Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent · Objective · Original

January 2010 | 1731 North Marcey, Chicago IL 60614 | www.biancoresearch.com

Special Report

January 2010

Are Higher Rates Sending A Signal?

January 14, 2010 Conference Call
(This transcript has been edited)

James A. Bianco, President, Bianco Research: Good morning, everybody. This is Jim Bianco. Welcome to our Conference Call.

Summary/Conclusion

In the last couple of Conference Calls, I have been talking the Fed's injection a lot of liquidity into the financial system and how the Exit Strategy is not going to be of their decision.

Now, Bill Dudley, the New York Fed President, gave a speech yesterday. And he said that he thinks that they could stay at 0% for somewhere between six months to two more years. To all of these comments -- whether it's been Dudley, or Bullard of St. Louis saying 2012, or the other ones that say the second half of this year – I have said that the answer is, "It's not your call. You will raise rates, you will begin the Exit Strategy when the Market demands that you do it."

A precedent, "Do you think that the Fed wanted to do all of those extraordinary actions in October of 2008, a few weeks before our Presidential election?"

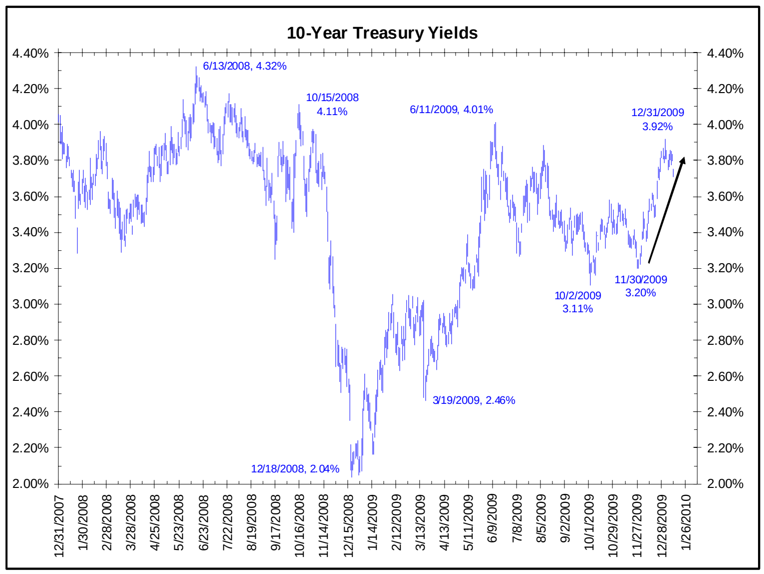
Prior to that, we thought that was the absolute worst time that the Fed could do something and try to influence a Presidential election. But it wasn't their call. The Market decided that it needed action at that point, and the Fed had no choice but to come into that action.

Likewise with this Exit Strategy. They can all guess on whether it's going to happen tomorrow or in the year 2012, somewhere in between, or somewhere later, but it will happen when the Market decides that it's going to happen.

10-Year Yields Creep Higher

As the chart on Page 2 shows, I have argued that it will happen when rates go up. When we get to a level on the markets that there is a fear of inflation, we will force the Fed's hand on that.

Now, this chart on Page 2 shows 10-year yields. I had argued that the level that we would be looking at would be if we were to take out the June high of four percent, then that would be the beginning of the discussion – the beginning of the discussion. If we were to take out the June 2008 high of 4.32%, then I think that we would be at a multi-year high in 10-year Treasury yields, and then that would solidify the discussion.



Currently, the 10-year note is at 3.75%. It hit a high on New Year's Eve, as high as 3.92%, which I show on the chart on Page 2. We are in an up-trend when it comes to yields. We haven't quite gotten there, but we're getting close.

That is kind of the message that I want to leave us with as I run through some of these charts and some of these arguments – that the point at which the Market is going to demand that the Fed start the Exit Strategy, I think, is a lot closer than a lot of people like Dudley perceive.

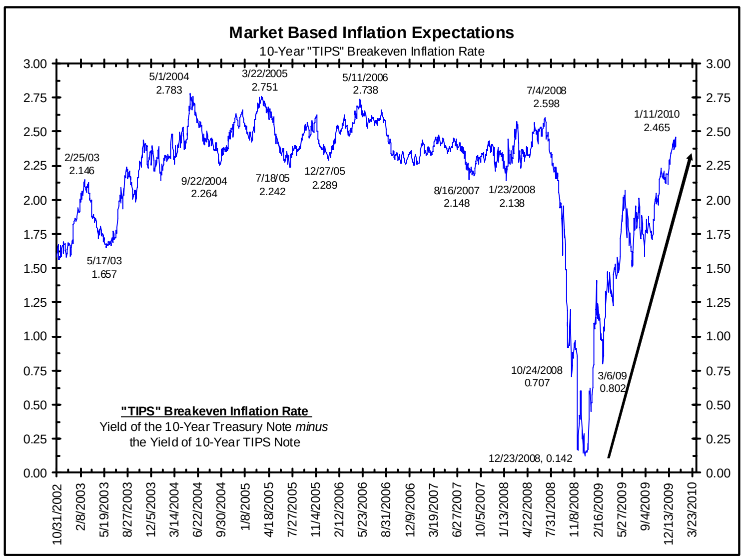
Dudley thinks that they have years. I think that they might have many weeks to several months. I think that it would take only another 30 or 40 basis points in the 10-year yield higher, and you would be at multi-year highs, as the chart on Page Two shows, and that would be a sign that we are starting to get into that.

Ten-year yields are not it alone. Let's go to Page 3 – "When does inflation become a problem?" And the chart that I show on the left, on Page 3, is the TIPS breakeven.

When Does Inflation Become A Problem?

What I want to point out about the TIPS breakeven is that this has been in a strong up-trend. The way that it has been portrayed in the financial press is that TIPS breakevens have returned to normal. They are in that kind of two-and-a-half percent expected inflation range, which is where the markets are when they are normal. That is technically true, as they are near that expected inflation range.

But as I drew this black line on the chart on Page 3, this is a very powerful up-trend. The high in this market was set just earlier this week when we hit 2.465% on the eleventh. Unless somebody has got some secret technical rules that I'm not aware of, I guess that we are all arguing that this strong up-trend is about to end.



I don't necessarily think that it's about to end because, on the corollary to this would be if we see a 30- to 40-basis point rise in 10-year Treasuries, then I think we are going to see a similar-type rise in TIPS breakevens. And you could take the TIPS breakeven out over its July 2008 high at 2.6%.

What does that mean? If you're above four percent in the 10-year yield, if you're above 2.6% in the TIPS breakeven, then you're at multi-year highs in inflation expectations, and you're at multi-year highs in interest rates. The argument at that point would be that the Market is fearing inflation.

Now, the Fed will do what the Fed typically does. After giving 8,000 speeches saying that the TIPS breakevens are a valuable tool in helping to guide monetary policy, should it go out over 2.6% and make a multi-year high, and you start reading stories in the *Wall Street Journal* or the *FT* such as, "Are the markets telling us that we are having an inflation problem," I think that what would essentially happen, then, at that point is that the Fed would give a bunch of speeches, trying to say that, "Nah, the TIPS breakevens got all of these special circumstances that we should be ignoring it now because it's giving us the answer that we don't want." But it's my guess that that's probably not going to fly.

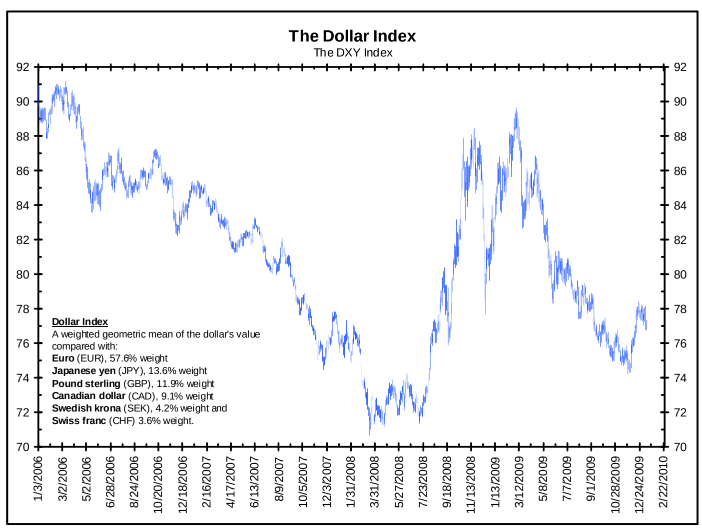
This is not that far away. This is 13 basis points higher than where we are now, and it's not that far away. So the message that I want to leave you with is when do the markets start to get to levels where we are at multi-year highs, multi-year extremes, when you would have to say that markets are starting to price in an inflation problem? And the answer is that it's really not that far away.

When Does Inflation Expectations Become Too Much?

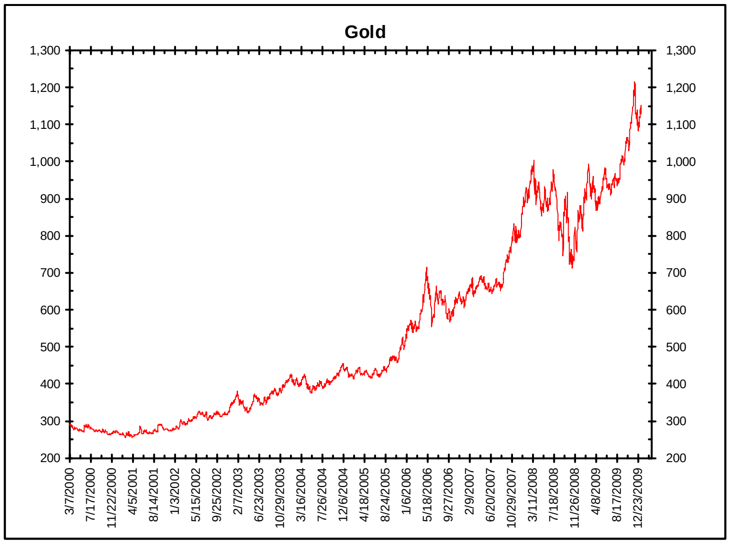
If we go to Page 4, the top chart is the Dollar Index. The bottom chart on Page 4 is gold. Let's start with the Dollar Index.

Here is a chart of the Dollar Index. And on the left on the chart there is a little explanation of how the Dollar Index is calculated. As you could see, it's over half the euro.

Another six- or seven-percent decline in the Dollar Index and it will be at its all-time lows that were set back in March of 2008. Another three- or four-percent decline, and we will be back at its November lows. This is not that far away. And the Dollar Index, as you can see in looking at what the dollar has been doing since the beginning of the year, has now slowly started back down toward those lows.



If you go to the next chart on the bottom of Page 4, again, it's the same thing with gold. It's bottomed out and is now approaching $1150 again. It's getting within about $60 of its all-time high. It's not that far away. It is not that much of a stretch to say that we could see an instance as we move forward from here – multi-year highs in long-term interest rates, multi-year highs on TIPS breakevens, multi-year lows in the dollar, or at least 18-month lows in the dollar, and all-time highs in gold.



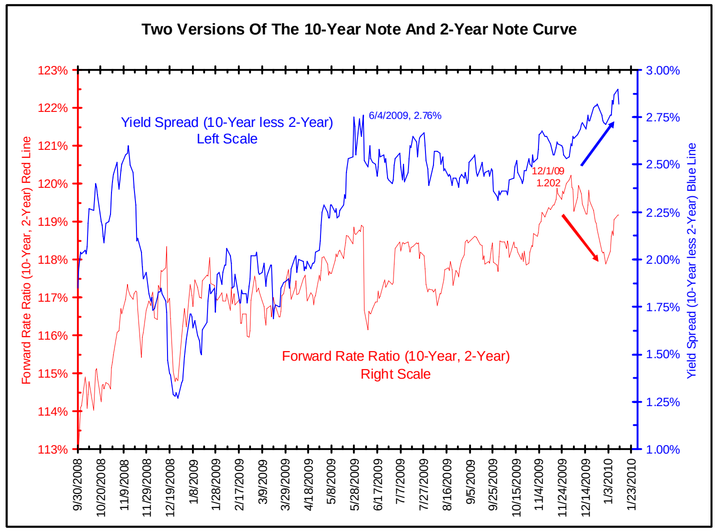
What is the Market message from all of that? The Market message could be that we are worried about inflation, and we need the Federal Reserve to take action.

Let me emphasize that these haven't happened yet. But they are not that far away. And if they happen, then I think that it will push the Fed into taking action. And that action is to forget what Dudley said and forget what Bullard said. When the Market is ready and demanding that they engage in the Exit Strategy, then they will engage in the Exit Strategy.

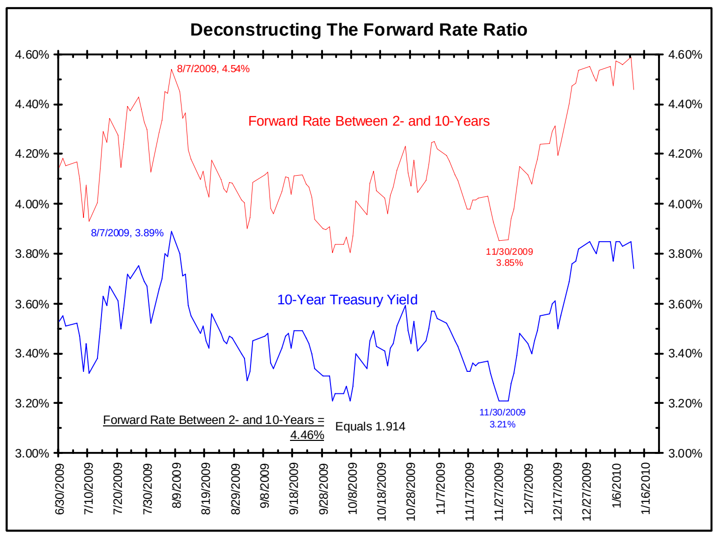
One Yield Curve Is Flattening – What Does It Mean?

One last point is on the charts on Page 5, and this is the yield curve.

The top chart shows two different yield curves – the forward-rate ratio yield curve and the regular two-year/10-year yield spread -- and the bottom chart basically deconstructs it. Let me start with the bottom chart.



The blue line on the bottom chart is the straight 10-year yield. Now, for the forward-rate ratio, what we do is calculate the forward rate between two and 10 years. If you're not familiar with the forward-rate ratio, all that means is that, if the two-year yield is at 93 basis points, and the 10-year yield is at 3.75% now, if I were to get 92 basis points for two years, then what yield would I need starting in Year Two to Year 10 in order to give me the equivalent of 3.75% over 10 years, the same as the 10-year yield?



Currently, that yield is somewhere at around 4.45% or so on the forward rate between two and 10 years. So if you look at the top chart, the top chart shows the forward-rate ratio between the two- and 10-years in red, and the yield spread in blue. And what we've noted in the past is that there has been a bit of a divergence between these two yield curves. While the yield spread has been moving higher and making new all-time highs, the forward-rate ratio has not.

What does that mean? As we argued in a *Market Talk* post a couple of weeks ago, I think that what it tells us is that the Market is expecting even higher forward rates as we move forward, thus flattening the curve. So when we look at the wide yield curve, there are two possible explanations for the wide yield curve.

A steep yield curve is consistent with growth. And everybody has been looking at the steep yield curve. And the *Wall Street Journal* and everybody else have been running multiple stories saying, "This is a good thing –this steep yield curve. It says that the economy is coming back."

Well, let me say the same thing with a little finer point on it. It means that we're going to get nominal growth, not necessarily real growth.

Nominal growth can come from one of two forms – it can come from real growth or it can come from inflation. The divergence between the forward-rate ratio and the yield spread suggests more of that nominal growth will come from inflation. When the forward-rate ratio and the yield spread are in line with one another, it suggests that more of that growth is going to come from real growth.

So since we have had the run-up in yields since the beginning of December, and we've had the widening yield curve, we've had a flattening forward-rate ratio, which, I think, tells us that the Marketplace is more skewed toward potential inflation problems.

So the Fed can worry and speculate, and run its tests on reserve repos and all that other stuff. But it's going to be the Market that tells them when it's time to go. And all of these indicators are really close to being at multi-year extremes all at the same time. And when they do get to multi-year extremes, I think that the message is unmistakable – there is a concern about inflation, and the Fed must do something about that.

The Most Interesting Trend At Year-End

If we go to Page 6 on the handout, there is a corollary to this. And the corollary to this argument has been that we haven't solved anything in the Credit Crisis. What we have done is that we have taken a financial crisis and a financial deleveraging, and we have replaced it with a government releveraging. And we have replaced it with a government releveraging around the world. And at some point, the markets of the world are going to say, "Enough" when it comes to the government releveraging.

And similar to the Exit Strategy possibly being close, we are beginning to see signs – beginning to see signs – that we might be close to governments saying, "Enough."

To start off on Page 6, the table basically shows the bailout totals over time as they have been calculated. As you can see right now, we've still got $8 trillion in bailout totals; the maximum committed $4.1 trillion has been spent on that. What is interesting is that the Fed totals have been coming down a little bit because of the roll-off in a lot of the lending programs. But the non-Fed totals, as far as money being spent, have increased by almost $1 trillion between September and December.

Bailout Totals

In Trillions

	Grand Totals		Fed Totals		Non-Fed Totals	
Date	Maximum	Current	Maximum	Current	Maximum	Current
11/25/2008	8.549	3.172	5.553	2.101	2.996	1.071
12/29/2008	8.700	3.049	5.058	1.905	3.642	1.144
2/9/2009	9.656	2.960	5.766	1.489	3.890	1.471
2/23/2009	11.624	3.802	7.566	1.481	4.058	2.321
3/30/2009	12.798	4.174	7.766	1.683	5.070	2.508
9/25/2009	11.564	3.025	5.871	1.590	5.693	1.435
12/23/2009	8.170	4.111	3.956	1.752	4.214	2.360

Today, in *News Clips,* we also had a story. Laurie Goodman of Amherst Securities, formerly of UBS, put out a paper estimating the total losses of Fannie and Freddie. With the usual caveats that we don't have, really, enough good public information to make a hard guess on it, so we'll go with the public information, she came up with a guess of $448 billion as far as what the total losses of those companies is going to be.

We've committed only $112 billion to the bailout, so what that means is that we're looking at the potential for another $336 billion added to the deficit – a huge number. Or, as I noted, Fannie and Freddie were placed in conservatorship on September 5, 2008.

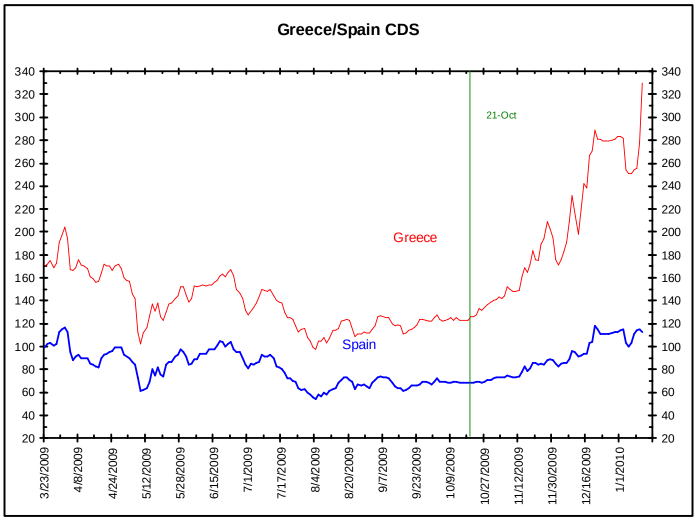
It's possible, as we look from September 5, 2008 forward, the U.S. Government is going to spend more money bailing out Fannie and Freddie than it's going to spend on the Iraq/Afghanistan wars from September '08 forward. It's an incredible sum of money.

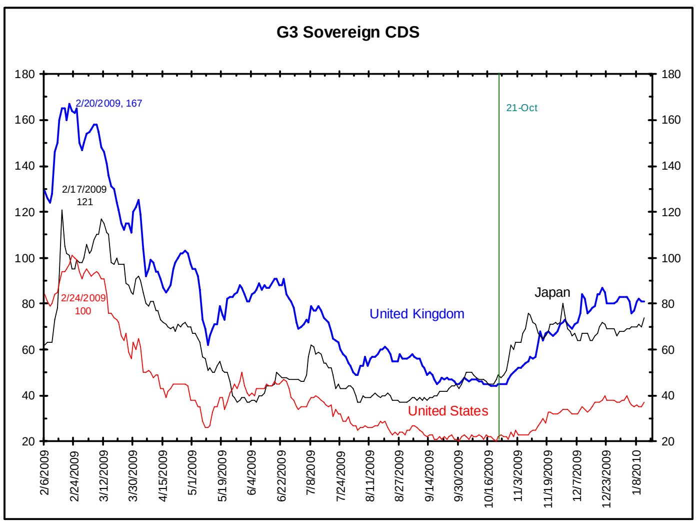
This doesn't even include the idea that Fannie and Freddie might be positioning themselves to buy delinquent mortgages out of existing MBS pools from the private sector so that they could offer these people principal reductions and other modifications, which would further increase their losses on top of it.

This is an example of what is the non-Fed total, as well. Fannie and Freddie are a huge number as far as that non-Fed total goes. But when is it going to be enough?

If we start to look at sovereign CDSs – and let's take the chart on Page 6, in the upper left – Greece and Spain – we can see that Greece has taken a new turn higher. The Spain sovereign CDSs are up quite a bit. October 21, as we mentioned in our December Conference Call, seems to be in inflection point date for a lot of this government debt that they have all started to turn higher. Greece and Spain certainly started to turn higher on those dates.

If you look at the bottom chart on this page, you will see that, again, after October 21, all of the G3 countries of the UK, Japan, and the United States – all of their sovereign CDS rates rose. Or if you want to say the same thing a little differently, it became more expensive for them to insure against default.



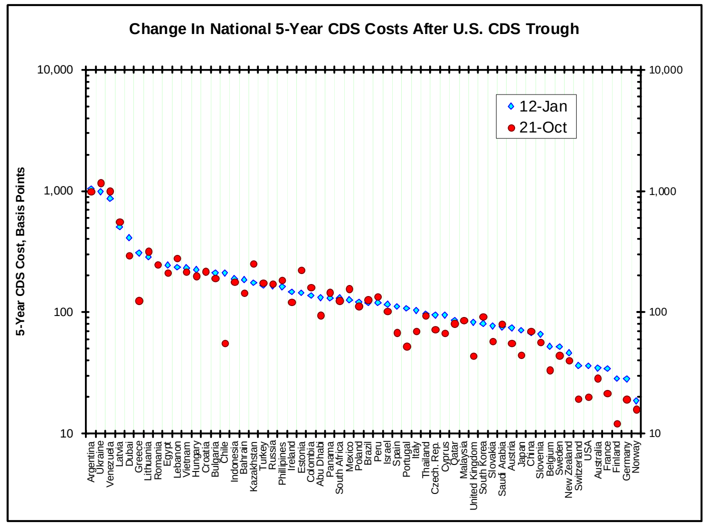


If you go to the chart on Page Seven, it plots a number of country sovereign CDS rates.

The blue dots are January 12 -- the last day that we have data for, for which we were able to calculate this – and are arranged in order from Norway, which has the lowest rates, to Argentina, which had the highest rates on January 12.

The red dots are where all of these countries were on October 21. And what you will notice is that the vast majority of red dots are below the blue dots. It's not all of them, but the vast majority of them are, suggesting that, across the globe, CDS rates – the insurance against default of sovereign debt – has increased since October 21.

Is this at a critical level? No. Is this something that needs immediate action now? No.



But these trends, combined with higher rates and combined with higher inflation breakevens, are all pointing in the same direction, that there might come a day closer than, I believe, people think, that we might be looking at saying potentially "enough" when it comes to a lot of these numbers.

So the message here is that we're not there now, but I think that we're getting there sooner than people think, to the point where there is a question – is all of this debt borrowing is going to be problematic for governments? Is the Fed's largesse going to be problematic for markets, and the markets are going to ask for it to be taken away? And the answers are, potentially, yes.

The Federal Reserve's Balance Sheet

On Page 8, let's turn our attention again to the Fed. Here is the status of the Fed's purchase programs on the table at the top of Page Eight.

The Status Of The Fed Purchase Programs

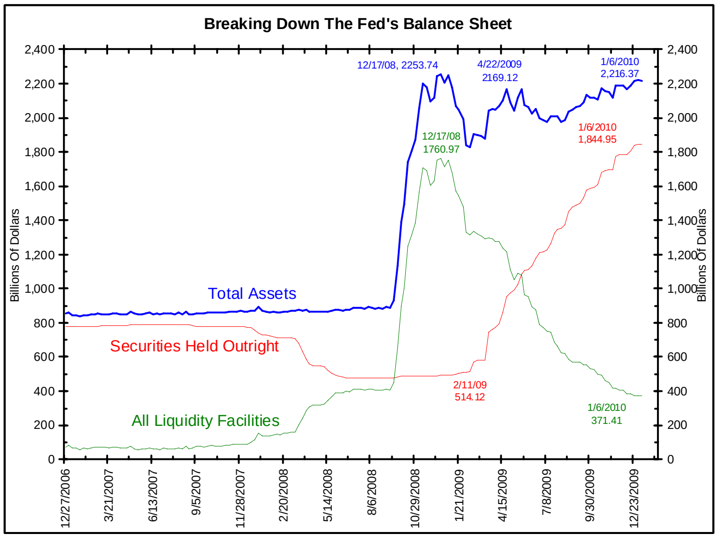
As of 1/6/2010

Sector	Bought (blns)	Size (blns)	% Completed
Agency	$159.88	$200	79.94%
MBS	$909.48	$1,250	72.76%
Treasury	$301.90	$300	100.63%
Totals	**$1,371.26**	**$1,750**	**78.36%**

You could see that the mortgage-backed securities purchases right now, as of January 6, are $909 billion, almost $1.4 trillion in total purchases. They are about three-quarters of the way through their program. They have targeted $1.75 trillion as far as their purchases go.

If you look at the chart on the lower left, it breaks down the Fed's Balance Sheet.

The blue line is total assets on the Balance Sheet. The red line is securities held. And securities held is at $1.8 trillion in total when you add up all of the securities that they owe, not just the ones that they've bought in the purchase programs, which is about $1.3. They had another $400 billion before they started these programs.



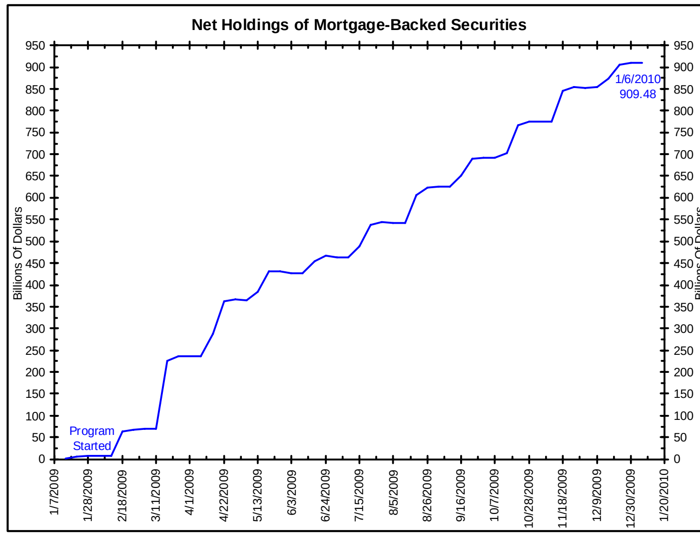
And then the green line shows the lending facilities, which are starting to run off.

Now, one quick point that I would make about the Balance Sheet -- and a lot of Fed officials have said this repeatedly, and I agree with them – is that the lending facilities are starting to plateau down a little under $400 billion. It doesn't look like that green line is going to just continue to decline all the way to zero; it's going to start to flatten out.

The purchase programs still have another $300- or $400 billion to go, and the Fed seems fully committed to go there. So the all-time record on the Balance Sheet is still back over a year ago – December '08 – at $2.2 trillion. We're around only $30- or $40 billion from a new all-time high.

We will probably see a new all-time high in the Balance Sheet, probably up around $2.5 trillion if all things stay equal, the lending programs plateau out, and we see another $400-or-so billion of purchases, probably in the first half of this year. That will be another big headline that we'll have. But it shouldn't be a big surprise that, at some point soon, the Balance Sheet is going to make a new all-time high.

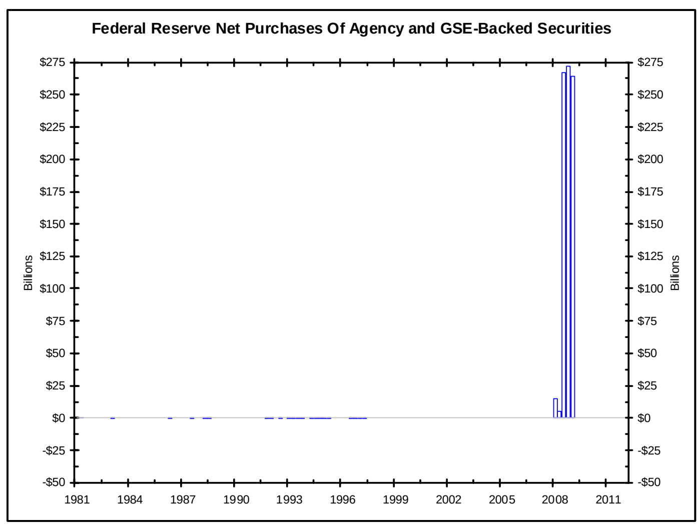
But what I want to focus on is on the Purchase Program of Mortgages. And that's the chart in the lower right on Page 8 – "Net Mortgage Holdings."



Where, at the beginning of 2009 -- almost exactly 12 months ago – zero, and now they're at around $909 billion. So the Fed has gone from nothing to almost the size of PIMCO in the space of a little over one year just in mortgage securities alone.

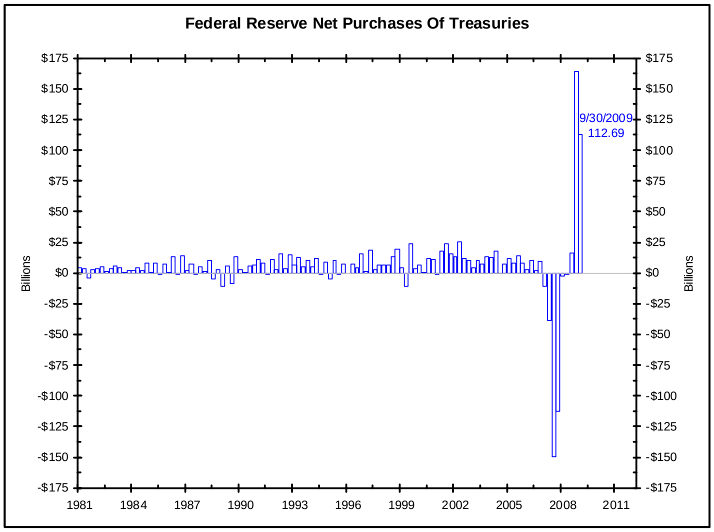
The Federal Reserve And Bonds

What is important to understand about this is that this gets back to this whole thing about sovereign debt rates going up and everything else. Let me start with the top, left chart on Page 9 -- "The Federal Reserve's Debt Purchases of Agency- and GSE-Backed Securities."



So this is the Fed's purchases of mortgages and of agency debt. This is the history of it. You could see in the chart that, in '81, around '93, and around '97, there are some really little bumps in the chart, meaning that, yes, they were active in those markets, as the numbers weren't zero. But then, all of the sudden, we've bound it up that the Fed has been purchasing -- for the first, second, and third quarters of this year -- $250 billion-plus of these types of securities. So they have been buying at a rate of around $1 trillion, which is another way of showing the same data that I showed on the previous chart.

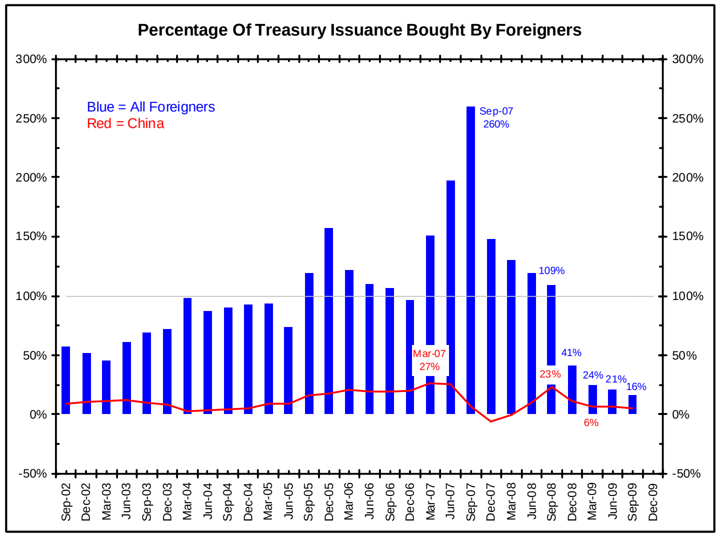
In addition to that, the chart on the lower left of Page Nine shows the Fed's purchases of Treasuries. Remember that, initially, in 2007 and 2008, you will see some big negatives in the numbers. Initially, when the Fed was ramping up its lending programs, it was trying to sterilize them.



What that means is that, as the Fed was increasing lending to the TAF, was increasing lending from the discount window, they were selling Treasuries off to keep their Balance Sheet at roughly the same level, just changing the mixture of it to more loans and fewer Treasury securities.

Then, in the first quarter of last year, they announced the Purchase Program. And you could see that they became massive buyers of Treasuries, as well.

So the Fed has become a massive buyer of Treasury securities, agencies, and mortgages. I'm just restating what we already know. And what is important about this is this chart here that is on the right on Page 9.



This is a contention that has become more and more in the Marketplace. In other words, on this chart, the bars show what percentage of Treasury issuance is bought by foreigners. To this day, a lot of people think it is still 100% or more, that we live on the good graces of the Chinese, in particular. Well, maybe not entirely. At least, by the official statistics, from March of '04 to September of '09, it was true that foreign purchases did total more than the Treasury was issuing, and that we were financing the entire deficit through foreign purchases. But that number has now decline to 16% in the Third Quarter. (We don't have Fourth-Quarter data yet).

The reason that that has declined is that, in the last two years, the deficit has gone from $300 billion to $1.4 trillion, almost a tenfold increase in the deficit over that period. But we have not had a tenfold increase in foreign purchases. It has gone up. There is no doubt that it has gone up, but not tenfold. So the purchases have been made up more and more by domestic investors. And the big domestic investor that has been helping to purchase all of this stuff has been the Fed through its purchase programs.

Now, wait a minute, I just showed in the purchase programs that they have bought only $300 billion of Treasuries, and they bought $1 trillion-worth of mortgages. Well, how did the Fed purchase Treasury securities? Well, they didn't do it directly.

"Households" And Bonds

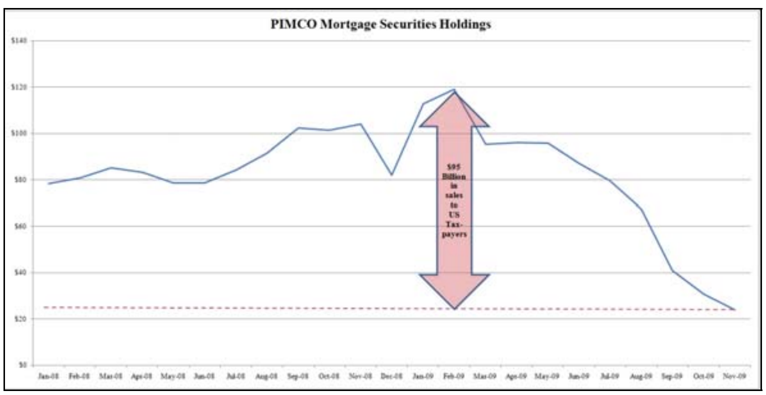
As we go to Page 10, the top, left chart – "The Household Sector Purchases of Agency and GSEs" – this is from the flow of funds. And let me be very clear about this chart. It says that it is the "household sector purchases of agency and GSE securities." "Households" is where everybody gets tripped up. The way that the Flow-of-Funds Report is calculated is that, some 40 years ago, they invented all of these categories for purchases of

GSE securities – pension funds, foreigners, mutual funds, monetary authorities.

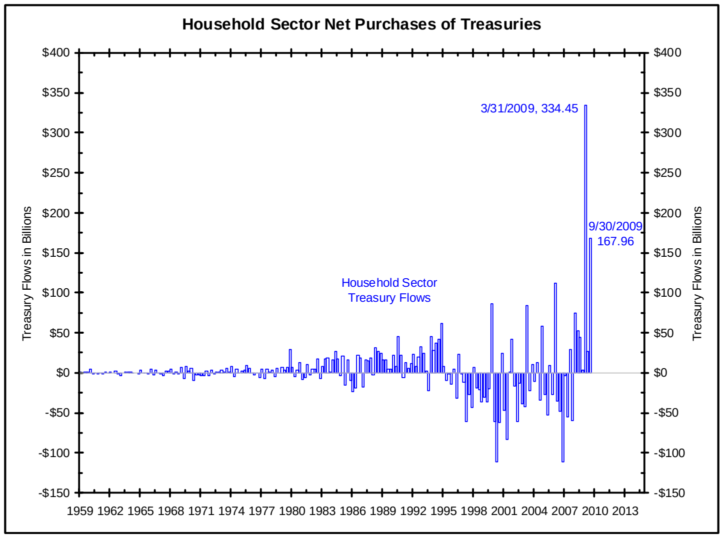
And then there is a category called Households. Households is not mom and pop. Mom and pop are in that category, but it is the default category where we stick everything that we don't have a category for, including hedge funds. Some institutional managers would be found in the Household category -- why? -- because they didn't exist forty or fifty years ago. They haven't recalculated the categories in the Flow-of-Funds Report, so more and more stuff gets dumped into the Household category by default.

So as the Fed has been purchasing almost $1 trillion per annum of mortgages and agency securities, those purchases have been coming from the Household Sector, or the default category.

Let me restate this differently. The Marketplace is selling its mortgage securities to the Federal Reserve. And one great example of that is the chart on the right on Page 10 -- PIMCO. Here is the PIMCO mortgage holdings. In February of '09, they were at $120 billion. In November of '09, the latest data that I have seen so far, they were at $25 billion, a reduction of $95 billion, or almost 10 percent of the purchases of mortgages that the Fed has done, you could argue, has come from PIMCO. PIMCO has reduced its mortgage holdings. The Marketplace has bought $950 billion less of mortgage holdings than they would have bought otherwise.



So what have they done with those mortgage holdings? That is the next chart on Page 10, which is "Household Sectors of Purchases of Treasuries."



Well, if they're not buying mortgages, and the households, as the default category, is selling all of their mortgages to the Fed, then they're buying Treasuries, they're buying corporates, they're buying municipals, they're buying everything else. This is why you see in the Fed's statements that they're worried about stopping the mortgage program.

What they are worried about is that the Fed has basically said, "We've taken out the mortgage market." If you look at the Barclays – or formerly Lehman Aggregate Index, 38% of the benchmark is mortgages. It's the highest percentage of any sector. It's larger than corporates, it's larger than Treasuries, and it's larger than agency debt. The Fed said, "We've got that covered. We're going to buy all of that. You, being the rest of the world, buy everything else."

If the Fed stops purchasing mortgages, then the rest of the world has to allocate $1 trillion toward purchasing mortgages, which the Fed has been doing. And that is where the fear is, that rates will go higher. That is the fear that we might have a problem with the deficit because now people that were buying Treasuries and were buying corporates will have to start buying mortgages.

Why will they have to stop buying mortgages? Because mortgage rate will start to go up until it attracts buyers. And if it gets high enough to attract buyers, then corporate and Treasury rates will have to go up to get their buyers. And then there is this big competition going on.

So the Fed has been staving this off with its Mortgage Purchase Program. It buys mortgages to allow everybody to buy everything else. The Fed has been openly talking about extending the Program, although they have not officially done it.

But the problem that I see is that, when you look at the way that CDS rates are going, interest rates are going, inflation breakeven rates are going, I could see a light at the end of the tunnel that the Market is not ready to allow this to continue to happen forever. There is a point at which they're going to say, "Enough." And I think that might be closer than everybody thinks.

The Curve - Is Anything More Important To S&P 500 Earnings?

In the last two charts that I wanted to run through, I wanted to talk about the important of these programs. I don't know if the Fed thinks of it in these ways, but maybe they should think of it in these ways.

Here is an interesting table that I found on Bloomberg. And then I found the data on Bloomberg. This is for fourth-quarter S&P 500 operating earnings versus fourth quarter a year ago. Now, remember that fourth quarter a year ago was the disaster quarter where all of the write-offs occurred. It was the worst quarterly performance in Corporate American history as far as the losses that everybody took. So it's a very good hurdle rate.

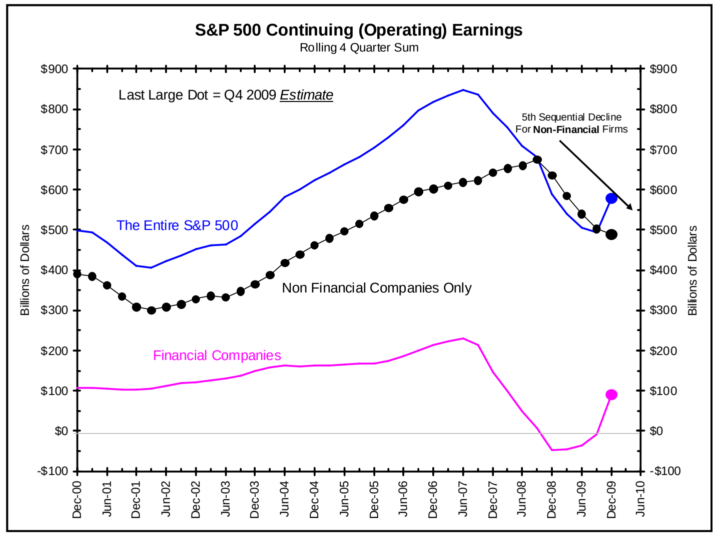
Sector	Q4/09	Q1/10	Q2/10	Q3/10	FY09	FY10
S&P 500 Index	**62.1%**	**29.1%**	**27.6%**	**20.2%**	**-12.2%**	**25.2%**
S&P 500 Ex-Financials	-2.8%	23.5%	22.9%	17.4%	-21.5%	18.5%
S&P 500 Financials	120.1%	84.3%	68.3%	40.7%	945.6%	87.2%

The S&P 500 operating earnings are expected to increase by 62% over fourth quarter of last year. Financials – no surprise – are expected to more than double because of all of the write-offs. Now, remember that this is operating earnings, so the billions and billions in write-offs are not counted in operating earnings. But the operating earnings numbers were expected to more than double when it comes to financials.

But the interesting part is the middle column – "X Financials." That's 422 of the 500 companies in the S&P 500; the other 78 are financials. Their earnings are expected to be 2.8% **lower** than they were in the disaster quarter a year ago. So all of the growth in earnings, the 60% rise in the Stock Market – we're about to get a 60% rise in earnings – is all coming from the Financial Sector.

So if you look at the chart on the left on Page 11, we took the same data and recast it a little bit differently. I used a rolling four-quarter sum to remove seasonality so that we could see the larger trend of S&P 500 continuing or operating earnings.

The blue line is the overall S&P. The pink line is financial companies only. And the black-dotted line is non-financial companies. The big dot is the estimate – estimate – for fourth-quarter numbers.

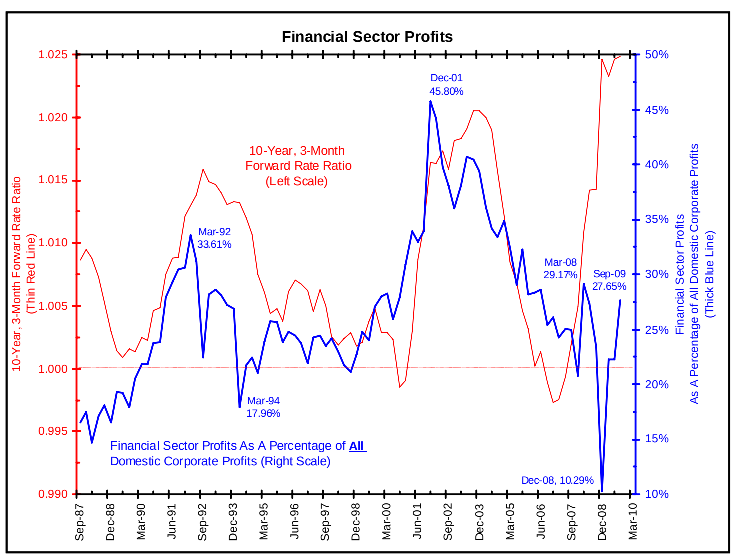


What is clear from this chart is that non-financial companies' earnings have not turned. Non-financial companies' earnings are still in a sequential decline. And if the estimates are correct, we are going to have the fifth straight quarter of a sequential decline.

The headline will be, of course, that we had nine straight quarters of sequential decline in S&P earnings, and that's about to reverse higher. But the reason that it is reversing higher is because of the rebound in operating earnings from financial companies. So what is driving earnings right now, what is driving to support the S&P at 1150 is financial company earnings, not operating company earnings. They have not turned.

Is Anything More Important To S&P 500 Earnings? - 2

Now, of course, what is driving financial company earnings? That is the chart on Page 12 – "Financial Sector Profits."



If you look at the blue line here, this is Financial Sector profits as a percentage of all domestic corporate profits. And the red line is the 10-year, three-month forward-rate ratio, the yield curve. The yield curve follows corporate profitability.

The Financial Sector profits, as I showed on this chart – this chart is just a different way of expressing it. This comes from National Income and Product Account data, or NIPA data. What this chart basically shows is that the very steep yield curve is driving Financial Sector profits higher. We know this. This is why we are having the hearings that we have been seeing in the last two days, where we have been beating up Wall Street, namely Lloyd Blankfein, because of the huge profits and the huge bonuses that Wall Street is paying. A lot of that has been coming from the extraordinarily steep yield curve.

We argued with the title on this – and this is something that is in the lead of *News Clips* today – is there anything more important to Corporate America than the yield curve right now? And for the moment, I would argue that, if you look at the big drivers of corporate profitability – regulation, taxes, productivity – then I'm going to put the yield curve in front of all of those right now. This is because all profitability from Corporate America is coming only from the Financial Sector, and it's coming only from the very steep yield curve. And that is an artifact of current Federal Reserve policy, which Dudley and everybody else says, "Maybe we're going to try and keep this ridiculously steep yield curve for many more years."

Conclusion

The fear, though, is that the Market is not going to allow this to happen. And I think that we are a lot closer to the Market basically ringing the bell and saying, "Enough. Time for the Exit Strategy." Again, it's not now, but I think that we're a lot closer to it.

And that is what we have to start to watch. If we see 10-year yields eke out over 4%, if we see gold eke out back above 1200, if we see the Dollar Index go down another two or 3% see TIPS breakevens eke out above 2.60%, then all of these things combined with widened sovereign CDS spreads would say to the Fed, "No, you cannot keep driving Financial Sector profits higher and higher with this steep yield curve. We're either worried about too much borrowing, too much inflation, or about both happening at the same time."

In conclusion, what aborts this? What gets this program or this idea that I'm laying out to not happen?

The answer, I think, is pretty straightforward right now. That answer is that we get very weak economic data like the Employment Report that we got last week. In other words, if the economic data does show up, and it shows up much weaker than everybody thinks, then yields will back off, TIPS breakevens will back off, and everything else will back off, and I don't think that we'll get to that point where the Market is hitting the bell and saying, "This is it. Time for the Exit Strategy."

We'll have to see. But I'm with the consensus for no other reason than I have no reason to doubt that the economic numbers are saying that things are getting better. The economic are saying that not only are things getting better but that they will continue to get better. So if they don't, if we get some serious talk of a double-dip, this will abort this talk.

I know Bob Gordon. He's on the Business Cycle Dating Committee. These are the people that call the end of the Recession. He was very upfront with this. This is nothing new, and this has also been in print:

I asked him, "What's the magic month that the Recession ended?"

He said, "June."

I said, "What's the holdup? Why isn't the Committee called the end of the Recession yet? If it's June, then it's seven months past."

He said, "It's Martin Feldstein."

Martin Feldstein is not completely convinced that the Recession is over. The rest of the Committee – Bob Hall, Bob Gordon, and the rest of them are. They are arguing somewhere between May and August, which would mean, basically, June and July; take your pick as to which month they want to pick.

We know that the Recession is over. We know that the Employment Report was minus 700,000 a year ago. Even though it disappointed last week, it's still minus 85,000. We know that we are going to get big, strong positive numbers starting in the spring – at least headline numbers – because of census highering. Expectations are for fourth-quarter GDP to be with a four-handle if not higher. These things are going to lead to higher rates.

Now, if all of this aborts, then I don't think that we are going to have this happen. So I don't see this aborting; but if it were, then that would be the thing that would stop it. So the problem that the Fed has is that their own worst enemy could be good economic numbers because good economic numbers are going to push all of these markets higher, and then the Market measures are going to tell the Fed that it is time for the Exit Strategy now.

And much like October of '08, the Fed will stammer and stammer, "Well, maybe, maybe, maybe not." And then the Market is basically going to say, "Are you not paying attention? Are you not attention?"

And moves in the Market will become extreme enough that the Fed will have to listen to them.

If you go back – and I vividly remember it because of the *News Clips* exercise that I'd go through – everybody was hoping that they could keep balancing the plates on sticks in the summer of '08, until after the Election. Well, they couldn't do it. The Market freaked out in September and October, before the Election. And I think that historians are going to look at that period of financial stress and say that that had a direct outcome on the Election. Maybe Obama would still have won, but he would have won by a different amount. But I don't think that we could say that that was irrelevant to the outcome of the Election. It was the biggest financial crisis in 70 years, which happened days and weeks before a Presidential Election.

So, just like that, the Fed is going to be in the same box. They are going to try and pretend that they can get away with it. They are going to try and pretend that the Market is not telling that there is a problem. But, eventually, it will be high enough and be strong enough that they will have to pay attention to it.

All right, that's what I've got for my numbers and thoughts here. I'll be willing to take some questions.

Questions and Answers

We go with first name only on questions. I know who you are when you ask a question, whichever format you use, and that is all that matters. So I try to encourage questions by keeping you semi-anonymous by using only your first name.

So you've got all of those different ways to ask questions.

The first question comes from **Joe**.

Question –

"Do you think that it's closer than everybody thinks because of anything other than rising rates?"

Yes. The argument here is based on rising rates, CDS rates, TIPS breakeven rates, long-term Treasury rates. Maybe I can go a little off of the board and say a little bit on the gold and a little bit on the dollar.

The reason that I focused on rates, especially long-term rates, is as I said, that the problem with looking at Market signals away from long-term rates – and that's why I started with long-term rates – is that, if you look at the dollar alone, if you look at gold alone, if you look at the Stock Market alone, if you look at corporate spreads alone, they're all strong trends. How do I know that this isn't just the natural correction?

Let me just take one strong trend – investment-grade corporate spreads. How do I know that this isn't just the correction of a natural trend or the start of a change of opinion in the Market?

Long-term interest rates have been vacillating sideways for six months. Should they break out of that sideways range, above four percent in the next couple of months, then that, I think, would be a sign that it's not just a correction of an overbought but the establishment of a new trend higher. And if everything else attaches with it, then that would be a powerful message that the Market is worried about inflation.

The problem is if you want to just focus on the dollar or if you want to focus on credit, then, at some point, we're going to get an overbought correction in all of those markets because of the strong trend. But is it an overbought correction, or is it the change of opinion? We don't know. That's why I would like to focus on range, because they have been going sideways, and they are going to be the clearest thing for us to tell that they have changed their trend. And that would happen as we move above four percent. And the further that we move above four percent, the stronger that would turn out to be.

OK, the next question is from Mark. Mark, are you there?

Mark: Hey, Jim, great presentation, as always.

I'm focused on the chart on Page Six – the "G3 Sovereign CDS." I guess that my question is how deep, how liquid, how fluid is that market, especially for the U.S., UK, and Japan?

Because you look at it and say that you pay 75 basis points or 70 basis points for CDS protection on Japan, and yet you're yielding only one, one and a quarter percent, maybe one and a half on Japanese notes. And so why would you even pay that?

Jim Bianco: Oh, that's – well, that's true.

A couple of things about this market –

Is it deep? Is it liquid? No, not very. It's more of an indicative market than anything else. I have had no reason to argue with the broader measures of the market.

If you look at the left-hand side of that chart, when we saw the peaks in CDS rates last February -- the U.S. got to 100, the UK in the middle of February got to 121 – that would be perfectly consistent with economic thinking. This is because, going into late February, we were starting to really worry about a lot of the financial markets falling apart.

Right at about that point – actually about two weeks later – we got all of the QE announcements. We got them from Switzerland, we got them from the UK, we got them from the United States, and then we got a reiteration of the Japan QE that already existed.

QE is another way of saying, "Don't worry about technical default. We will print the money to pay you. It might not be worth anything, but at least there won't be a technical default."

What is interesting is that, right about the time that the Fed ended its QA program on Treasuries, we started to see everything start to drift back higher. That's that October 21 line.

Is this a market where you can go out and hedge out a third of the government issuance? No, nothing close to that.

Is it a market that we could look at as saying that, if the needle is pointing north then things are getting worse? I think that's fair. I think that's fair that, if the rates are going higher, then it is suggestive that there is a problem.

Now, in your example about Japan, you're right. The yield somewhere around 1.4 percent, and it will cost you 85 basis points to buy insurance against that. Japan has got a tremendously large debt-to-GDP ratio. Japan is no longer a triple A-rated country. It lost that triple-A rating in 2001. And so it's consistent with the credit of Japan.

If I could say one last thought about these markets, there is a flaw. We've kind of kidded around with this a little bit at times, but there is a flaw with the way that these markets work.

In the UK, if you buy sovereign CDS, then you're paid in dollars. If you buy sovereign CDS on the United States Treasury, then you're paid in euros. Now, the idea is sound that, if I were to buy an instrument that is protecting me against default of the United States Government, then the last thing that I want to do is get paid in dollars because that would suggest that the dollar is worthless anyway, and so why would I want to get paid in dollars to protect against the U.S. Government default? So you get paid in euros.

Of course, that brings up the point of, well, how much are euros really going to be worth on the day that the U.S. Treasury defaults, or how much are dollars going to be worth on the day that the UK Government defaults? You should be paid in gold. But you're not paid in gold in these markets. So there is that technical flaw, which I think that everybody is looking past.

So I offer just those thoughts. I think that, if you were to look at the lines, then I would say that they are consistent with what I would have expected. But you're right in that these are not deep, liquid markets. I think that these are more indicative markets.

Did you have a followup or any other thoughts to that, Mark?

Mark: Yeah, actually, I do, but it's not related to the G3 CDS markets; it's more on the inflation expectations market.

You get a time period – and I think that, obviously, everybody would agree that just tremendous amounts of liquidity have pushed spreads and have narrowed spreads, have pushed the Gold Market up, and have helped to revitalize the Equity Market. But from the perspective of the real economy, the real economy probably stopped hemorrhaging in the middle of the summer. But it's going to take a while -- and this is the Fed's argument – before you get any type of snap-back and resource utilization, which would put pressure on prices.

So you can have the sort of financial market, liquidity-driven, asset-driven inflation. But the real economy just seems like there is absolutely no pricing power and really has a lot of deflationary forces still working on it between commercial real estate, deflationary forces still working in the Residential Housing Market, and certainly no wage pressure whatsoever.

Jim Bianco: The dictum that Milton Friedman became famous for was "too much money chasing too few goods." And in the Fed – let me see if I can find it real quickly as I talk – if we were to look at Page Three, I've some wording there from the FOMC Minutes. And, basically, the statement that they were worried about was –

You're right about resource utilization. That is why we don't have inflation right now. In fact, we've gone a little bit more cynical on that and have said that the other reason that we don't have inflation is that the Banking System is somewhat dysfunctional.

But the fear is – and this is how the markets can demand the withdraw of liquidity, if you read that red part on Page Three that I highlight from the Minutes, when things turn around, the fear that the Fed has, which is something that I have said for months, is that it will happen quickly.

The Banking System will heal. It will start handing out loans. Everybody will start demanding loans. You will see this massive, massive pile of excess liquidity get used very quickly, and that could be potentially inflationary. That is your "too much money chasing too few goods." If I were to update Friedman's dictum from what we've seen happening now, we have the potential of way too much money. And once that potential is realized, there are too few goods.

So you're right. We don't have that inflation now. We have a somewhat dysfunction Banking System. Also, the excess resources have been keeping inflation under wraps. But if we go too long with all of this excess liquidity, as the Fed explained on

Page 3, then excess reserves quickly – you know, I'll just read from the Fed:

A few participants noted that banks might seek, as the economy improves, to reduce their excess reserves quickly and substantially by purchasing securities and/or easing credit standards and expanding their lending. A rapid shift, if not offset by Federal Reserve actions, could give excessive impediment to spending and potentially result in expected and actual inflation higher than would be consistent with price stability.

I have argued that since the summer, that, when this turns, it's going to turn quickly. And that is why, when Dudley says six months to two years, and everybody else starts that, they are insistent on waiting too long. And that is why I think that the markets are going to demand this from them – "Stop. Get rid of this money now before we have a real inflation problem."

So you're right. It's not here today, on January 14. But at some point, we are getting closer. I think that date is closer than we think -- when the markets move, when the recovery comes, when the banks turn, and everything starts going the other way. And all signs suggest that the Fed is insistent on being too late and creating inflation.

Do you have one more followup on that, Mark?

Mark: No, that's OK. Thanks, Jim. Great points.

Jim Bianco: Thank you. Bye-bye.

On line is **Dick**. Dick, are you there?

OK, he's not there because he sent me an email while I was talking to the last person. So let me read his question outright:

"What percent of S&P 500 earnings do financials represent at this time? And what is the historic percentage of earnings of the S&P 500?"

Well, I guess the S&P 500 I don't have off the top of my head. But if we were to look at the NIPA numbers, which is the last chart, the last page, to answer those questions, you could see that, right now, NIPA is the entire economy. The S&P is representative of the entire economy.

At the end of the Third Quarter, 27.65% of all corporate profitability came from the Financial Sector. Now, a year ago – December – the fourth quarter of '08, it fell to 10 because of all of the massive write-offs. So it has gone from 10% to 27%.

You could see that, over the last 20 years, it has averaged around 25% or 30%, so it's back into its average. When the curve got very steep in the 2001-to-2003 range, it did get up north of 40%. So those are the historic numbers that you can look at when you look at the earnings numbers.

Dick also asks, "Energy dominated earnings way out of its historical proportion for a period. That ended badly. Is there any parallel with the financial companies' earnings that lead to ending badly?"

Absolutely. What the "ending badly" is, is that if you believe that what is pushing financial earnings higher from the 10 percent to 27 percent that we see on this chart, on the last page is that very steep, record steep yield curve. They are going to keep going higher and higher.

Unless the Fed finds a period where they could slowly and deliberately flatten the curve over a period of many years, there is probably going to be a sharp reduction in the yield curve like we saw from 2004 to 2006, when it inverted in this period of two years after coming off a record steepness.

Now, I think that you will probably see the same thing happen again now. When the curve starts to flatten, it will start to flatten quickly and in a big way. And a lot of those earnings will simply disappear, quickly and over a period of a few quarters, not over a period of many quarters.

So that is the potential for it to end badly, that the Fed is forced out of an inflation scare to get aggressive in raising rates and severely squash the yield curve down. The Fed could be put in a bad place. The could be put into a place that either they are going to have to ignore inflation pressures and suffer those consequences, or they are going to have to acquiesce to those inflation pressures and severely flatten the yield curve.

Now, again, the thing that prevents this from happening is if the economic numbers just turn bad; and if the numbers turn bad, then that would prevent this thing from happening.

The next question is from **Carl**:

"You said the divergence between 10-year forwards versus the twos/10s is indicative of wider forward rates. Could it foretell a lower two/10 spread implication?"

Well, the divergence between 10-year forwards and twos/10s is indicative of higher inflation expectations. This is as opposed to, I think, if they were in line with one another – remember that a wider curve means higher nominal growth. But which pushing of it – is it coming from real growth or is it coming from inflation?

I think that when the forward-rate ratio and the twos/10s curve are in line with one another, you are correct to say that it is more from the real side of the ledger. If it's a divergence between them, then it's more from the inflation side of the ledger, as well.

By the way, in December of last year, we saw exactly the opposite. The twos/10s curve was flattening severely. But we had a widening of the 10-year, three-month curve. And that widening that we saw last year did foretell that we were very close to the bottom in two-year rates because we would see a rebound in real growth; and we did. We went from –6 to positive by the second quarter. So that is the way that I think that we would measure or at least think about those.

The next question is from **Brian**:

"How much of the growth in the third and fourth quarters is due to government stimulus? With non-financial earnings estimates still negative, can the economy grow without more stimulus?"

I think that a lot of it is due to government stimulus. I think that a lot of it, if we were to define government stimulus as not only the $787-billion Stimulus Program and Cash for Clunkers, and everything like that, but we would also define it as "said largesse," then I think that a lot of the numbers that we have seen are why we are having economic growth.

It is about cheap money. It is about zero money. That is why we are having growth. And that is the only thing that is pushing earnings higher. Non-financials have not turned around. Non-financials will turn around when the economy turns around, when hiring comes back, and all of that. If you take away the cheap money, the economy is really left with not a whole lot as far as where it's going.

The next question is from **Jeff**:

"It his recent speech, Bernanke absolved the Fed of responsibilities for the housing bubble due to lower-rate policies. Does this in any way suggest that he is likely to cling to lower rates more a combinative policy for longer during this cycle, as well?"

I think that the answer is absolutely yes. And I was very critical of this last week in some of the writings that we did.

Bernanke said that lower rates did not foster the housing bubble. What Bernanke did was that he took the Taylor rule and changed the rule after the fact. And instead of using natural inflation, the Fed uses their green book – inflation forecast.

It's a secret inflation forecast, I might add. We don't get to see the green book forecast for five years. So we don't know, since 2005, what that forecast has been. And the Fed is saying, "But if you plug our secret forecast into it, it says that we should have been at one percent in 2003/2004."

John Taylor, the inventor of the Taylor rule, subsequently came out and pooh-poohed this whole idea. As he pointed out, the Fed is using a forecast of inflation. We can go back and look at the green book forecast up until 2005, and we know that they are not very good. Can the Fed forecast inflation? We can then look at what the actual numbers are, and they're not good.

So what the Fed is arguing is, "Here is a wrong forecast on inflation. It says that the Funds Rate should have been at one percent. We put the Funds Rate at one percent, so, therefore, we didn't cause the housing bubble because we had interest rates at the rate that the model said that it should have been."

Does that make any sense? It makes no sense at all to me.

You used a wrong forecast. You came up with the wrong number. You put rates at that wrong place. That's really a better explanation of what they did.

So, yes, I think that the Fed is begging that they are going to make a mistake. They want, if you will, to make a mistake by staying too long. And I think that the message from that is the chart on Page Three.

If you look at the chart on Page Three, which is the inflation breakeven rate, it has been in a strong up-trend. What will probably end that up-trend is when the Fed starts the Exit Strategy. But we will have to see how high those inflation breakeven rates wind up going before we go there.

Beau asks a question:

"It might be early to ask this question, but based on your best knowledge, what is the most likely pattern once the Fed starts to hike – 25 basis points at every meeting or a larger rate hike and a pause for several meetings to see the impact? Is there any material impact on the Fed's rate being zero versus one or two, except sending a signal of a rate hike?"

Last week, I had something in *News Clips*. I keep mentioning this because, if you want, I can send you these links so that you could see it all written out. It was based on something that Susan Bies said. Susan Bies was a former Fed governor. She said that, for all of the talk of Exit Strategy, the Fed has not defined how the Exit Strategy is going to work.

There are three ways that it could work:

We have $1 trillion of excess reserves. Are they going to reduce those, first, down to zero, and then raise rates sequentially?

Are they going to raise rate first and then reduce the excess reserves?

Are they going to do both at the same time?

She argued that the Fed should raise rates first and then remove the excess reserves. I have argued that the Fed should do the opposite. They should remove the excess reserves first down to zero.

What we both agreed on, I might add, is what the Fed should not do, which is to do both at the same time. When you do something like this – doing the Exit Strategy – there will be unintended consequences. You're better off moving one indicator – either reducing reserves or raising interest rates. See what happens. Then you know that, if you have a bad reaction, you did too much or did not do enough.

If you're moving two indicators at once, then you don't know whether or not the Market is reacting to the reserves or interest rates, or a little of each. And you don't know what to undo to stop this. So that seems to be the one thing that they have done.

Now, the Fed seems to be insistent that they are going to move the reserves first because they have been testing reserve repos, the term deposits, all of these other things. Issuing their own debt was an idea that they floated last week, as well. These are just ideas that they are floating. These are all on the reserve side.

So I think that what they will probably wind up doing is removing excess reserves first. That is a nice way of saying that they will stop purchasing mortgages, and then they will look to find ways for banks to use those excess reserves.

Term deposit is a way that the Fed will offer a security. "Take your excess reserves and put it with us, and we will pay you an interest rate for them." That way, it gets those excess reserves out of the System, and that is what term deposits are. The Fed will issue securities, issue debt, and buy them up with the excess reserves. That's another way that they can get rid of them.

The easiest way to get rid of them, of course, is to sell them. But they don't want to sell mortgages. They are deathly afraid of that. I think that that is the way that they are going to go.

But, to your question directly, Beau, if they are going to raise rates – everything that I have read and seen is that they have learned the lesson from 2003. Quarter point at a clip, for every meeting, very predictable was part of the problem. It took them two years to get to 5.25. And it was too slow.

So, this time around, I think that what you will see is that you might see the first hike be 100 basis points, get back to one percent. I don't know that that's the case, but that is an ongoing discussion, that once it's time to go, then go. Don't start moving from zero to 25, to 50, to 70. That's four meetings. That's six months. In six months, you're at one percent.

In a year, you are approaching two percent. But if you had to get back to four or five, it's going to take you three years at that point. If you don't start until the year 2012, then you're talking about rates being under four percent until the year 2015. So I think that once they start raising rates, it will probably come in bigger numbers.

All right, we are a little over an hour into this call. The last question is a very straightforward question from Ben. I'll take that.

There are some other questions. I will answer any other questions that anybody has, and I will add those to the transcript that we will put out on Monday.

Ben says:

"Currently, are you bullish or bearish on the markets? It sounds like you are finally bullish on the points that you have made, market in line with fears of expectation and exceptionally steep yield curve."

All right, to put these in simple terms:

- Bearish on long-term Treasury rates.
- Expecting 10-yearTIPS breakevens to move higher.
- Bullish on things that would be beneficial to higher inflation like TIPS breakevens, like gold, like a lower dollar.
- Stocks, bonds, and other risk markets – neutral, leaning toward the next idea being bearish.

We are not at the point with interest rates and TIPS breakevens and all of that other stuff to say that we've got an inflation problem; but we're close. When we get there, I think, then, the risk markets turn bearish because that heightens the reduction.

The money comes out. The liquidity goes away, then, and then the risk markets have problems. We're not there now, so I'll stay neutral.

But when we get there – above four percent, above 260, 10-year TIPS breakevens above 1200, and the narrative in the Market is, "We have an inflation problem," then the Exit Strategy has to begin to turn bearish on risk markets.

So that's the best answer that I can give you. If there are any markets that I missed in that, then please give me a call or an email afterward, and we could discuss it from there.

All right, I want to thank everybody for joining me on the call.

Thanks and goodbye.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511
Fax (847) 304-1749
e-mail: research@biancoresearch.com
http://www.biancoresearch.com

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599
James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511
Howard L. Simons hsimons@biancoresearch.com
Greg Blaha gblaha@biancoresearch.com
Ryan Malo rmalo@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.
Director of Sales & Marketing (800) 606-1872
Fritz Handler fritz.handler@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560
Fax (847) 304-1595

e-mail inforequest@arborresearch.com
http://www.arborresearch.com

Domestic - For more information about Arbor Research & Trading and its services:

New York Sales Office

The Chrysler Building
405 Lexington Ave
New York, NY 10174
Edward T. McElwreath ed.mcelwreath@arborresearch.com
Phone (212) 867-5326
Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

London Sales Office

4 Broadgate, 2nd Floor, Room 57
London England EC2M 2QY
Phone 44-207-965-4784 Fax 44-207-965-4787

Neil Tritton neil.tritton@arborresearch.com
Ben Gibson ben.gibson@arborresearch.com

Chicago Sales Office

James L. Perry james.perry@arborresearch.com
Phone (847) 304-1560 Fax (847) 304-1595

Geneva Sales Office

Rich Kleinbauer rich.kleinbauer@arborresearch.com
Phone (41) 22 363-9229

Far East Sales Office

Robert Reynolds robert.reynolds@arborresearch.com
Phone (847) 756-3680 Fax (435) 647-3073