 2011)

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Source: Federal Reserve; Encima Global

- If we're wrong and the Fed changes to a less dovish stance, we think the dollar would strengthen (attracting capital to the U.S.) and gold, oil and other commodity prices would fall, adding to U.S. growth. However, recent comments by Fed Chairman Bernanke, NY Fed President Bill Dudley and Fed Vice Chairman Yellen have reiterated the Fed's view that current inflation is temporary, the economy has downside risks and extreme accommodation is appropriate.

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