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Special Report

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Contradictions: The Fed vs. the Bond Market

By John Mauldin

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The following is excerpted from John Mauldin's latest weekly E-letter

For more information, see: <http://www.2000wave.com>

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Two weeks ago we examined the changes in our lives. Last week we looked at imbalances in the economy. This week the theme that I see in my daily reading is the large number of major contradictions apparent in the markets. There are so many contradictions we will not get to them all, but let's start, as it will make for some interesting and controversial analysis.

Fannie and Freddie Distort the Market

The main contradiction we will deal with starts with a lunch conversation I had with bond market analysts and guru Jim Bianco two weeks ago in Chicago. Jim is one of the smartest analysts I know and is a fascinating font of information.

We were talking hedge and macro funds, and he asked me what I thought was the best "trade" I saw. I answered that for aggressive traders, I liked the Eurodollar options. I will explain them in more detail below, but they are pricing in a Fed interest rate rise of over 1.75% by December 2004, which is just 14 months from now. I opined as how I did not think there is a significant chance of such a magnitude of a raise actually happening, and that I could not understand how the bond market could actually believe the Fed would raise rates that fast.

Jim replied, "They don't. The Eurodollar futures mispricing is a result of Fannie Mae and Freddie Mac distorting the market." As he explained his reasoning, and as I have thought about it since then, I think he may have an answer for part of the

puzzling contradiction between what the Fed is saying and what the market is pricing.

First, the Fed cannot be any clearer about their intention to keep short-term rates low. A "considerable" period is how they term it. One Fed governor told us a few weeks ago that a considerable period is 18 months. That is past the end of 2004.

Typical is what influential San Francisco Fed President Robert Parry, the second longest serving Fed policymaker, had to say:

"The rise in long-term interest rates since summer has already taken the wind out of the refinancing boom, which put so much money in people's pockets. Core inflation, which is already under 1.5%, may slip even lower. The recent period of weak investment demand has not only led to a fall in inflation, but it has also depressed economic activity.

"Thus, there is less concern about surprises that could push the inflation rate up, and more concern about surprises that could push the inflation rate lower, possibly even leading to deflation."

For now, let's simply take the Fed at its word that rate increases are not in the near term future. Except that the bond market seemingly does not take the Fed at its word, nor do the futures market imply anything close to trust or belief. My "favorite" trade I mentioned to Jim got crushed this week. There are two ways to bet on or hedge interest rate risk and direction. You can invest in Fed fund futures or Eurodollar futures. (Fed fund futures are typically used for shorter-term moves and Eurodollar futures are used for longer term hedging. That is because after a duration of about one year, the Fed funds futures markets are not very liquid or sizeable, and the Eurodollar markets are where the huge action is, as we will see.)

The September '04 Eurodollar contract implies that the Fed will raise rates by 1.25 % over the next 11 months. If you go to December '04, rates are expected to rise by 1.71% and if you go to December 2006, the market apparently thinks short term Fed fund rates will be 4.96%, almost a full 4% rise. Can you say 9.5-10% mortgage rates, boys and girls? That also implies that inflation plus growth will be well north of 6-7%.

But wait, there is an odd fact within the very markets. If you go to the Fed funds rate for August of '04, there you find that rates are expected to rise only 0.75%. The market is saying that just one month later rates will rise by a full half percent.

The market is saying that Alan Greenspan is going to raise rates by 0.5% just 45 days in advance of what will be a very close presidential election (on top of the 0.75% they think he will have raised by August). Further, the market is implying that the economy, or inflation, or both will be so strong that Greenspan will have no choice but to do so.

I am not going to dispute that the economy is not growing strongly. It clearly is. It could grow at an above trend pace for well into next year. That makes me happy. But I think there is some inherent weakness in this recovery that makes it more suspect than others recoveries we have experienced since the end of WW2. As we will see, I find it hard to believe that there is something in the economic water that could cause Greenspan to raise rates 45 days in front of an election.

Let's go to my favorite macro analyst, Greg Weldon, and look at some of the data he slices and dices in his latest Money Monitor, arguing that there are no rate increases in our future. (www.macro-strategies.com)

"Bottom Line: over the last FOUR months, the annualized rate of decline in US Average Weekly Earnings is (-) 1%. Without income reflation [growth in personal income], there is virtually NO ladder for inflation to climb, ESPECIALLY under the auspices of CONTRACTING money supply." (quote with edits) Think about that. No growth in income in the strongest quarter in many a year.

"... without income gains, wealth reflation will be the SOLE support going into an election year." By wealth reflation, Weldon means stock market and housing price gains. Yet that might be in jeopardy as the Fed actually appears to be tapping on the brakes by tightening the money supply.

The Fed Hits the Brakes

He documents at length the significant recent slow down of growth of M-2 and M-3. He asks: "CAN wealth reflation in the US withstand the TIGHTEST monetary conditions since the last great stock-market wealth DEFLATION??? ... with the tightest monetary stance via long-term-of-short-term M3, since 1997."

Then he offers this very interesting data from the Philadelphia Fed Survey:

"While ALL the focus was on the admittedly robust OUTPUT data, we note the less-focused-upon "Special Question" segment of the survey, which asked:

- *If you experienced a decline in Production during the 2001 Recession (72.5% of all, did), has Production returned to pre-2001 levels? 85.7% replied NO.*
- *Then, If not (85.7% of the 72.5%), WHEN do you expect Production to return to pre-2001 levels? 53.1% said between 2Q-4Q 2004 ... BUT the rest, over 43%, said "Not in the Foreseeable Future".*

"Indeed, nearly a THIRD of ALL firms stated that Production is NOT likely to regain pre-2001 levels. YET, money supply [growth] is trending well BELOW the degree of stimulus that was on the offer, since pre-2001.

"FAR WORSE, in the macro-secular sense, is this final tidbit from the 'Special Question' segment of the Philly Fed:

- *"23.4% of the 85.7% of ALL firms that originally stated that Production had not reached back to pre-recession levels, said they did NOT expect Production to reach back to pre-2001 levels ... BECAUSE of ... "Long-term Decline in the Industry."*

"Indeed, note the Fed's own text ... 'Moreover, a large percentage of firms (44 percent) do not expect production to return to those pre-recession levels in the foreseeable future, for reasons involving competitiveness or long-term declines in their industries.'"

"YEAH, [he writes sarcastically] lets TRIPLE the Fed Funds rate!!!"

The headlines you read talk about how jobs are getting better. If you look at initial claims, you might get that idea. They are below the psychologically important 400,000 and are dropping ever so slowly. Comparing the real numbers with last year, there is a slight improvement, which is good.

But Continuing Claims are rising, and back to levels seen earlier this year. Taken together, this means that fewer people are losing their jobs, but fewer are also finding jobs.

Let's reflect upon that for a moment. We are told the economy grew by something like 6% in the third quarter. That means with inflation we are talking a nominal rate of over 7% and maybe 8%. That is as powerful as it has been for a long time.

And yet, no jobs. No income growth. As Weldon notes elsewhere, only 2% of those firms surveyed said they were paying lower prices, with 25% paying higher prices, yet 72% say they have no pricing power and are unable to raise prices.

Let's look at where the out-sized growth came from last quarter. Stephen Roach tells us 2% of real GDP growth came from automobile sales in the last two quarters. Consumers, supplied with a tax cut and massive home equity financing from the second quarter as rates briefly dropped to historical lows, took the heavy incentive deals they were offered on cars which were also priced lower than this time last year.

"Surging expenditures on consumer durables [mostly automobiles] accounted for about 2.0 percentage points of annualized real GDP growth, alone, over the past two quarters. To the extent that such an impetus did not reflect the fundamentals of pent-up demand, a payback of like magnitude would not be surprising. Historical experience does, in fact, tell us that's the norm after any spike in durables spending -- let alone the excessive one of the past two quarters. Since 1960, there have been 16 instances of excessive growth in durable goods consumption (defined as an annualized growth contribution exceeding 1.5 percentage points of real GDP) that contributed, on average, 2.2 percentage points of annualized real GDP growth; in the two quarters that followed, the growth contribution slowed dramatically, on average, to just 0.1 percentage point. To the extent such a payback is likely after the current spending burst, it could act as a sharp depressant on overall demand growth in subsequent quarters. That development, in the context of a lingering jobless recovery, could raise serious questions about the staying power of America's current cyclical resurgence." (Stephen Roach of Morgan Stanley)

Could auto sales maintain this level for one more quarter? Perhaps, as small business people all over America come to the end of the year and realize that under the current tax code, if they buy an SUV that weighs over 6,000 pounds (Lincoln Navigator, Cadillac Escalade, Lexus, Chevrolet, Ford, etc.) they may be able to deduct the entire cost from their 2003 taxes. In essence, the government just made

these monsters more affordable than smaller cars at two-thirds the price.

(Yes, to my shocked readers in Europe, a 1986 tax rule provides that small businesses can deduct the cost of commercial vehicles, which are defined as small trucks that weigh over 6,000 pounds, which in the US includes large SUVs. The Bush tax stimulus package allows small businesses to deduct up to \$100,000 of capital business expenditures immediately per year, up from \$25,000 if I remember right. The idea was to get businesses to buy more computers and equipment and furniture, etc. Under the current rules, SUVs also fit into this category. Only in America.)

The good news is that the US economy apparently grew 6% in the third quarter of this year, and should do well this quarter and into the New Year. But this is a stimulus led recovery, and where will the next shove come from? The Bush administration has to hope that oil will drop to around \$20, or that rates will somehow come back down.

Roach says, and I agree, "Eager to jump-start the US economy prior to the upcoming presidential election, the Bush Administration focused on front-loaded tax cuts that were designed to have maximum impact in 2004. "Spring-loaded" was the term used by Treasury Secretary John Snow to describe the growth potential of these measures. Well, the White House may have gotten more than it bargained for. The risk, in my view, is that the policy induced stimulus occurred sooner than expected in 2003 -- leaving the US economy having to face the "air-pocket" of a payback in early 2004. Needless to say, that would come during a period of maximum vulnerability insofar as the election cycle is concerned."

Let's be very clear. There are some very positive signs in the economy. Revenue growth seems to be picking up. There are some anecdotal signs that employment might be starting to rise, although it has not shown up as yet in the data. Housing is still relatively strong, and consumer spending is growing.

Further, I am not complaining about the stimulus driven recovery. Recovery is a good thing. If any of the Democratic presidential hopefuls were currently president and actually pursued the policies they espouse, we really would be experiencing the worst economy since the Hoover administration. Without the combined and powerful stimulus of the Bush tax cuts, federal deficits and Fed engineered lower rates, it is difficult to imagine anything but a severe post bubble and post 9/11 recession.

(The best thing the Republicans have going for them is Howard Dean, who increasingly reminds me of Michael Dukakis, another very liberal Northeastern state governor who came from nowhere to win the

Democratic nomination only to go down in flames in the general election. This country might be ready by election time for another centrist Democrat like Lieberman, but a far left Democrat, which Dean clearly is, is not in the cards.)

The point that I am trying to make with the litany of data I provided is that this economy cannot withstand higher interest rates. Do you think home sales, mortgage refinancing and consumer spending, not to mention auto financing and other debt-driven consumption, is ready for higher rates?

This economy is vulnerable in a way that no 6% growth economy in my memory has ever been. If the Fed actually raised interest rates by 1.75% within the next 14 months, pushing mortgages close to 8%, increasing financing costs, impacting home sales and home values, how long would it be before we were staring at a recession and another serious stock market correction?

Further, interest rate increases are disinflationary at best, and in this environment, could actually foster deflation. Go back to Parry's statement above, and compare it with scores of other recent Fed speeches and releases. They are worried about the "surprise" of deflation. They see the softness and vulnerability. This is not a Fed that will raise rates until reflation in incomes, pricing power and business investment has demonstrated an ability to sustain themselves in spite of rate increases.

Contradictions: The Fed vs. the Bond Market

Yet, the bond market is pricing in such rates. What are these guys reading (or smoking)? Are you and I, dear reader, the only ones who can understand the clear language of the Fed? Or are we gullible little fish who cannot see through the lies?

And now we come to Bianco's insight. He points to Fannie Mae and Freddie Mac as the culprits for the contradiction between Fed talk and market rates.

Ginnie Mae (the Government National Mortgage Association) is totally owned by the US government and run by the Department of Housing and Urban Development (HUD). Its debt is truly government guaranteed.

Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Association) are private companies. The government does not explicitly guarantee their debt. They do have a \$2 billion line of credit with the Treasury that they could use in a liquidity crisis.

But the market treats their debt as if the US government guarantees it. That means Fannie and Freddie can borrow money at much lower rates than can, say, J.P. Morgan or Citibank. I suppose you can argue that is a benefit to consumers, as it does

mean that home mortgage rates can be lower as well.

But what Fannie and Freddie have become are Government Sponsored Hedge Funds. Management has taken advantage of their "special" relationship and uses it to increase private profits for shareholders and large salaries, options and bonuses for management.

Essentially, they lend long and borrow short. Since short term rates are lower than long term rates, they pocket the difference. They increase their profits by the use of very large amounts of leverage.

This is known as a "carry trade," and is a regular practice of hedge funds and other investment companies. There is nothing wrong with this. Some of my favorite funds practice this type of investing. Properly practiced, it can produce some steady, if not spectacular, profits.

What Fannie and Freddie do is what good hedge funds should do. They go into the futures market to hedge their interest rate directional risk. You see, if short-term rates were to rise above the average rates they have lent to their long-term mortgage buyers, they could find themselves in the position of losing money. Lots of money. So they hedge.

They do this in the Eurodollar futures markets. They use swaps or options on swaps called swaptions. (Swaptions are options contracts, which in return for a one-off premium payment, give you the right to enter into a swap agreement at the option expiration.) Again, nothing wrong with this.

Bianco notes the problem lies in that they need over a Trillion Dollars (that's with a "T") of these derivatives. In order to get a trillion dollars to line up on the other side of the trade (to take the risk from Fannie and Freddie), they have to pay a premium. Apparently it may be a big premium.

Bianco argued at lunch, in the shadow of the Chicago futures markets, that it is not the expectations of bond traders for actual rate increases, but the massive need for Fannie and Freddie to hedge its portfolio that drives the Eurodollar rates.

Why do Fannie and Freddie need such high-powered hedge exposure? Because if they acted like Ginnie Mae, their profits would be much less, stock price growth would be lower and management would not get the fancy pay packages and option incentives.

Do I think Fannie and Freddie are at risk today because of this? No, I am not saying that, and neither is Bianco. But there is a limit.

Frank Raines wants to grow his firm (Fannie) 15-20% a year. Where are they going to find more

credit worthy risk takers/speculators on the other side of the swaps trade?

Let's be very clear. They could not do this if the market did not price their debt as if the US government backed it. The "spread" would not be there. Otherwise, Citigroup and Morgan and other investment banks would be significant competitors.

As long as the market sees that level of risk, the game can continue. But what if they simply try to get too big? How long can you grow a finite market 20% compound a year? What if there is a hiccup? How quickly would the risk premium for the Eurodollar rise? Not very long. The technical term is a "jiffy," which is the name of an actual unit of time, which is 1/100 of a second. (The things you learn as you read. Thanks, Art.)

First, if there were a problem, the US Treasury would step in within the next jiffy to provide whatever cash was needed. No administration, Democrat or Republican, will let the US mortgage market and home values crash due to a "liquidity event" at Fannie or Freddie. Think the Savings and Loan crisis was big? It would be a picnic compared to a major problem with Fannie and Freddie. The implicit guarantee the markets perceive is actually quite real. These firms are too big and too important to fail. The US taxpayer, however, picks up the ultimate insurance tab.

For every \$100 billion their "hedge book" increases, the costs for acquiring the hedge is evidently rising. What is the point when we get to "too much?" I don't know, and neither does anyone else. We may be a long way from there, or maybe not.

The point is that a private company seeking private gains should not be putting the entire US mortgage market and the US taxpayer at risk, even if they think the risk is small.

The management of these firms is comprised of very smart men and women, and I am sure they employ some of the smartest PhDs anywhere to run their hedge book. But so did Long Term Capital Management.

Where's the Market Discipline?

The problem with Long Term Capital Management (LTCM) was that there were no market restraints or market discipline on the firm. Greed drove all those investment banks to lend LTCM money in the lust for commissions, and LTCM refused to show any of the firms their "hedge book." You can bet if the investment banks had seen their total exposure, they would have reined the Nobel Prize management team in, in very short order.

But who is looking over Fannie's shoulder? "Don't micro-manage us," say Raines. Translation: don't mess up our gravy train.

Everyone seems to acknowledge that federal oversight is weak. There is now a bill in Congress to move the oversight to the Treasury Department, but Fannie and Freddie lobbyists have so watered down the bill that it is worse than the current situation. If oversight goes to the Treasury under the current guidelines, that increases the implicit government guarantee and US taxpayer exposure. But it creates no real controls.

If Fannie and Freddie want the advantage of an all but explicit government guarantee, they should open their hedge book to complete scrutiny and be subject to leverage curbs. At a minimum, they should be made to shorten their duration risk exposure (another risk which I will not take the space to go into, but which is real enough).

Yes, under such a situation they will not make as much profit as they do today. But so what? Why should a small group place the rest of us with a large risk, even if it is thought to be remote?

We would scream if a Morgan or a Citigroup or some other private firm would be allowed to put US taxpayers at risk for private gain. What is the difference with Fannie or Freddie?

Alan Greenspan argues, and I think rightly, that the Fed should manage not for the more likely of problems, but for the possible problems that would cause the most harm. It is better to tolerate some problems than to experience a problem, which could lead to disaster.

The mortgage debt market is now larger than the government debt market. One can make an argument it is the most significant piece of the US economy. Why take any risk at all?

Yet, if Bianco is right, the bond market sees more than a little risk, and that is why interest rate futures are priced so high in the face of the Fed telling us rates are going nowhere. If there were no risk to this trade, there would not be such high-risk premiums.

Congress needs to shorten the leash on Fannie and Freddie. Public or private. In or out. But not both. Perhaps Fannie and Freddie are right. Maybe the risk is low. But so was the risk to Long Term Capital. It is a risk that US taxpayers should not take, are not paid to take, yet Congress has let the lobbyists convince them otherwise.

More Contradictions.

How can we once again be in Bubble valuations? Amazon at a P/E Of 151, Priceline at 220 and the list goes on and on. Caroline Baum points out the China have lost 10,000,000 manufacturing jobs in the last

few years due to productivity increases. Who do the Chinese politicians blame? Who is their currency scapegoat? Our politicians on both sides of the aisle pander to our nationalistic tendencies, as do politicians worldwide. Do we really want China to risk major turmoil and a reactionary return to a nationalistic world? Think Germany in 1932.

What of the clear contradiction between the argument for free trade and the seeming arrival of protectionist sentiment upon every shore throughout the world?

Enough. There are just too many, and it is time to go home.

Let me suggest that the hedge funds and major traders who read me might go to Greg Weldon's web site mentioned above and contact him directly. He has a rather pricey (several thousand a year) service in addition to his less expensive retail letters. I am sure he will send you a few weeks' samples. They are worth every penny if you are "working the markets."

If you would like to meet in New Orleans October 29-31, please let my office know. If you have

already written about getting together, you should have been contacted by now. Have yourself a great week.

Your almost ready to finish his book analyst,

John Mauldin

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