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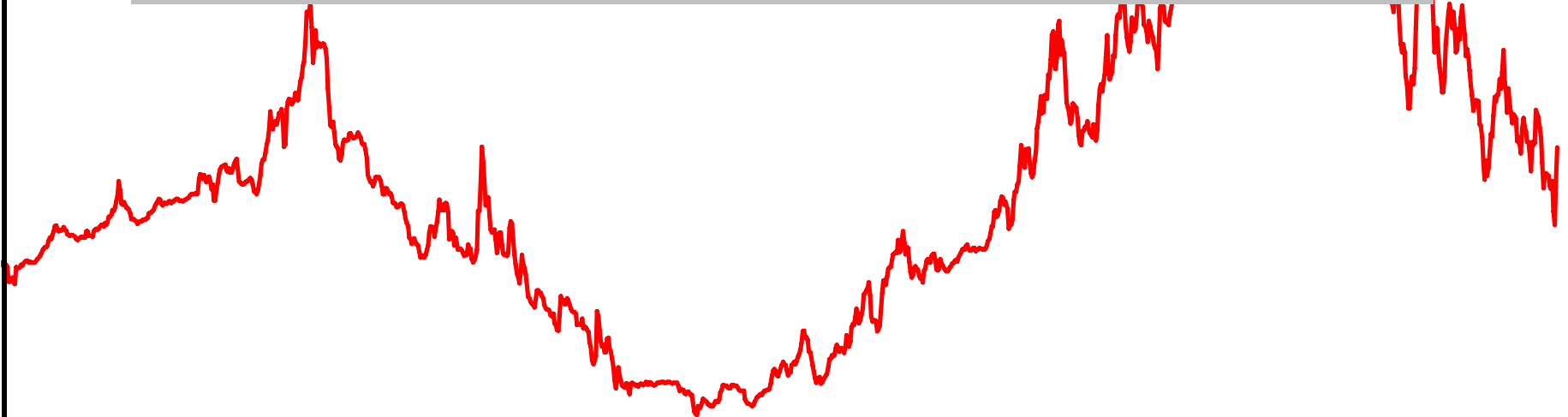
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What Volatility And The Markets Say About The Economy

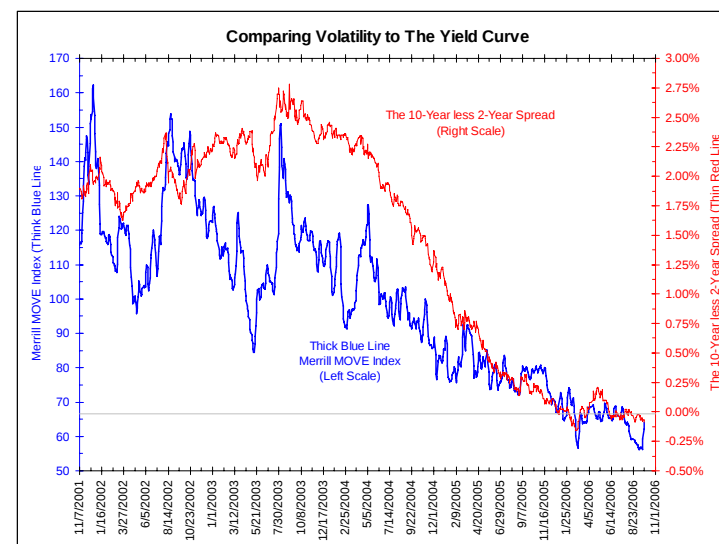
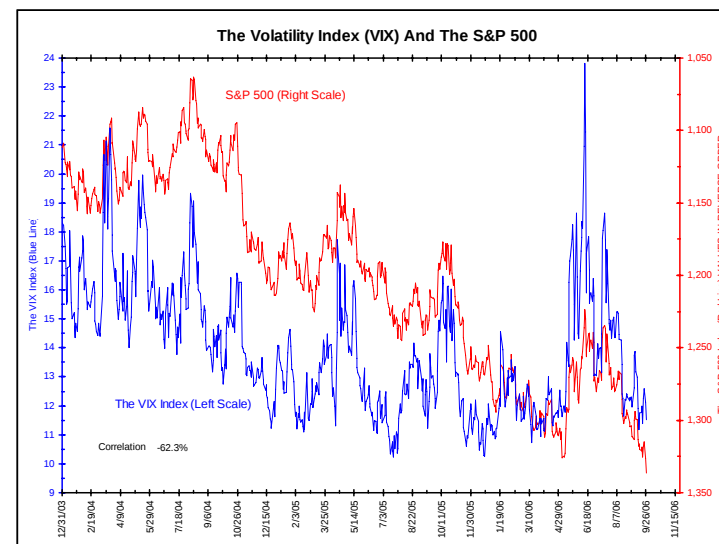
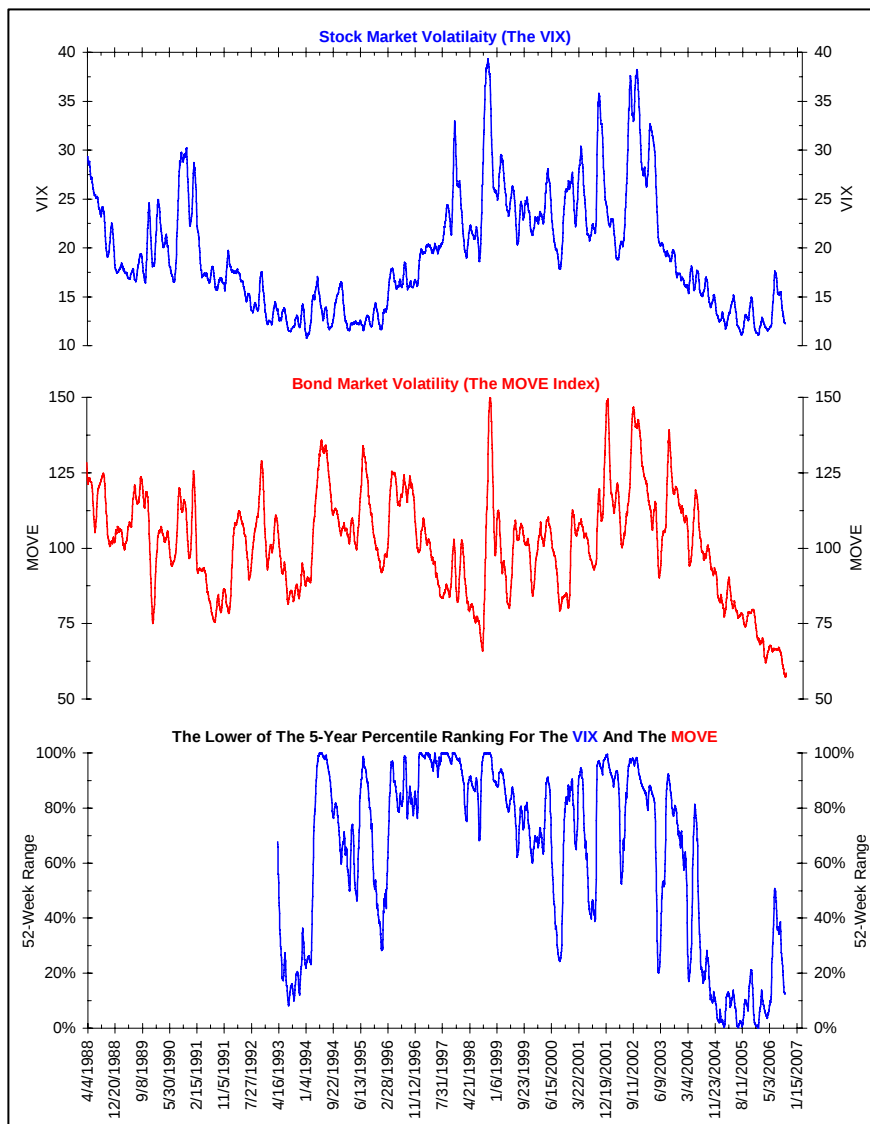
Conference Call Presentation Package

September 28, 2006

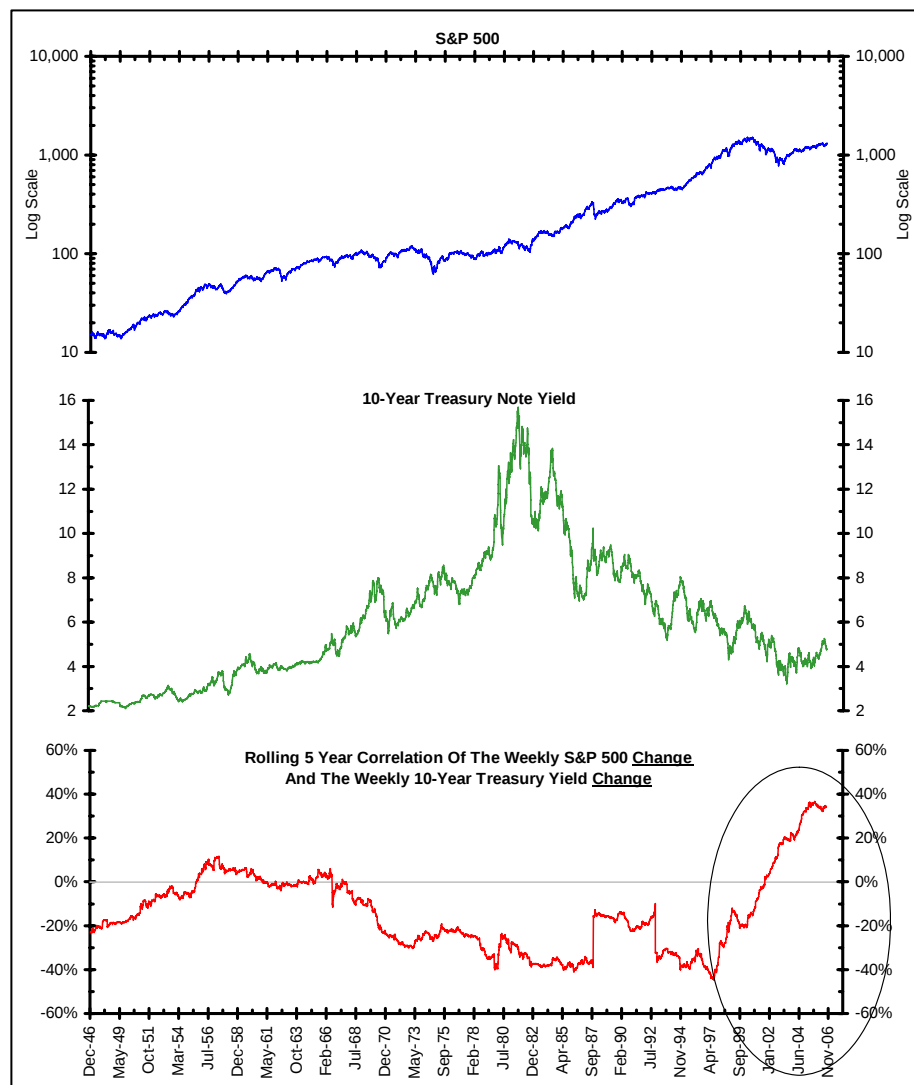


Long-Term Interest Rates - 1900 to 2005

Low Stock And Bond Market Volatility Together



Do Stocks Drive Yields? - 1

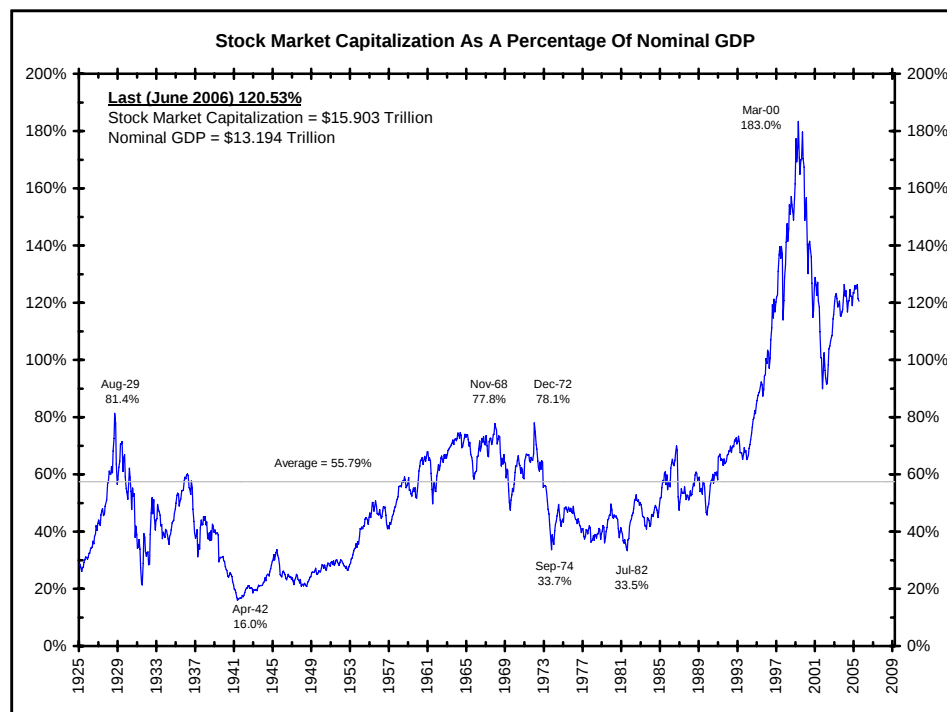


The relationship between stocks and long-term yields has been a fascinating subject to us. It is fascinating in that we have witnessed one of the biggest shifts in the history of finance and very few seem to have noticed, or are interested. As the chart to the left shows, the relationship between stocks and long-term yields changed dramatically in the late 1990s (bottom panel).

As we all learned in business school, falling yields are bullish for stock prices and rising yields are bearish. This is depicted as the negative correlation between the mid 1960s and the late 1990s (bottom panel). While most still think this is the case, the rising correlation of the last several years suggests this is not the case. Now rising stocks are met by rising yields and falling stocks are met by falling yields.

Why is this the case? This is the fascinating part. Few seem to offer a reason, but we have suggested that it is because the stock market has become the most important economic indicator today. It dominates consumer confidence, as we detailed in a May [Special Report](#). It drives homebuilders' views of the housing market, as we detailed in a recent [Market Facts](#).

Do Stocks Drive Yields? - 2

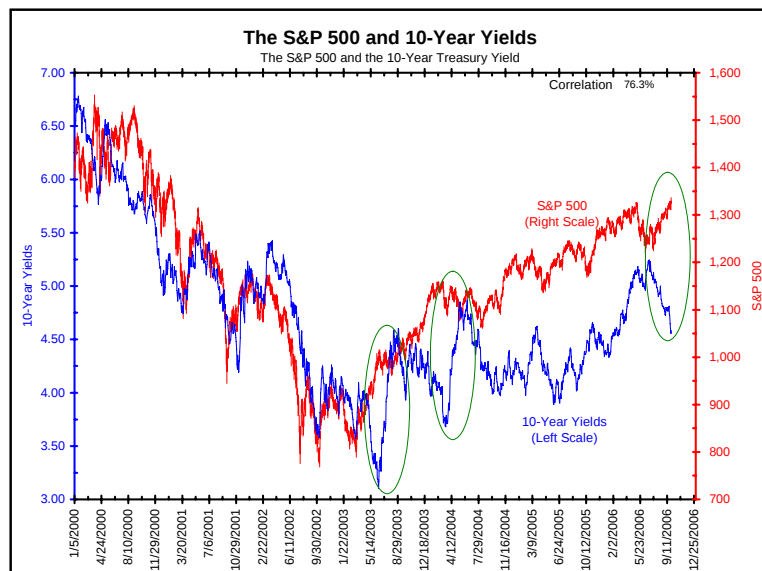


The chart to the left shows the size of the stock market in relation to the size of the economy, the market capitalization to nominal GDP ratio.

At 120% of GDP, the size of the stock market is well off its 2000 peak of 183% of GDP. But, it is much higher than anything we have seen prior to the late 1990s. Or, once the stock market started reaching these lofty levels in the late 1990s, it stopped being a reflection of the economy and became a driver of the economy. At this point the bond market started viewing the stock market as an economic indicator and started reacting to it, much as it reacts to non-farm payrolls.

Under this theory, the stock market drives yields. Higher stock prices are believed to be enough to expand the economy, raise consumer confidence, and put upward pressure on long-term interest rates. Lower stock prices are perceived to be a headwind to the economy, lower consumer confidence, and put downward pressure on long-term interest rates.

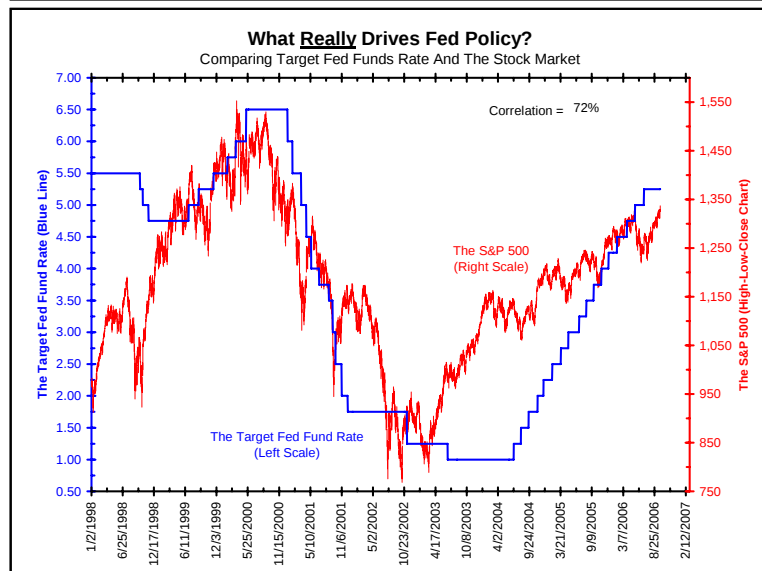
Do Stocks Drive Yields? - 3



Are stocks and bonds reverting back to their pre-1998 relationship? If you believe our theory that it is about the stock market's effect on the economy, the answer is no. That said, as the chart to the upper left shows, there seems to be a divergence in the relationship, as the green ovals show.

What is causing the latest divergence? We believe it's Fed policy and it will not last. Every other time we have seen a divergence in this relationship, it was around a change in Fed policy and lasted only a few months.

In mid-2003 (left-most green oval) the Fed cut the funds rate to 1% and started using forward-looking statements like "considerable period." In mid-2004 (middle green oval), the Fed started raising rates from its "emergency rate" of 1% and said its rate hikes would be measured. Now (right-most green oval) the Fed has paused after 17 consecutive rate hikes.



Are 10-Year Yields Really Low?

The Wall Street Journal - [In a Turnaround, Slowing Economy Spurs Bond Rally](#) Access requires subscription

In one of the bigger surprises in financial markets this year, a growing sense that the economy is slowing and inflation receding is fueling a rally in the nation's bond markets, pushing Treasury-bond yields to their lowest levels in months. The rally -- which started 10 weeks ago and has gained momentum in the past few days -- may help to shape the outlook for both the economy and for investments in coming months. Some doubt the rally will last, but if it does, lower interest rates could help buoy stock prices, make it easier for investors to make potentially risky bets with borrowed money, and ultimately help soften the blow from a weaker economy and a cooling housing market.

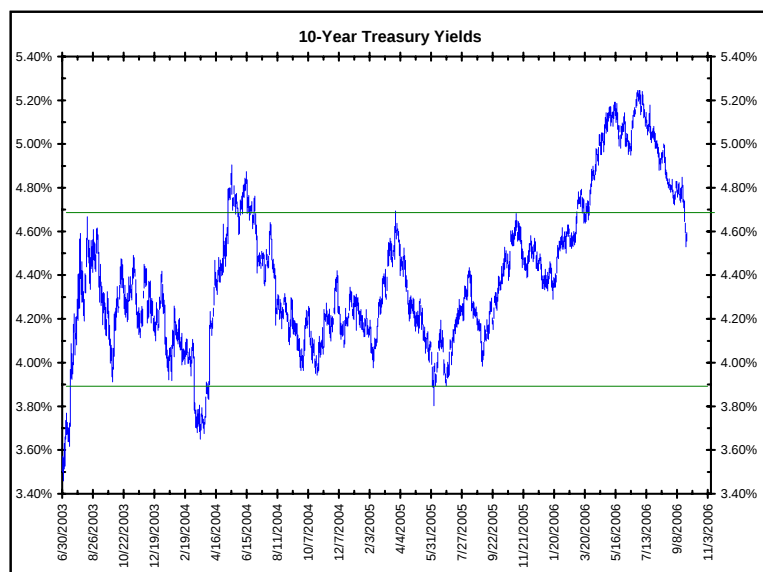
Comment - For the last several years, variations of this story have been written constantly. "The dollar says this", "the stock market is forecasting something" or "the bond market says that." And in the last several years, most of these "messages from the markets" have been wrong. Why? As we stated in a [Market Facts](#) yesterday:

*Markets are not GDP futures. They move up and down for reasons other than the changing outlook for the economy. If the economy is dominating the markets, this message should be consistent across many markets. **This is not the case today.***

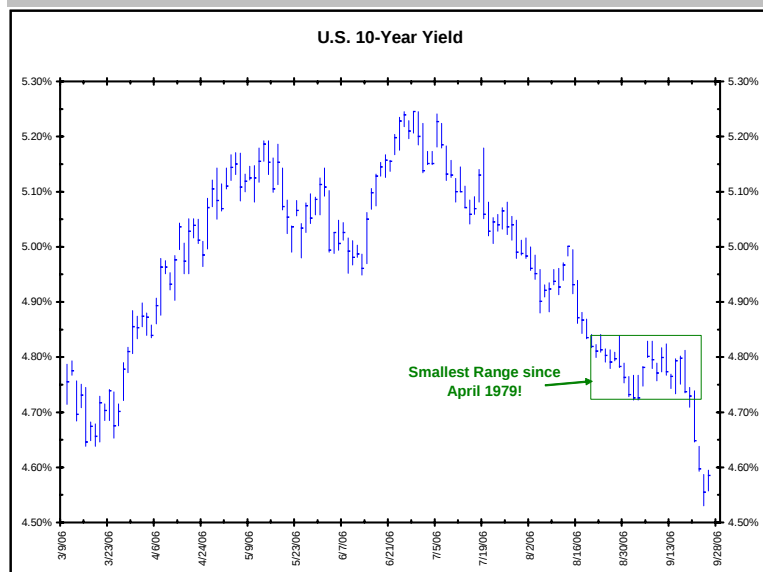
For every argument that a market is saying the economy is slowing, there is an equally compelling argument that it is not. The most compelling argument the economic bears have is the inverted yield curve. The most compelling argument the economic bulls have is a new five-year high in the S&P 500 in the last week. Both are among the 10 components of the LEI.

Or, to put it another way, what is *The Wall Street Journal* trying to tell us the day that the S&P 500 makes a new five-year high by highlighting falling bond yields and saying it means the economy is slowing? Are they telling us that the stock market "doesn't count?"

Lastly, look at the chart to the left; if you think bond yields are "low" now, what were they saying in mid-2003, spring-2004 and mid-2005? I do not seem to recall the recessions they forecasted back then.

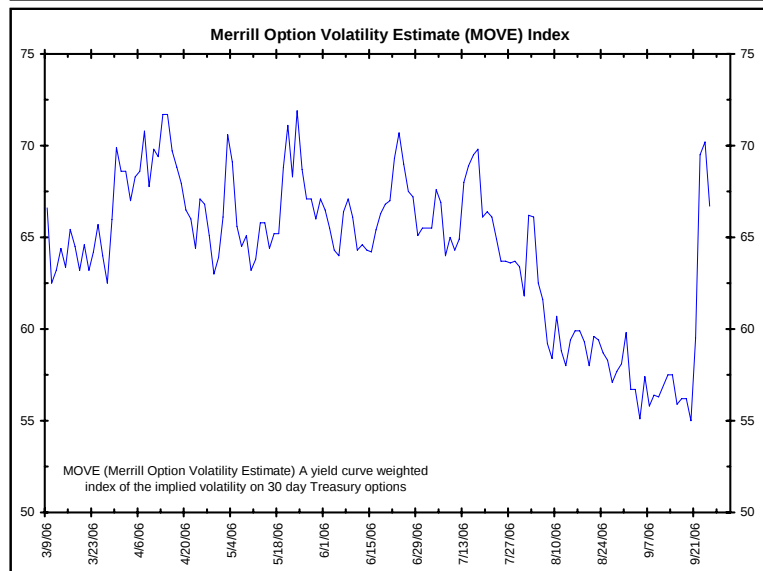


The Bond Market Noticed The Tight Range!



In the bond market, never has so much been written about so little. During the first three weeks of September we were overwhelmed with commentary about the "big moves", "shocking surprises" and how the "violent reactions" in bonds suggested that the market has re-assessed the long-term outlook for the economy, inflation and humanity.

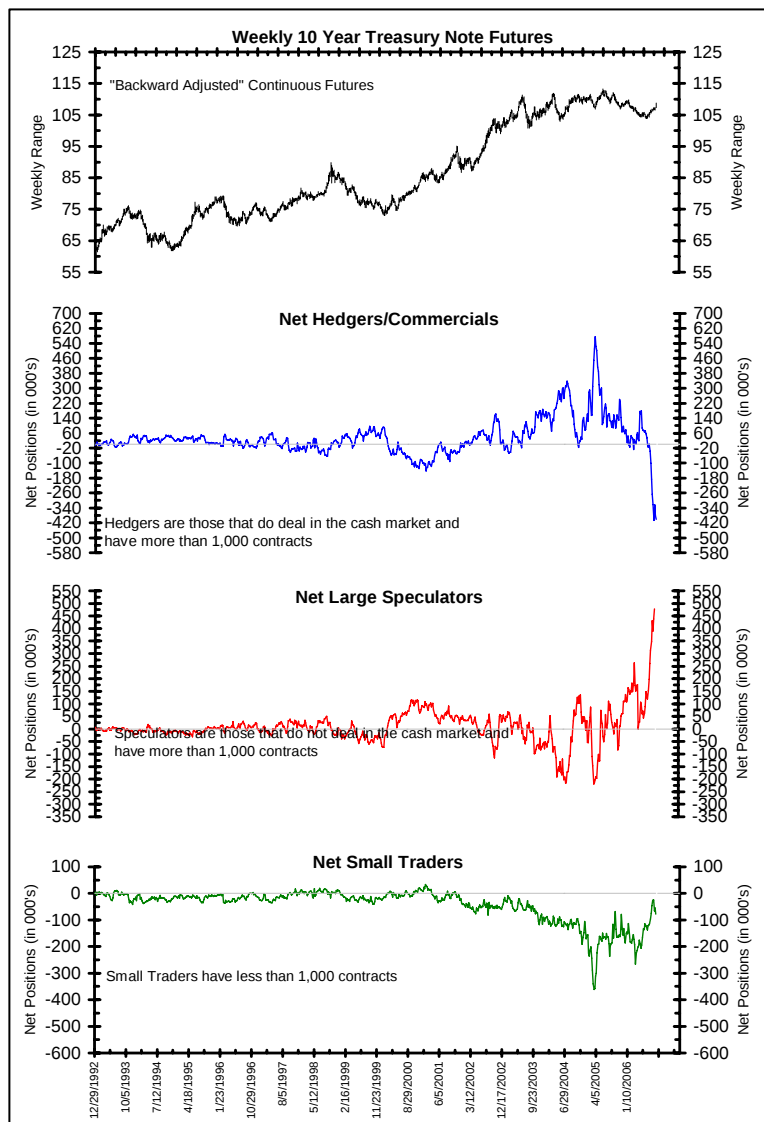
As the top chart shows (green rectangle), the last 22 trading days between August 22 and September 21 saw the 10-year yield close within a tiny eight basis point trading range. This is the smallest 22 day trading range for the closing yield of the 10-year note since April 1979! Or, to put it another way; if you are a bond manager and had to pick a month in your career to completely ignore the market, this last month was the time to do it. Nothing happened!



Virtually no one notice or commented on this small trading range. Rather, during this trading range every new low, measured to the third or fourth decimal point, was looked upon as upon as further evidence that the economy was slowing.

The bond market sure noticed. It appears it had grown accustomed to this trading range, and when it broke, volatility spiked in a big way. This suggests the recent move lower was technical in nature and not the bond market sending a message that the economy is slowing.

Bullishness From Speculators To Economists

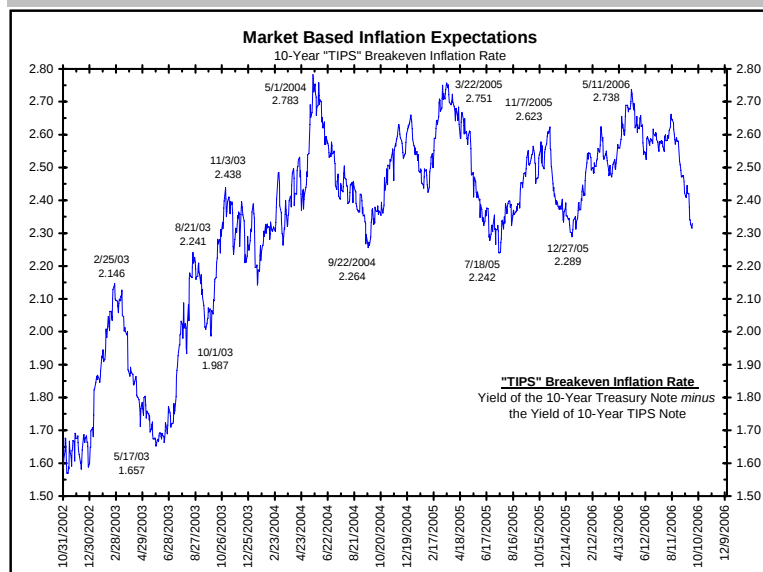


Bearishness Is Moderating

Results From Bloomberg's Monthly Economist Survey For The 10-Year Treasury Yield

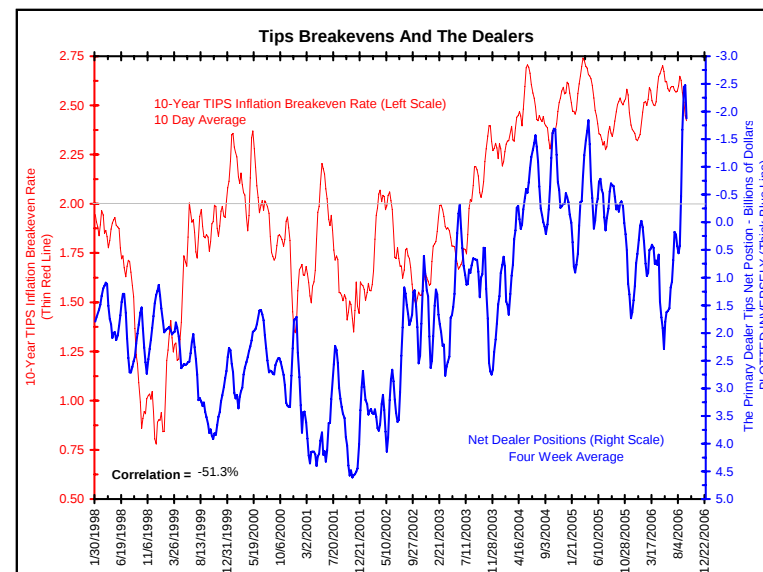
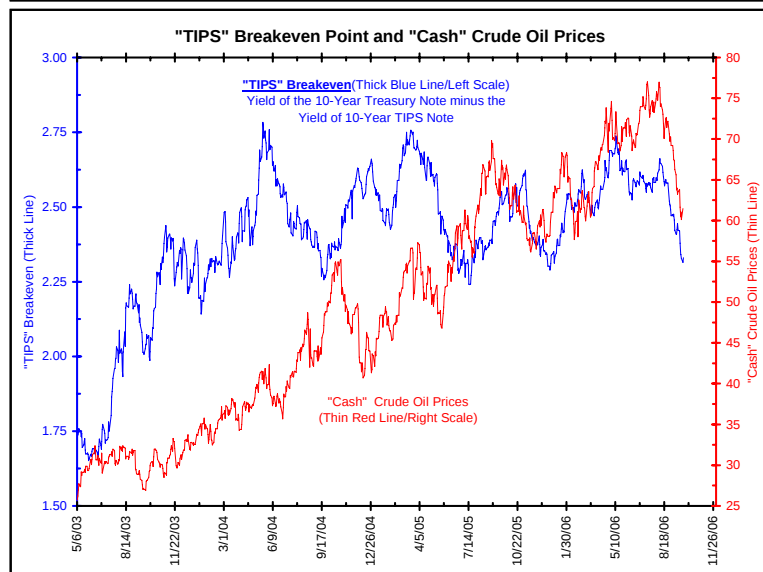
Survey Date	10-Year Yield	Median Forecast 6-Months (2 Qrts) Foreword		Number of Econ. Surveyed	% Expecting Higher Lower Rates		Highest Forecast	Lowest Forecast
		Level	Change		Rates	Rates		
17-Dec-02	4.12%	4.40%	0.28%	64	94%	6%	5.10%	3.40%
24-Mar-03	3.97%	4.25%	0.28%	65	83%	17%	5.20%	2.80%
8-May-03	3.68%	4.40%	0.72%	57	93%	7%	5.20%	3.65%
9-Jun-03	3.27%	3.80%	0.53%	51	90%	10%	5.00%	2.75%
2-Jul-03	3.54%	3.90%	0.36%	53	83%	17%	4.90%	2.95%
8-Aug-03	4.27%	4.40%	0.13%	51	67%	33%	5.70%	3.70%
9-Sep-03	4.36%	4.70%	0.35%	57	77%	23%	5.70%	3.60%
6-Oct-03	4.17%	4.50%	0.33%	55	91%	9%	5.80%	3.50%
4-Nov-03	4.30%	4.53%	0.24%	54	89%	11%	5.10%	3.50%
8-Dec-03	4.27%	4.55%	0.28%	61	92%	8%	5.10%	3.60%
7-Jan-04	4.24%	4.70%	0.46%	55	93%	7%	5.50%	4.00%
9-Feb-04	4.05%	4.40%	0.35%	59	100%	0%	5.10%	4.10%
9-Mar-04	3.97%	4.50%	0.53%	67	97%	3%	5.25%	3.75%
6-Apr-04	3.91%	4.50%	0.59%	72	96%	4%	5.25%	3.60%
3-May-04	4.49%	4.70%	0.21%	72	90%	10%	5.10%	4.25%
8-Jun-04	4.65%	5.20%	0.55%	51	96%	4%	5.65%	4.45%
7-Jul-04	4.46%	5.10%	0.64%	53	98%	2%	6.00%	4.44%
9-Aug-04	4.40%	5.00%	0.60%	54	96%	4%	5.70%	3.90%
9-Sep-04	4.20%	4.90%	0.71%	59	96%	4%	5.90%	4.00%
13-Oct-04	4.06%	4.69%	0.63%	60	95%	5%	5.70%	3.80%
9-Nov-04	4.07%	4.50%	0.43%	62	92%	8%	5.50%	2.80%
9-Dec-04	4.22%	4.78%	0.56%	62	98%	2%	5.60%	4.10%
10-Jan-05	4.27%	4.70%	0.43%	66	97%	3%	6.00%	3.80%
9-Feb-05	4.13%	4.55%	0.43%	72	98%	2%	5.25%	4.00%
9-Mar-05	4.34%	4.75%	0.41%	63	98%	2%	5.35%	4.30%
8-Apr-05	4.43%	4.90%	0.47%	63	97%	3%	6.50%	4.09%
6-May-05	4.19%	4.75%	0.56%	61	100%	0%	5.25%	4.35%
9-Jun-05	3.93%	4.60%	0.67%	61	95%	5%	5.40%	3.80%
12-Jul-05	4.06%	4.50%	0.44%	66	94%	6%	5.50%	3.85%
9-Aug-05	4.32%	4.80%	0.48%	65	89%	11%	5.65%	3.70%
14-Sep-05	4.09%	4.60%	0.51%	57	96%	4%	5.50%	3.70%
11-Oct-05	4.35%	4.70%	0.35%	71	93%	7%	5.65%	3.90%
9-Nov-05	4.57%	4.90%	0.33%	63	90%	10%	5.60%	4.00%
9-Dec-05	4.52%	4.90%	0.38%	69	87%	13%	5.75%	4.00%
10-Jan-06	4.43%	4.73%	0.30%	70	93%	7%	5.50%	4.15%
9-Feb-06	4.53%	4.80%	0.27%	74	82%	18%	5.50%	4.25%
8-Mar-06	4.63%	4.90%	0.27%	70	77%	23%	5.75%	4.15%
11-Apr-06	5.00%	5.05%	0.05%	77	69%	31%	5.75%	4.20%
9-May-06	5.10%	5.21%	0.11%	80	70%	30%	5.75%	4.30%
8-Jun-06	5.03%	5.28%	0.25%	66	74%	26%	6.00%	4.35%
12-Jul-06	5.12%	5.29%	0.17%	62	77%	23%	6.00%	4.35%
11-Aug-06	4.95%	5.20%	0.25%	69	70%	30%	6.10%	3.75%
8-Sep-06	4.76%	5.00%	0.24%	77	51%	49%	6.05%	4.25%

TIPS Inflation Breakeven Rates

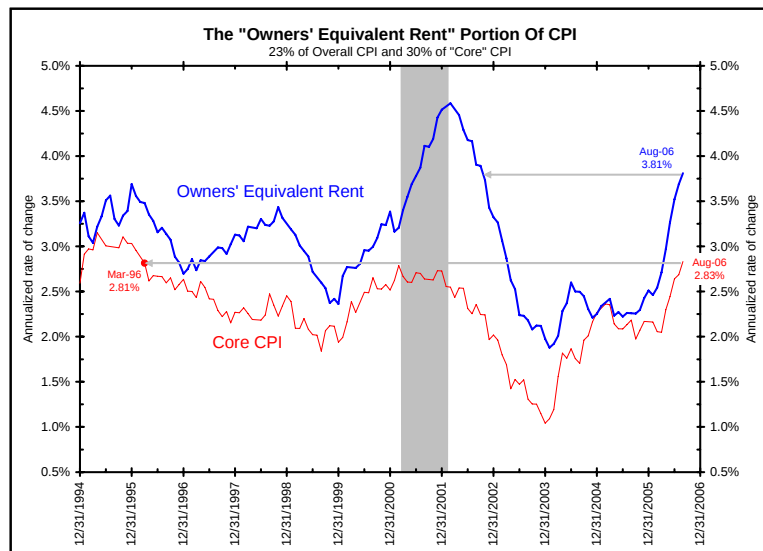


Finally, inflation expectations also play an important role in determining the message of the markets. Lately, inflation expectations have been falling and many have reasoned this means the economy is going to slow. However, as the chart below shows, inflation expectations have only fallen to the lower end of their range of the last few years. Such a move is not significant when interpreting what it means for the economy.

TIPS breakeven inflation rates are priced off of overall CPI (or "headline" inflation). A significant component of this is energy prices. The recent 20% slump in crude oil prices combined with the inverted yield curve can account for the bulk, if not all, of the decline in inflation expectations. Furthermore, as we argued above, the recent decline in crude oil has been fairly typical for the last few years. The same can be said of the decline in inflation expectations; it is only at the bottom of its recent range. Could TIPS breakeven inflation rates be telling us that crude oil's decline is nothing special?



Will Weak Housing Cause *Higher* Core Inflation?



As the charts on the top left shows (OER) is 30% of core CPI. The recent surge in OER has driven core inflation to a **new ten-year high**.

A survey of rentals is used to impute housing inflation. The problem with this measure is it is contra-cyclical to the housing cycle. That is, when housing is strong, demand for [rentals wanes](#) and OER falls. This happened between 2002 and 2004 when core CPI fell to near 1%. The Federal Reserve responded to this drop in core inflation by cutting rates to 1.00% and openly worrying about deflation.

Conversely, with housing weakening, the [demand for rentals is strong](#). This is raising OER and driving up core inflation. The Federal Reserve had responded to rising core inflation by increasing short-term interest rates continuously through the June FOMC meeting.

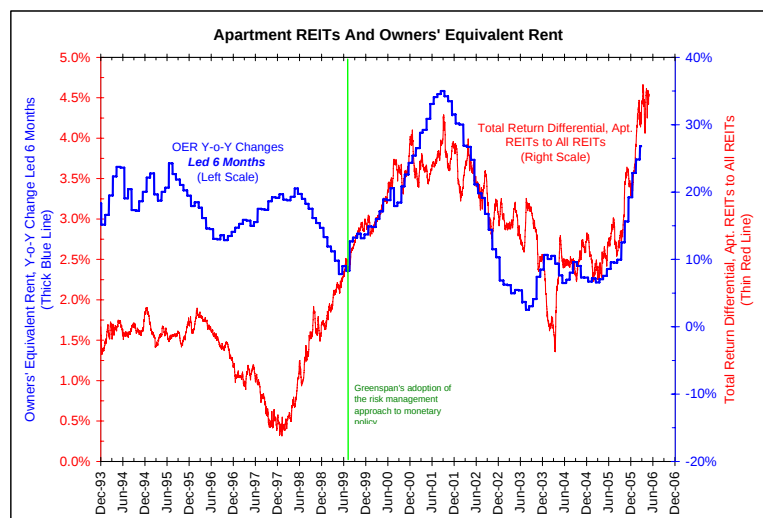
If housing continues to weaken, and shifts demand back to rentals, this might not only weaken real growth, **but keep core inflation moving higher**. Given weak real growth and higher core inflation, what would the Federal Reserve do? We believe they would respond to the inflation data and raise rates again.

But the Federal Reserve has said repeatedly core inflation will fall in the months ahead. We cite the [minutes](#) of the August 8th FOMC meeting:

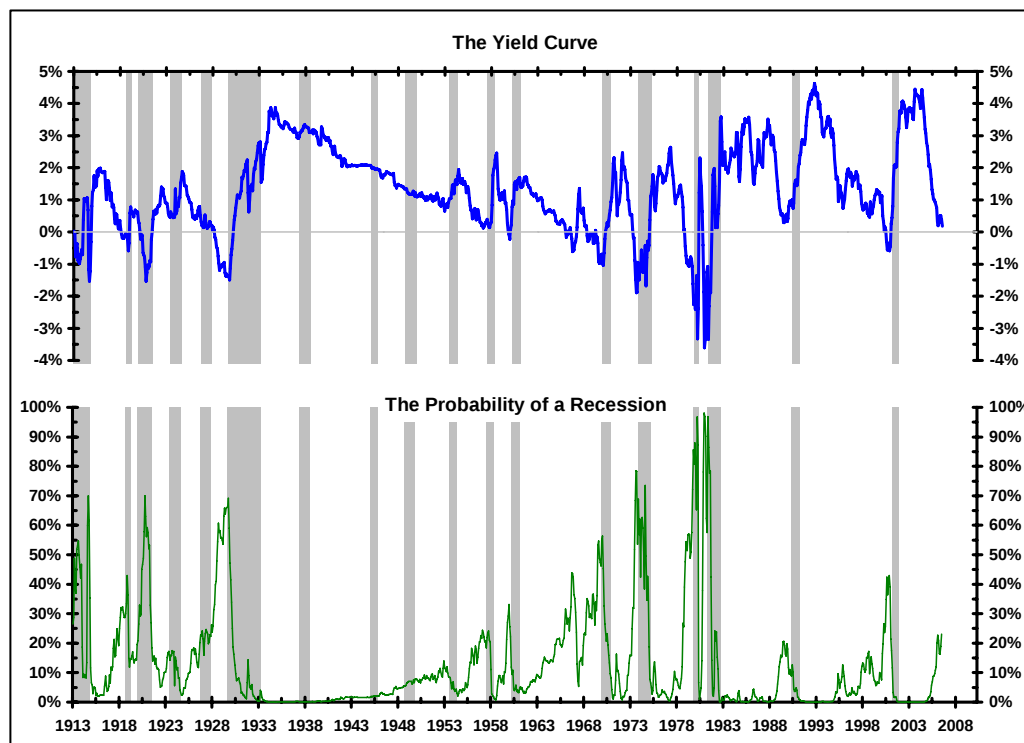
The recent acceleration in shelter costs, which contributed substantially to the increase in core inflation this year, could prove short-lived.

They said it without offering any idea how it will fall. The [chart to the lower left](#) shows OER (blue line) and the relative performance of Apartment REITs to all REITs (red line). When apartment REITs are outperforming (rising red line), OER rises. When apartment REITs underperform (falling red line), OER falls.

The relative performance of apartment REITs lead OER by six months. Its recent strong performance has yet to be reflected in OER.



The Yield Curve Predicting Recessions - 1

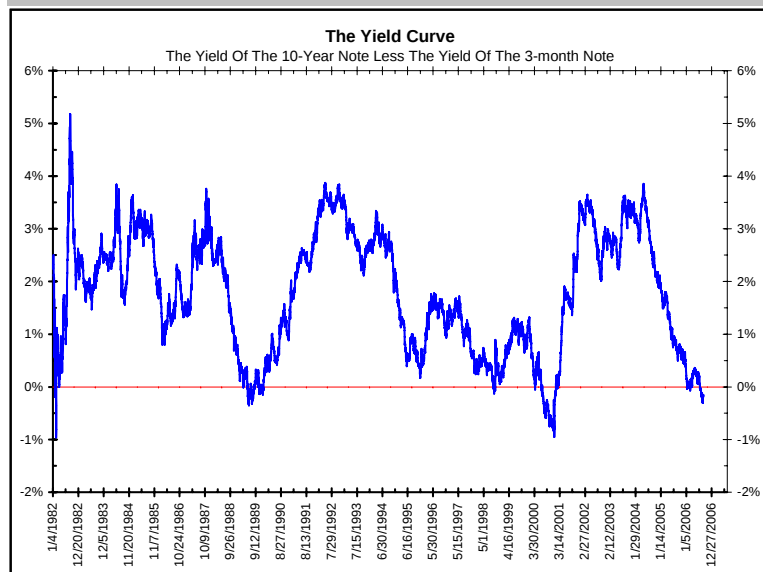


The Federal Reserve of New York recently published a paper entitled [The Yield Curve as a Leading Indicator: Some Practical Issues](#) wherein the yield curve was used as a 12-month-ahead predictor of recessions. The model calculated the probability of a recession based on the yield curve alone. The top panel to the left shows the yield curve and the bottom panel shows the probability of a recession. The shaded areas are observed recessions.

At first blush it is indeed an impressive indicator. While it has given many "false negative" readings (recessions when the probabilities were low, see the 1930s), it has never given a "false positive" (no recession when the probabilities were high).

Many economists are looking at this indicator and arguing that a recession is a near-certainty in the next year. And given the history of this indicator, it hard to argue against it.

The Yield Curve Predicting Recessions - 2



(continued from the previous page)

So what is there to argue about this indicator? We wonder if this is the correct yield curve to use.

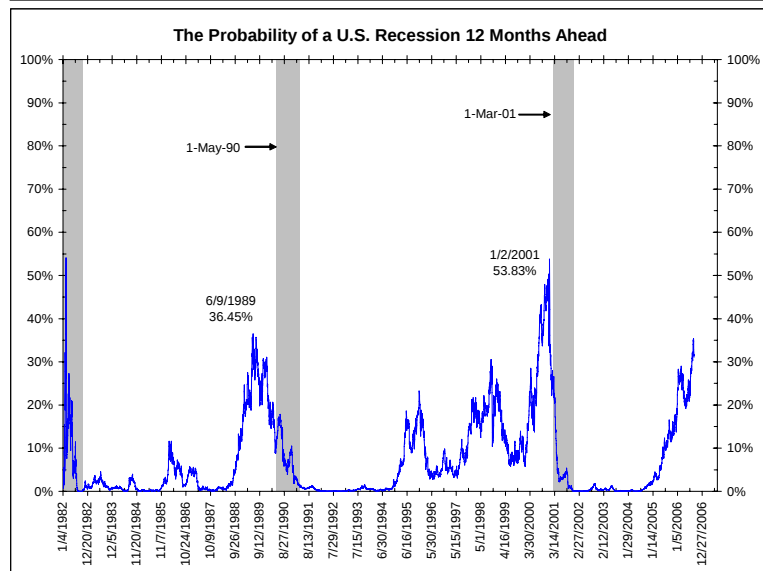
If short-term rates are the cost of funding, then which short-term rate should we use? Is it the federal funds rate or can financial institutions fund themselves in any currency that offers a lower rate? We believe the latter to be true; we need only look at the yen carry trade and Japanese short-term rates near 0.25% to argue thus.

Further, how much does it cost to finance at the 10-year rate? This may sound like a trick question but the swaps market now allows corporations to "term out" to any maturity and change their fixed borrowing costs to the lowest ones offered on the yield curve.

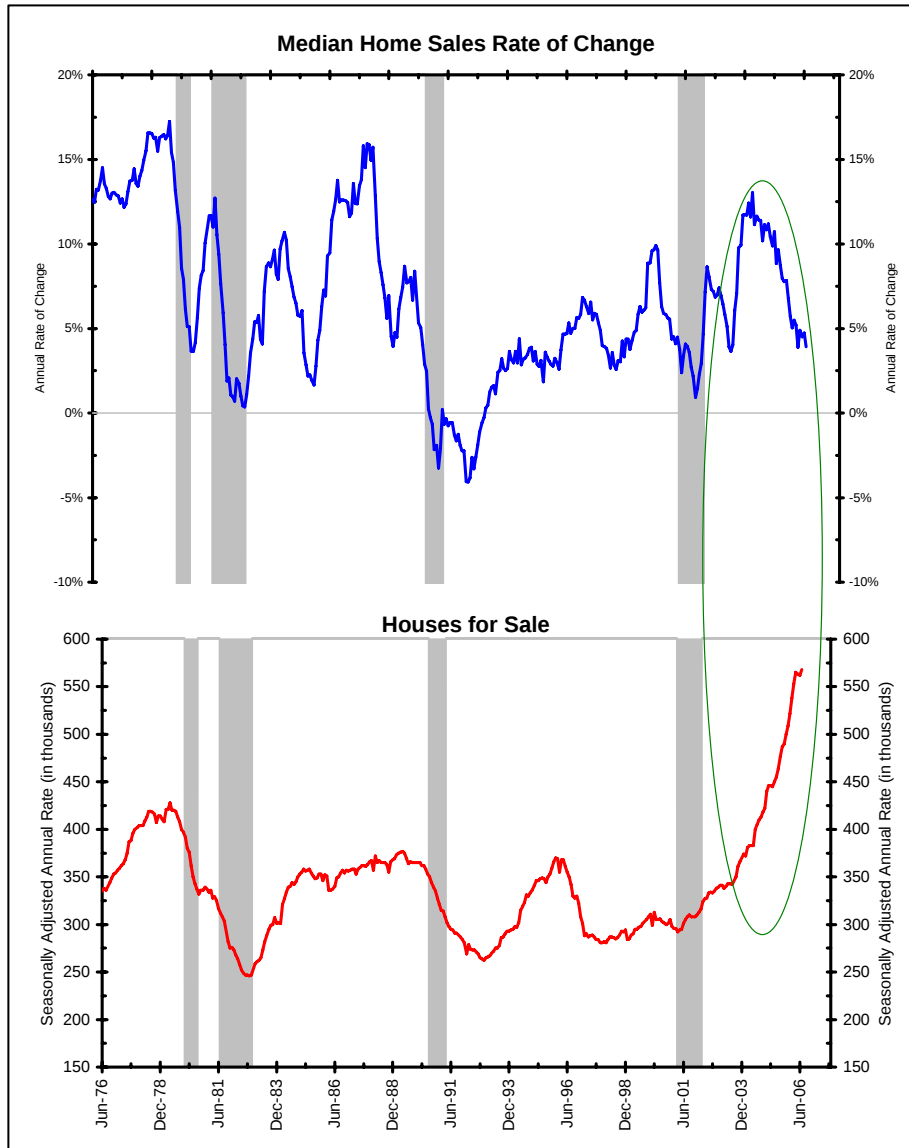
What we are arguing is financial innovations and global markets have rendered a single-currency static yield curve irrelevant. The FRBNY's single-factor model is based on history now inoperative.

If it sounds like we are arguing "this time is different," we are. The ability to borrow yen or some other currency and term them out in the swap market is different now than it was in 1982 for the simple reason such a market was not then extant.

This is not a forecast that the yield curve is going to be wrong so much as a statement; "let's think twice before we accept this at face value."

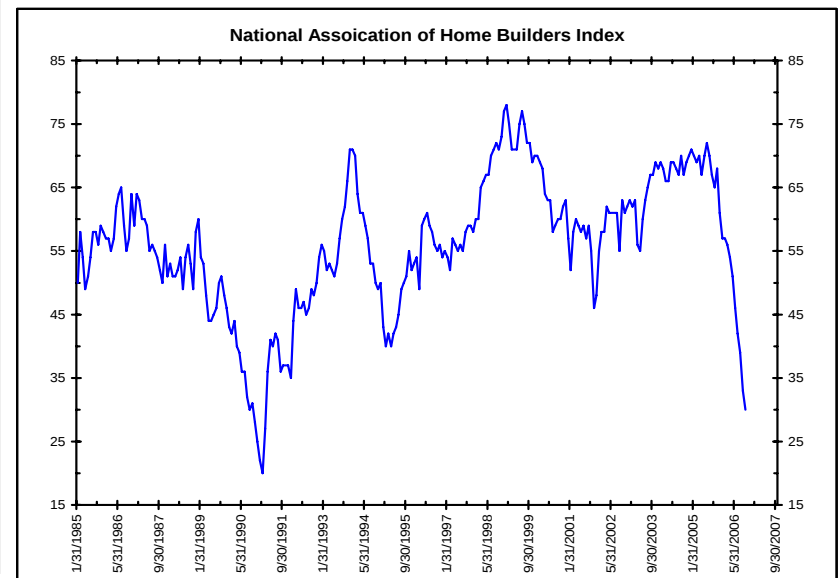


Real Estate – The Downside



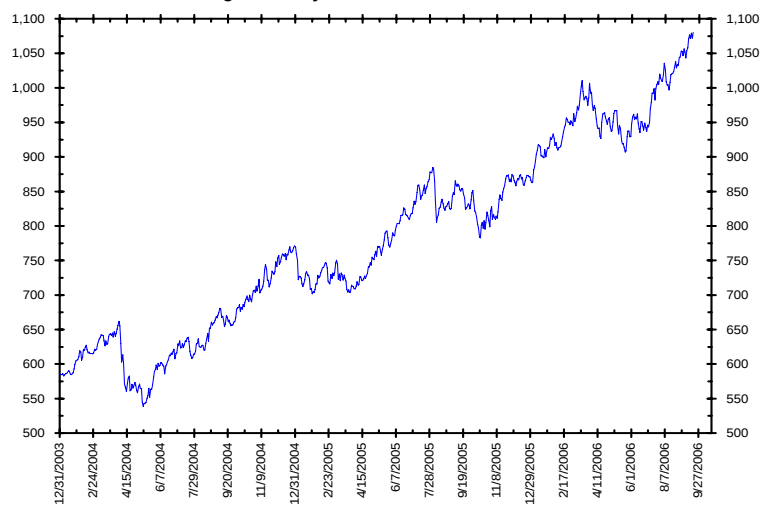
These charts show that home prices are moderating (median home sales) as inventory (houses for sale) rises. They also show homebuilders are very pessimistic about their prospects. We argued in an August [Market Facts](#) this is more a measure of homebuilders' stock prices than future activity.

While these charts paint a troubling picture for housing, other market-based measures for real estate suggest otherwise.



Real Estate – The “Ok” News

The Morgan Stanley Real Estate Investment Trust Index

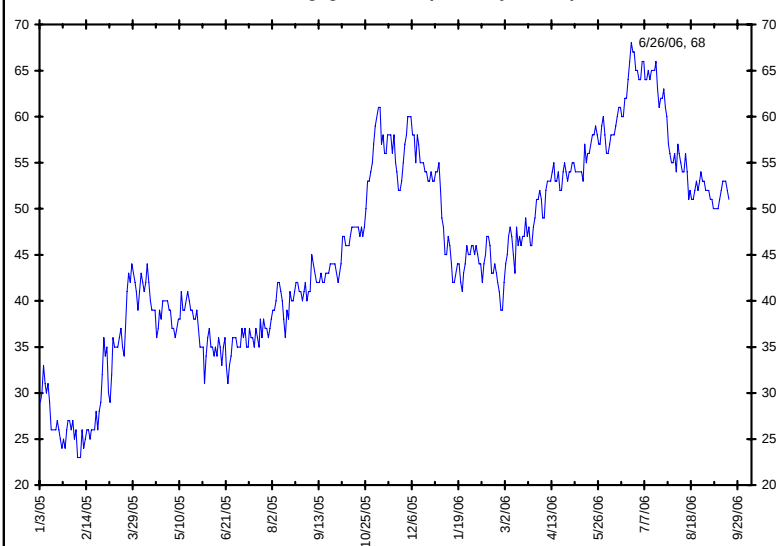


The Morgan Stanley index of real estate investment trusts (left) is a good measure of the market's opinion about the ability of commercial real estate to maintain rising total returns. It would be difficult to extract a negative message from this chart.

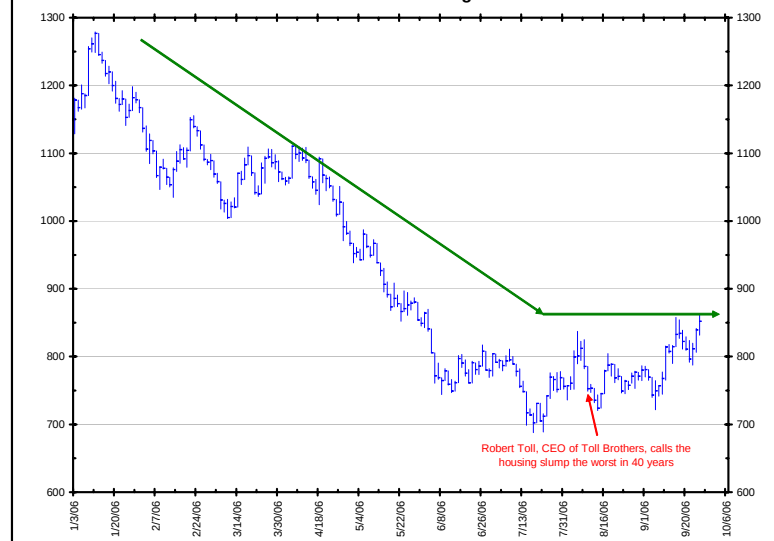
Despite gloom and doom about housing, the spreads in mortgage-backed securities (bottom left) have been narrowing since June. Furthermore, they are not significantly wider than the levels seen during the so-called “frothy” period of spring/summer 2005.

Finally, we would argue that homebuilding stocks (below) are looking like they are bottoming. Admittedly, this is somewhat subjective, but the green arrows below highlight the fact that the long slide in housing stocks appears to have ended. Also, contrarians will note that the low in housing stocks was timed perfectly by Robert Toll, CEO of the nation's largest homebuilder, Toll Brothers. On August 9th, he called the housing market the worst he has seen in 40 years.

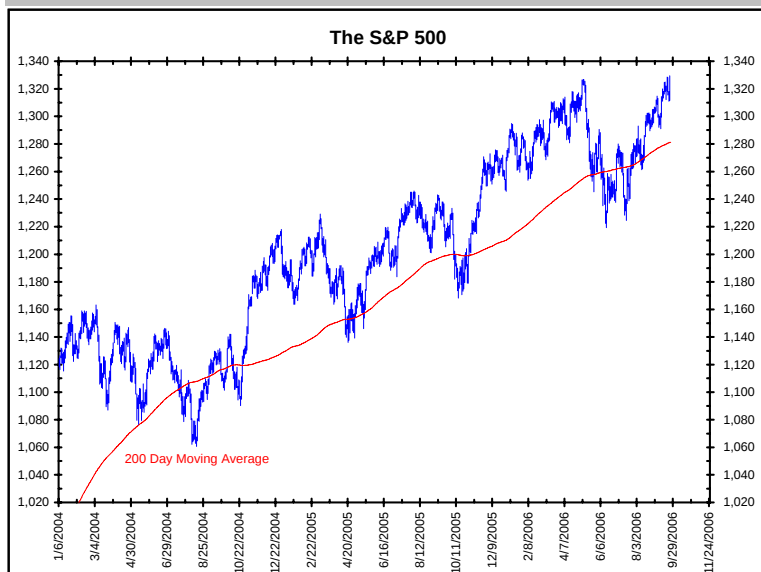
The Merrill Mortgage Master Option Adjusted Spread



S&P 500 Homebuilding Index



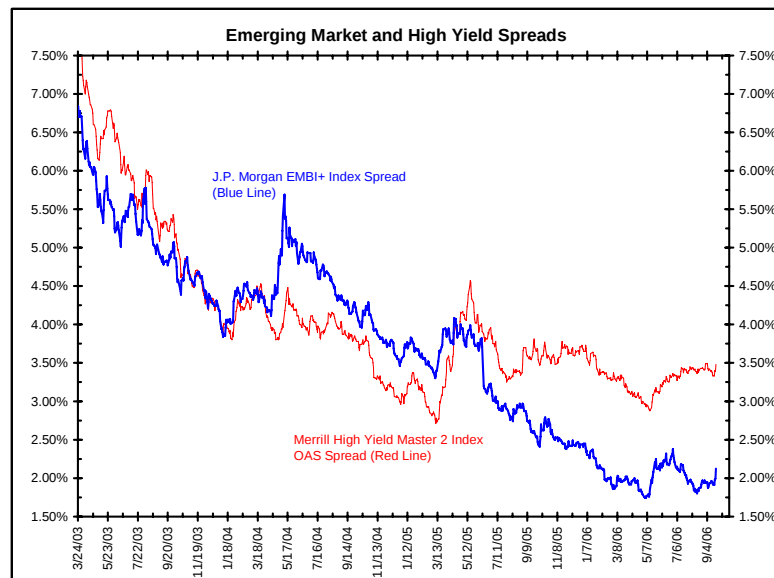
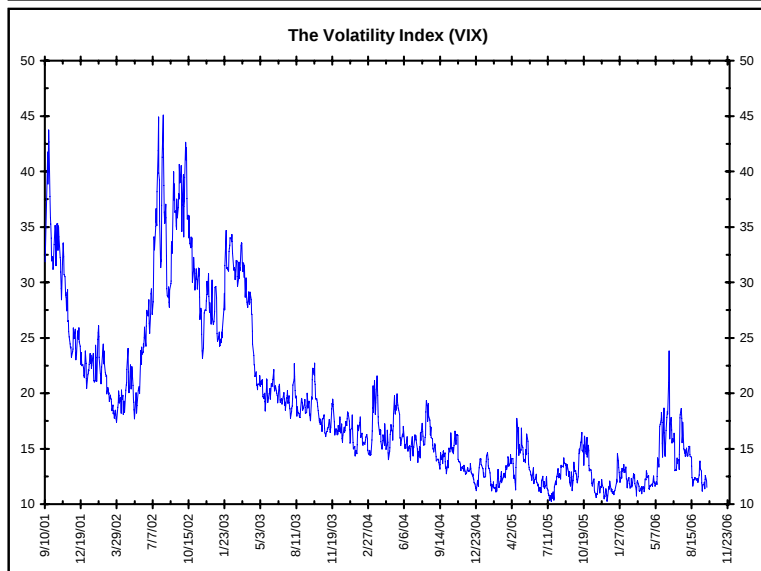
Stocks And Credit – No Economic Worries Here



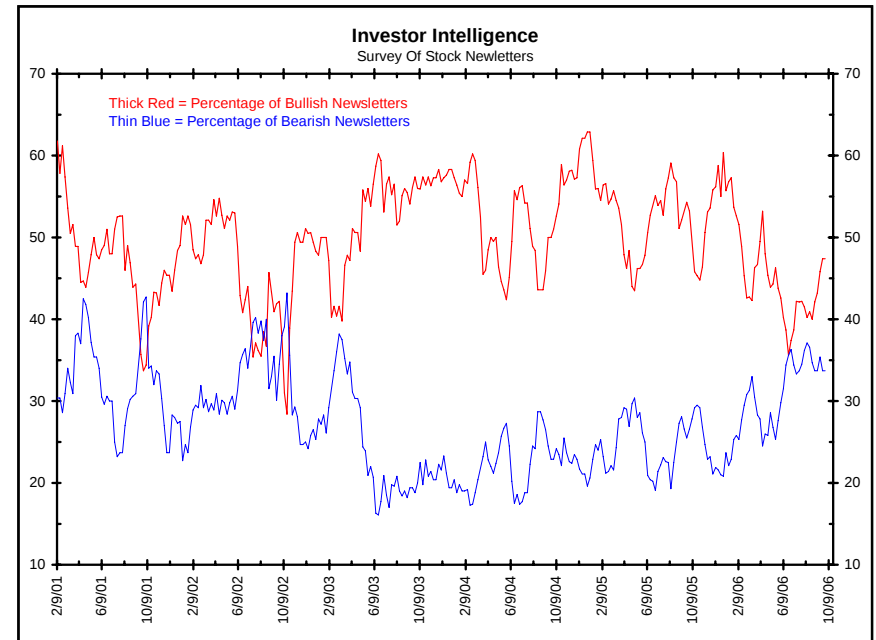
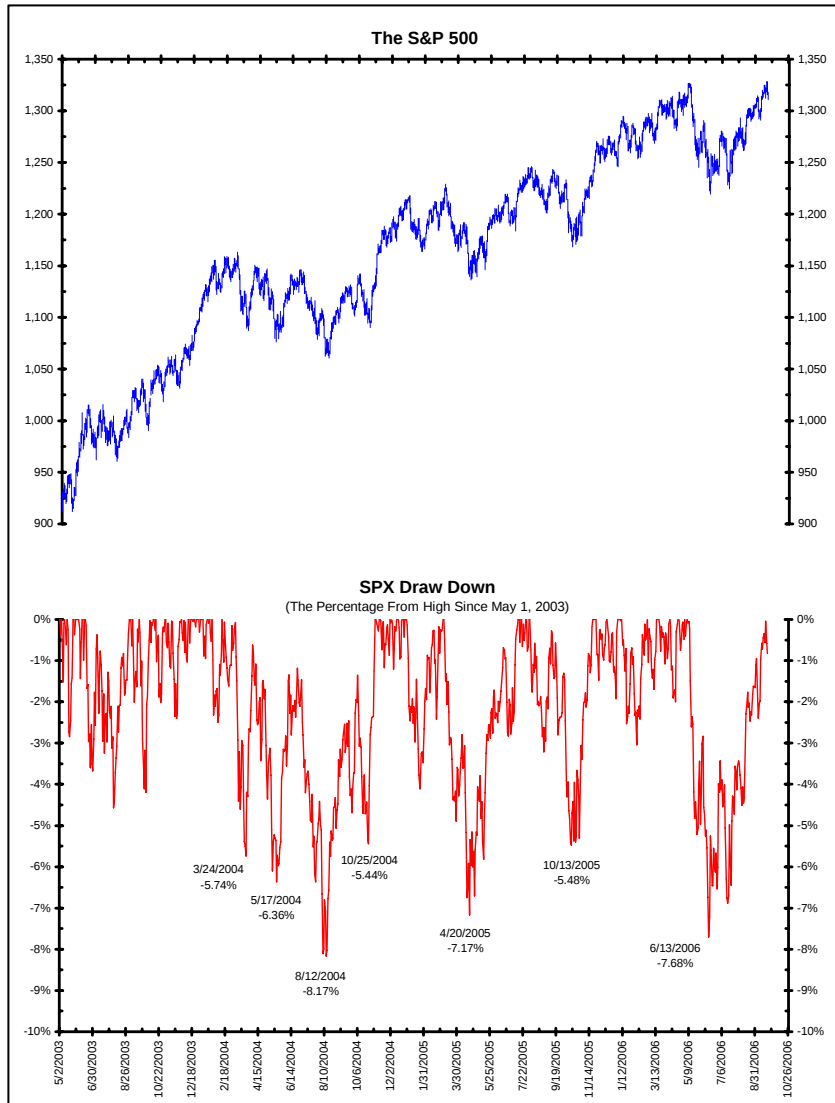
The S&P 500 (left) is one of the 10 components in the index of leading economic indicators (LEI). Its ability to predict the economy, while not perfect, is better than most other markets/indicators. As the chart shows, after a weak spring, the S&P 500 moved into an uptrend and made new five-year highs in the last week. This is hardly the action one would expect if an economic slowdown were coming.

Additionally, a popular measure of risk, the VIX index (bottom left), is near its recent lows; this suggests little fear in the marketplace.

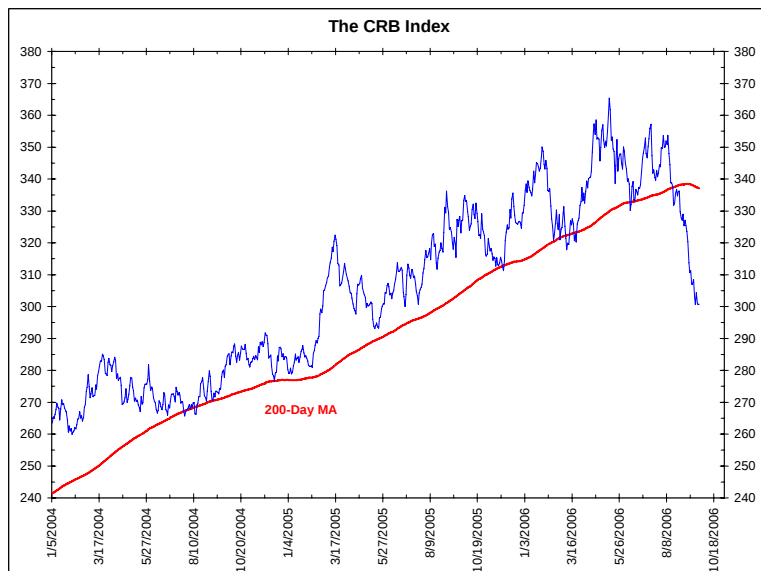
Finally, credit and emerging market spreads (below) are also supposed to be sensitive to changes in the economic outlook. However, as the chart below shows, these spreads have remained relatively tight this year. This suggests little fear of an economic slowdown from these markets.



The Case For Stocks



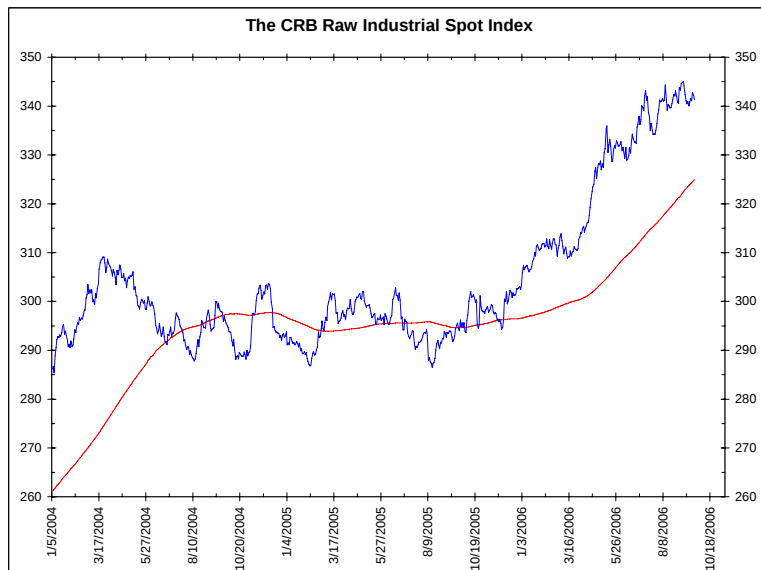
Commodities – Two Very Different Paths



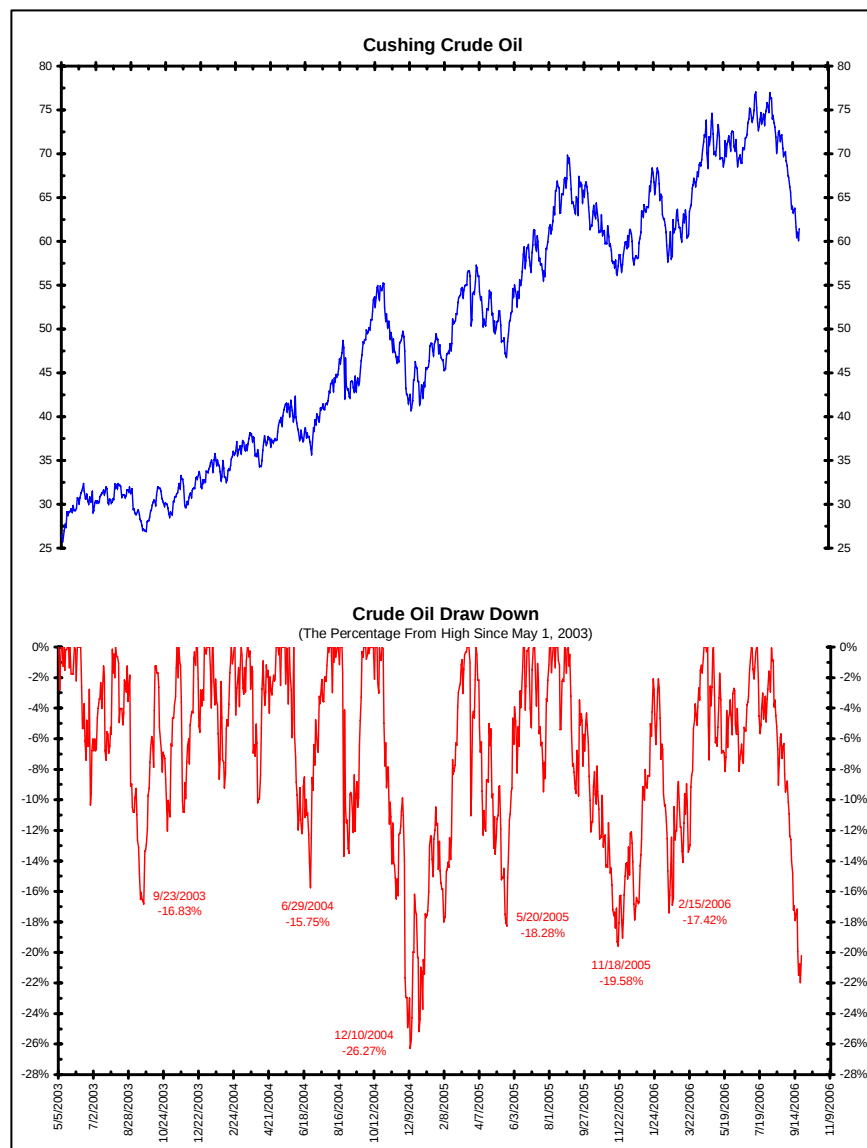
This is another sector that is giving the economic bears hope. As the chart below shows, the Reuters/Jefferies CRB index is now mired in its biggest slump in almost five years. Such a move is consistent with an economic slump.

However, the CRB index is an index of commodities that underlie futures contracts. As we argued in a March 2005 [Commentary](#), the popularity of long-only commodity index funds has been distorting the movements of commodities with actively traded futures contracts.

If, however, we look at an index of commodities less associated with active futures trading, such as the CRB Raw Industrial Spot index (below), the picture is very different. If commodities were slumping because of economic weakness, these prices should be falling, not continuing to rise.



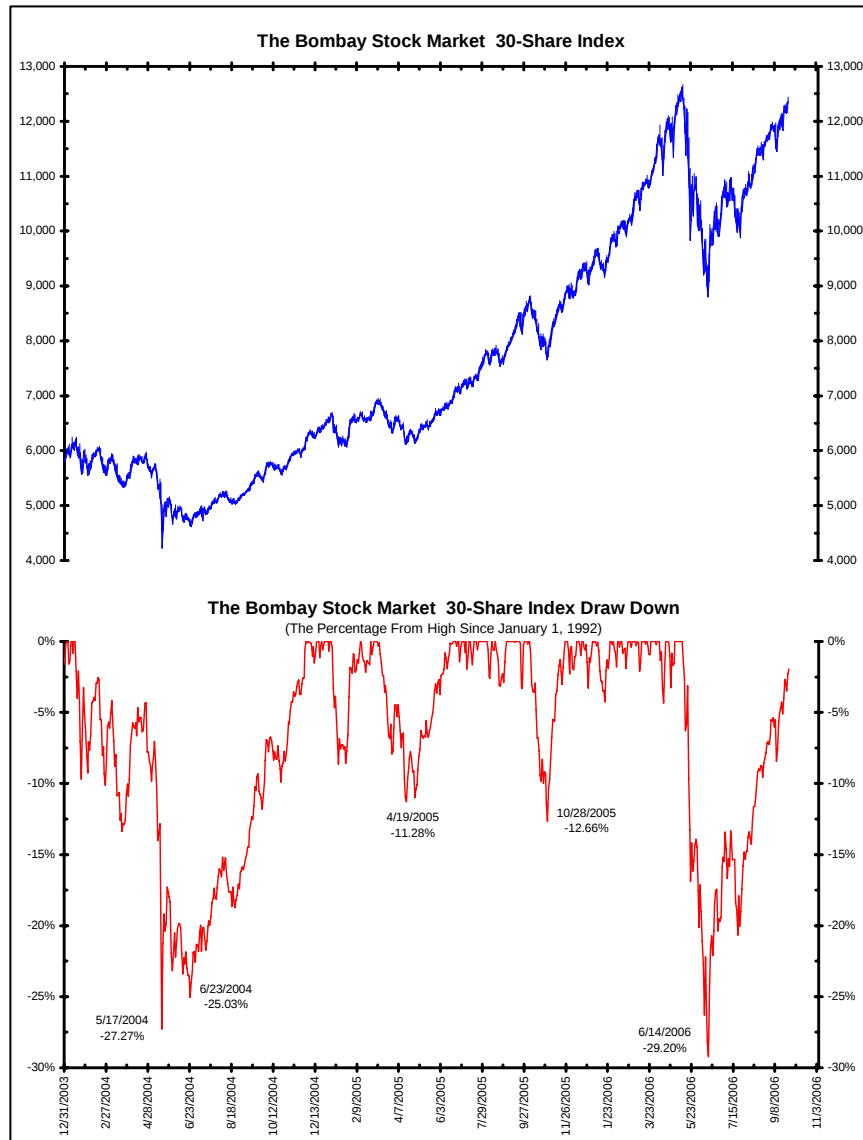
Crude Oil – Seven Bear Markets, Or None?



Finally, no discussion of commodities would be complete without talking about crude oil prices. Lately the press has been dominated by talk that crude oil is in a "bona fide bear market." However, as the chart shows, crude oil appears to be in a fairly typical correction.

This is the seventh time in the last three years that crude oil has corrected more than 15%. One of these corrections saw crude decline as much as 26%. We do not recall these numerous declines as prices have recovered to new highs following each decline.

Remember Four Months Ago, When EM Was “Dead”



Reuters (May 22) - [India's stocks recover after largest-ever fall](#)

Police patrol lakes, canals in India for suicidal brokers following 10 percent stock plunge.

Indian police are watching out for possible suicides by brokers and investors after a steep market slide wiped out billions of dollars in share values, officials said on Monday. . . "A financial crisis can trigger suicides. We are just trying to prevent them. Till now, no such cases have been reported," said R.K. Patel, a police official in the western city of Ahmedabad.

Comment - One of the biggest myths is that the 1929 and 1987 stock market crashes caused many suicides. To this day, many still believe that traders and brokers jumped out of their windows after totaling their losses those days. Historians have investigated and have not been able to document a single suicide attributed to the either crash.*

As the chart to the left shows, the Bombay stock market has recovered almost all of its losses of just four months ago (losses that were so devastating that brokers were killing themselves).

** A few have remarked that the great speculator of the early 20th century, Jesse Livermore, committed suicide following the 1929 crash. He did commit suicide after the '29 crash, 11 years after (on November 28, 1940 in the Sherry-Netherland Hotel)! It is his story with the dates conveniently forgotten that keeps people believing suicides are common when the market declines.*

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