

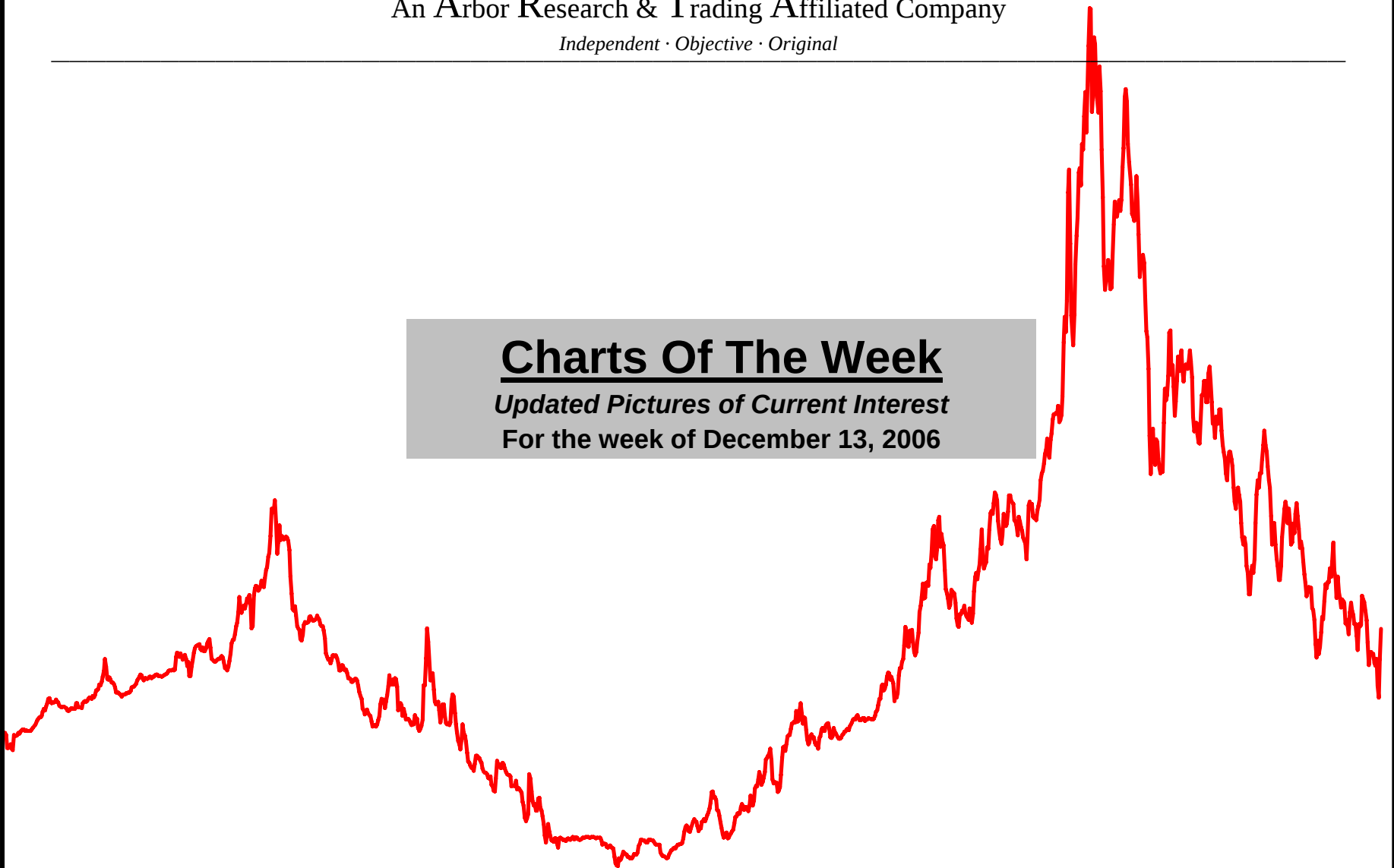
Bianco Research L.L.C.

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Charts Of The Week

Updated Pictures of Current Interest
For the week of December 13, 2006

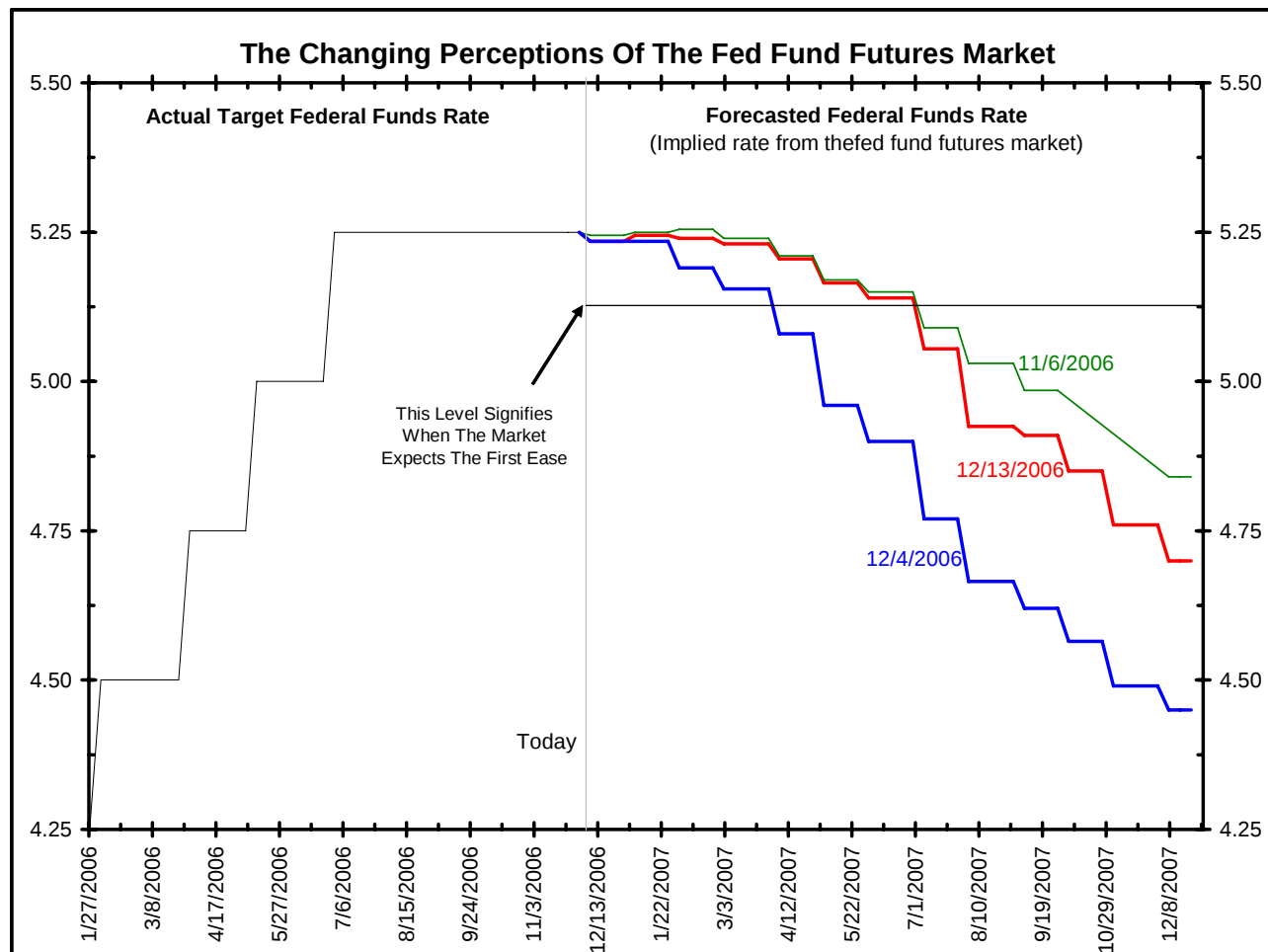


Long-Term Interest Rates - 1900 to 2005

What About the Federal Fund Futures Market?

From A Recent [Commentary](#)

The chart below shows what the market expects next year. The black line to the left is the actual federal funds rate. The colored lines to the right are the forward rate curve, or what the market expects, on three different dates. The red line shows Today's expectations. Currently this market is pricing the first rate cut at the June 2007 FOMC meeting.

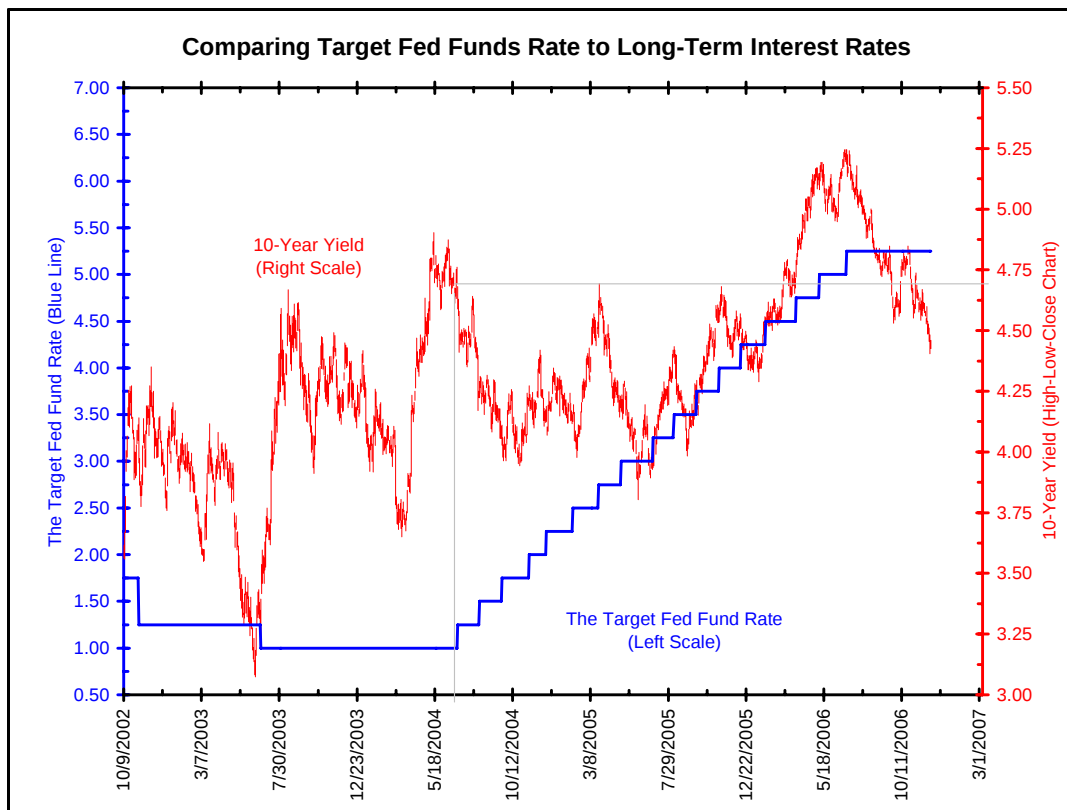


Is A Hawkish Federal Reserve Causing A Bond Rally?

From A Recent [Commentary](#)

Explanations of market movements too often are dictated by folklore and habit. This is true especially when explaining the movement of long-term interest rates based on perceptions of Federal Reserve policy.

The consensus is long-term interest rates rise in response to a higher federal funds rate; the converse is true, too. However, as the chart below shows, this has **not been the case for the last several years**. In 2003, when the Federal Reserve held federal funds (blue line) steady at the “emergency rate” of 1.00%, long-term interest rates rose. From 2004 to 2006, when the Federal Reserve raised the federal funds rates at 17 consecutive meetings, long-term interest rates declined (red line).

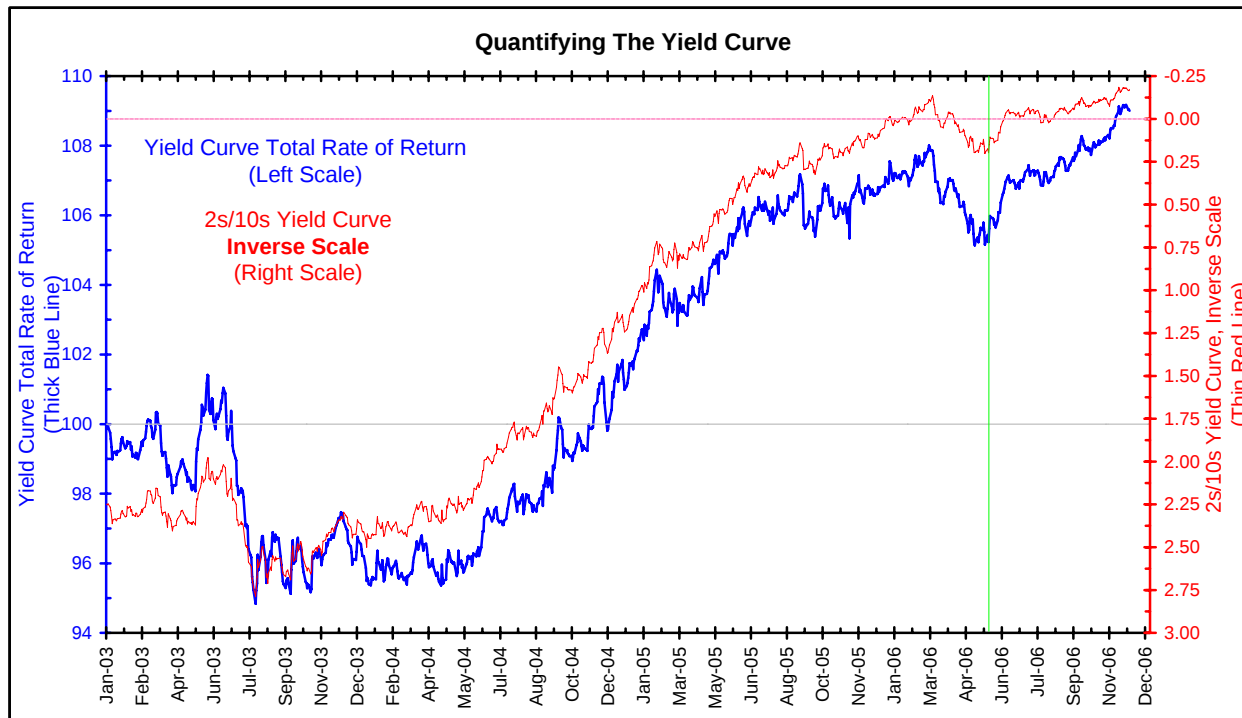


Yield Curve, Convexity And Total Returns

From Our Latest [Total Return Review](#)

We discussed the issue in May as if the yield curve flattening which began in the summer of 2003 was behind us; this assumption was premised on the correct assumption the Federal Reserve's rate-hike cycle would end soon. Instead, the 2/10 yield curve (thin red line, inverse scale) began to flatten just before Memorial Day and moved back into an inversion by mid-June 2006 (green vertical line). We now have to consider the February 23rd – May 25th steepening of the yield curve a correction within a broader flattening trend, not a new steepening trend.

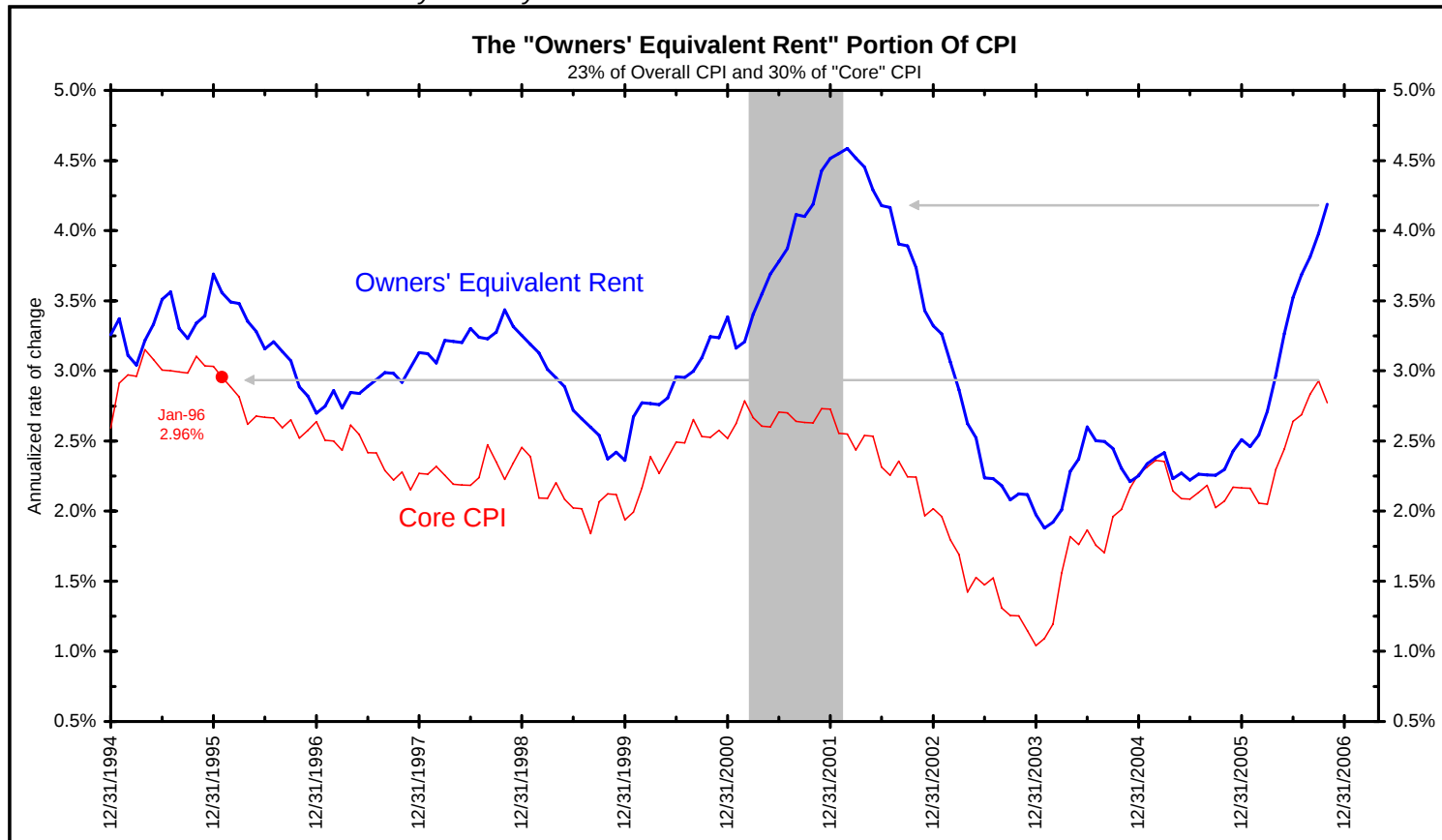
How did an index of the total return on the trade of financing ten-year Treasuries with a duration-weighted borrowing of two-year notes (thick blue line) fare since the end of May? The index increased from 105.728 on May 25th to 109.003 on December 1st, while the 2/10 yield curve flattened by more than 30 basis points. The key to these returns was the bullish flattening of the curve; ten-year yields declined more than 60 basis points during this period.



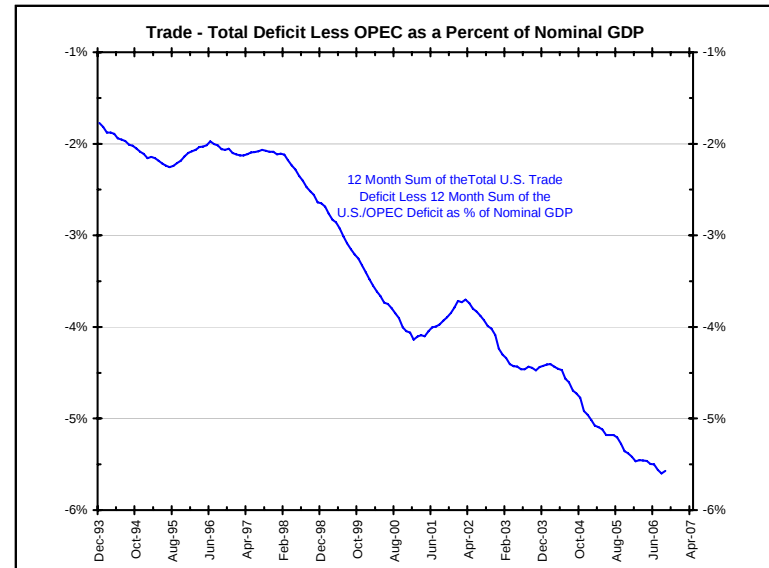
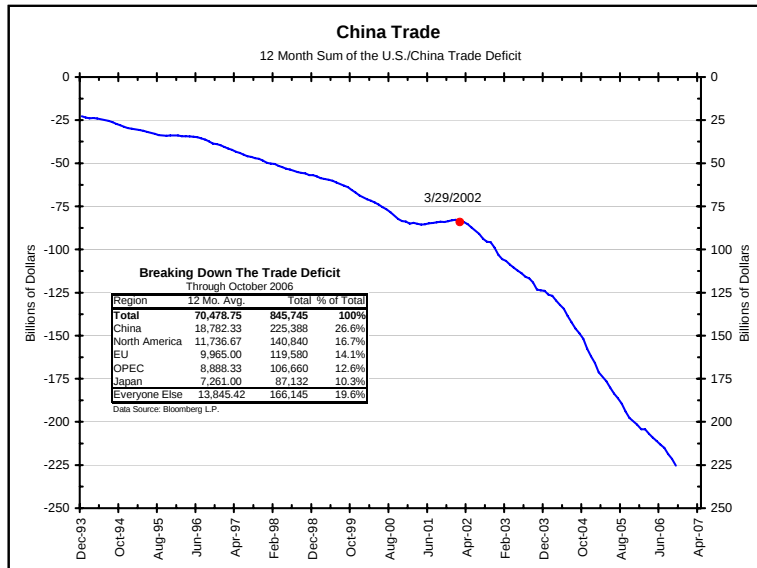
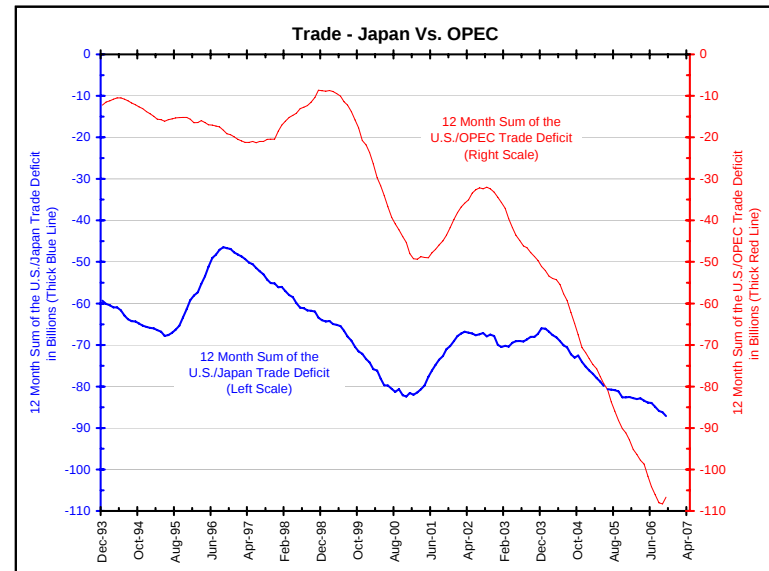
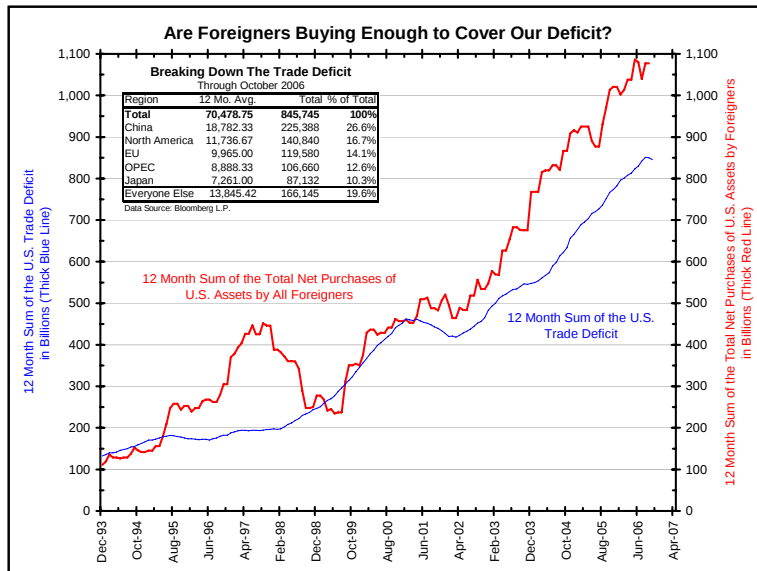
The Measure Of Core Inflation Problem?

While we agree that inflation is not as big a problem as the measures say, as detailed in a [Special Report](#) last week, the Fed is trying to stress transparency through rules/guidelines. They have pinned future policy on a fall in the **measure of core inflation**. For this too happen, OER (30% of core CPI) needs to stop accelerating (currently at 4.2% year-over-year). Not only has the marketplace failed to offer solid reasons for why OER will fall enough and bring down the **measure of core inflation**, Chairman Bernanke is also uncertain as to what it will do. On [November 28](#) he said:

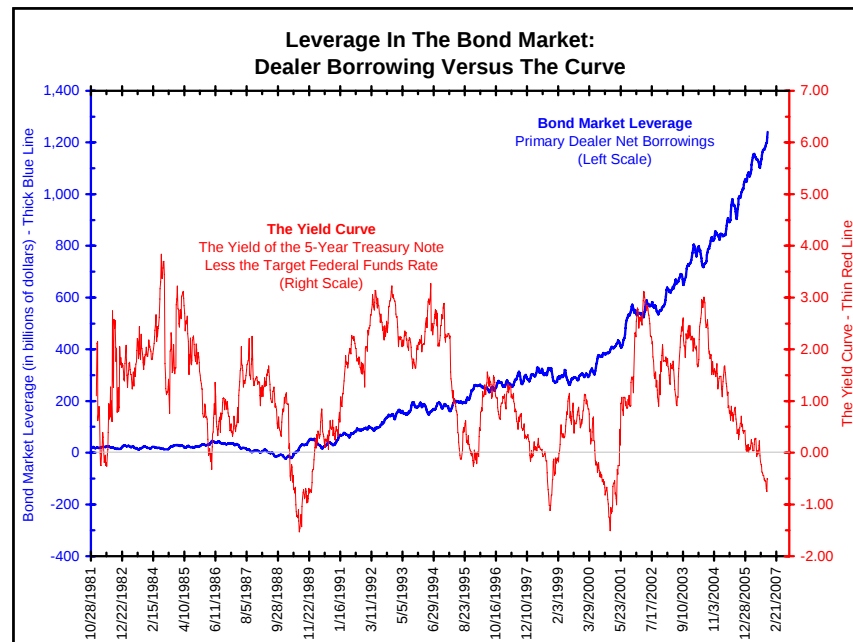
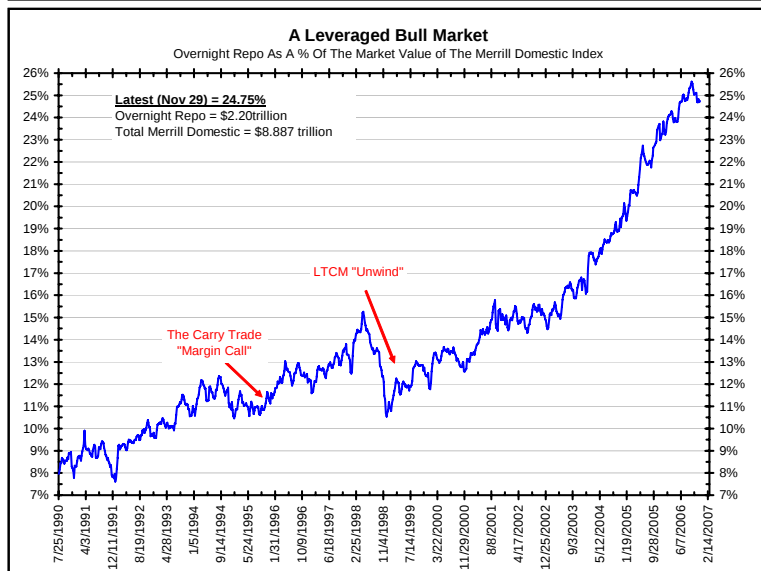
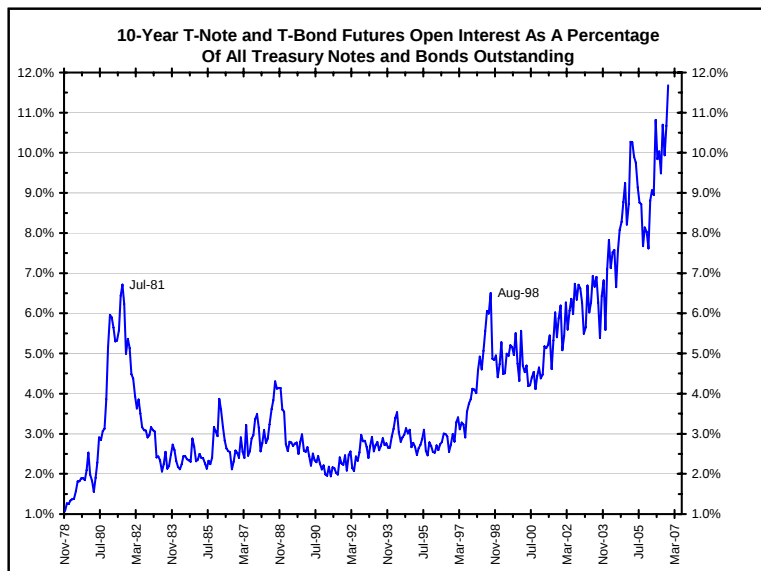
The most recent monthly increases in OER generally have been smaller than those earlier in the year, and further slowing may occur as the supply of rental units increases and the demand for owner-occupied housing stabilizes. However, the future evolution of this measure is difficult to know with any certainty.



Detailing The Trade Deficit



Measures of Leverage In The Bond Market



Bond Market Volatility

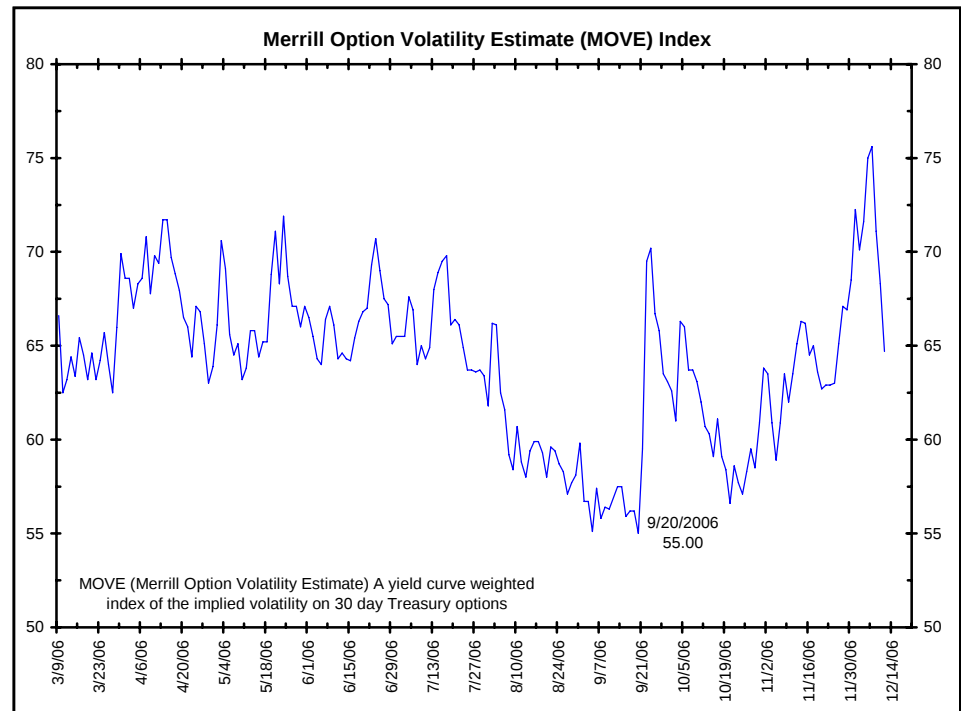
From Our [Newsclips/Daily Commentary](#)

In recent months, many asked why financial market volatility is so low. All too often, the conclusion has been that hedge funds are selling volatility. And with over 9,100 hedge funds in existence, the probability that some fund somewhere is engaged in an action to which you can attach a label is high. This includes selling volatility by methods as yet unaddressed.

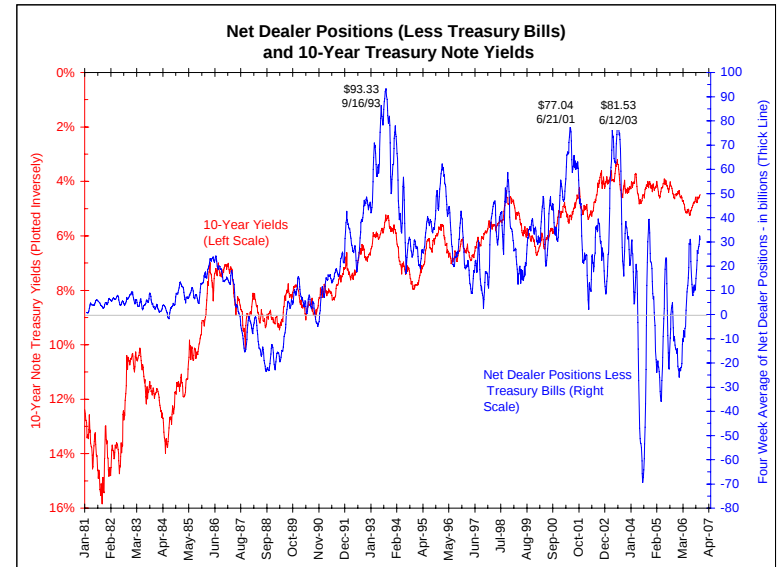
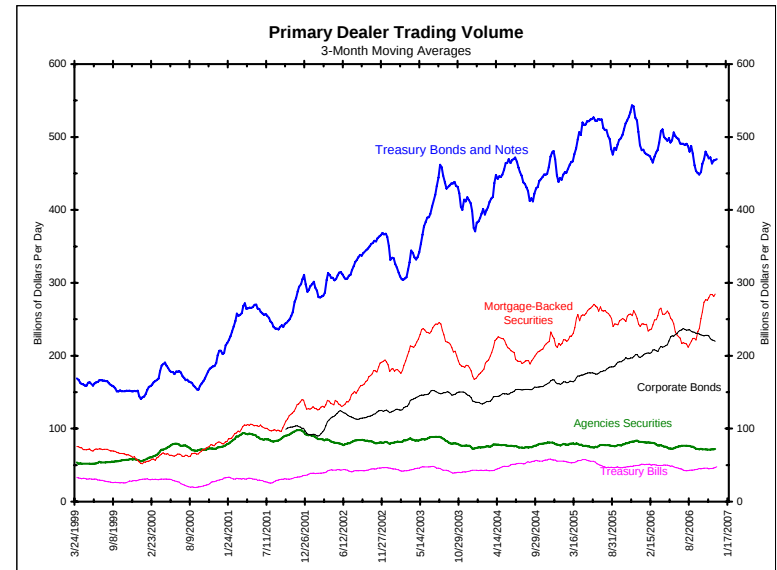
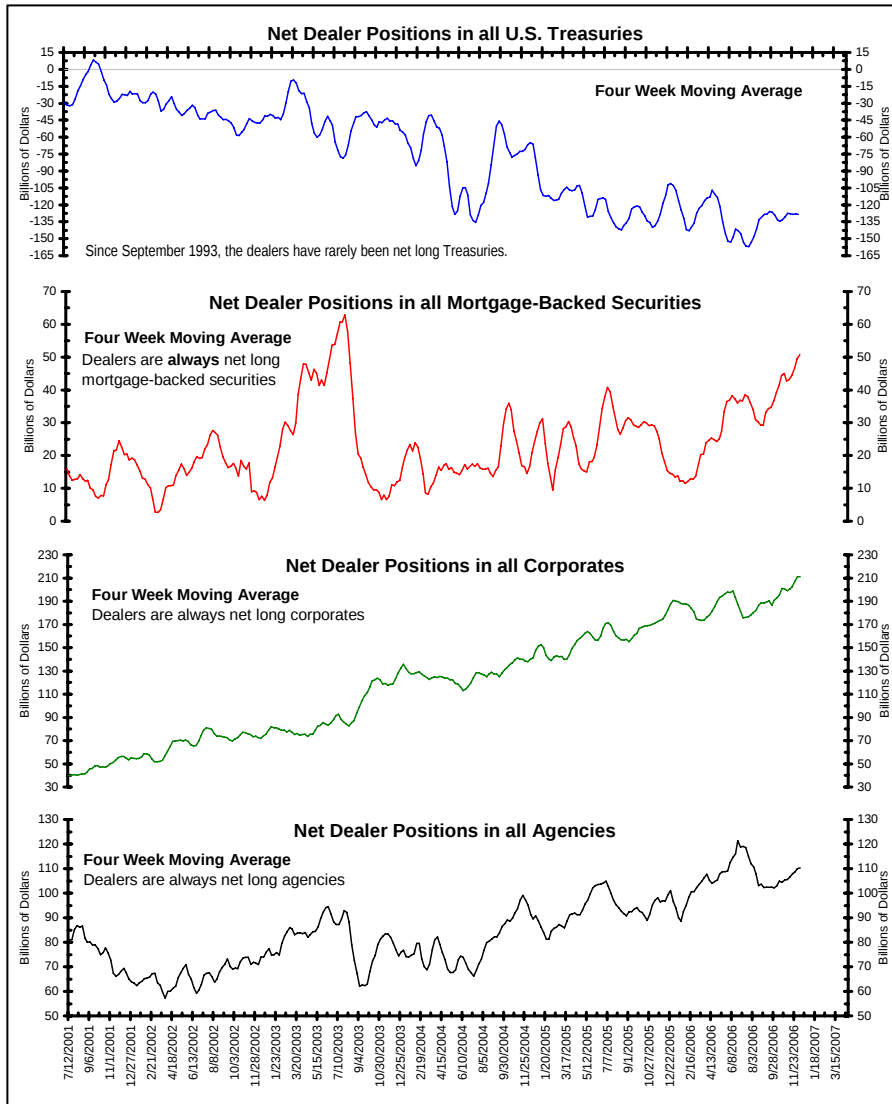
This argument's logic collapses quickly. Implied volatility reflects the price for insuring against future uncertainties. It is non-persistent over time; if your forecast today is for hot weather next July, what temperature events over the next three days will alter that forecast? Moreover, it presumes a known, quantifiable and stable relationship between the tradable prices of the underlying instruments and implied volatility itself. The price of insuring against an uncertain risk arriving at an uncertain time has no closed-form arbitrage relationship against the price of an underlying asset, such as a bond.

As we detailed in our September 28 [conference call](#) and our November 6 [Commentary](#), we believe volatility is low because of increased transparency from the world's major central banks, especially the Federal Reserve, and what had been the parallel policies between the Federal Reserve and the European Central Bank as measured by the expectational structures of their respective LIBOR curves. These policies diverged in late November; the market expected relatively tighter policies from the ECB and the euro rose in response on the foreign exchange markets.

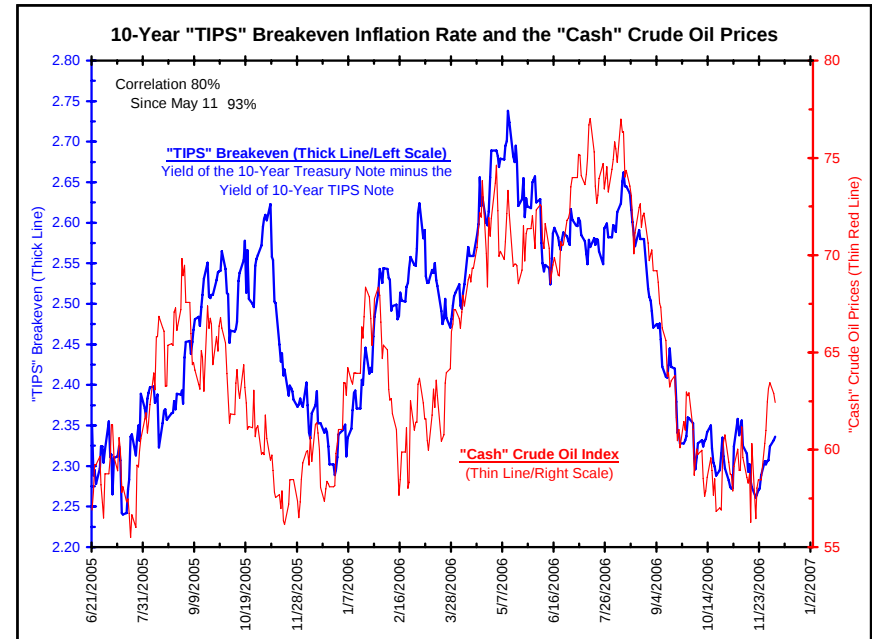
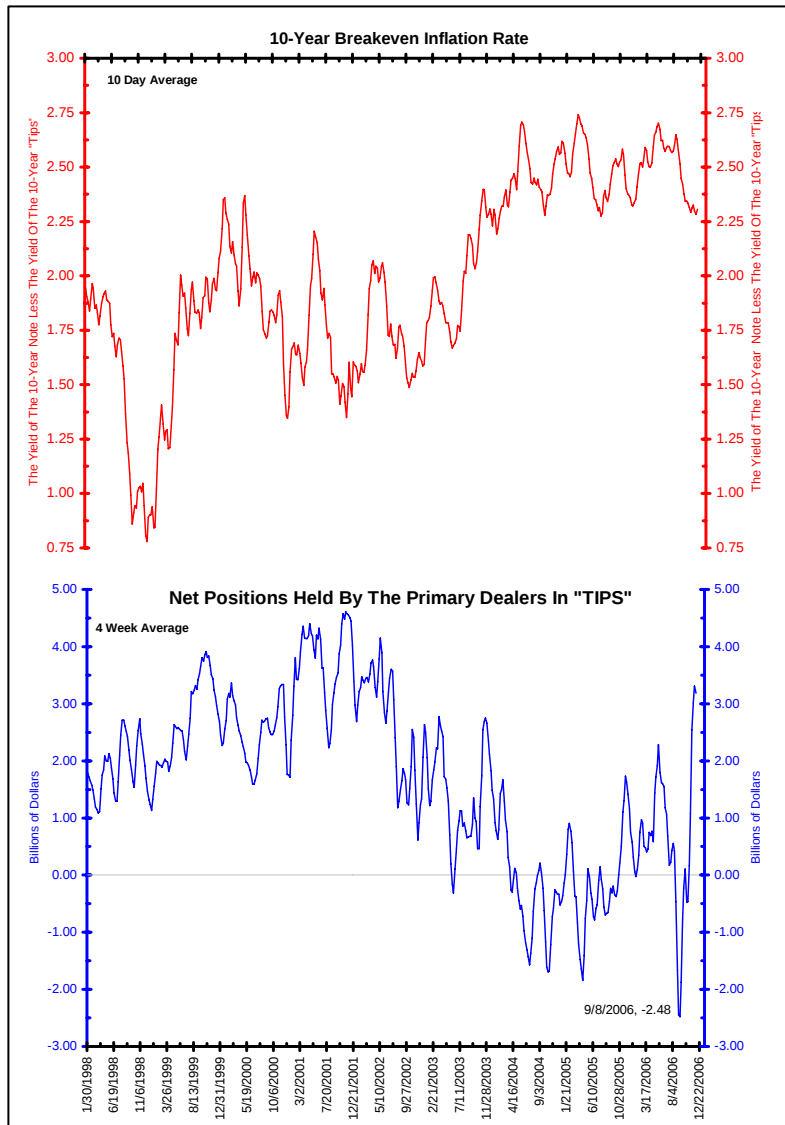
It is divergent policies such as these that affect volatility, not the zero-sum and non-demonstrable trading of hedge funds.



Primary Dealer Trading Volume And Positions



TIPS Dealers and Crude Oil

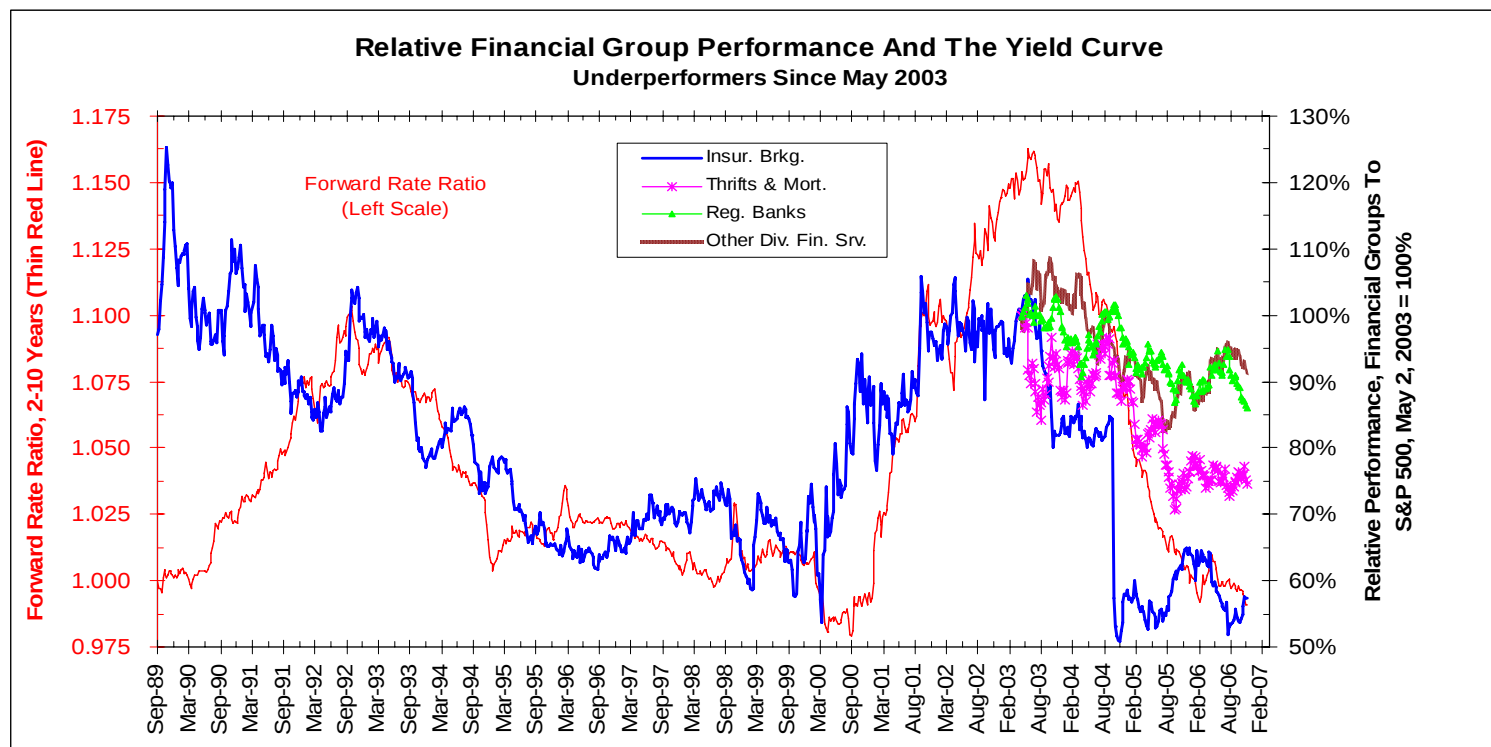


Carry And Financial Stock Group Performance

From A Recent [Commentary](#)

The Forward Rate Ratio, our measure of the yield curve, is the thin red line in each chart. Of the four groups in the underperformer classification, three obviously are carry-dependent. These include the Thrifts & Mortgages (magenta), the Regional Banks (green) and the dryly-named Other Diversified Financial Services (hatched brown), which consists of Citigroup, JP Morgan Chase and Bank of America. The fourth, Insurance Brokerage, consists of Marsh & McLennan and Aon.

These groups' business model is linked to the classic carry dependency of financial firms. We should not be surprised they have underperformed in 2006, nor should we be surprised when they outperform whenever the next yield curve steepening cycle arrives.

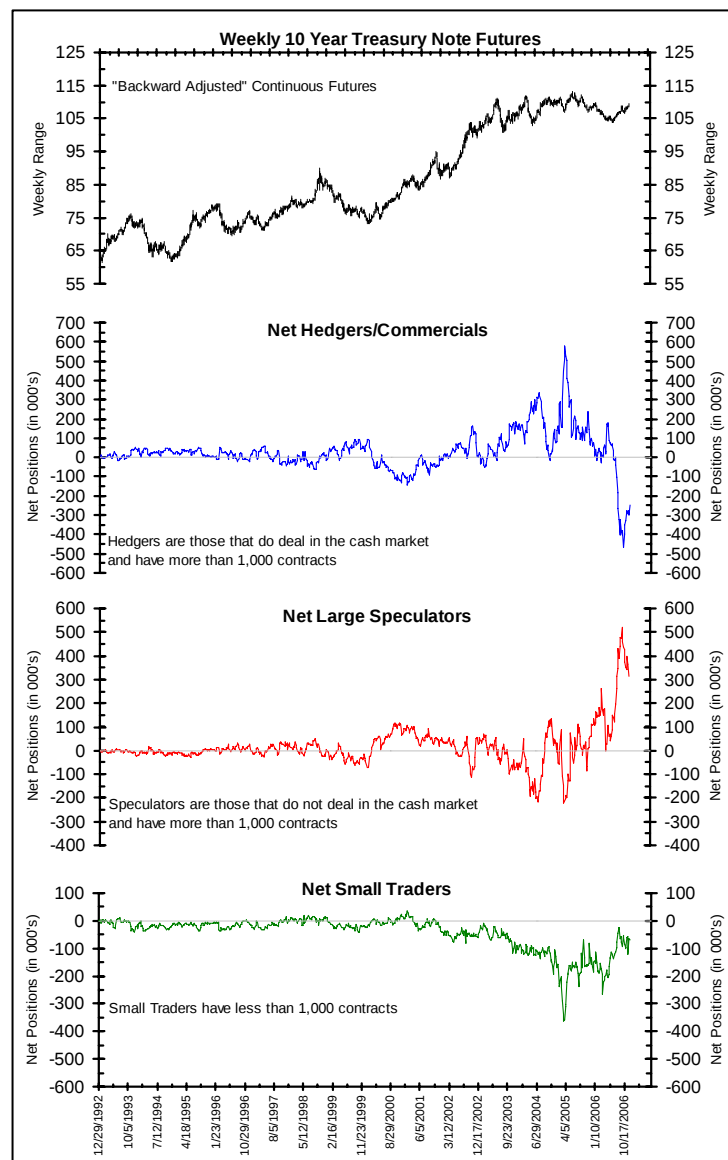


10-Yr Futures: Large Speculators Continue Long Liquidation

From Our Latest [Commitment Of Traders Update](#)

Friday's Commitments of Traders data for 10-year note futures showed Hedgers were **net short 247,294** contracts on December 5. At the same time, Friday's report showed the Large Speculators were **net long 314,946** contracts on December 5.

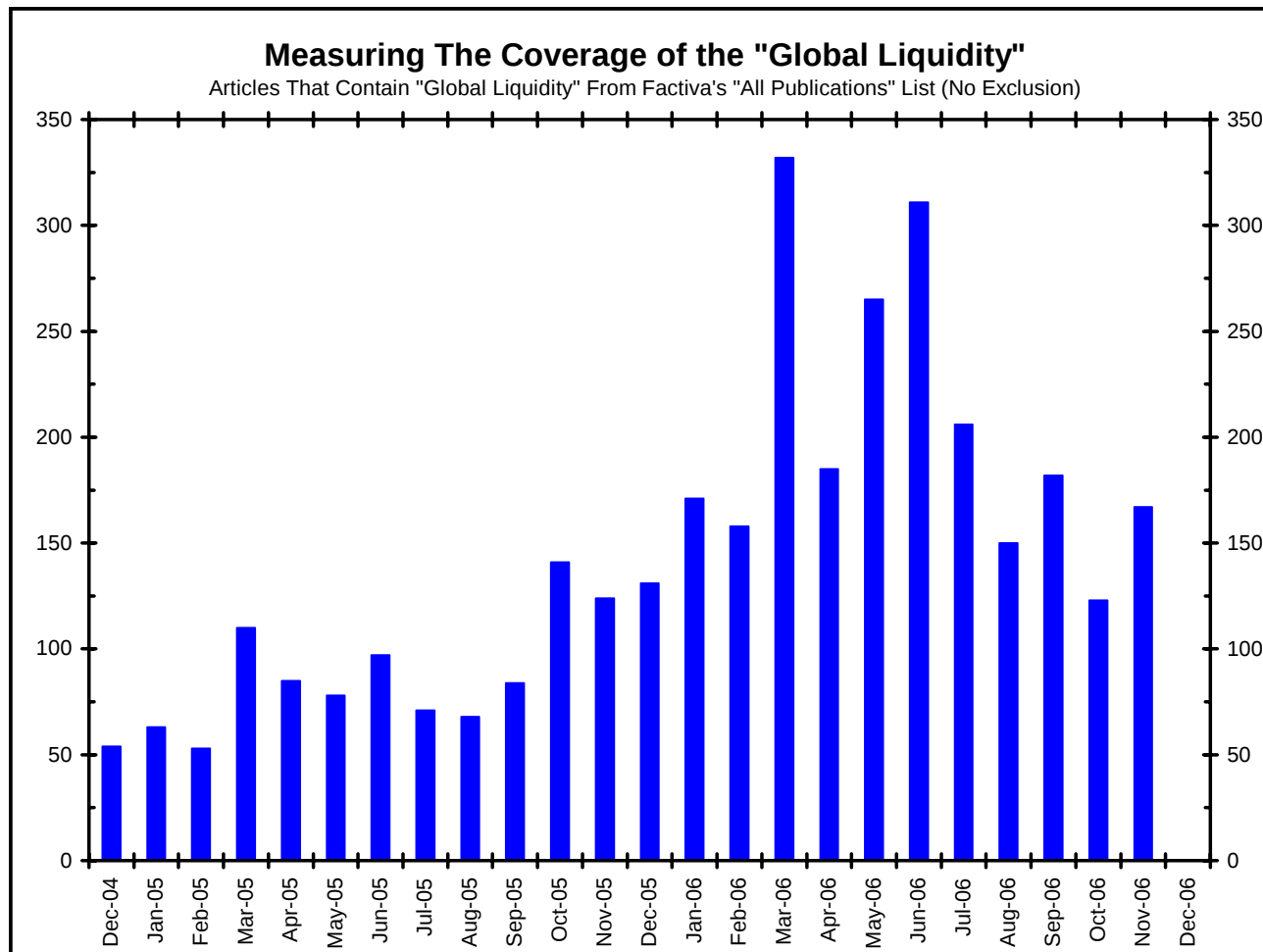
The oft-noticed record net long position of Large Speculators in ten-year note futures has been under liquidation for weeks, even as the notes themselves continue to climb. For this contract, at least, the Large Speculators adopted the tactic of buying low and selling high as opposed to their normal *modus operandi* of buying high and trying to sell higher.



Talk About Global Liquidity

From Our [Newsclips/Daily Commentary](#)

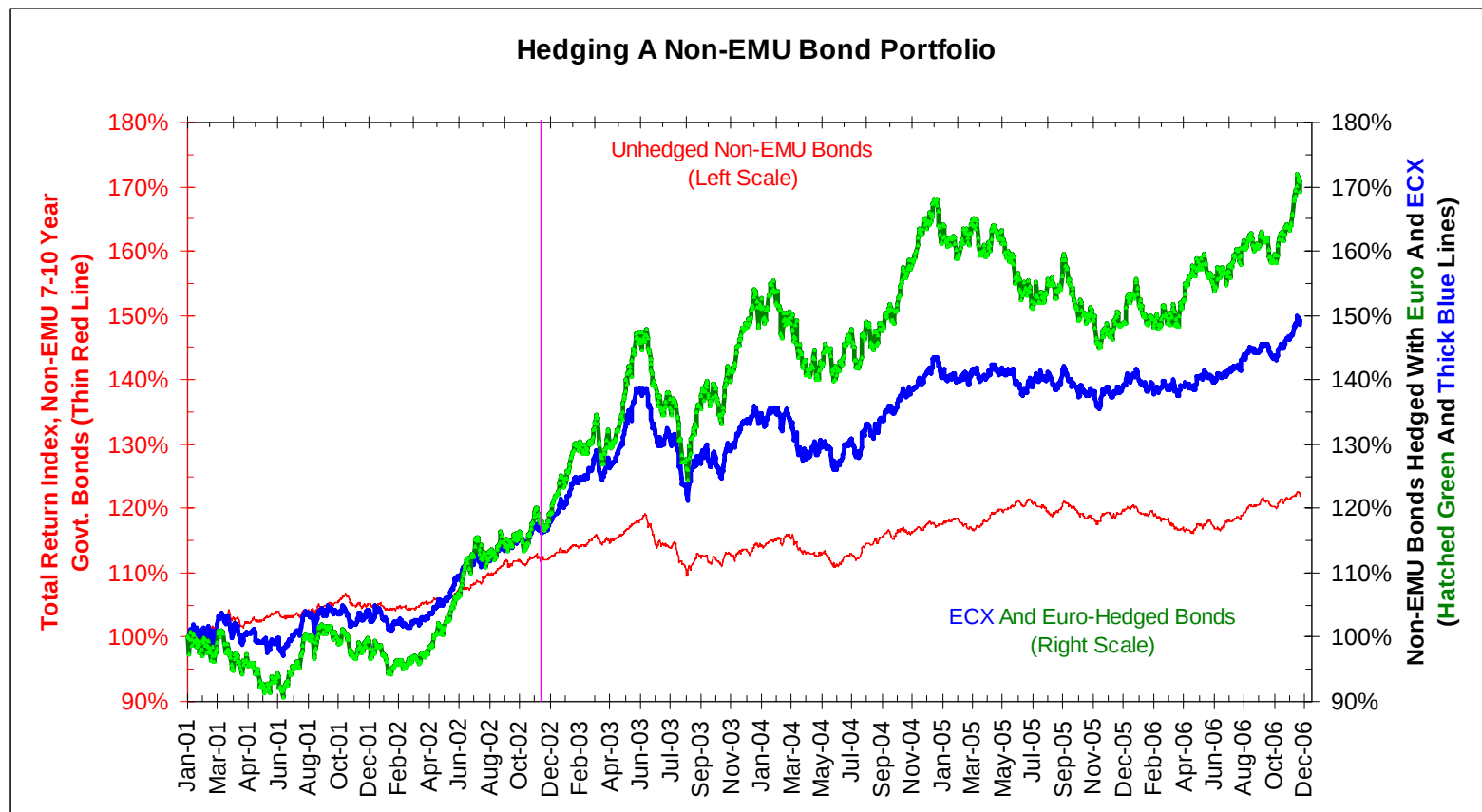
There is certainly no doubting that global liquidity is a hot topic in any financial discussion recently. We created the chart below to try to mimic David Rosenberg's study mentioned in the article above. It shows the total number of instances that the term "global liquidity" is mentioned each month in Factiva.com's "All Publications" list. While excess liquidity is still a topic of interest, it appears from this chart that it was a much hotter topic in the period from March 2006 to June 2006.



Comparative Hedge Returns

From A Recent [Market Facts](#)

What does a total return index of non-EMU 7-10 year government bonds rebased to January 2001 look like unhedged (thin red line) and hedged with either the euro or the ECX (hatched green and thick blue lines, respectively)? Over the life of the hedge, hedging with a long euro position provides the greatest total return in euro terms. This reflects the euro's 2003-2004 strength against the dollar. **Regardless, euro-domiciled investors who hedged their portfolios outperformed the non-hedgers by a substantial margin.**



The Dollar's Status As A Reserve Currency

Rumors of the dollar's (blue line) demise as a reserve currency – see the litany of links below – are exaggerated greatly. Yes, the percentage of dollars held in national reserve accounts has declined since the advent of the euro (red line), but this was to be expected with the creation of a common currency in a region with a combined GDP greater than the U.S. Prior to 1999, few would have held francs, lira, pesetas, escudos, marks, markka, schillings, guilders, drachmas or punts with the realization, post-Maastricht, of their impending demise? The mind rebels. And while a few central banks hold Japanese yen in their coffers (green line), this most likely is attributable to some form of international etiquette best understood inside the cloisters of the Bank of International Settlements in Basel.

Yes, the dollar: You're either with it or against it.

[FinancialSense.com](#) - [WILL CHINA LEAD A STAMPEDE OUT OF THE US DOLLAR?](#) (NOV 2006)

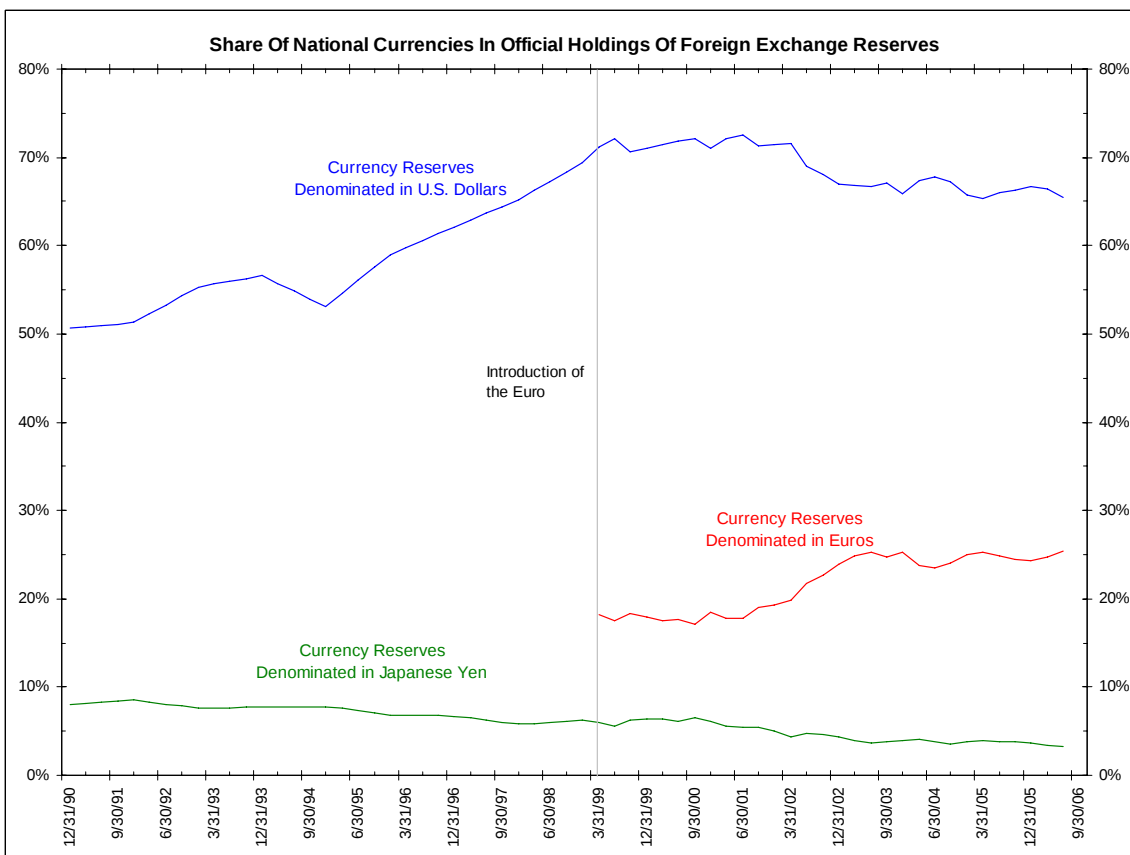
[MiddleEastForex.com](#) - [Euro to overtake dollar by 2015, says UAE official](#) (DEC 2006)

[EnergyBulletin.com](#) - [Signs Grow Of Dollar Losing Favor As World's Reserve Currency](#) (FEB 2005)

[Mosnews.com](#) - [Russia Shifts Part of Its Forex Reserves from Dollars to Euros](#) (SEP 2006)

[Telegraph.co.uk](#) - [Bank of Italy slashes dollar holdings in favour of UK pound](#) (MAR 2006)

[FinancialCryptography.com](#) - [USD shift in reserve currency status confirmed - call it 10% per year](#) (JUNE 2006)



Your View Of The Dollar Depends On Where You Are

From Our [Newsclips/Daily Commentary](#)

In May 2004, we penned an op-ed for *The Wall Street Journal* that applies here. Some excerpts:

[\(May 10, 2004\) Irreconcilable Differences Over the U.S. Economy](#) by James A. Bianco

For years American and European investors held similar opinions about the U.S. economy (as expressed through their opinion about U.S. interest rates). While not always right, it was hard to discern any difference of opinion between an American and European investor on this subject.

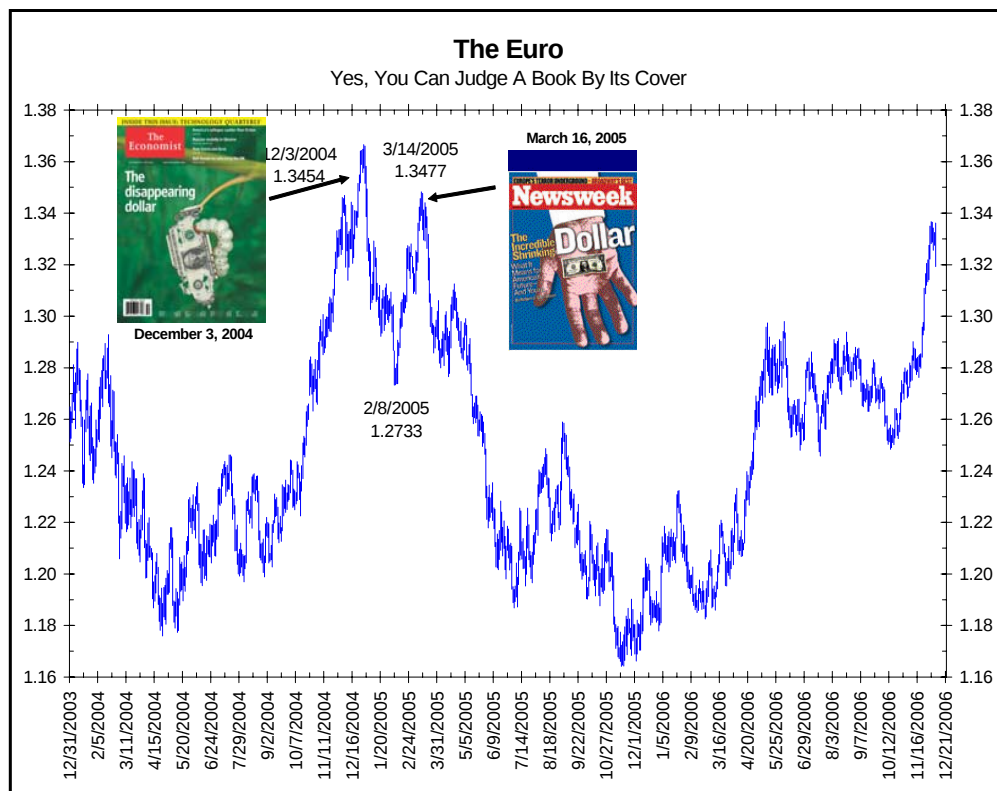
Since the Iraq war, this is no longer the case. European and American investors now hold nearly polar opposite views about the U.S. economy.

American investors have a very optimistic view of the U.S. economy. They expect the massive amount of fiscal and monetary stimulus pumped into the economy over the last few years to produce above-average growth over the next several years. They even fret this growth could lead to an inflation concern. They view last week's strong jobs report as further evidence the economy is booming.

. . . Lastly, the dollar's weakness is a concern, but not sufficient by itself to alter the optimist outlook of American investors. European investors, by contrast, are very pessimistic about the U.S. economy. They argue that the economy has been artificially supported by one-time tax cuts and easy Fed policy so recent signs of strength are unsustainable. Once the Fed starts raising rates, which they seem ready to do, and tax cuts "run out," they believe the U.S. economy will falter. When it does, any inflation talk will revert back to the inevitability of deflation similar to the post-bubble Japan experience. The dollar's weakness is viewed as evidence that the U.S. Empire is waning.

Two years later and little has changed. As the story above says, Americans are little concerned about the recent weakness in the dollar. As the stories below suggest, Europeans are so worked up about a falling dollar that they are breathing into brown paper bags to prevent themselves from hyperventilating. Little wonder that last week it was a European based publication, *The Economist*, that featured a [cover story](#) that the dollar would fall further.

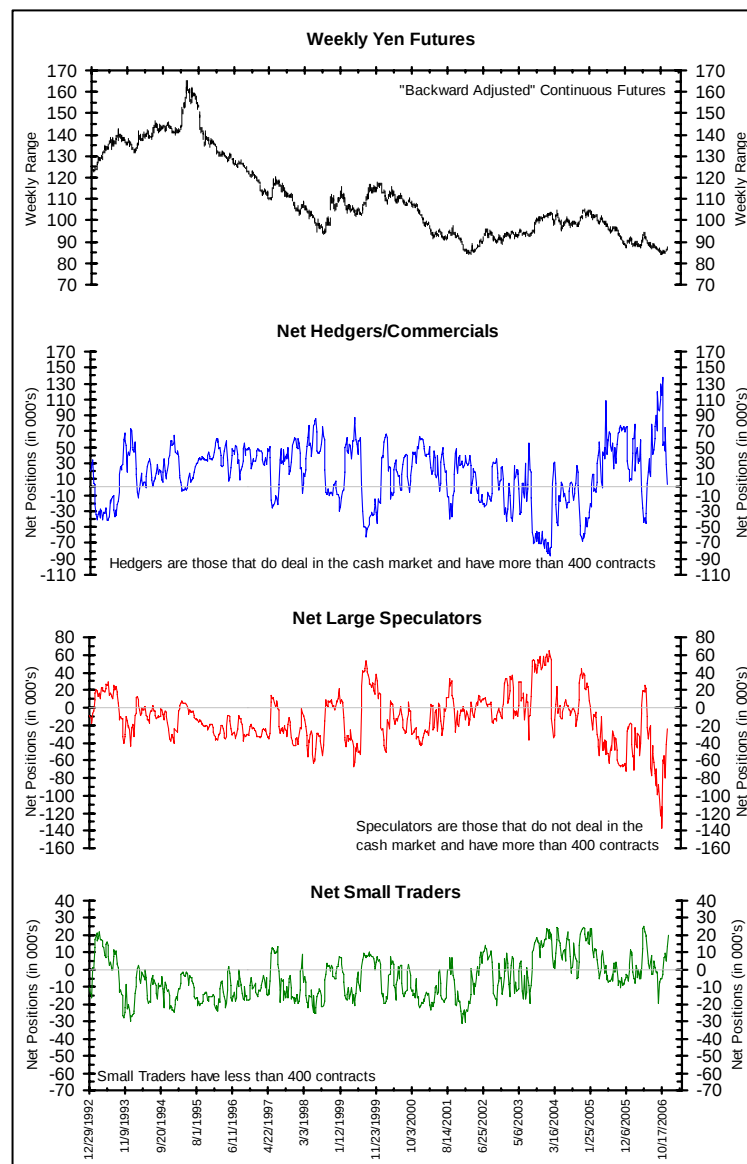
As we detailed Friday, it is more likely that European hysteria about dollar weakness means a low is near rather than American complacency meaning further weakness is coming. As the chart below shows, this was the case two years ago as we suspect it will be the case again.



Yen Futures: Large Speculators Cover Shorts

From Our Latest [Commitment Of Traders Update](#)

Friday's Commitments of Traders data for Yen futures showed Hedgers were **net long 3,743** contracts on December 5. At the same time, Friday's report showed the Large Speculators were **net short 23,537** contracts on December 5. The yen's modest upturn since October prompted a burst of short-covering by Large Speculators; we must note the December futures are expiring shortly and the forex market thins considerably at year-end. It would appear few short positions taken prior to September's expiration were closed profitably, and the December 8th selling in the yen simply added insult to injury.



Robert Toll's Opinions

From Our [Newsclips/Daily Commentary](#)

Is Mr. Toll a housing market visionary or its version of John Chambers (the CEO of Cisco Systems who insisted, right before the tech market collapsed in the spring of 2000 that he had "visibility" for years to come and everything looked great)? We would argue that he is John Chambers redux and is offering little more than an emotional reaction to his stock price (as we detailed in an August [Market Facts](#)).

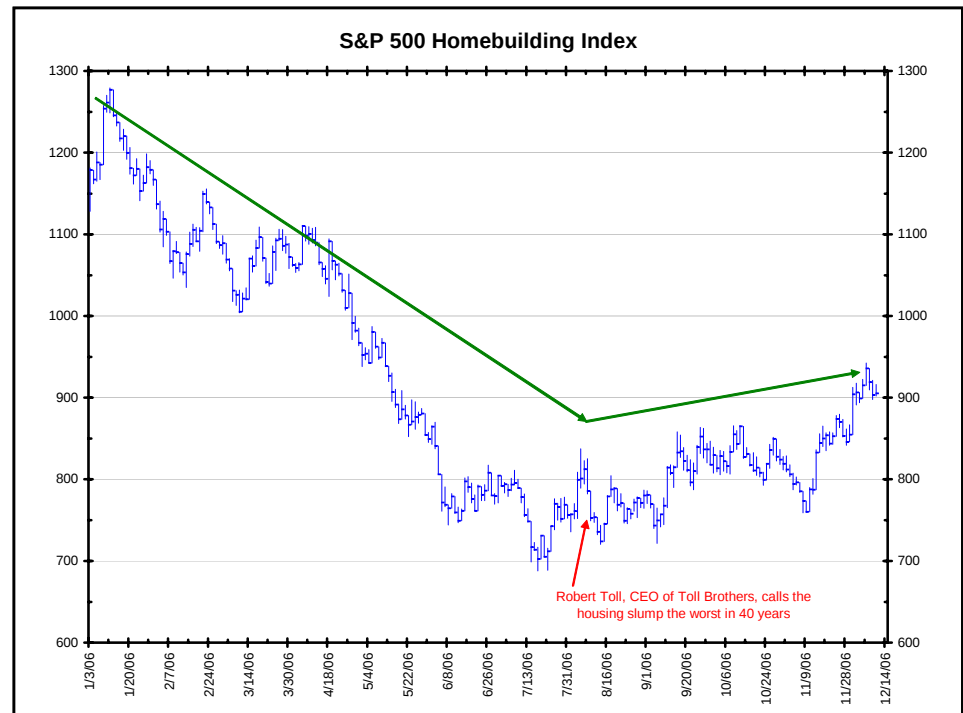
On October 3, 2005 when Toll's stock was at a multi-year high in a [USA Today article](#), Bob Toll said the following to Ron Insana:

But according to Robert Toll, the CEO of Toll Bros., one of the nation's home builders, there is no bell tolling for the housing market. Toll says that the housing market will be fine for years to come, despite the concerns of "bubble heads" (like myself) who worry the housing boom is about to bust. Toll says not to worry, at least as far as his company is concerned, because the brothers Toll have so many homes left to build, their closing bell is still many years away.

Toll went on to say he had "visibility" through 2010 and saw rising earnings and clear skies. 10 months later Toll Brothers is choking on too much inventory and he is crying this is the worst housing market in 40 years. Some visibility. Then on [August 9](#), Bob Toll said: The slowdown "is the first downturn in the forty years since we entered the business that was not precipitated by high interest rates, a weak economy, job losses or other macroeconomic factors," Toll said in his statement. "Instead, it seems to be the result of an oversupply of inventory and a decline in confidence," he added.

"Speculative buyers who spurred demand in 2004 and 2005 are now sellers; builders that built speculative homes must now move their specs; and nervous buyers are canceling contracts for homes already under construction." Toll's warning turned out to be an excellent time to buy the homebuilding stocks. The S&P 500 Homebuilding index advanced 22% since this warning.

We would argue that Robert Toll's predictions are contrarian indicators like John Chambers? We could probably guess his opinion based on an inspection of his stock chart as he seems to be describing the trend of the previous few months. Given this, his latest prediction of a bottom in the housing market does not bode well for the homebuilding stocks.



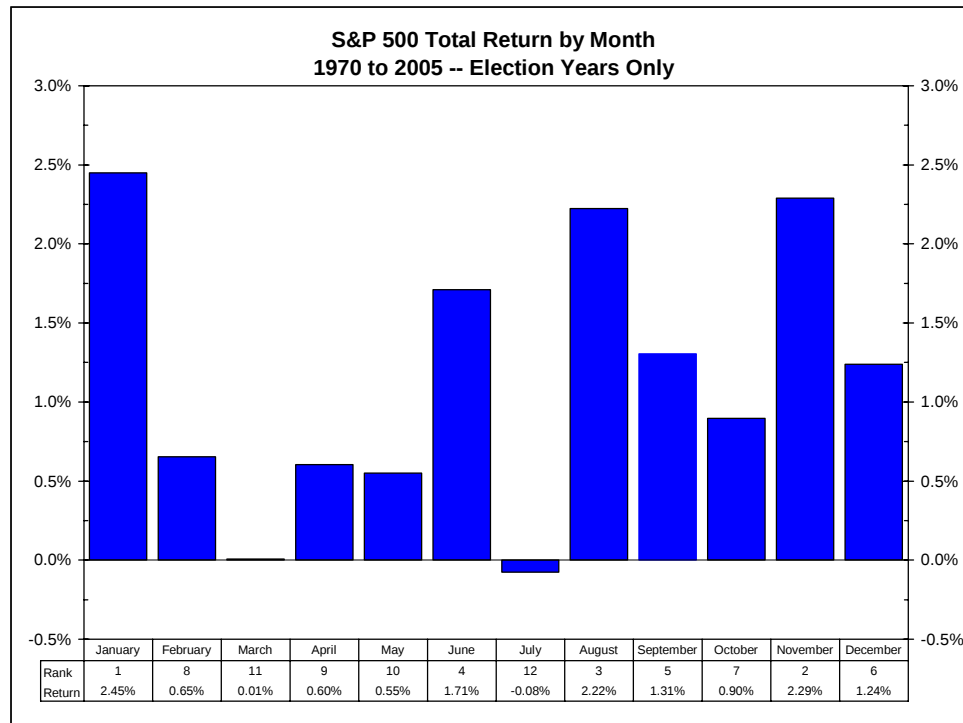
Stock Market Seasonal Pattern

From Our [Newsclips/Daily Commentary](#)

MarketBeat (WSJ Blog) - [The Holiday Month](#)

The market is headed for a gloomy open to December, which has traditionally been the best month for the S&P 500 going back to 1950. In December, the average gain by the S&P 500 is 1.7%, according to the Stock Trader's Almanac, while this has been the second best month for the Dow, with an average gain of 1.8%. The Dow, S&P and Nasdaq have gained five months in a row, however, and investors are concerned about economic conditions, which point to a third consecutive quarter of below-trend growth. Analysts at Birinyi Associates note with some satisfaction that this bull market, now the fifth-longest since 1962, has been the most methodical, with an average daily gain of 0.078%, a slower rate of increase than the other ones — which “suggests a slow steady pace which we think is preferable to starts and stops,” they write. However, in recent weeks the market has started bouncing — which has been of concern to them.

Comment - If you believe in seasonal patterns, the stock market has two more good months, December and January, before things turn down. Of course, July to September was supposed to be a bad period for stocks, which it was not this year.

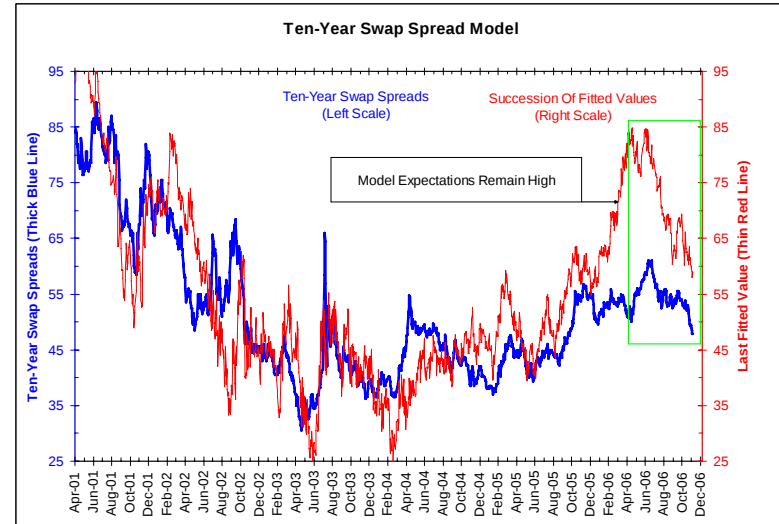


Ten-Year Swap Spreads

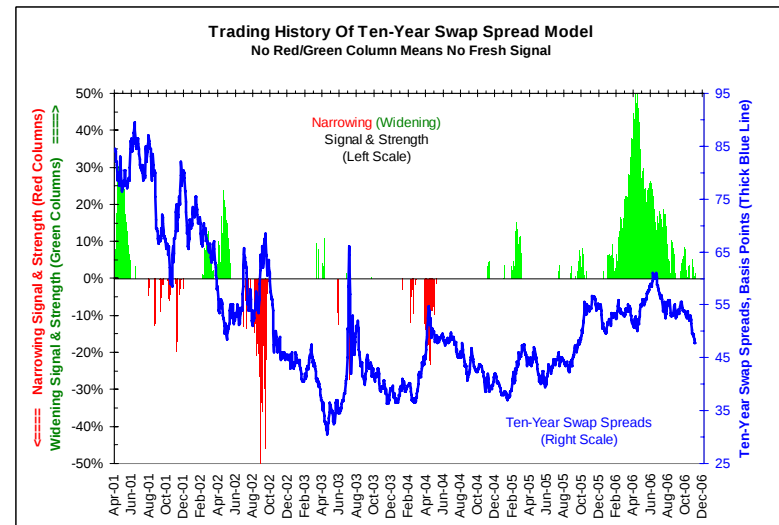
From Our [European Fixed-Income Spread Model Update](#)

Contribution Of Inputs Over Past Week				
Factor	Coefficient To Swap Spread	Factor's Beta	Factor Movement	Contribution To Signal
Ten-Year Note Yield:	Positive	0.934	Falling	Narrowing
3-6 Month LIBOR Curve:	Negative	0.316	Falling	Widening
Ten-Year Note Volatility:	Negative	0.112	Falling	Widening

- Both actual ten-year swap spreads (blue line, top chart) and the model's expectations (red line, top chart) narrowed
- The operating signal, a widening initiated on Nov. 29, 2004, (green columns, lower chart) has been reinforced by successive signals, most recently on November 29th
- Two of the three variables in the model (top table) worked toward a continued widening this week



Summary Historic Statistics				
From April 23, 2001				
Historic		Current		
Total Signals:	11	Current Position:	Widening	
Correct Signals:	6	Entry Date:	29-Nov-04	
Percent Correct:	54.5%	Entry Price, BP:	39.75	
Average P/L:	7.6173	Current Price, BP:	47.80	
Total P/L:	83.79	Current Open P/L:	8.05	

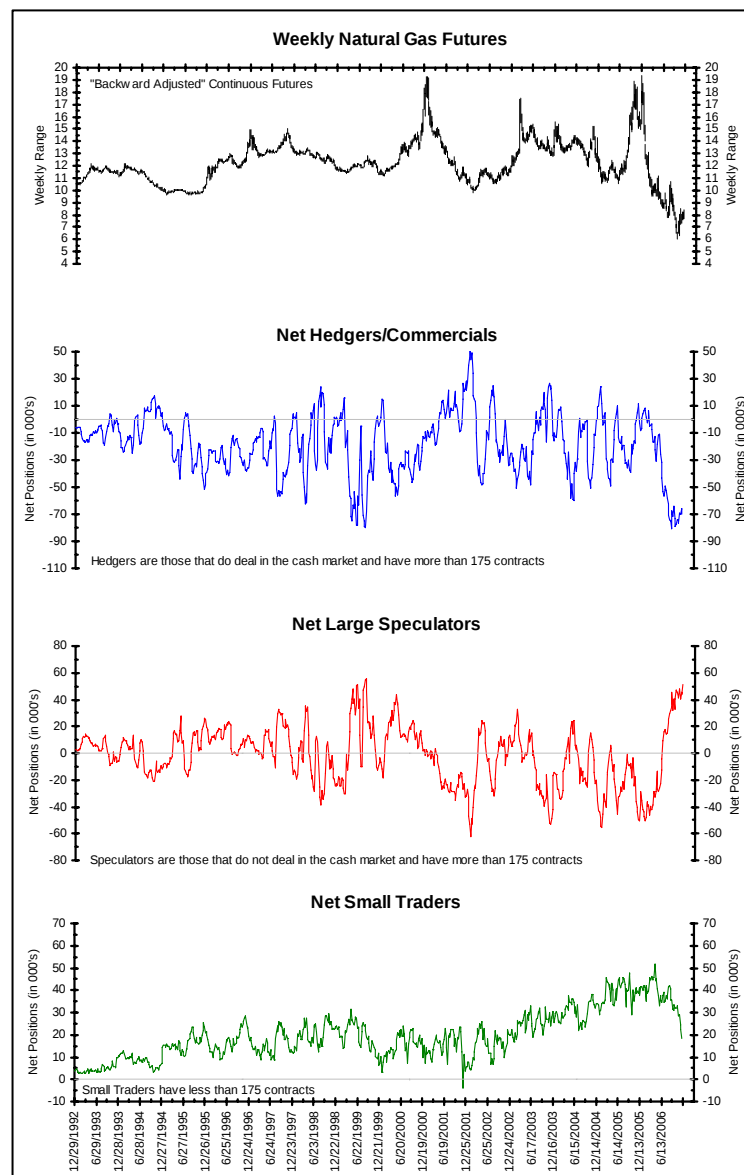


Natural Gas Futures: Large Speculators Hear Sirens' Song

From Our Latest [Commitment Of Traders Update](#)

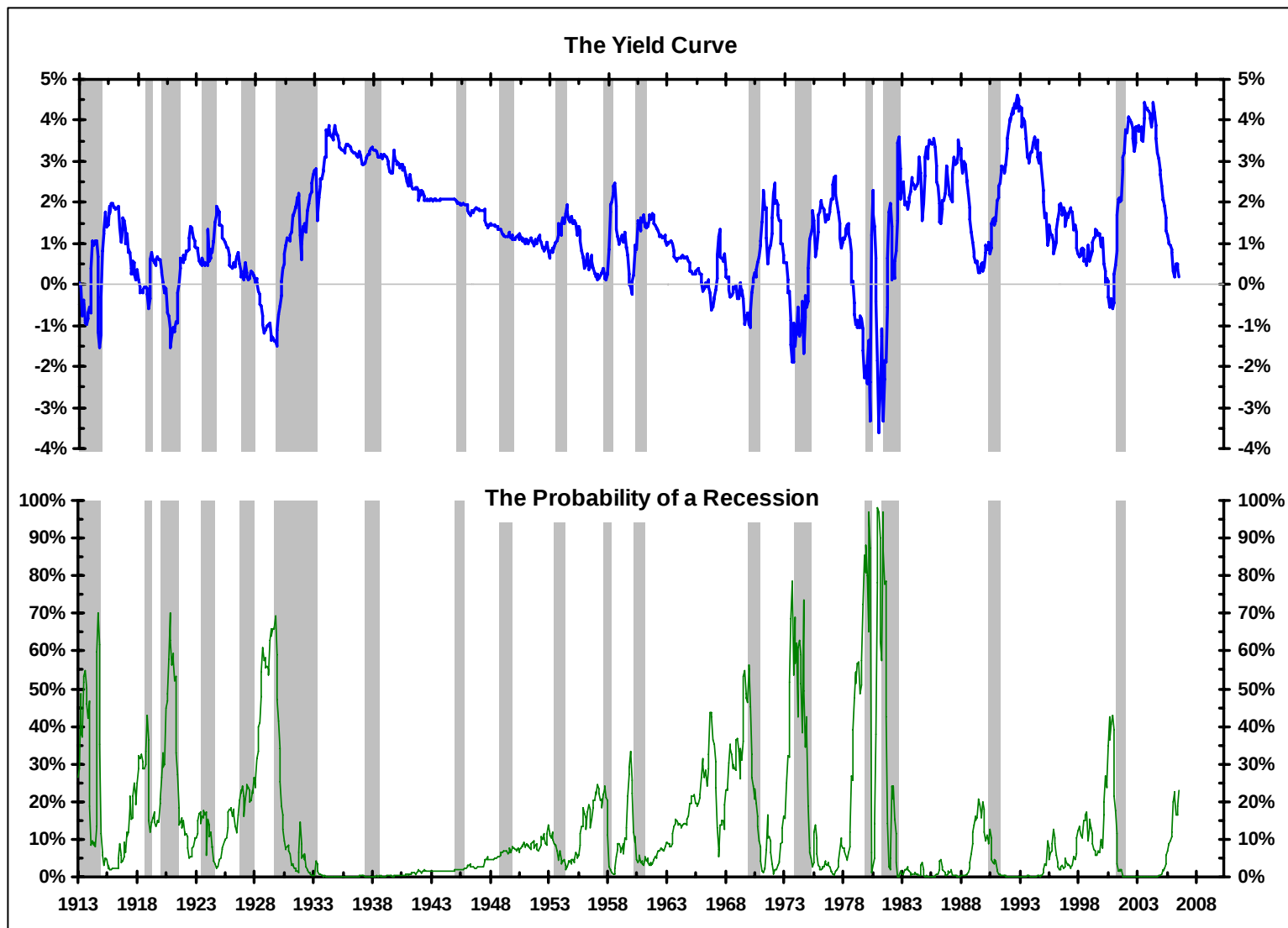
Friday's Commitments of Traders data for natural gas futures showed Hedgers were **net short 69,692** contracts on November 28. At the same time, Friday's report showed the Large Speculators were **net long 51, 544** contracts on November 28.

A generation of executive fools thought they could run airlines; their successors think they can run newspapers. Their commodity-trading children think they can trade natural gas, which helped bring down Enron, MotherRock and Amaranth, amongst others. Often wrong but never in doubt, the Large Speculators have moved to a near-record net long. We wish them the best.



The Probability Of A Recession Since 1913

From Our Collection of [Long-Term Charts](#)



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