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Commentary

Market Opinions and Topics of Interest

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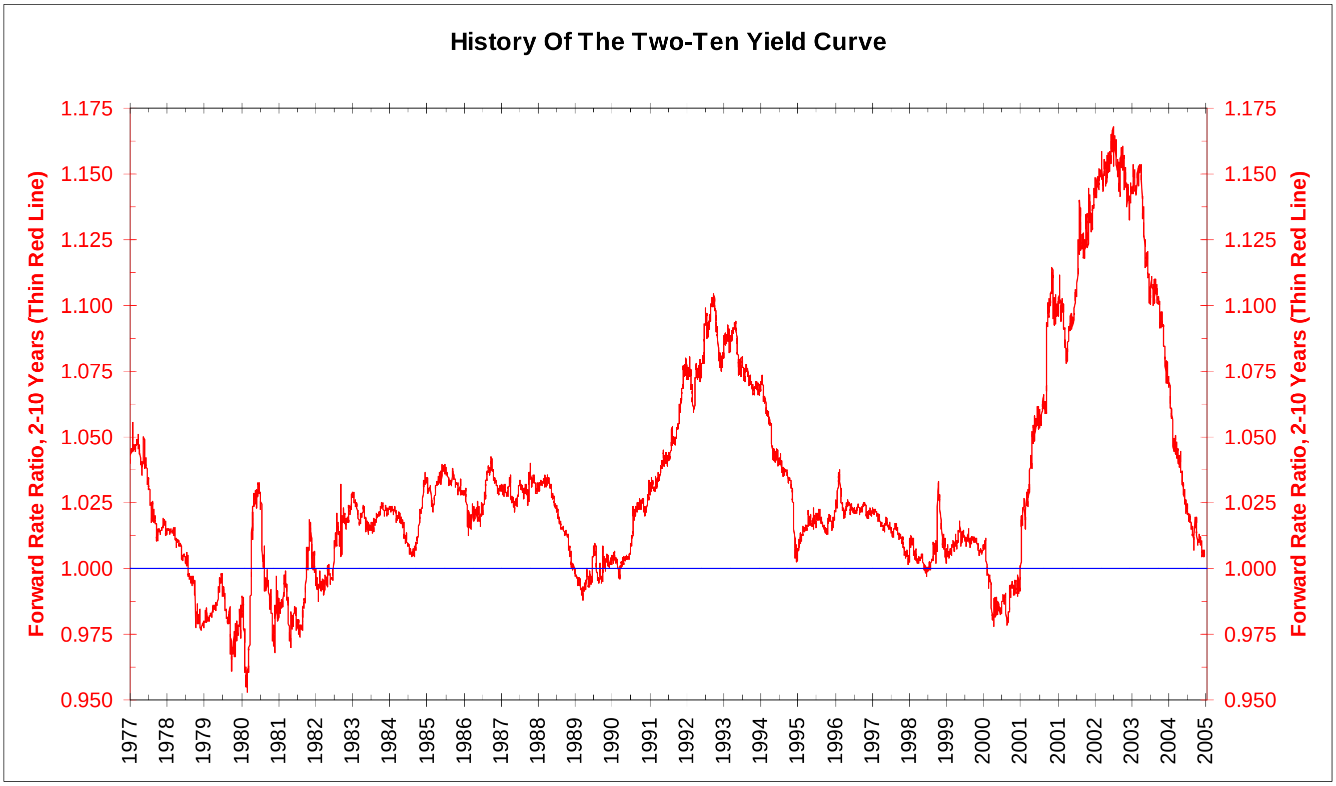
An Inversion Is Not Unthinkable

Markets move further and faster than we think and seldom in a way rewarding to the greatest number. Yet if the question-and-answer session in our recent Conference Call is a microcosm of professional sentiment, there is a measure of skepticism bordering on disbelief that the yield curve can invert.

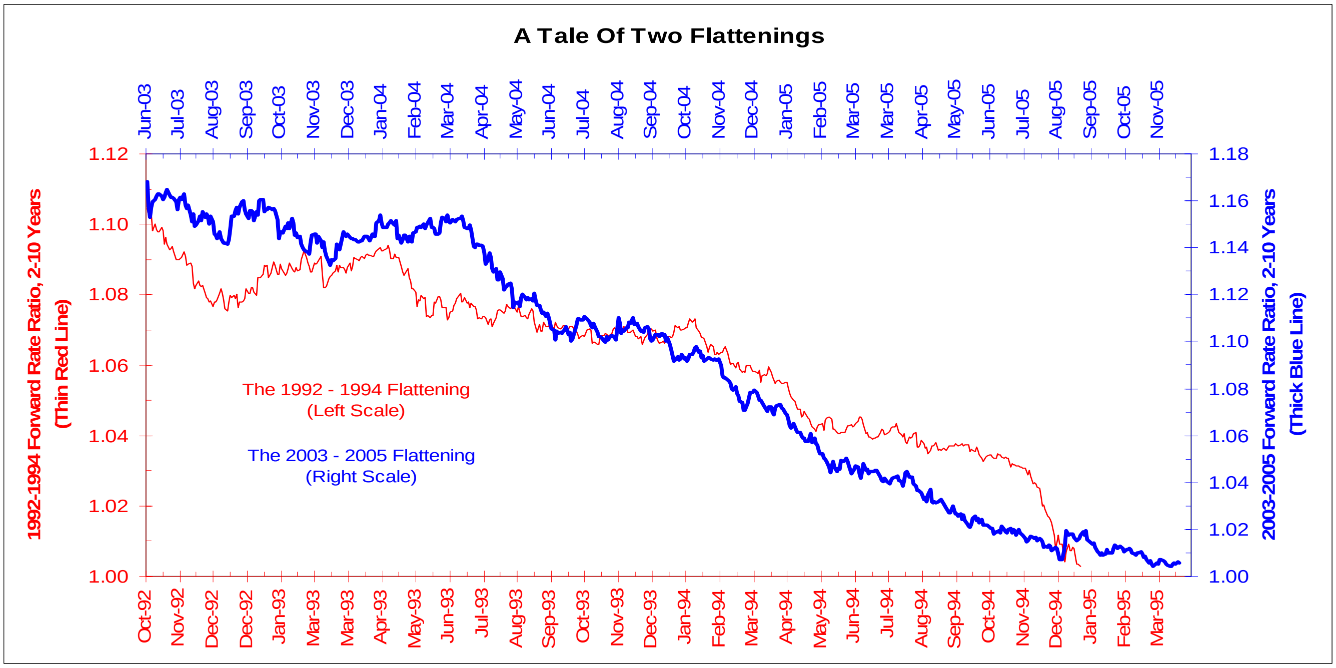
Why this should be is unclear. A history of the two-ten yield curve since 1977 as measured by the forward rate ratio (FRR, thin red line) shows four distinct inversions, one near-inversion and the current hovering over an inversion. A FRR below 1.00 (blue line) denotes an inverted curve.



A Matter of Scale

Market analogies often are instructive. The entire premise of technical analysis is human behavior does not change, so we are likely to do the same things as we did before. The closest parallel to the present curve flattening is the 1992-1994 market. Coincidentally, the 1991-1992 steepening was the most prolonged and abrupt in this history up until the 2001-2003 steepening. The 1992-1994 market approached inversion at the 2-10 segment, but did not actually invert.

How does the current flattening compare? If we line up the two FRRs from their respective maxima, October 5, 1992 and June 24, 2003, we see how the current market (thick blue line, following page) roughly parallels the 1992-1994 market (thin red line). The two flattenings are depicted on separate scales to emphasize their respective rates of change. **The current market has remained in its flattening phase for 63 trading days longer than its predecessor without inverting. This should be somewhat comforting to those who doubt an inversion is coming.**

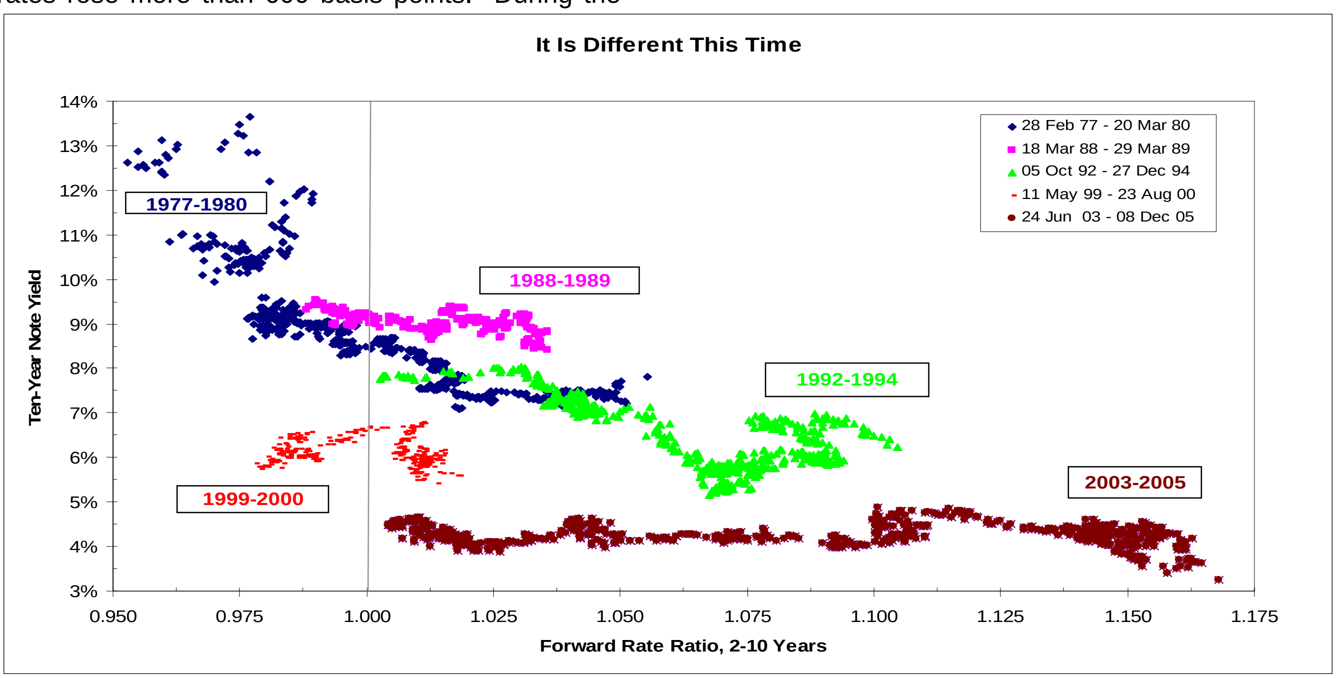


But, for all of the parallels between today and 1994, the two markets are quite different. So we would hesitate to proclaim this overlay as evidence an inversion is not coming. In fact, all of the flattening episodes noted are quite different from each other. **The current flattening is unique in terms of its extent as measured by the FRR and by the bullish condition at the long end of the curve.**

A Bullish Flattening

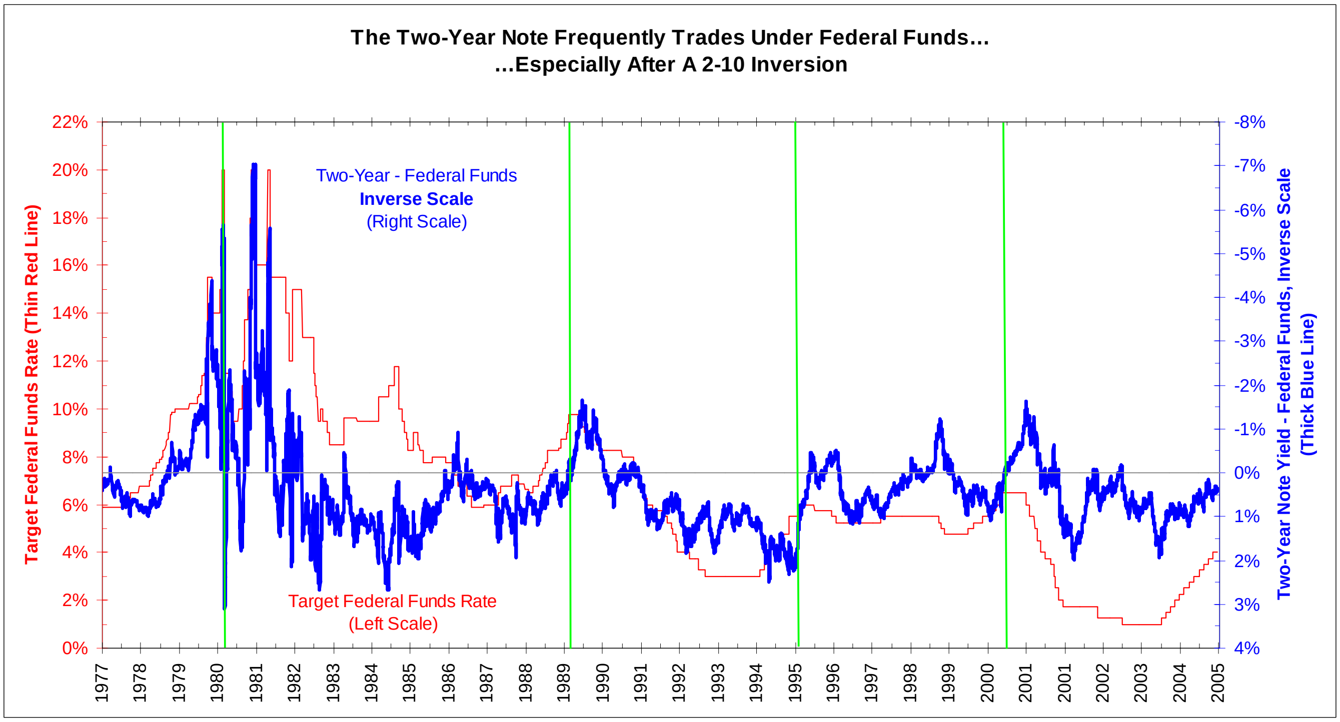
The chart below plots the ten-year yields of each flattening against the FRR of each flattening. During the February 1977 – March 1980 flattening from a FRR of 1.055 to 0.953 (dark blue dots), long-term rates rose more than 600 basis points. During the present flattening from June 2003 onwards (dark red squares), in which the FRR has declined from 1.168 to 1.004, long-term rates have remained within a tight trading range (its horizontal shape). The 1992-1994 flattening (green triangles) and both the 1988-1989 and 1999-2000 inversions (magenta and red dots, respectively) all witnessed rising long-term rates. The trend from lower right to upper left is conspicuous in its absence in the current market.

The bullish flattening of the curve has lessened the bite of the Federal Reserve's rate increases. This may encourage a further and farther set of rate hikes by the central bank than the market anticipates at present.



The Role of The Federal Funds Rate

Let's map the history of the target federal funds rate (thin red line) against the spread between two-year notes and the federal funds rate (thick blue line, plotted inversely). The low points of the FRR in each flattening cycle are marked with green vertical lines.



Conclusion

The record since 1977 is clear: **Each and every time the yield curve starts to steepen from its low point, a time always coincident with the last increase in the federal funds rate, the two-year note's yield moves under the federal funds rate.**

If the federal funds futures market is correct - and this market's track record through our November 2005 **Market Facts** demonstrates its recent perfect accuracy - we will be at 4.50% at the start of the Bernanke era.

The two-year note is at 4.425% at the time of this writing. If the market senses that 4.50% is the end of the rate-hike cycle, the two-year can stay right where it is and satisfy the chart above.

If further increases in the federal funds rate are in the offing, it is by no means given that the two-year note's yield will exceed the federal funds rate. And if these further rate hikes start to squeeze both economic growth and inflation expectations, the ten-year can easily trade under the two-year.

The sequence will unfold as it has in the past: The curve's maximum inversion will occur when the federal funds rate peaks. Two-year notes will yield less than federal funds and the ten-year note may very well trade under the two-year note to complete the inversion across the entire yield curve.

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