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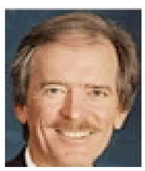
Bond Market on TiLT ?

Thesis: We view the TLT as a good short as US Treasuries continue to come under pressure in light of increasing signs of global inflation as well as an unwind of the flight to safety trade. At nominal yields of 3.85%, the 10-year does not adequately compensate for inflation risk. Because volatility may be quickly moving from the stock market to the bond market, we recommend investors look at outright puts or put spreads in the TLT.

The unprecedented level of market stress over the past 9 months has caused dislocations in risk that have largely been expressed in spreads. In equities for example, the spread of downside implied volatility to upside (the "skew") reached extreme levels, especially in financials where uncertainty has been greatest. Spreads in the risk arbitrage market – an indication of broad sentiment on the feasibility of deal completions – have also illustrated the extent of the market turmoil. In credit, spreads of all types – corporate, asset backed, municipals, loans, commercial paper, LIBOR, and swap spreads - have reflected the degree of dislocation in the market place as investors have sought to shed perceived risk of any kind. The liquidation of paper in these asset classes and the search for a "safe haven" has played a strong role in the rally in the US government bond market. The decline in treasury yields, coupled with the sell-off in spread products has created some of the widest risk premia the fixed income markets have ever seen.

Many believe that the US government bond market is overvalued and the six high profile investors below have recently expressed similar views on the pricing of treasuries.[1]

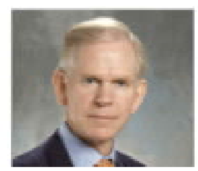

Larry Fink
Blackrock


Bill Gross
PIMCO


Doug Kass
Seabreeze


Dan Fuss
Loomis Sayles


Bill Miller
Legg Mason


Jeremy Grantham
GMO

- *"The move into treasuries has the makings of a bubble." ~ Larry Fink*
- *"Treasuries are the most overvalued asset in the world, bar none." ~ Bill Gross*
- *"The bond market is in a bubble reminiscent of…other bubbles during previous eras." ~ Doug Kass*
- *"We are in a bubble, in a hot air balloon, and now it is starting to leak." ~ Dan Fuss*
- *"The two-year Treasury yields under 2 percent, and is thus valued at over 50x earnings!" ~ Bill Miller*
- *"Government bonds globally are now badly overpriced…" ~ Jeremy Grantham*

We share the view that the rally in US Treasuries, largely a function of the rush to safety amidst the leverage unwind, is overdone in light of the Fed's loose monetary policy and what appear to be accelerating inflationary pressures. For example, with the 10 year Treasury yield at 3.85%, and with TIPs priced to yield 1.5% (Bloomberg WBI <go>), the break-even 10 year inflation rate is roughly 2.35%. One can argue that nominal yields reflect market forecasts of extremely weak GDP growth in the US over the coming years, but at 3.85%, there is little room for error when an inflation premium must be absorbed. The stance of Fed policy, the USD, the trend in the CPI and what may be an escalating global inflation warfare expressed in hard and soft commodities all point to inflation risk. Gordon Brown recently called on industrialized nations to act to address the inflation crisis and the World Bank is in "emergency mode" as food prices rise. On Friday, the Japanese government bond market experienced a violent sell-off as the year-over-year consumer inflation rate accelerated to 1.2% and traders speculated that central bank governor Shirakawa will focus on slowing inflation via monetary policy.

In the US, the most recent Michigan consumer sentiment report has one year inflation expectations at 4.8%, the highest reading ever. Although during his early tenure at the Federal Reserve, Greenspan often spoke of the Fed's goal of fighting the self fulfilling psychology of inflation, Gross of PIMCO suggests that the Fed's goal is *reflation* - of effectively easing the pain to borrowers via the tax on lenders that comes from inflationary policy. **We are concerned that the "safe haven" status of US government debt has effectively forced investors to substitute an unacceptable**

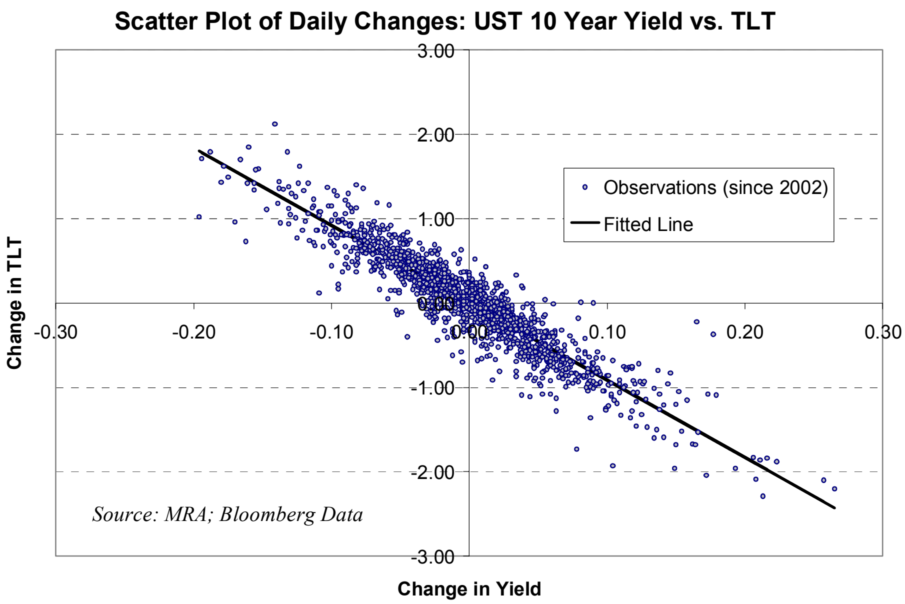
[1] The opinions expressed in this piece are solely those of the author.

risk (credit) with an acceptable, but apparently accelerating risk, (inflation).

The most headline-grabbing aspect of the inflation backdrop has been the US dollar price of energy, metals and food related commodities. While the China and India industrial demand side of the energy story has been well articulated, the recent rallies in commodities are also tied to dollar weakness and US monetary policy. We may be, as some argue, in the midst of a commodities bubble, but the wave of speculative funds entering the market is in part a reaction to the ongoing depreciation of the dollar. As we have seen with the tech and housing bubbles, prices can move well away from fair value for extended periods of time as the feedback mechanism of the market engenders speculation. In its March policy decision, where members Plosser and Fisher dissented on the 75 basis point ease, the FOMC put greater emphasis on inflation than it did in its January statement. The following is from the text of the 3/18 statement:

> *"Inflation has been elevated and some indicators of inflation expectations have risen. The Committee expects inflation to moderate in coming quarters, reflecting a projected leveling out of energy and other commodity prices and an easing of pressures on resource utilization. Still, uncertainty about the inflation outlook has increased. It will be necessary to continue to monitor inflation developments carefully."*

In addition to an elevation of inflation concerns, the recent rise in yields is a function of an unwinding of the flight to safety trade. For example, on March 17th, when Bear Stearns was absorbed by JPM and the Federal Reserve, the 10 year note yield reached a low of 3.3% as the VIX surpassed 32. Shortly after the 75bps cut in the Fed Funds rate on March 18th, traders still viewed meaningful reductions in the rate as likely with a 28% implied odds of a 50bps cut (to 1.75%) as of March 25th. Currently, futures prices imply a 78% chance of only a 25bps reduction and a 22% chance that the Fed will leave rates unchanged. With sensitivity to the inflation headlines and with many professionals suggesting that the worst of the credit crisis may be behind us, the Fed is likely more apt to make changes in monetary policy at a more moderate pace going forward and allow itself an opportunity to digest incoming economic data. **Our view is that the most intense phase of the Wall Street mark to market meltdown (ABX, ARS, loans) is over and that the artificial bid to government bonds will come undone, especially if we continue to see unwelcome inflation data.** Daily price changes in the TLT have a -93% correlation to daily changes in the yield on the 10 year Treasury. Below we show a scatter plat that shows the incidence of changes in each since July 2002 when the TLT was created. Based on regression analysis, we can expect a roughly 90 cent decline in the TLT per 10bps increase in the yield on the 10 year treasury.



- Dean Curnutt