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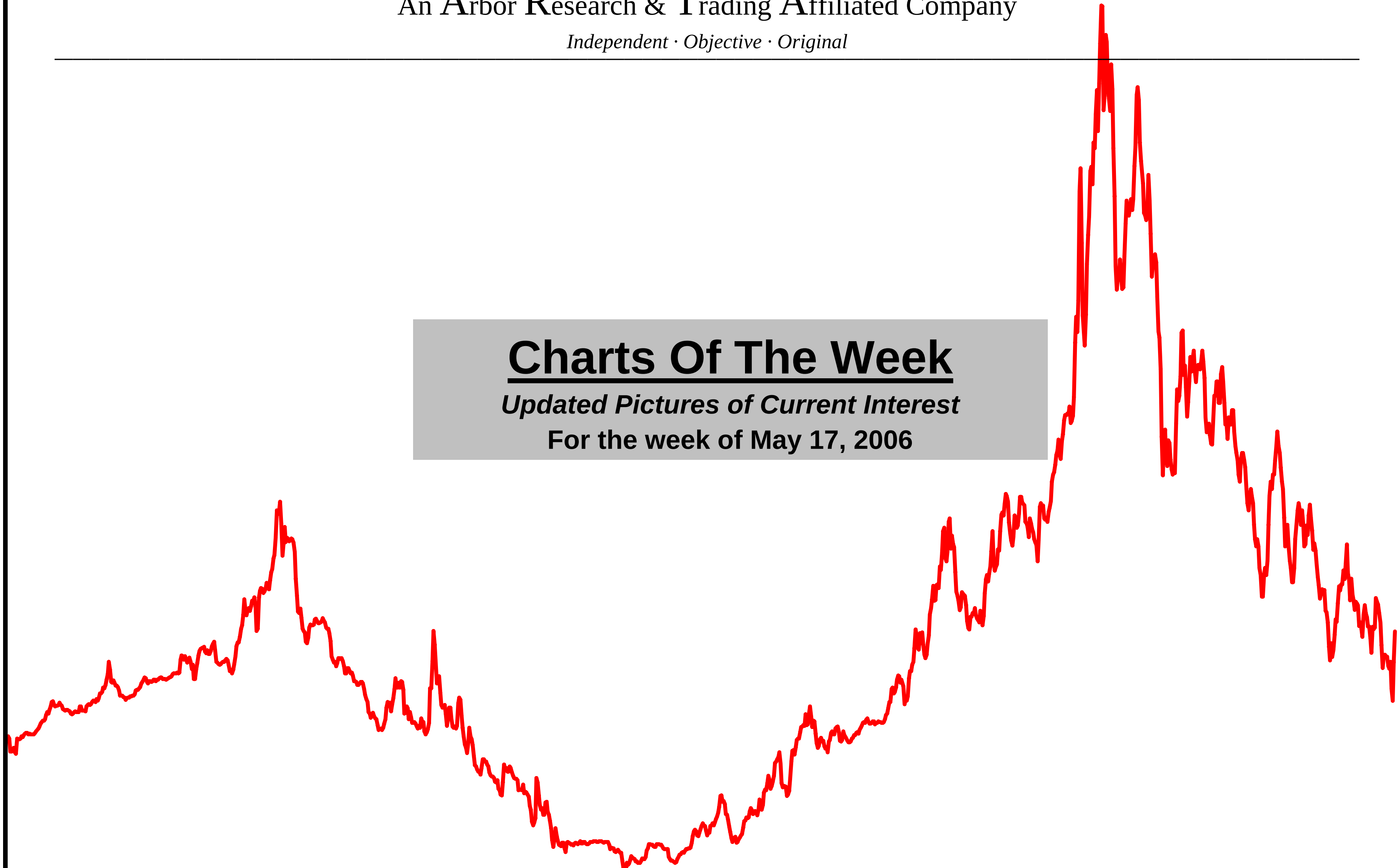
Charts Of The Week

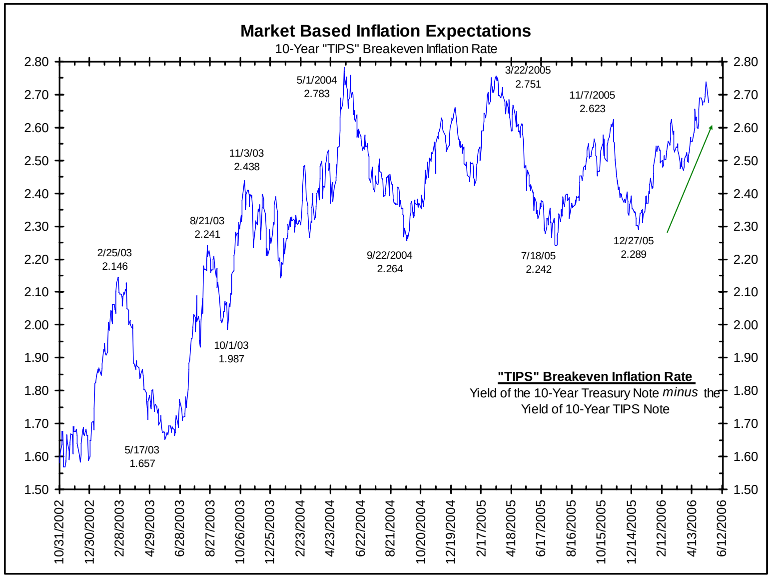
Updated Pictures of Current Interest

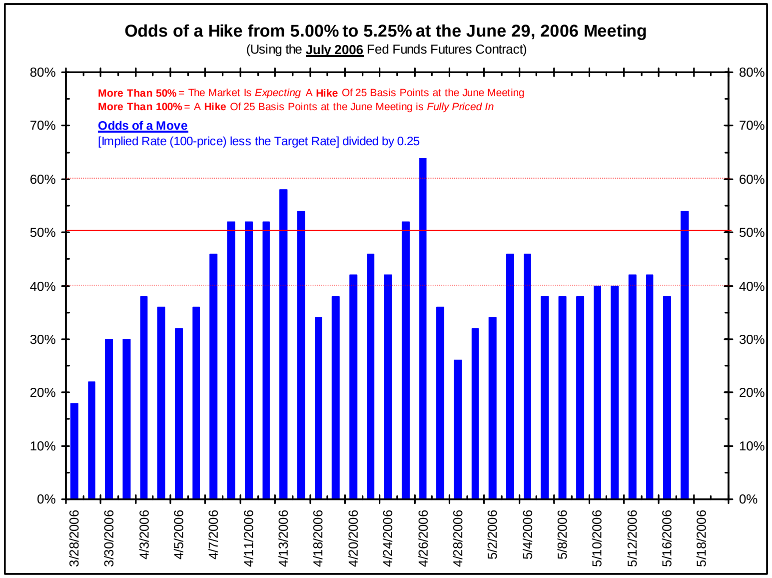
For the week of May 17, 2006



Long-Term Interest Rates - 1900 to 2005

Inflation Drives Fed Policy For Now





From This Month's Inflation Watch Update

It is our belief that the Federal Reserve has been grasping for any reason it can find to stop hiking rates. They have wanted to stop since January when they dropped the word "measured" from their statements and have hinted at this fact repeatedly. However, the economic data, stock market and booming commodities have not given them an opening to stop.

In last month's Inflation Watch Update, we detailed that both Core CPI and Core PCE, the two inflation measures most commonly used by the Fed, are nearing the upper bound of the range that the FOMC probably deems acceptable (between 1.00% and 2.50%). Combine this with the already dovish image Bernanke has and the markets believe this is a recipe for disaster. Their fears have been confirmed by a rising TIPS breakeven inflation rate throughout this year, shown in the first chart on the next page.

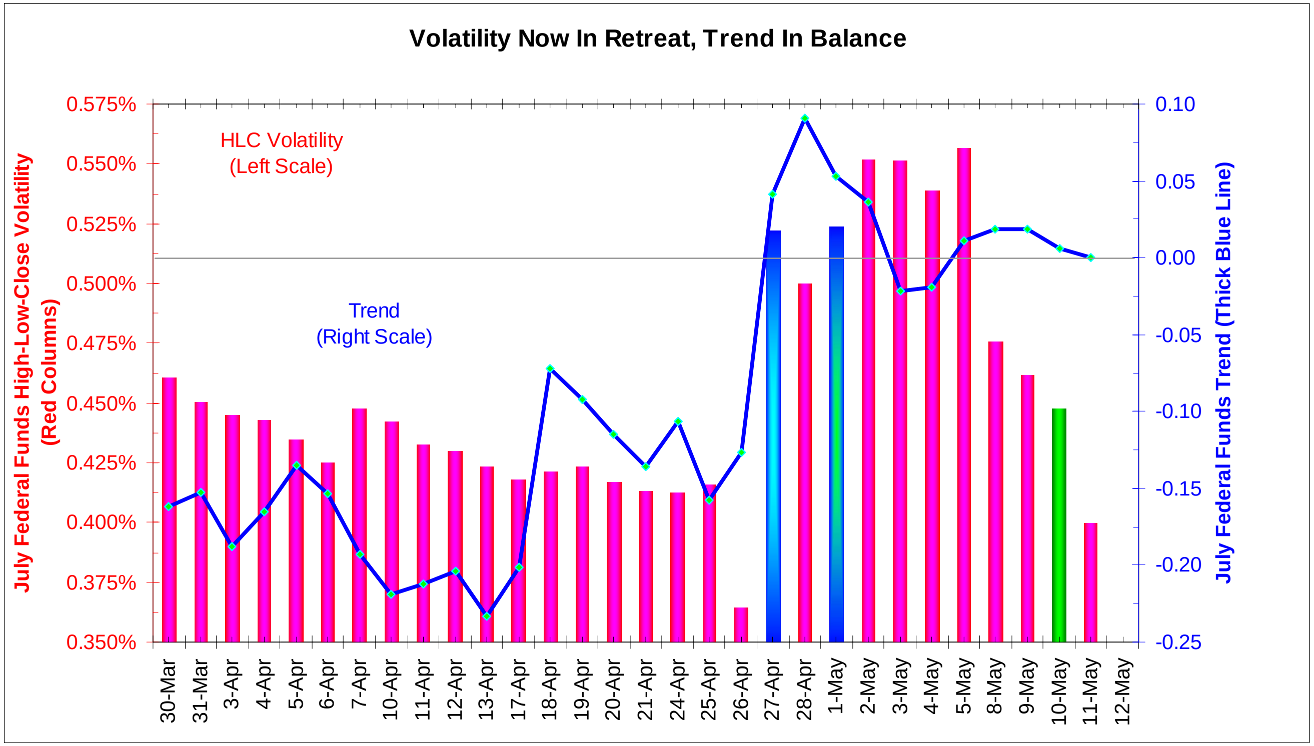
Today's higher-than-expected CPI release may have just shut the door on any chance the FOMC had to pause at the June 29 meeting. As the second chart below shows, the odds of a hike at this meeting moved from 38% as of yesterdays close to 54% upon release of the CPI statistics. Unless the economic data over the next 31 trading days shows signs of a drastically slowing economy, these odds should not change materially and we would expect Bernanke to heed to the market's concerns, hiking the funds rate to 5.25% on June 29.

When Uncertainty Becomes Certain

From Our Latest Market Facts

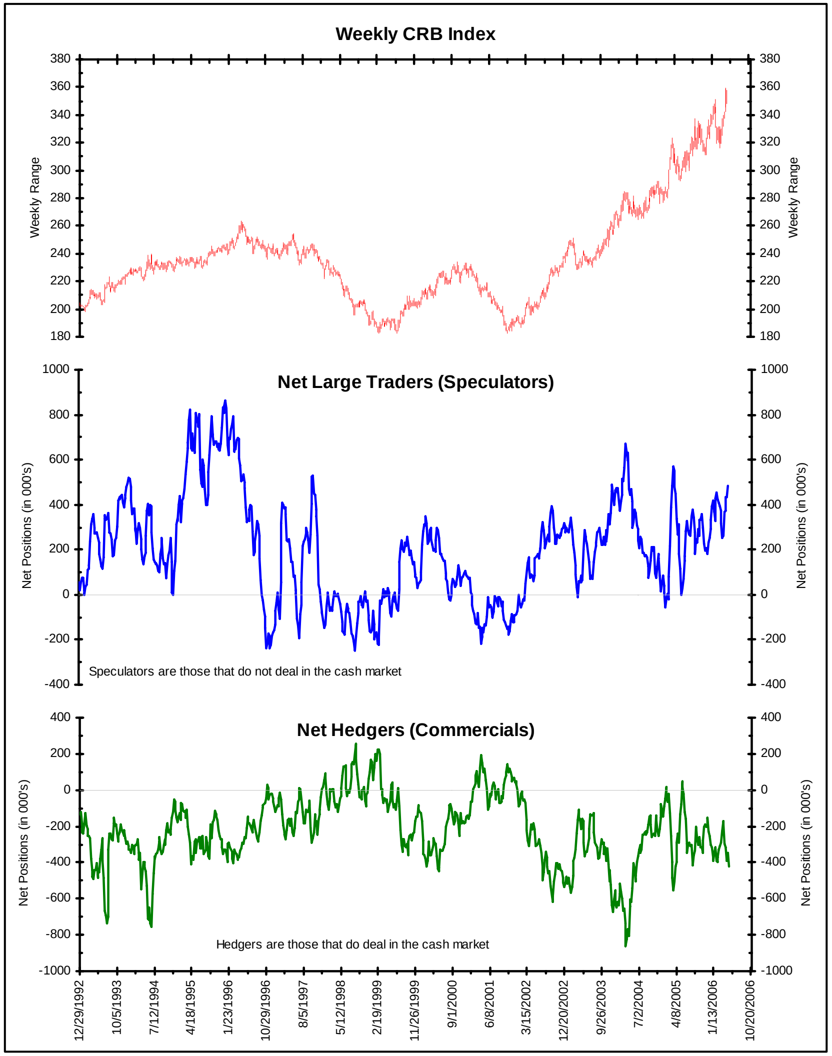
We observed in a recent Market Facts how the Federal Reserve's efforts at transparency were becoming self-defeating. The jump in high-low-close volatility after Ben Bernanke's April 27th testimony (blue column) was accompanied by a reversal in the July federal funds futures contract's trend (thick blue line). The inadvertent recantation via Maria Bartiromo on May 1st (blue-green column) maintained this level of uncertainty.

How did the market react following the May 10th FOMC meeting (green column)? Volatility fell significantly and the trend measure moved to zero. The federal funds futures market at the close of business on May 11, 2006 was at its lowest energy state.
Restated, the market is uncertain as to the direction of Federal Reserve policy, but it is completely comfortable in this uncertainty. While saying "I don't know," is seldom an acceptable response for an individual on Wall Street, it is an accepted response for the market as a whole.



Who is Speculating In Commodities

From Our Newsclips/Daily Commentary



We agree that the CoT data shows that large speculators are not piling into commodity futures as commonly thought. The chart below aggregates the net positions of the large speculators and the hedgers in all the components of the CRB index. It shows that, taken in total, large speculators and hedgers are not at extremes.

Furthermore, the public is not getting long gold. The amount of gold held by the gold ETFs (streetTracks and ishares) is determined by the funds' managers (in accordance with the prospectus, of course). If the manager sees strong demand for these funds, he will buy gold and issue more shares. Despite a several hundred dollar rise in gold over the last few months, the amount of gold held buy these funds has peaked, and even declined slightly before this week's sell-off.

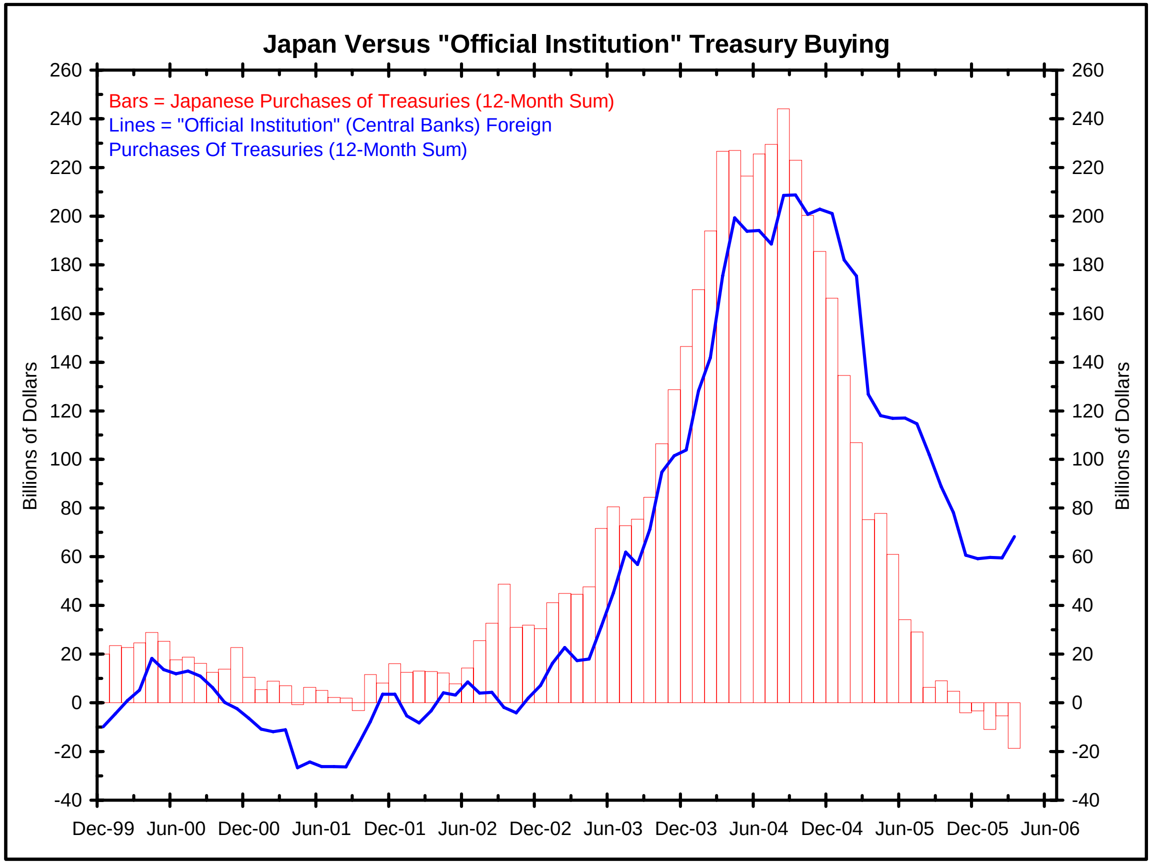
If traditional large speculators do not hold extreme long positions and the public is afraid of buying gold despite a parabolic rally, who is buying commodities? Most gold is in the hands of traditional institutions investing in long-only commodity funds. These institutions believe they are buying an asset class that is not correlated to stocks and bonds. Since there are trillions of dollars in financial assets, even a small transfer of this money into long-only commodity funds will send prices soaring higher. See the quote above about how much money it would take to buy this year's lead and zinc production.

We detailed this is in a March 2005 commentary.
Are commodities in a bubble? Yes. Are they over-speculated? Yes. Who is doing it? As we illustrated above, neither the large speculators nor the public are responsible for this speculation. Rather, the large bulk of commodity investing is from staid, run-by-committee, un-leveraged institutional funds which think they have found an uncorrelated asset to stocks and bonds.

Central Bank Treasury Activity Is Dominated By Japan

From This Month's U.S. Treasury's International Capital Statistics Update

Today's TIC data showed that foreign official institutions (read central banks) were net **sellers** of $6.27 billion of Treasuries. This was the first time that central banks were net sellers of Treasuries since last September. This comes amid reports that some middle eastern official institutions are diversifying their reserves into the Euro. Is this a sign that central banks are losing their appetite for dollars? In a word, no.



Who Are The Central Banks?

When talking about central banks, the image comes to mind of many different central banks each pursuing its countries own interest. In actuality, however, we believe this data is dominated by one player – the Bank of Japan.

The chart below plots total official institution Treasury activity against Japanese Treasury activity. It is understood that the Bank of Japan is the dominate Treasury buyer in Japan.

This chart suggests that the Bank of Japan's flows dominate the entire category of official institutions. Simply put, why were all foreign institutions **sellers** of $6.27 billion of Treasuries? The Japanese were **sellers** of $14.19 billion of Treasuries.

How/Why Foreigners Buy Treasuries

From This Month's [U.S. Treasury's International Capital Statistics Update]

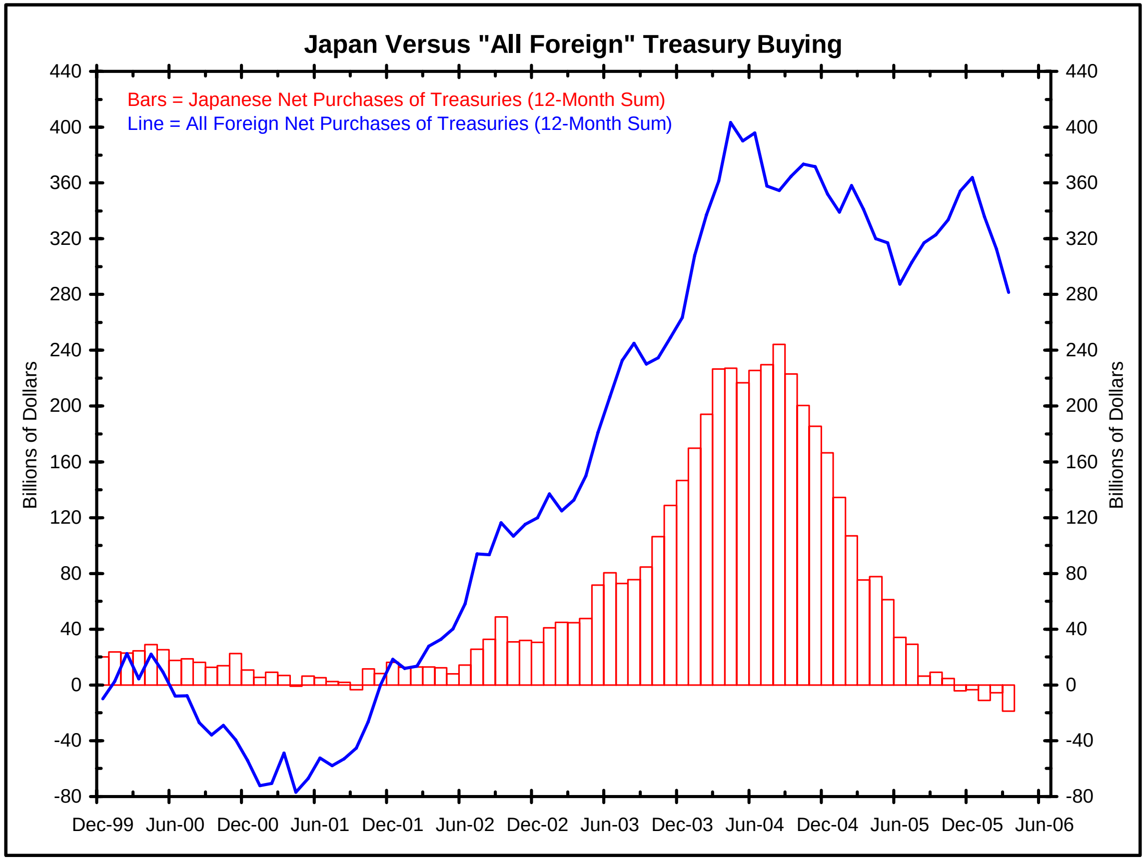
So, what drives Japanese purchases of U.S. Treasuries Notes and Bonds? The chart below may go a long way in explaining this.

Notice that, as Japan's net purchases began to decrease (red bars), All Foreign purchases (blue bars) held steady. This means that "other" or private investors stepped up their purchases of Treasuries and largely made up for the decrease in Japanese purchases.

Why are "other foreigners" buying more Treasuries? We have argued before that foreign activity in Treasuries, taken as a whole, is an exercise in following the momentum of the dollar. The exception is the Bank of Japan.

So, when the dollar is weak, "Other (private) Foreigners" shun investments in a weak currency. In this case other foreign flows stall or decline. When the dollar is strong, other foreign flows rise as these investors chase the momentum of a strong currency.

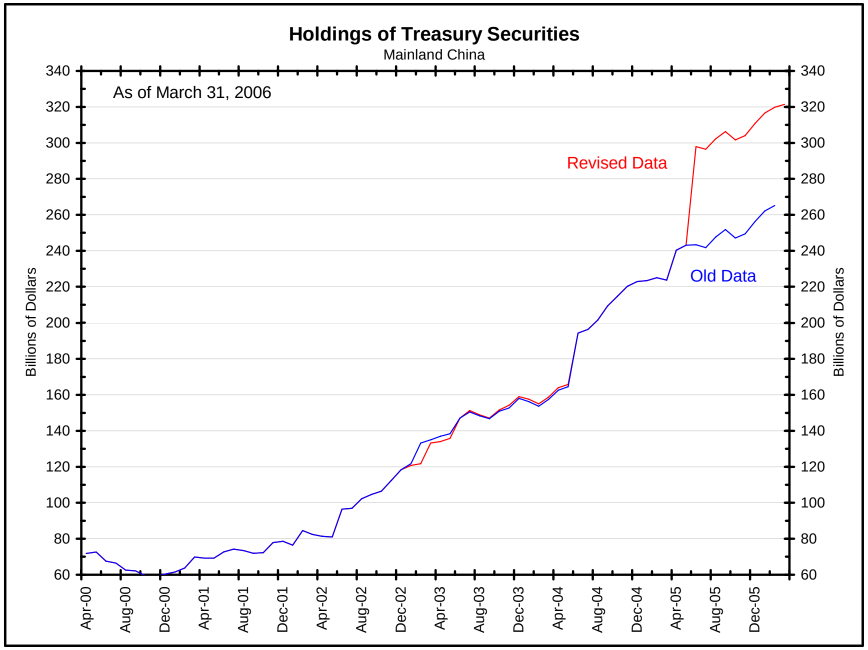
The Bank of Japan, on the other hand, is not a for-profit trader; it is acting in the best interest of the Japanese economy in general and its exporters in particular. Much of Japan's perceived self-interest is about simultaneously financing its U.S. customers while preventing an appreciation of the yen against both the dollar and the yuan (which makes their huge export business unprofitable). This means literally acquiring hundreds of billions of dollars in international circulation to support a weak currency like they did in 2004. Conversely, when the dollar is strong (real or perceived) like it was by the end of 2005, the Bank of Japan's constant support is no longer necessary. So, it refrains from additional purchases as profit-seeking "Other Foreigners" busily buy up the Treasuries to get exposure in that currency.

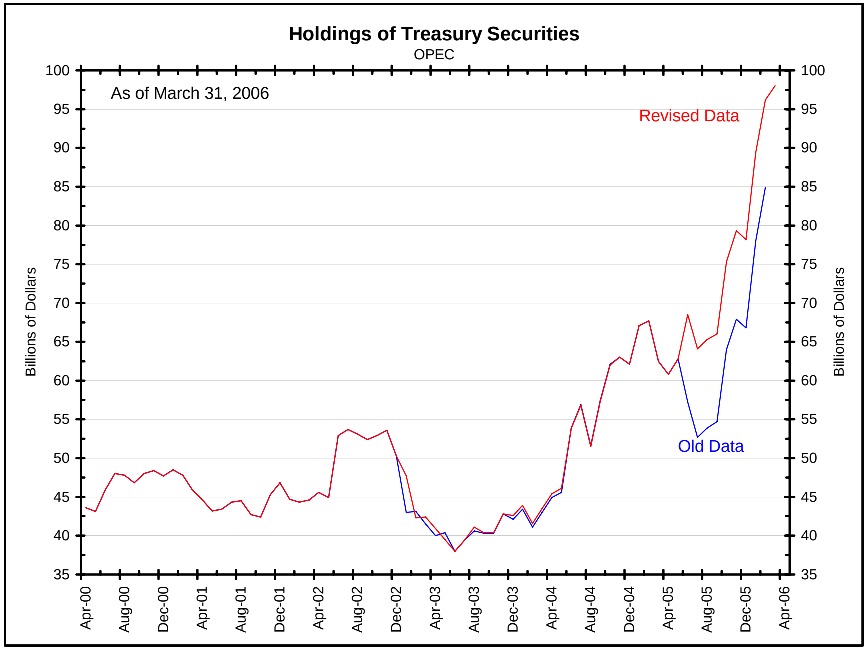


Treasury Holdings

From This Month's [U.S. Treasury's International Capital Statistics Update]

Last month the Treasury Revised the Data for Treasuries holdings back to April 2005. The revisions made to the purchases of China and Opec in particular caught our attention. While they were both revised higher, neither was revised to the point that this should be headline material.



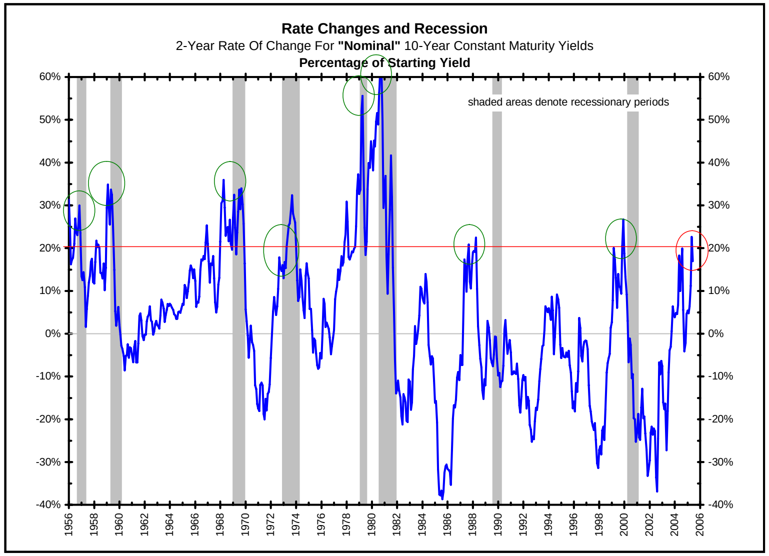


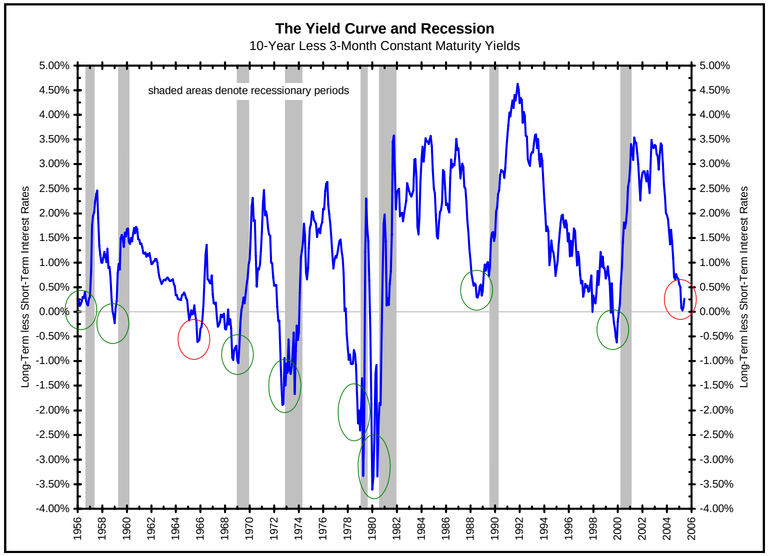
Should We Now Look For A Slowdown?

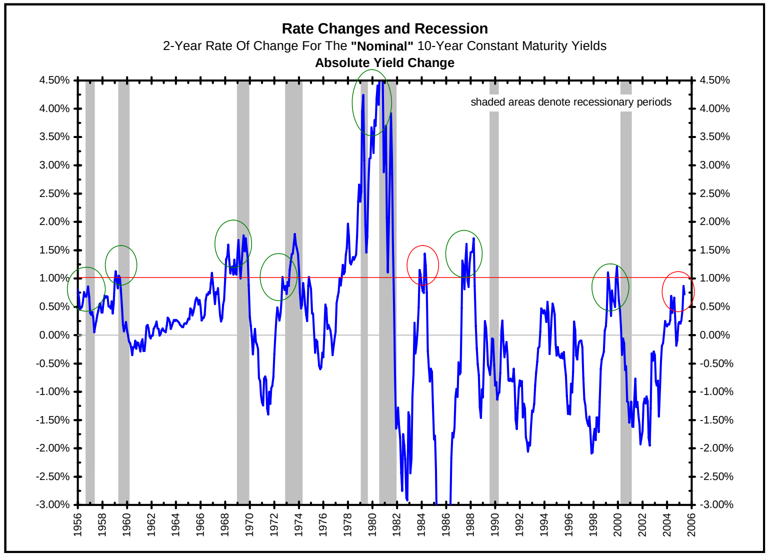
We argued during the period of yield curve inversion earlier in the year it was the direction of long-term interest rates that was more important than the shape of the curve. Previous inversions (chart below) occurred within rising rate environments (charts to the right). So long as the environment remained a “bullish flattening,” one wherein short-term rates rose and long-term rates remained stable, we argued no recession was imminent.

Now that the curve has steepened into a positive spread, the “inverted curve is leading a recession” talk has all but disappeared. However, the recent steepening has involved rising long-term rates. The chart to the top right shows interest rates are 20% higher than their levels of two years ago. While the chart to the bottom right is not 100 basis points higher than it was two years ago, this should happen in the next few months.

If higher rates matter more than an inverted curve, **now** is the time to look at both the level and term structure of interest rates and worry about the economy.







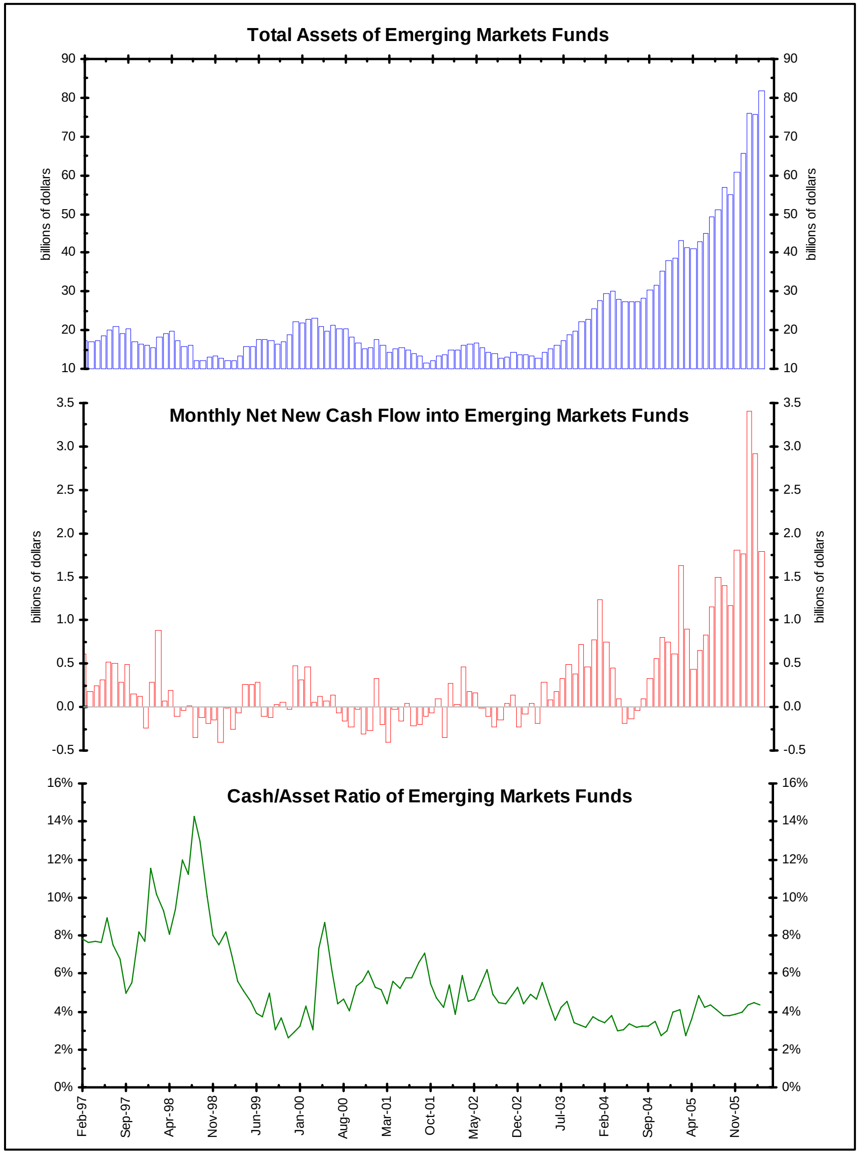
Booming Emerging Market Flows – Half An Idea

From Our Newsclips/Daily Commentary

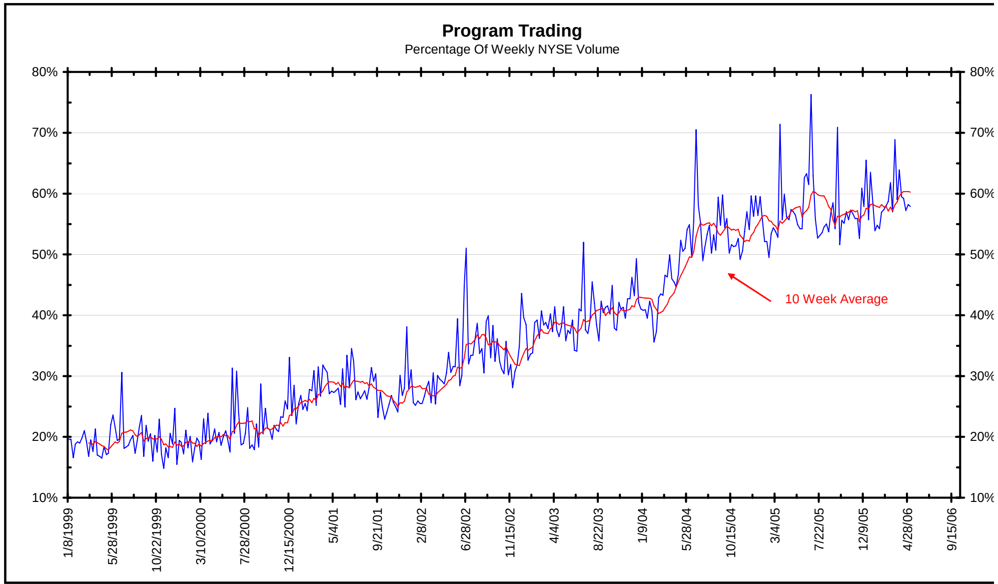
All good investment ideas need two things
1) a market that is stretched to an extreme and 2) a catalyst to reverse this extreme

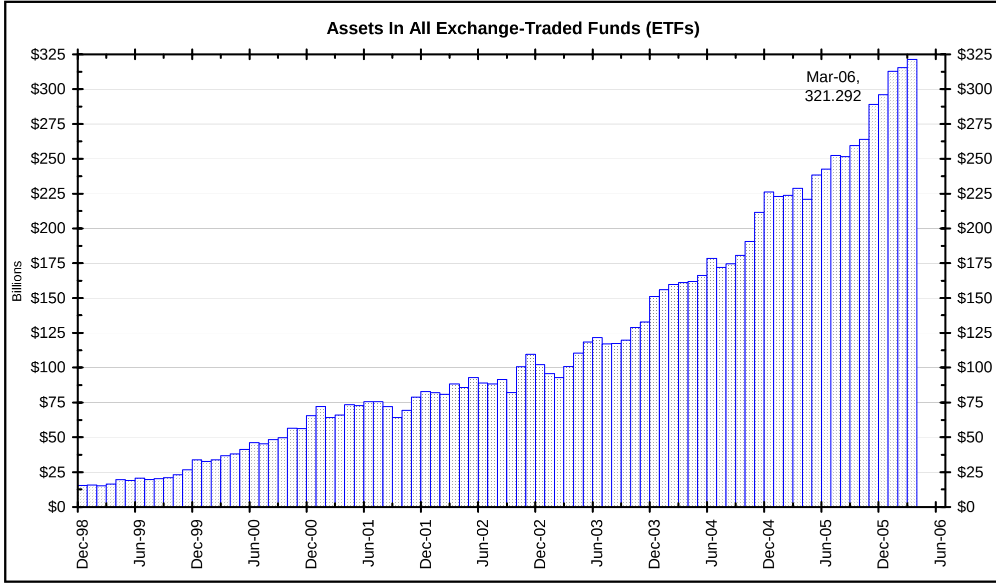
We will agree that flows into emerging market mutual funds are at an extreme. Further we will agree that such heavy flows into a narrow sector often end badly for those investors (see tech stocks circa 2000). However, as the chart below shows, the public has been pouring money into this sector for three years. And since early 2004, we have read and heard a steady stream of pundits who recently discovered these flows and warn of impending disaster. It has not happened.

What we are missing now, and have been missing for three years, is a catalyst for a reversal. None is offered here. And with the dollar weakening, moving money off-shore should reap good returns. So, we're left where we have been for three years, with half an idea. Until a catalyst becomes clear, we are skeptical this sector is ready to roll-over.



Are ETFs Taking Over?





ARMs Payments Versus Interest Income – An Offset?

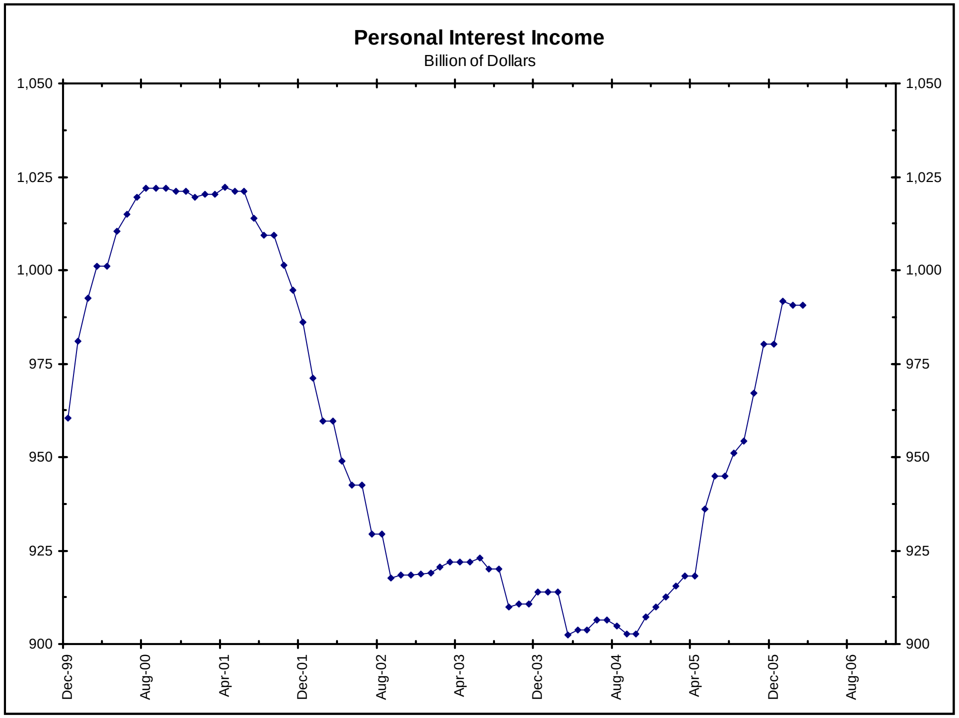
Slate.com **-** **[ARMs Control]**
That adjustable-rate mortgage seemed like such a great idea. Then interest rates started climbing.
According to the Office of Federal Housing Enterprise Oversight, the volume of ARMs tripled between 2001 and 2004, from $304 billion to $985 billion in 2004. At the end of 2004, there were about $1.4 trillion in ARMs outstanding. That figure is likely significantly higher today, since the ARMs accounted for about 31 percent of the $2.9 trillion in mortgages issued in 2005, according to the Mortgage Bankers Association. For every 100 basis points (i.e., 1 percent) mortgage rates rise, holders of adjustable of ARMs will owe an extra $14 billion per year in interest.

Comment - This story forgets that not every ARM is a one-year adjustable. Many are hybrids that are fixed for a period before they adjust. Many ARM's do not start adjusting until later this year and again in 2009.

But leaving this aside, this link falls into the trap of looking at only half of the story. What about income? The chart below shows that the public is now getting an additional $90 billion a year in income thanks to higher interest rates. At $14 billion per 1%, this means ARM holders are paying $56 billion a year more in interest costs.

But households are making an additional $90 billion in income. Granted these are not the same households; ARMS owners tend to be strapped younger home buyers and income gainers tend to be older savers. But, looking at it from a macro point of view, these two offset each other and all the hand wringing about higher short-term interest rates is largely offset.

From Our Newsclips/Daily Commentary



Detailing The Trade Deficit

From Our Newsclips/Daily Commentary

Forgive my ignorance, but I'm a little hazy about how this works. The last time I checked, the dollar floated against all the major currencies. And like all freely traded markets, currency markets are hard to predict. Just ask Warren Buffett.

Does the administration have some secret levers they can pull? If they do, they must work really well as they pull these levers without telling anyone and they get the desired results. And regarding the goal of reducing the trade deficit, see the following table:

If the dollar devalues against the euro, the implications for the trade deficit would be negligible since the EU accounts for only 15% of the total deficit. What about the yen? As the chart below shows, lower crude oil prices will have a bigger effect on the trade deficit than the yen.

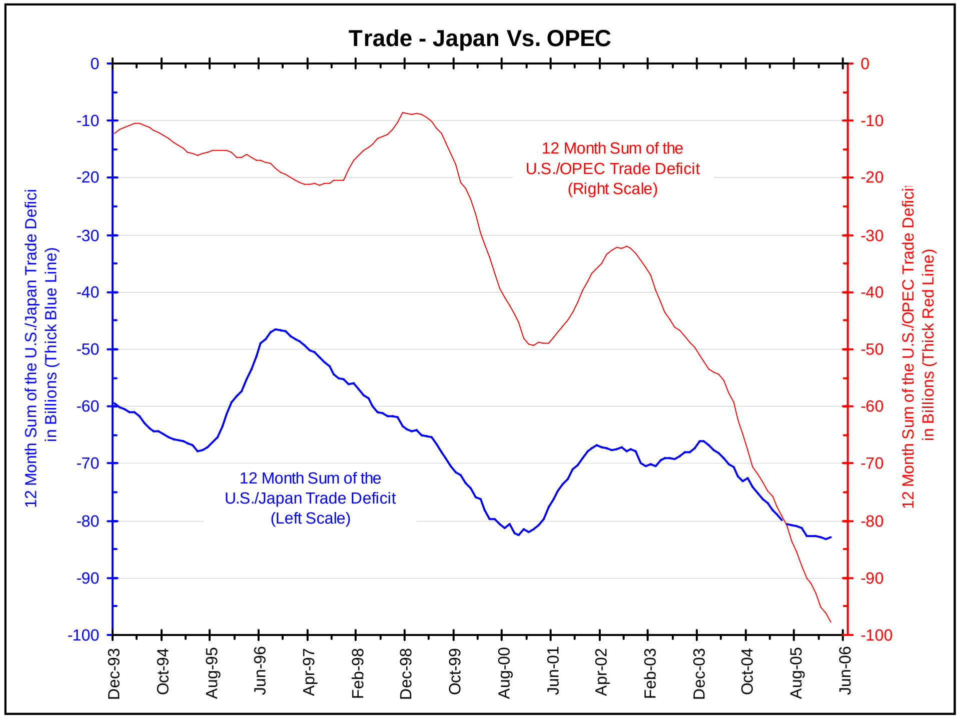
Looking at these numbers, it would take something on the order of a 50% devaluation of the dollar to affect the trade deficit. A move from 1.20 euro to 1.30 euro will have virtually no effect.

Breaking Down The Trade Deficit

Through March 2006

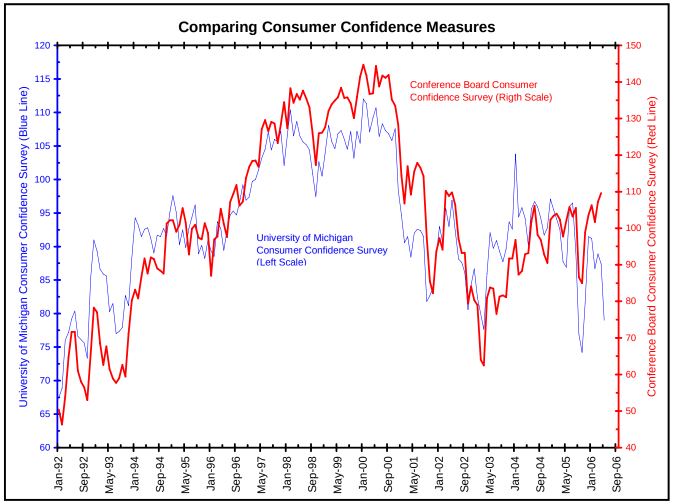
Region	12 Mo. Avg.	Total	% of Total
Total	**67,146.92**	**805,763**	**100%**
China	17,243.08	206,917	25.7%
North America	11,256.50	135,078	16.8%
EU	10,392.25	124,707	15.5%
OPEC	8,140.83	97,690	12.1%
Japan	6,909.83	82,918	10.3%
Everyone Else	13,204.42	158,453	19.7%

Data Source: Bloomberg L.P.



Consumer Confidence – What Is It Tracking?

We have argued consumer confidence is a nebulous concept. Poll respondents interpret this question in the same subjective manner as they do for Presidential approval ratings. For the last 15 years or so, participants in these surveys have interpreted the question by describing what the stock market did last month. Most consumers either believe the stock market is the most important economic indicator in our economy or believe this to be the proper lens.

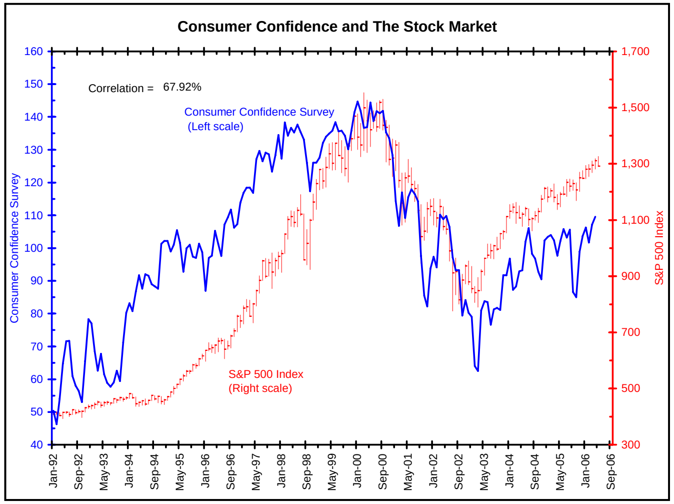


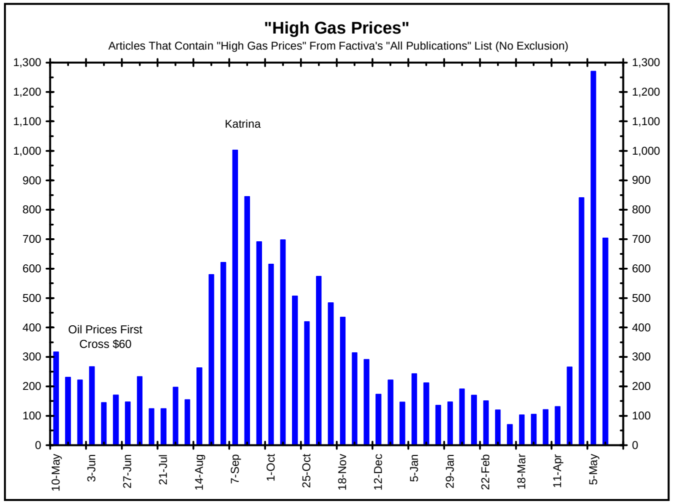
To this end we have often used the chart below showing the high correlation between consumer confidence and the stock market.

This usually brings objection from supporters of these surveys. They argue that "pocket book" issues like gasoline prices, income and employment prospects drive these surveys. They argue last week's Michigan consumer confidence survey, whose decline of 10 points was attributed to gasoline prices, as evidence it is not just the stock market.

The chart to the upper right overlays the Conference Board consumer confidence survey (which is shown below against stock prices and made a new four year last month) and Michigan's survey. Other than the last plot, they are remarkably similar – as you would expect.

Why did gasoline prices dominate the Michigan survey? See the chart to the lower right. As six-fold increase in the screaming by the press about gas prices drowned everything else out. Unless the press reports about high gasoline prices stay at this level, we expect these surveys will revert back to their historical norm – describing last month's stock market action. If so, their usefulness will be limited. But this will not stop the Fed using this flawed measure to set policy.





What Drives The President's Approval Rating?

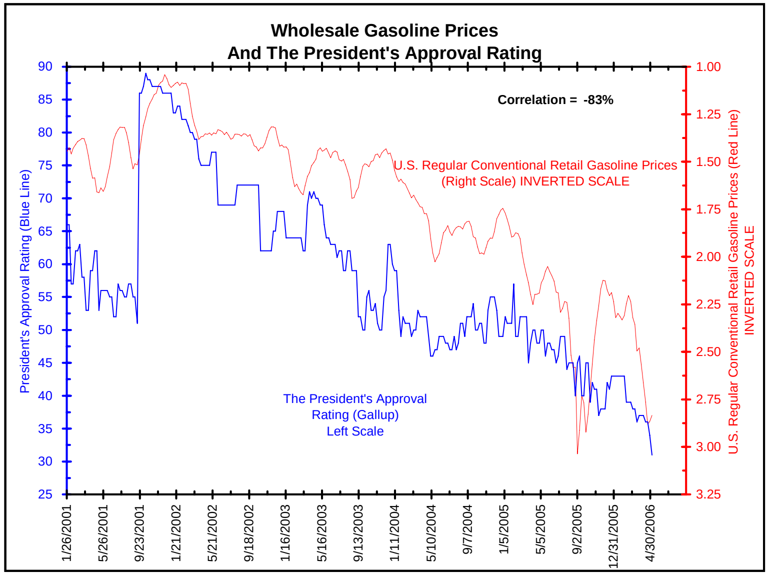
As we argued on the previous page, survey questions are subject to interpretations. None more than the President's approval rating.

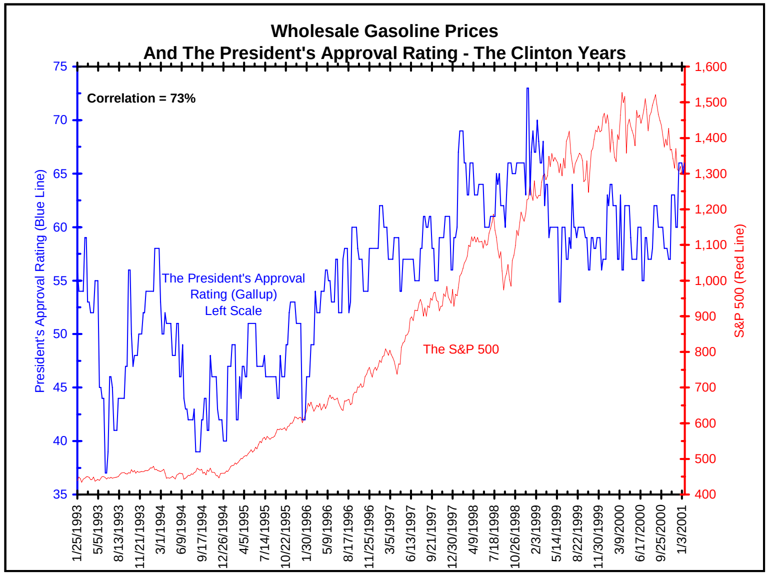
The question asks if you approve of the President's job as CEO of the Federal Government. Few know how to answer this question. So, they interpret it against an external reference.

Currently we believe this question is dominated by gasoline prices. As the top chart to the right shows, gas prices have been 83% correlated to President Bush's approval rating. During President Clinton's two terms, gasoline prices were a near random 13%.

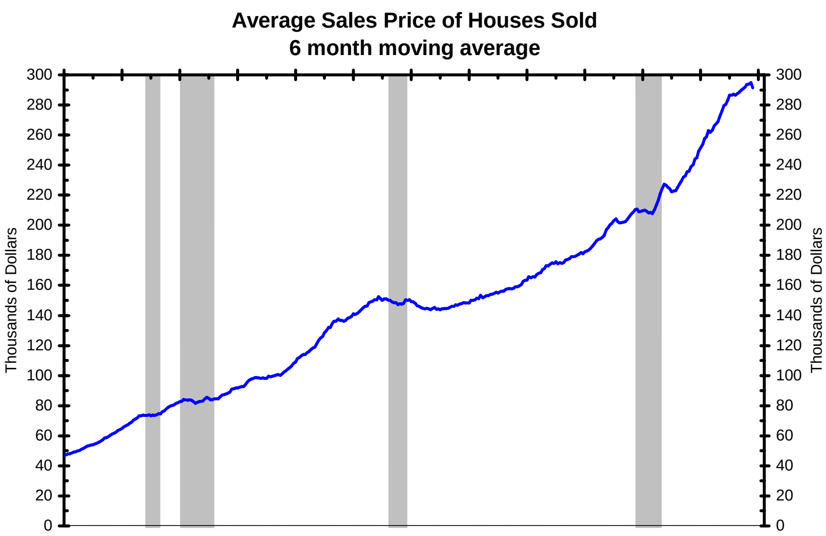
However, during President Clinton's administration, stock prices dominated. His approval rating and stock prices were 73% correlated versus a negative correlation under President Bush.

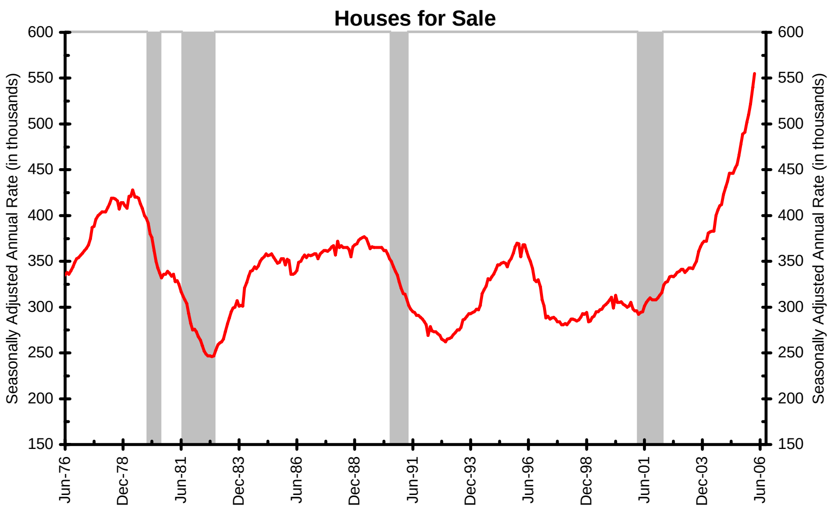
The real issue with these surveys is not what they say but rather what question is being answered. And when determining that, the simpler the explanation the better.

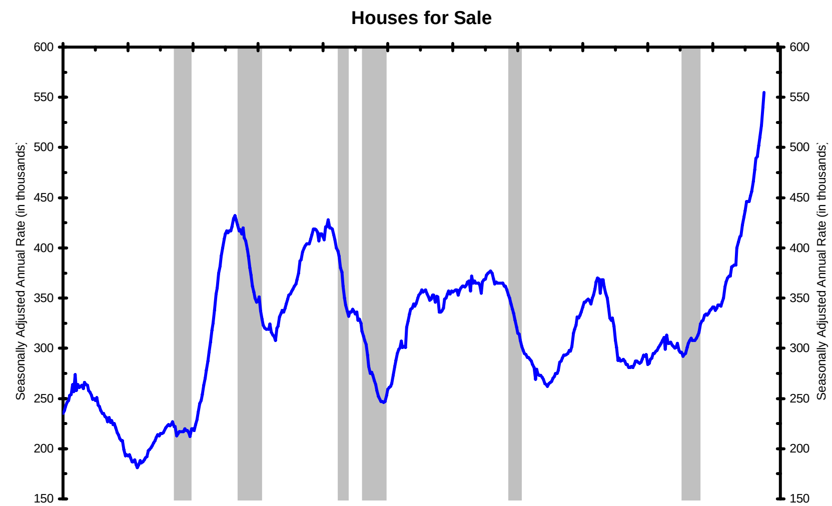


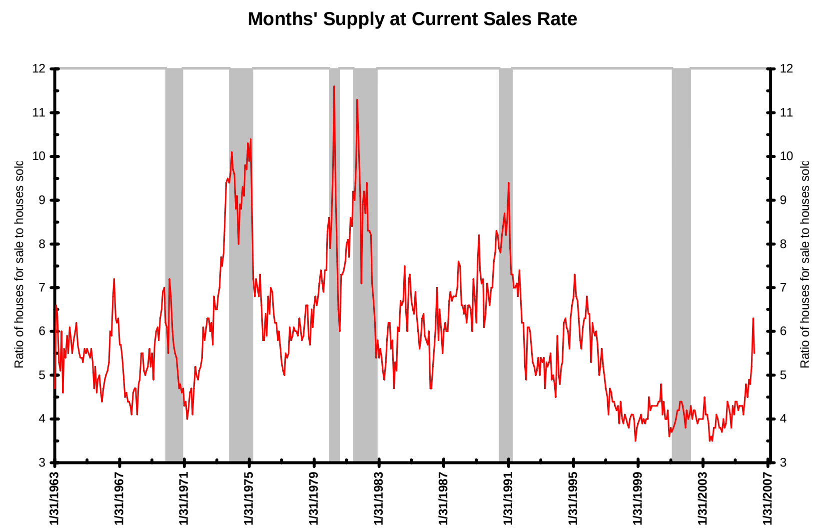


Housing - Rising Supply Weakens Prices . . .

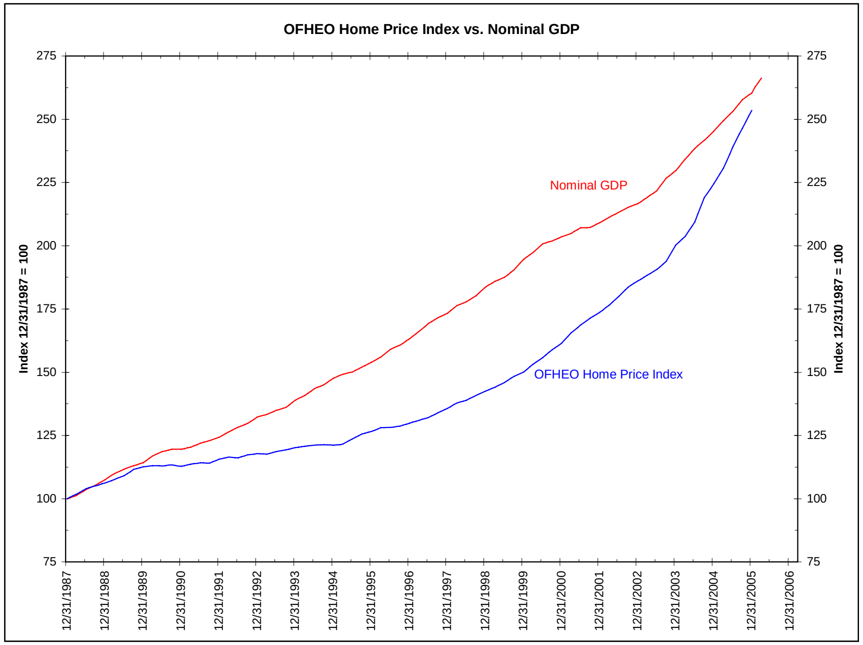


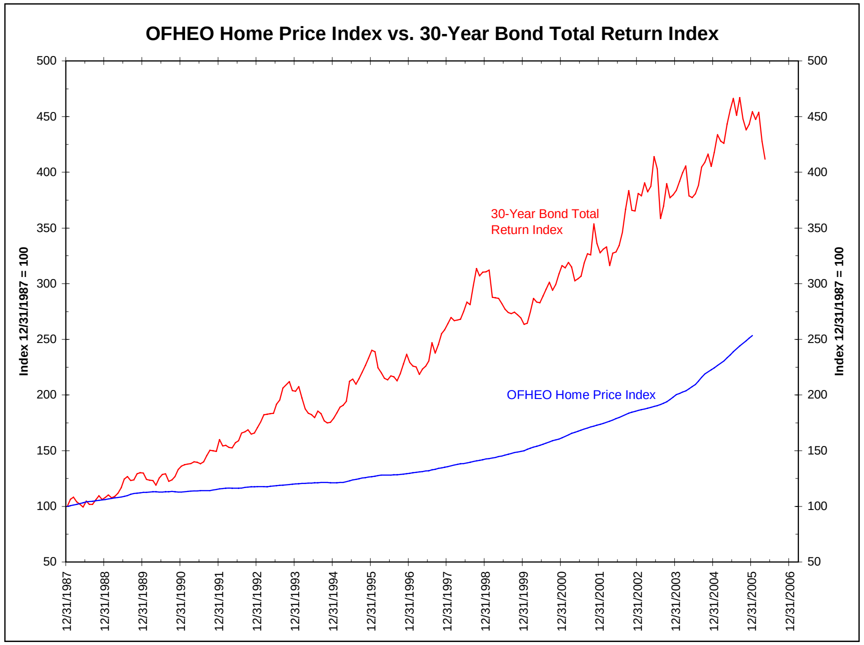






. . . But House Prices Have Lagged Bonds and GDP

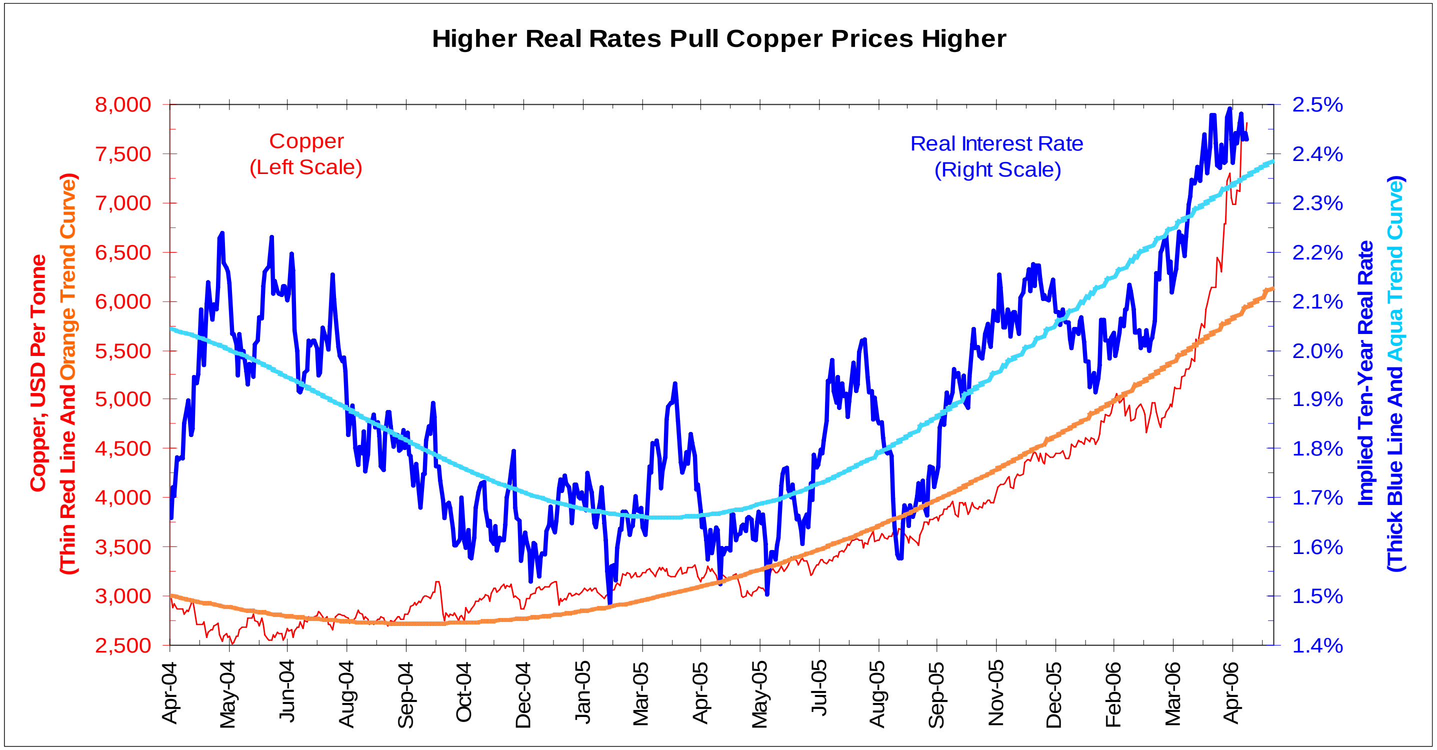




The Demand-Pull Effect On Copper Prices

From A Recent Commentary

We can demonstrate the demand-pull effect on copper prices by mapping them (thin red line and orange trend curve, following page) against the implied ten-year real rate of interest derived from the TIPS market (thick blue line and aqua trend curve). Only when real interest rates began to rise in mid-2005, prima facie evidence that demand for capital finally was exceeding the infamous and possibly non-existent "global savings glut," copper prices began their acceleration. The rise in real rates continues both to lead and to outpace the rise in copper prices. If you really want to see lower copper prices, pray for a recession.

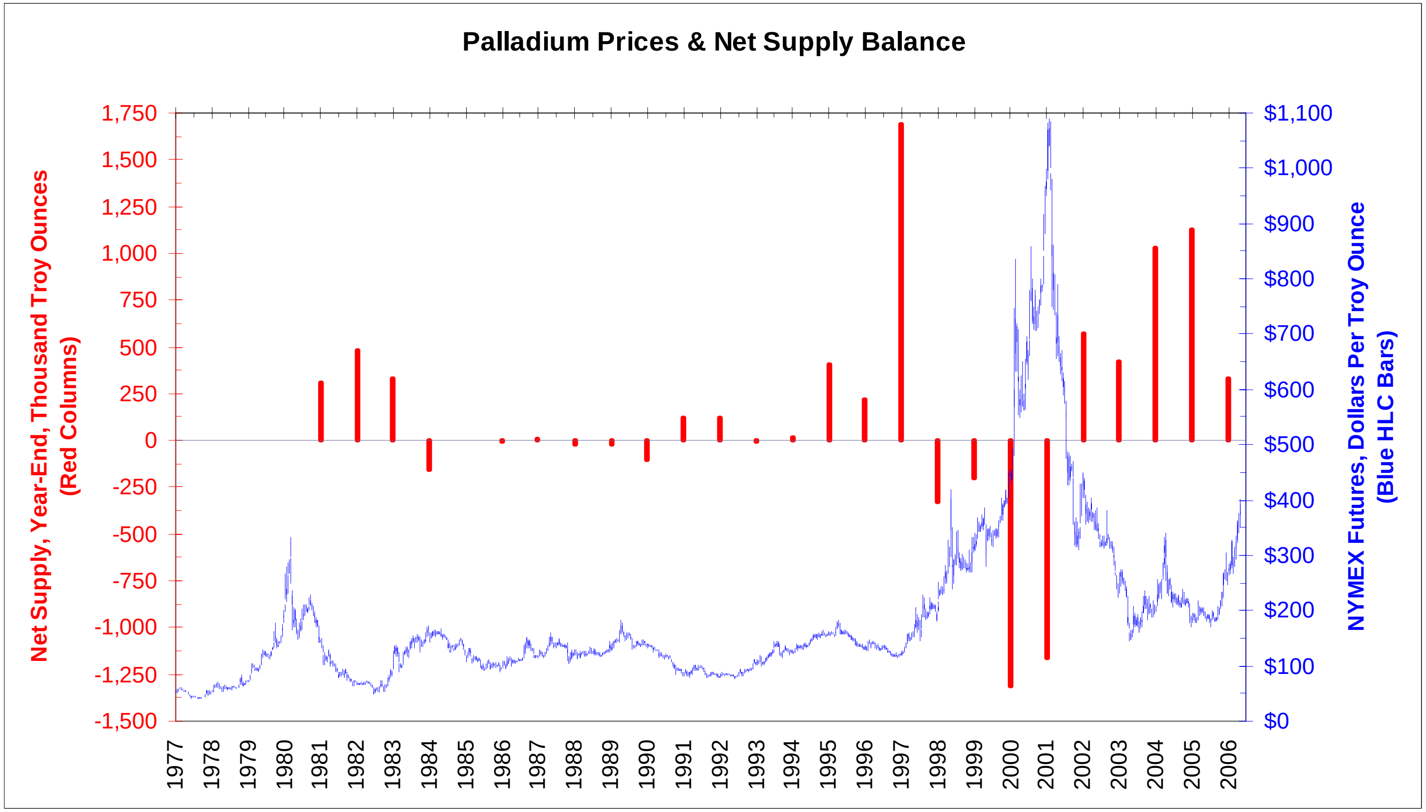


Commodity Substitution: The Case Of Palladium

From Our Latest Market Facts

While palladium (blue HLC bars) is in a bull market, it has failed to draw the rapturous attention of other industrial metals such as platinum and copper or of other precious metals such as gold. We could be so impudent as to enquire why, after five years of net additions to global supply (red columns) palladium is in a bull market at all, but after reviewing the historic treatment of heretics we will simply accept the price trend as given and surrender ourselves to the tender mercies of the "hot commodities" crowd.

Or will we? The changing supply, demand and usage patterns of palladium offer a glimpse into how the bull markets in various metals will end. All physical balance data are from Johnson Matthey.



TIPS And Treasuries: The Same Thing?

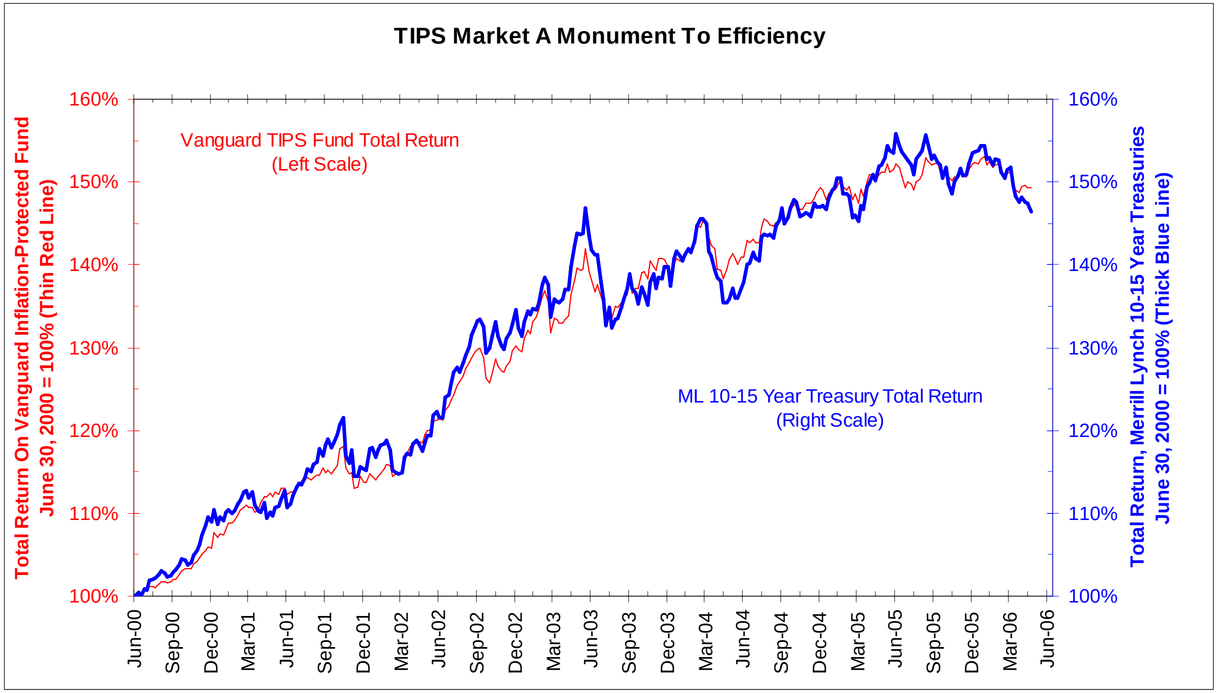
From Our Latest Commentary

The most recent producer price index data should go a long way toward assuaging fears of incipient inflation; despite a 0.9% increase in the headline number, the core PPI rose only 0.1%. The answer is so simple: Confine your purchases to whatever is in the core index and abstain from buying food and energy.

But if you persist in worrying about minutiae such as the 17.4% annualized growth rate in the Journal of Commerce-Economic Cycle Research Institute's industrial price index, you can always buy inflation protection in the form of TIPS (thin red line). They should keep you sheltered from the storm whilst the careless see their savings eroded by inflation in conventional Treasuries (thick blue line).

Only if you subscribe, as the SEC does, to theories such as reading the Prospectus will you be able to outsmart the market. We should expect investors to bid the price of TIPS higher to arbitrage away any real return advantage to conventional Treasuries. In an efficient market, the differences between two assets should be minor, random and normally distributed. This certainly appears to have been the case over the past six years.

A Vanguard Inflation-Protected fund with an average maturity of 7-20 years is used to proxy for the total return on TIPS. A Merrill Lynch index of 10-15 year Treasury bonds is used to proxy for the total return on conventional Treasuries.



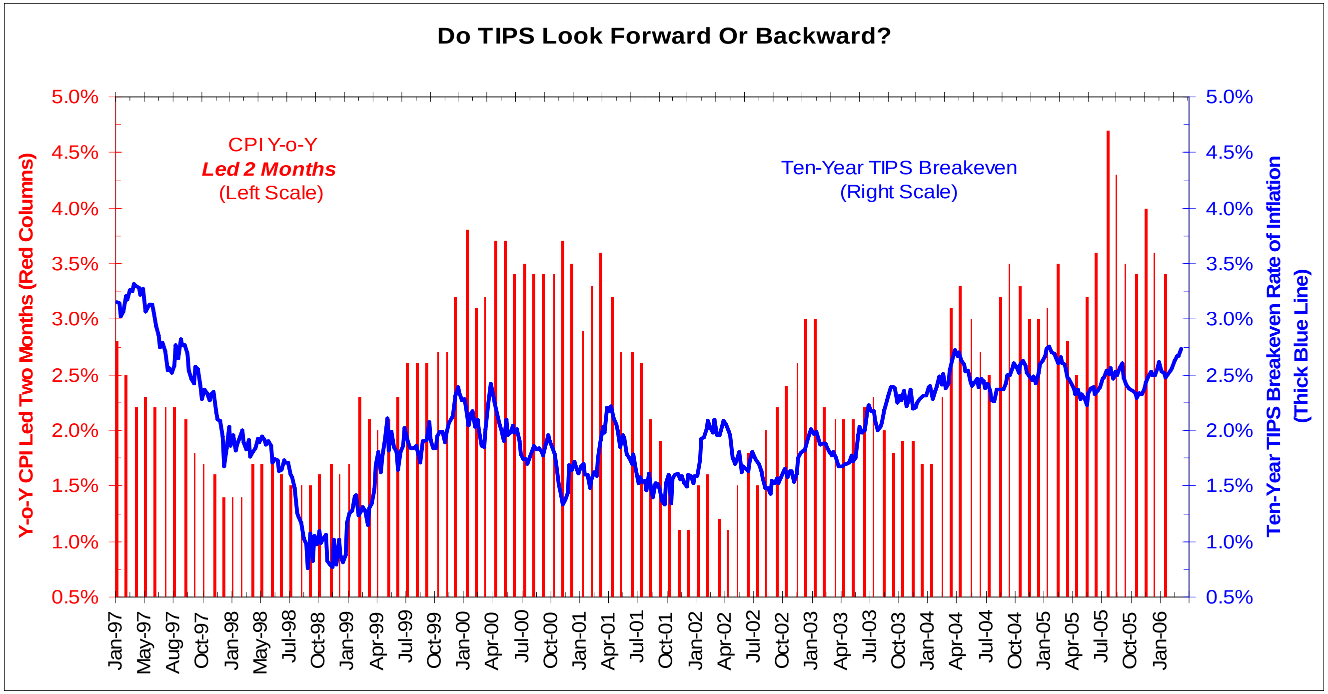
Do TIPS Forecast Inflation?

From Our Latest Commentary

The TIPS market should price off the expected average annual All-Urban CPI. If we want to get technical, we should add TIPS embed certain options. You are short a call option on government honesty in reporting consumer inflation, and as the accrual of principal on TIPS is taxed on an ongoing basis, you are short a call option on higher income tax rates. And as the payoff on TIPS is linked to the CPI, not to the actual inflation in your life, you should not expect protection from the latter.

In a statement designed to make a behavioral finance specialist fall down laughing, expectations for the future should be independent of recent experience. Does the ten-year TIPS market (thick blue line) forecast the CPI independently of recent experience?

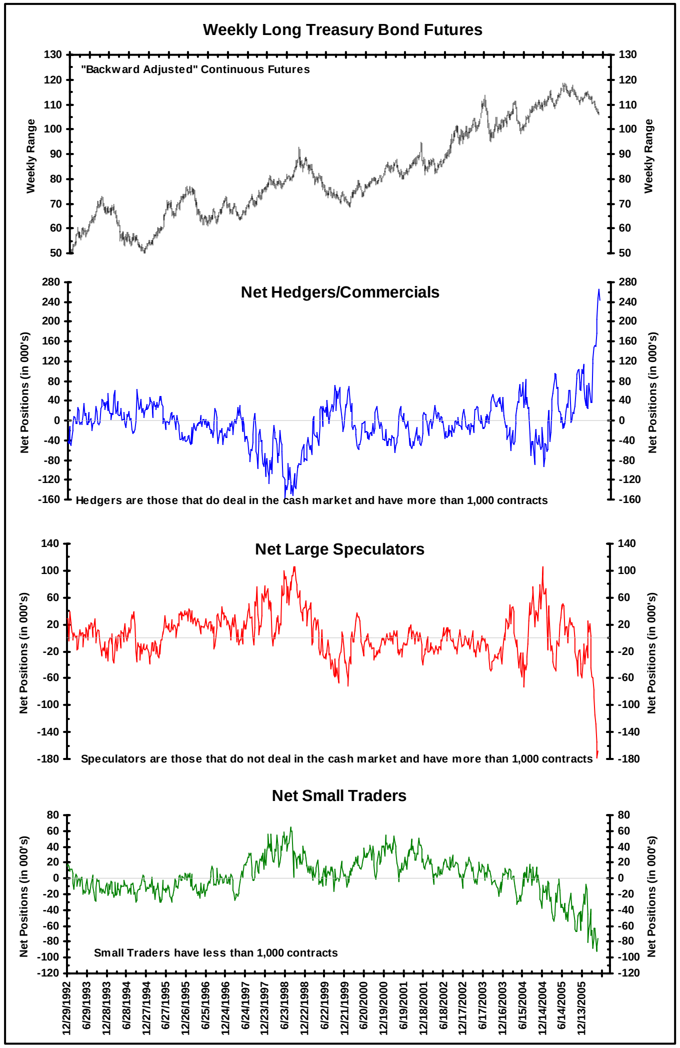
To some extent, yes. Nine years of evidence suggests it gets a fairly decent two-month directional forecast for changes in the CPI (red columns), but it is way off on the magnitude of these changes. In recent years, its forecast bias has been for expected inflation to be well below recently reported inflation. This is equivalent to saying the market has confidence in the inflation-fighting abilities of the Federal Reserve.



30-Year Bond Futures: Speculators Near Net Short Extreme

From Our Latest
Commitment Of Traders Update

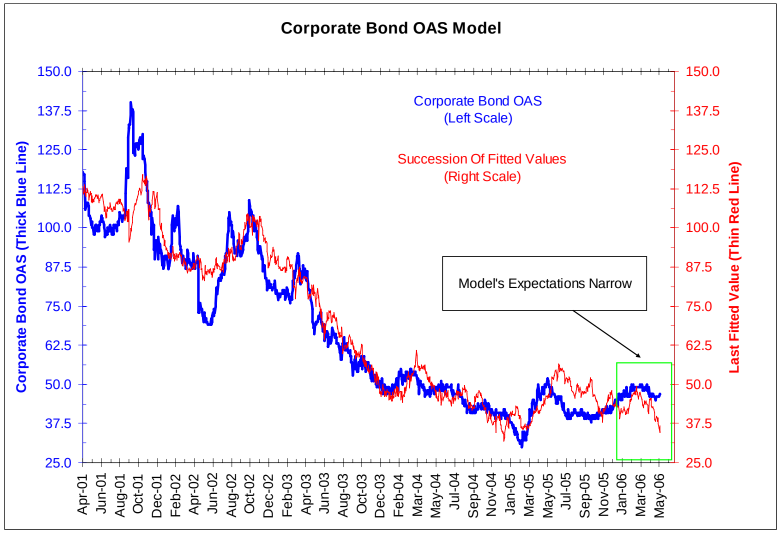
Friday's Commitments of Traders data for bond futures showed Hedgers were net long 243,700 contracts on May 9. At the same time, Friday's report showed the Large Speculators were net short 167,881 contracts on May 9.



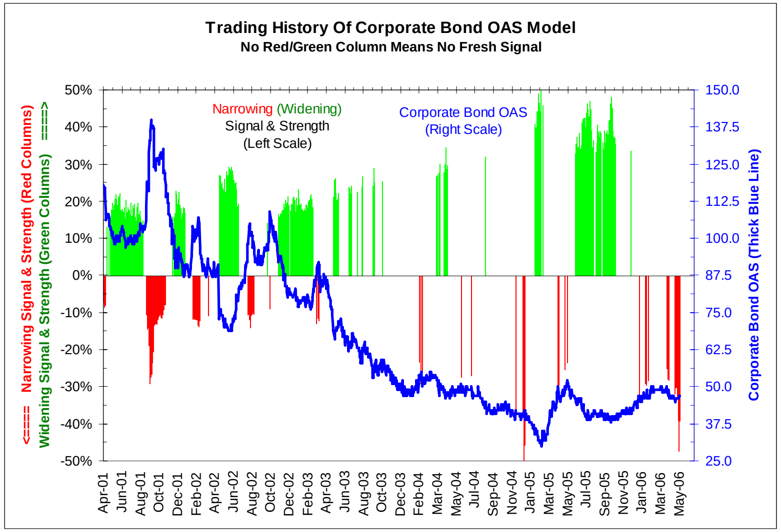
Corporate Bond Option-Adjusted Spread

From Our European Fixed-Income Spread Model Update

Contribution Of Inputs Over Past Week				
Factor	Coefficient	Factor's Beta To OAS	Factor Movement	Contribution To Signal
Euro:	Negative	0.612	Rising	Narrowing
3-6 Month LIBOR Curve:	Positive	0.307	Rising	Widening
Ten-Year Swap Spreads:	Positive	0.272	Rising	Widening



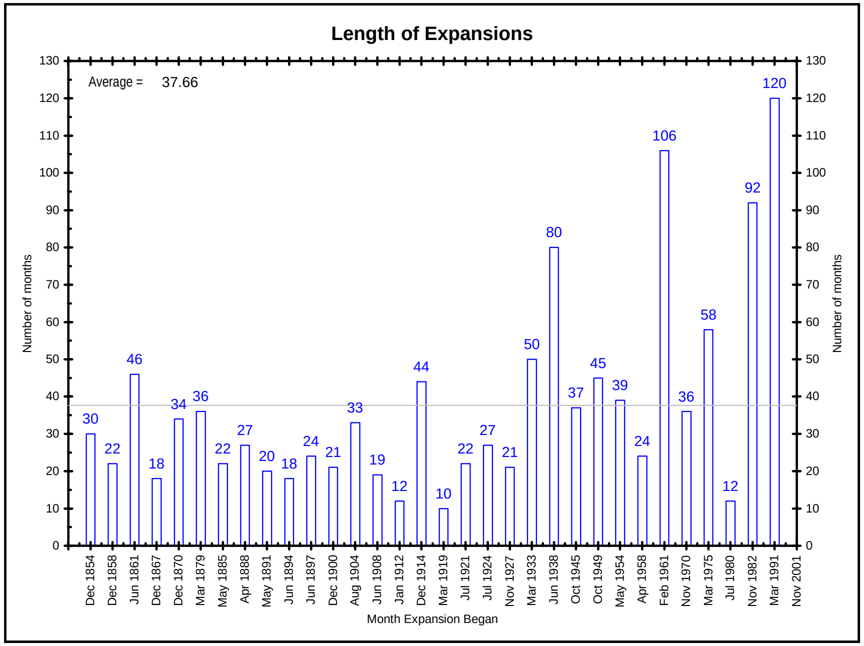
- OAS levels (blue line, top chart) oozed higher. The model's expectations (red line, top chart) continue to narrow
- The operating signal, a narrowing initiated on January 4th, was last reinforced on May 15th (red columns, lower chart)
- Two of the three variables in the model (top table) worked toward narrower OAS levels this week

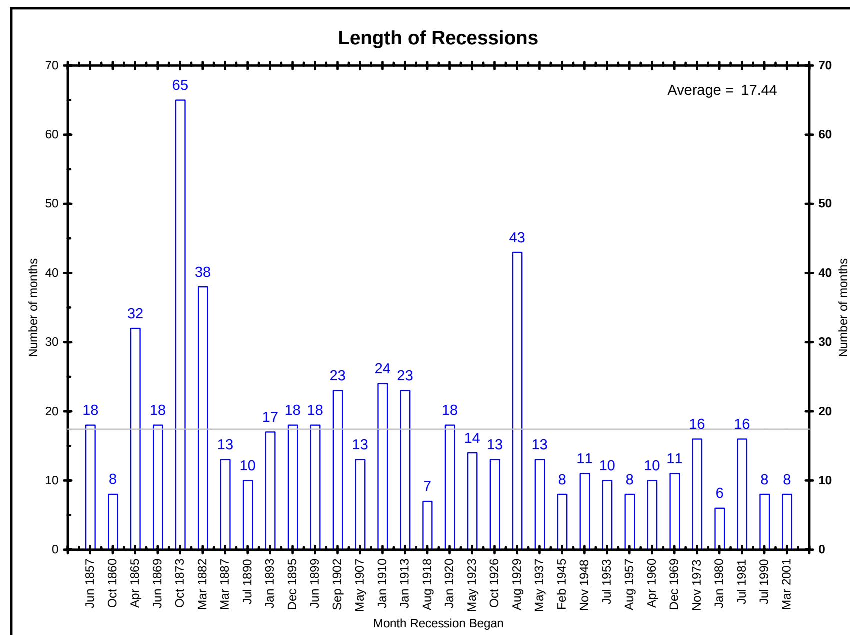


Summary Historic Statistics			
From April 23, 2001			
Historic		**Current**	
Total Signals:	21	Current Position:	Narrowing
Correct Signals:	17	Entry Date:	04-Jan-06
Percent Correct:	81.0%	Entry Price, BP:	47
Average P/L, BP:	6.7	Current Price, BP:	47
Total P/L, BP:	141	Current Open P/L:	0

Long-Term Look: 152 Years of Expansion and Recession

From Our Collection of Long-Term Charts





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