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Commentary

Market Opinions and Topics of Interest

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An Impending Bond Rally

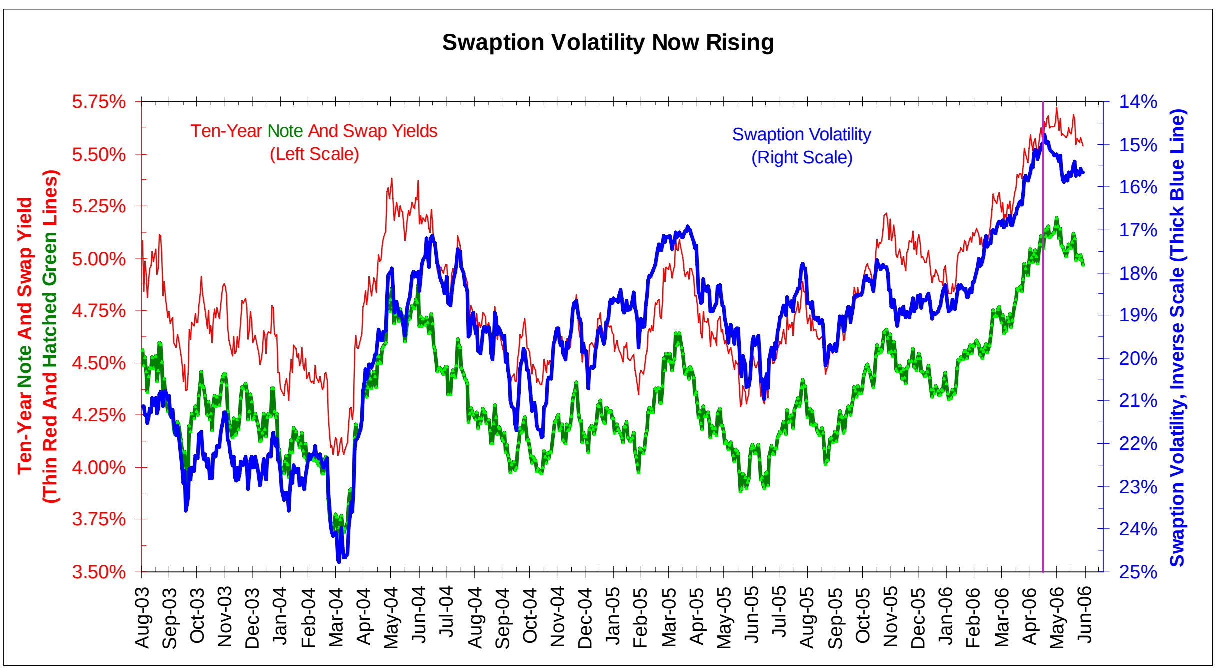
Swaption volatility (thick blue line, inverse scale), a topic addressed in an April Market Facts, is starting to rise. It had bottomed at 14.79% on May 1st (vertical magenta line), the date when Maria Bartiromo relayed Ben Bernanke's clarifications of his April 27th Congressional testimony.

We concluded in April:

> *The swaption volatility measure provides a useful link between attitude and behavior.* ***When we see it rise even as yields continue to rise, we will know the market, collectively, is uncomfortable with the trend.***

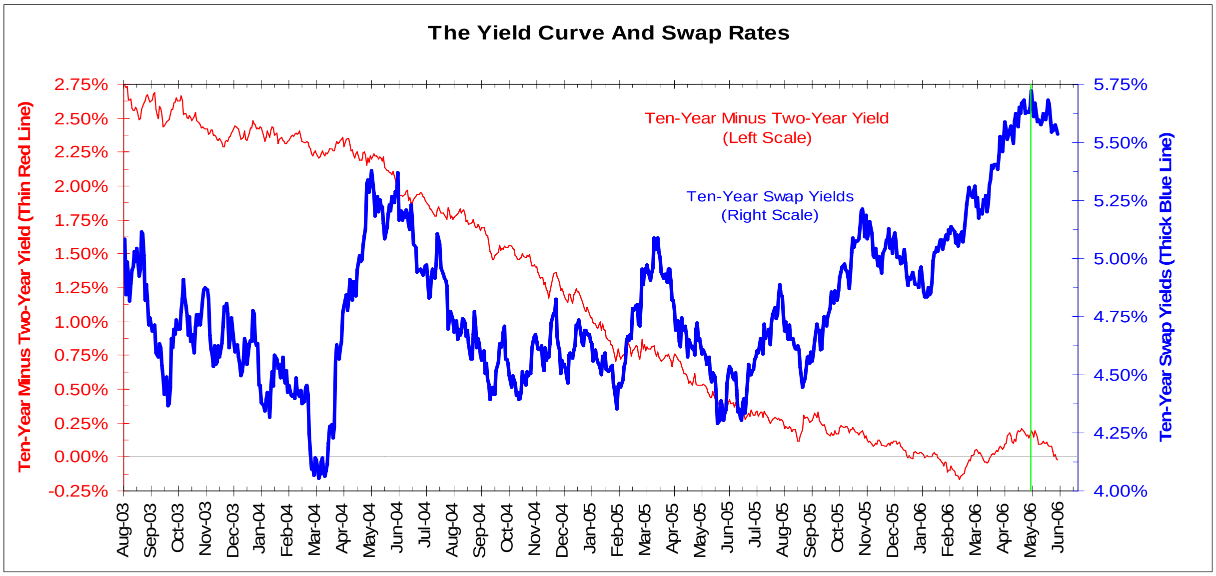
The turn higher in swaption volatility was followed by several days of higher ten-year Treasury and swap rates (hatched green and thin red lines, respectively). These yields peaked on May 12th.

Those yield levels have turned lower. Equally important, the yield curve has resumed flattening and inflation expectations have turned lower during this same period, discussed below. **Do these developments signal a return to the bullish flattening of the yield curve that dominated bond markets between 2004 and February 2006? Was the recent bearish steepening of the yield curve nothing more than a significant minor correction with a major trend?**



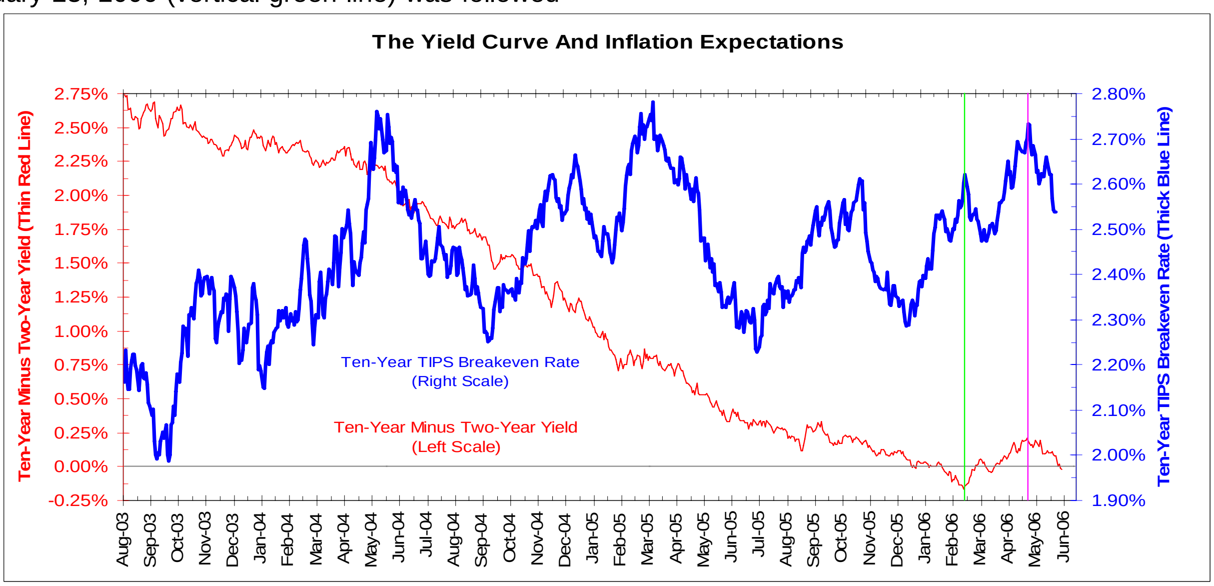
The Yield Curve Flattens Anew

The yield curve as measured by the absolute spread between ten-year and two-year Treasury notes (thin red line, following page) hit its local maximum on May 3rd at a little more than 20 basis points, but did not begin flattening in earnest until May 19th. Swap yields (thick blue line) peaked shortly thereafter (vertical green line). **Both developments are consistent with the notion the market is starting to take the Federal Reserve's combined rate-hiking and inflation-jawboning campaign seriously.**



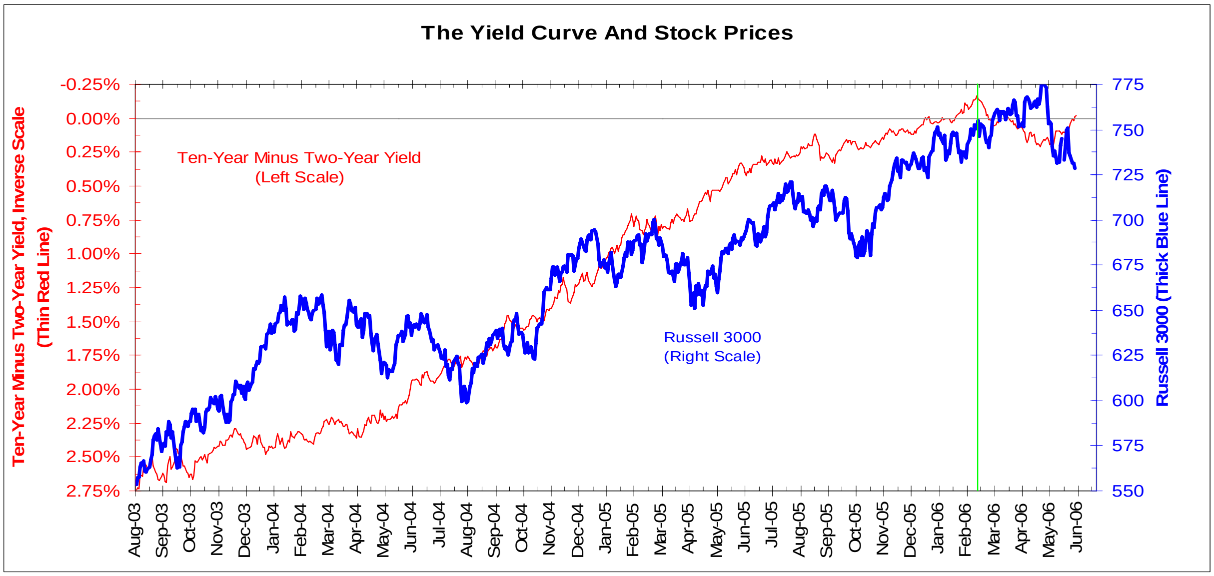
TIPS And Stocks Confirmation

Confirmation of this Federal Reserve credibility hypothesis can be found in two other markets, the ten-year TIPS breakeven rate of inflation and U.S. equities. If we map the ten-year TIPS breakeven rate of inflation (thick blue line) against the ten-year / two-year spread (thin red line), we can see how the re-steepening of the yield curve commencing on February 23, 2006 (vertical green line) was followed shortly by a burst higher inflationary expectations. The opposite occurred with greater immediacy. The flattening of the yield curve noted above coincided with an abrupt decline in inflationary expectations (vertical magenta line). **This decline, to be sure is linked to reduction in yen liquidity as noted in a recent Commentary. If inflation is a surfeit of money, the world's main central banks appear determined to act.**



While it would be simplistic to ascribe all movements in equity markets, both in the U.S. and in the emerging markets – the subject of a May Commentary – to monetary policy, we must agree stocks cannot ignore hostile monetary policy forever. Indeed, the admonition "Don't fight the Fed" might have predated the Federal Reserve's 1913 creation.

Prior to the late-February nadir of the yield curve (thin red line, inverse scale, marked with vertical green line), the Russell 3000 index (thick blue line) had no problem rising in the face of a flatter yield curve. We had advanced that theme in a December 2005 Commentary. The reason for this conclusion was simple: While the yield curve was getting flatter, the Federal Reserve and other central banks had not been creating tighter credit conditions, only raising rates back toward a neutral level. **The sharp downturn in the Russell 3000 and other global equity markets is a forward-looking statement by investors that conditions are starting to tighten. Neutral is now in the past, not in the future.**

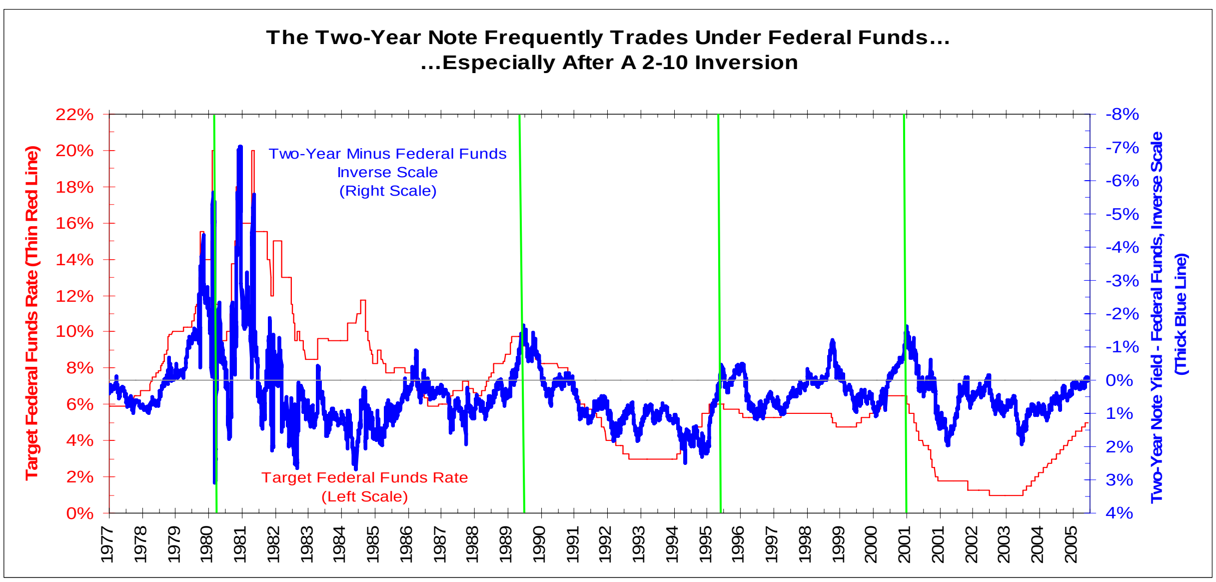


Inversion And Federal Funds

Let's update an analysis from a December 2005 Commentary, one which concluded:

> *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.***

This situation obtained between May 10 and June 6; on June 7th, the spread was exactly zero. If we map the spread between two-year notes and federal funds (thick blue line, inverse scale) against the target federal funds rate since 1977 (thin red line), we can see both the inversion and the long duration of the present tightening cycle. The times of maximum inversion of the ten-year / two-year note spread as measured by the forward rate ratio are marked with vertical green lines.



Conclusion

All the pieces for an emergent bond rally are falling into place: A move back toward inversion with the two-year note trading under federal funds, rising swaption volatility, declining inflationary expectations and a slowing economy. If, as suggested in the December Commentary these rallies begin at the last rate hike, we suggest the impending increase on June 29th will complete the puzzle.

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