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Volume, 11 No. 10 Last Commentary: April 28, 1999

COMMENTARY

Market Opinions And Topics Of Interest
May 18, 2000

The Trade No One Recommended?
Part 1 – How Bad Has Spread Product Performance Been?

Lately a dominant theme in the fixed-income markets has been the poor performance of spread products. In this commentary we take a look at how poor this performance has been. In upcoming commentaries we offer reasons and theories why this performance has been so bad.

Year-to-Date Performance
(as of May 16, 2000)

Index	Total Return
Merrill Treasury Master	2.62%
Merrill Agency Master	0.49%
Merrill Mortgage Master	0.37%
Merrill Corporate Master	-0.80%
Merrill High Yield Master	-2.16%

Source: Ryan Labs

As the above table shows, Treasury securities have been far and away the **best** performing fixed-income sector this year. This is no surprise. However, what may be a surprise to many is how long this performance disparity has lasted.

Chart 1: This chart shows the rolling 1-year performance of some of the major Merrill Master indices over the Merrill Treasury Index. A number above zero means that the Master Index is outperforming the Treasury Master Index. As number below zero means it is underperforming the Treasury Master Index.

Currently all the Master Indices measured are below zero. This means that the Treasury Master Index outperformed all other indices for the last year.

Chart 2: In this chart we take the data from Chart 1 and rank the performance of the Treasury Master Index. A ranking of 5 means that over the previous 1 year period, the Treasury Master Index has been the worst performing of the five Master Indices studied (a list of these indices can be found in the nearby table). A ranking of 1 means it has been the best performing.

In late 1998, the Treasury Master Index achieved a number 1 ranking (as the best performing Index studied over the previous 1 year period) for the first time in the 1990s. This came in the wake of the financial crises of that year. After the data from late 1998 rolled off, the Treasury Master Index quickly dropped to number 5. This should not be a big surprise as mean reversion is common in this kind of analysis. However, note that the Treasury Master Index quickly returned to number one in the last few months.

Chart 3: This chart is exactly the same as Chart 1 except it uses a 3 year rolling period versus a 1 year rolling period. Notice that the all the Master Indices measures are below zero.

Chart 4: This chart is exactly the same as it Chart 2 except it uses a rolling 3 year period. What jumps out from this chart is that Treasuries are the best performing Master Index for the first time since the bull market began in 1981. The Treasury Master Index achieved this number 1 ranking in January of this year.

Conclusion

The Treasury Master has outperformed all other major fixed-income Master Indices year-to-date; over the last 1 year; and over the last 3 years. The Treasury Master is even starting to show signs of superior performance on a 5 year basis. Yet, as the title implies, we are hard pressed to find **any** Wall Street strategist that has recommended an over-weighting in Treasuries even though it has been the correct strategy for over three years now!

This is an important distinction because we believe that many are not aware how long spread product has under-performed. We say this because many of the reasons that are typically offered for the poor performance of spread product only address the last few months of under-performance. (Treasury

buybacks, supply, poor stock market performance, etc.) We believe any discussion of the poor performance of spread product should offer reasons that have been valid since early 1997. We will offer our reasons in part 2.

Chart 1

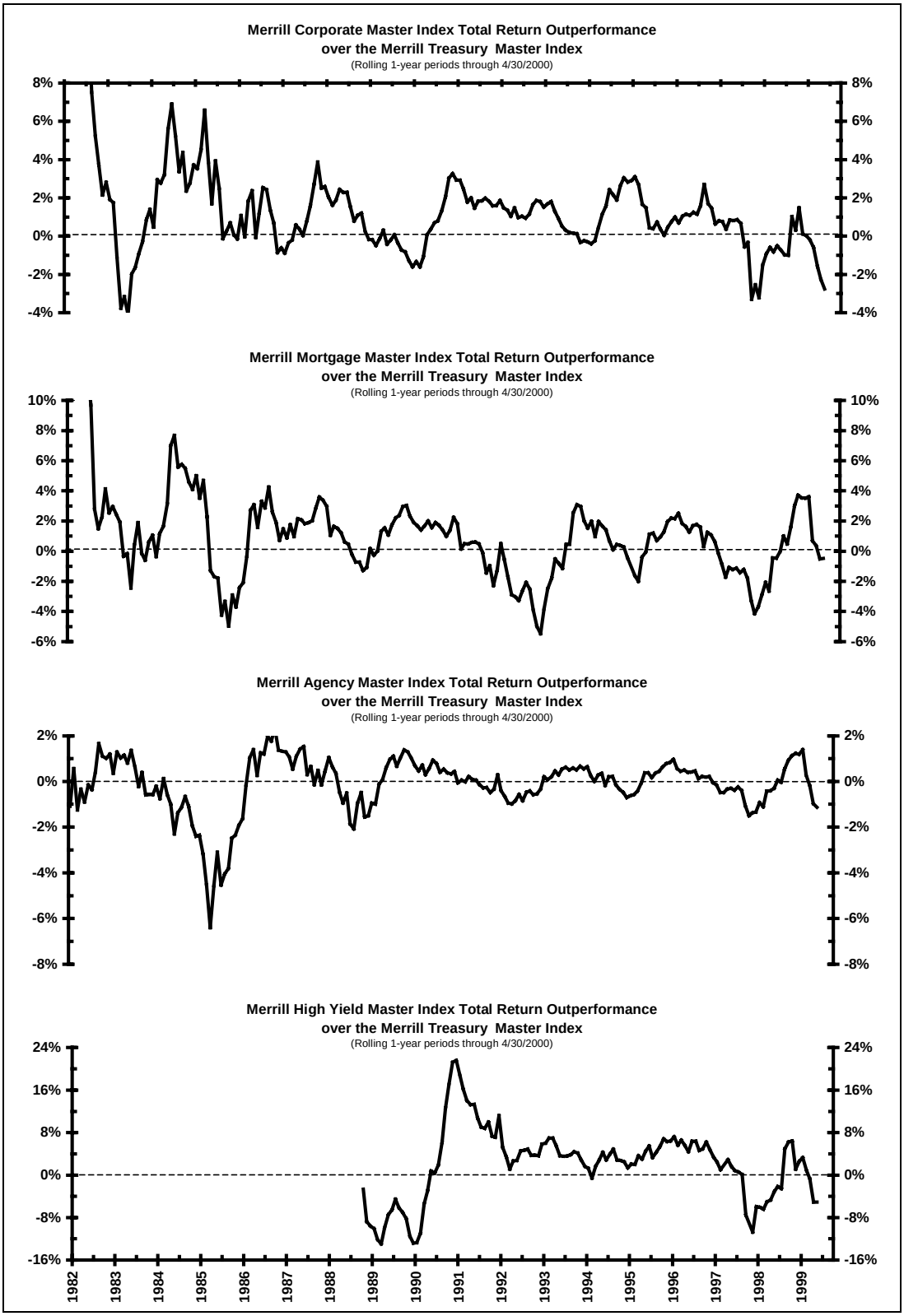
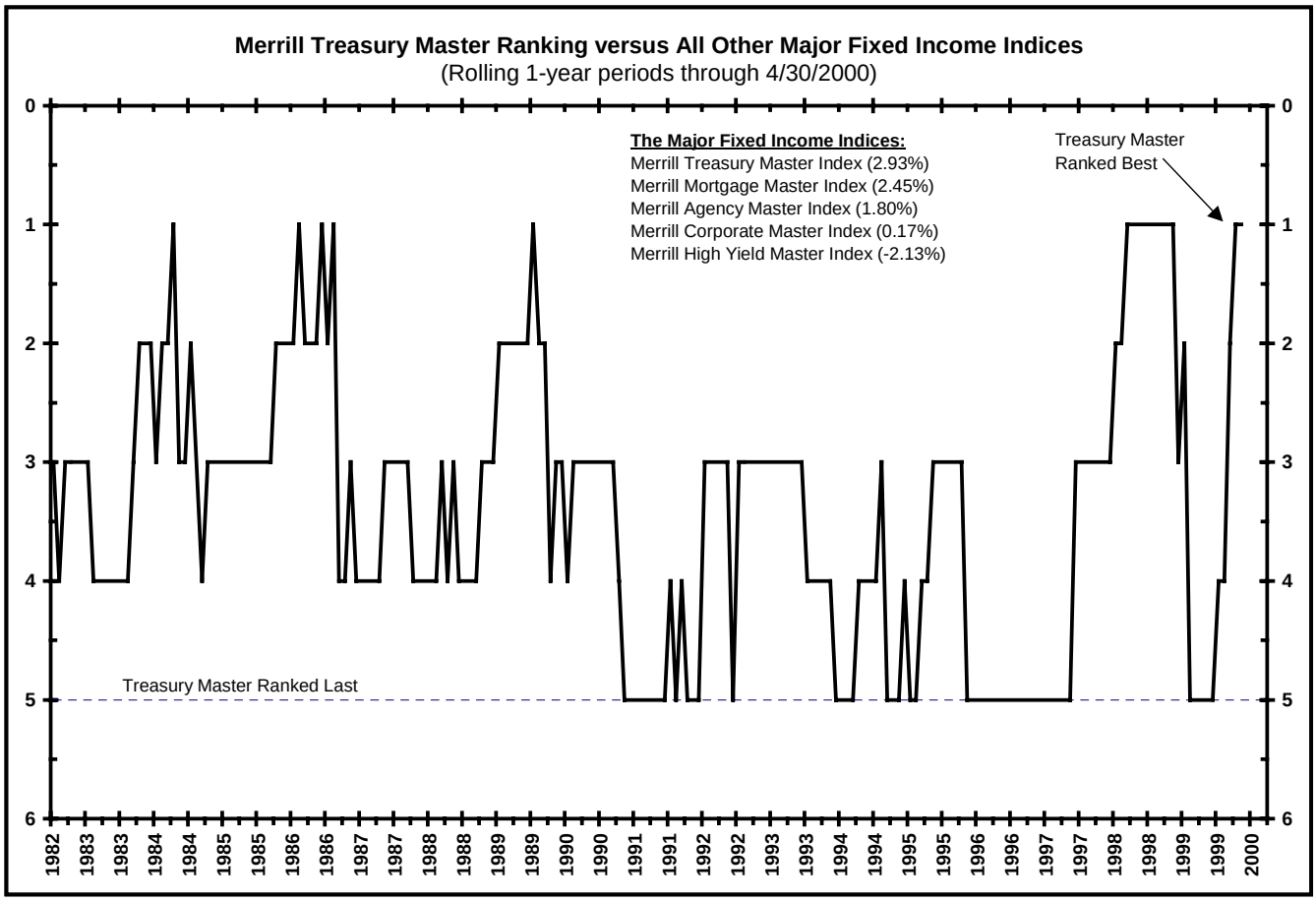


Chart 2


Merrill Treasury Master Ranking versus All Other Major Fixed Income Indices
(Rolling 1-year periods through 4/30/2000)
The Major Fixed Income Indices:
Merrill Treasury Master Index (2.93%)
Merrill Mortgage Master Index (2.45%)
Merrill Agency Master Index (1.80%)
Merrill Corporate Master Index (0.17%)
Merrill High Yield Master Index (-2.13%)
Treasury Master Ranked Best
Treasury Master Ranked Last
0
1
2
3
4
5
6
1982
1983
1983
1984
1984
1985
1985
1986
1986
1987
1987
1988
1988
1989
1989
1990
1990
1991
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1999
2000

Chart 3

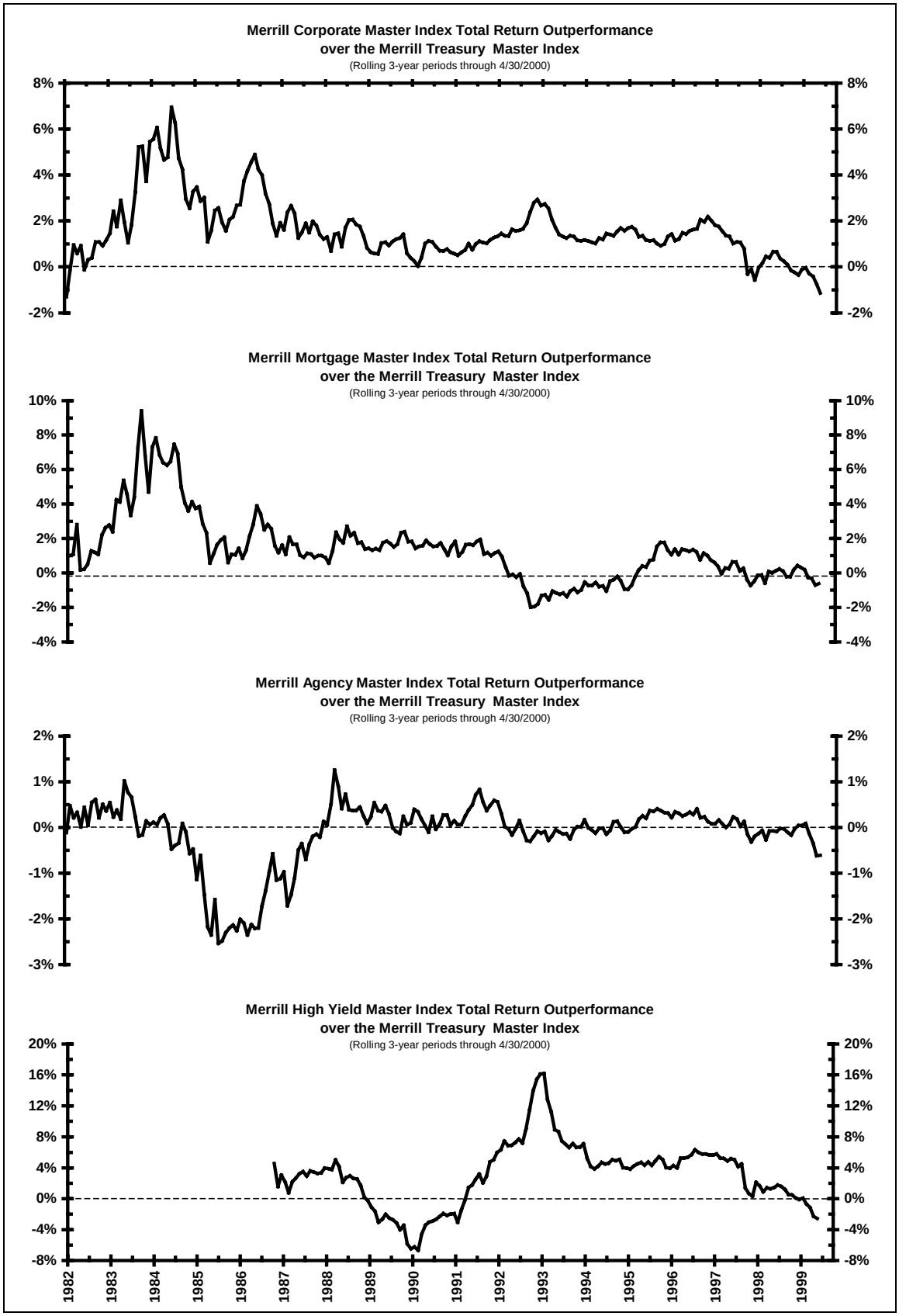
Merrill Corporate Master Index Total Return Outperformance
over the Merrill Treasury Master Index
(Rolling 3-year periods through 4/30/2000)
8%
6%
4%
2%
0%
-2%
Merrill Mortgage Master Index Total Return Outperformance
over the Merrill Treasury Master Index
(Rolling 3-year periods through 4/30/2000)
10%
8%
6%
4%
2%
0%
-2%
-4%
Merrill Agency Master Index Total Return Outperformance
over the Merrill Treasury Master Index
(Rolling 3-year periods through 4/30/2000)
2%
1%
0%
-1%
-2%
-3%
Merrill High Yield Master Index Total Return Outperformance
over the Merrill Treasury Master Index
(Rolling 3-year periods through 4/30/2000)
20%
16%
12%
8%
4%
0%
-4%
-8%
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999

Chart 4