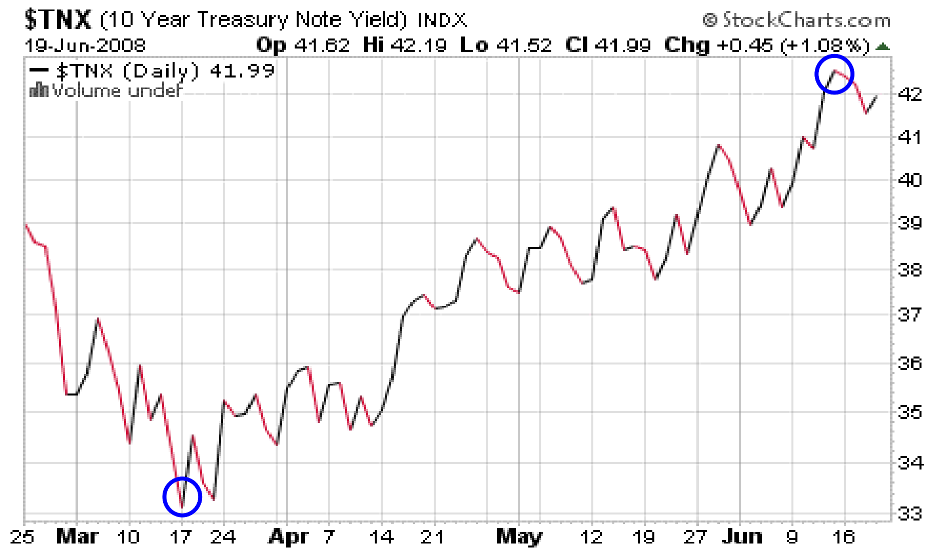
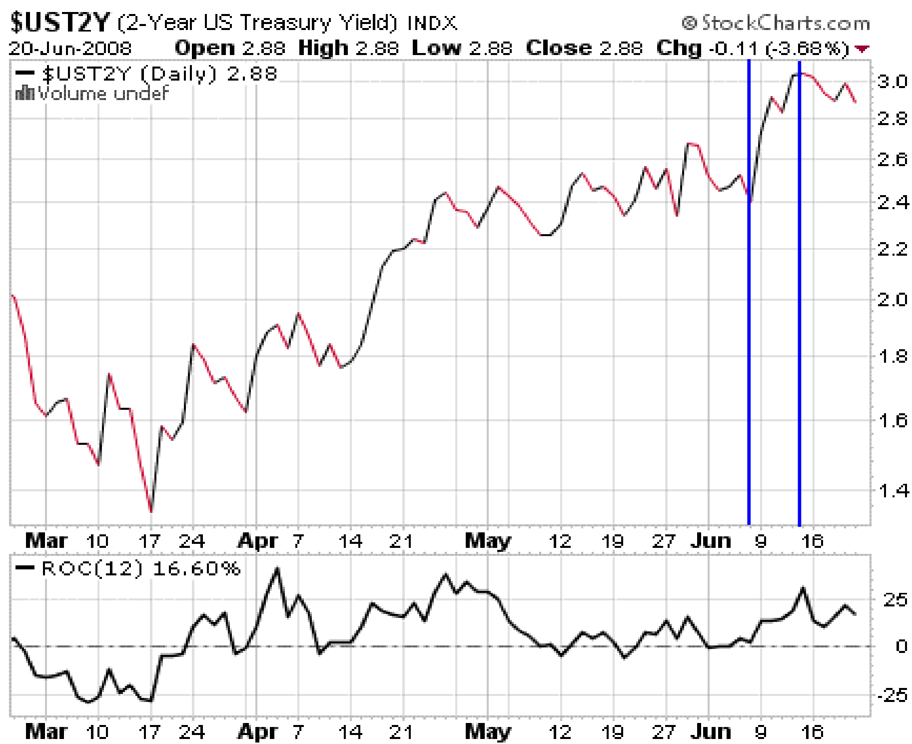
YieldSafeINVESTMENTS LLC

OUTLOOK
"Bullish on Bonds"
6/17/2008

We believe U.S. Treasuries are likely to rally in the coming weeks ahead. Since late March, bond prices have been falling as yields have been rising. As shown in the graph below, the 10-Year Treasury Note Yield has advanced from 3.33 on 3/20/08 to 4.26 on 6/13/08, nearly 100 basis points. According to Bloomberg.com, treasuries have had their worst 2 month loss in April and May since 2004.



We think there are 2 main causes to this surge in interest rates. One, there has been a flight out of quality in which investors have taken money out of bonds and placed it into stocks. This is evident by that the fact that the stock market has rallied in April and May while the bond market has declined. Two, inflation expectations have drastically increased. As commodity prices have surged, the Fed has shifted its stance from spurring growth to fighting inflation. Accordingly, the bond market has strongly discounted the chance of the Fed hiking interest rates to fight inflation. The most obvious sign of this was in the action of the 2-Year Treasury Note which is the most sensitive to expectations in Fed Fund policy. The 2-Year Treasury Yield skyrocketed to 3.04 from 2.38 a week earlier, the largest one-week rise in yield since 1987. See the graph below which shows the 1 week increase in yield between the two blue lines.



So what would cause bonds to rally? One, a stock market correction. A sell-off in stocks would re-ignite the flight to quality trade in which investors would flee stocks for the safety of bonds. Given an environment of growing subprime fallout, surging commodity prices, and the possibility of war, one could not rule out this possibility. Two, a decrease in inflation expectations. The bond market has discounted a high probability of the Fed hiking rates to combat inflation. We think these expectations are unrealistically high as it is unlikely for the Fed to hike rates given the credit crunch, fragile banking system, weak housing market, and election year. The bond market should rally when its high expectations of a Fed rate hike decrease to reflect reality that the Fed is unlikely to hike rates.