Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

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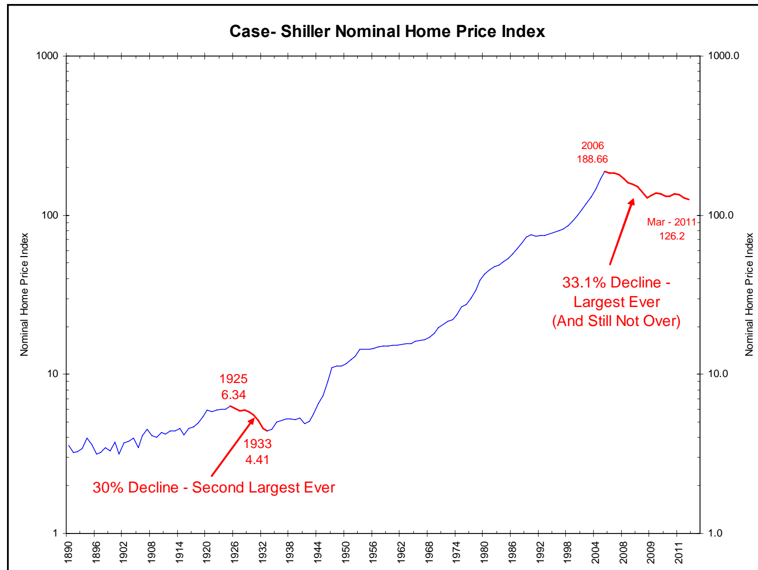
What Happens After June 30?

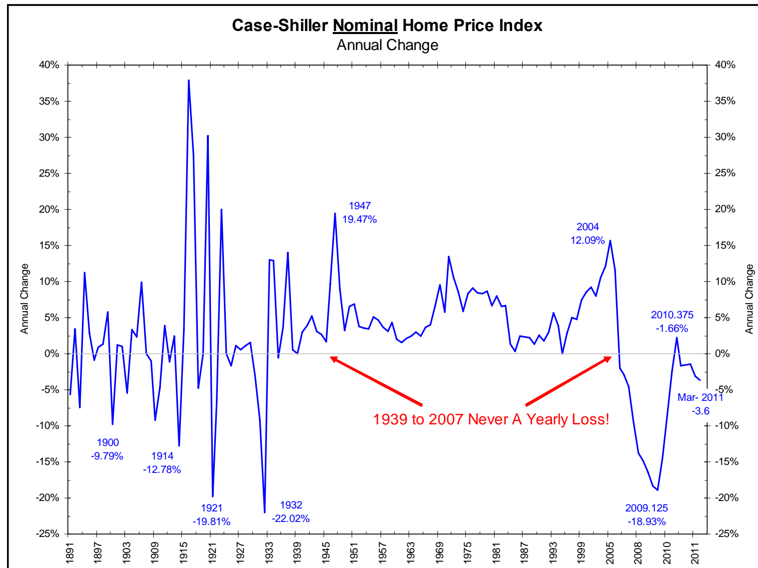
Presentation Package

June 2, 2011

Long-Term Interest Rates - 1900 to 2010

Housing – Worse Than The Great Depression?





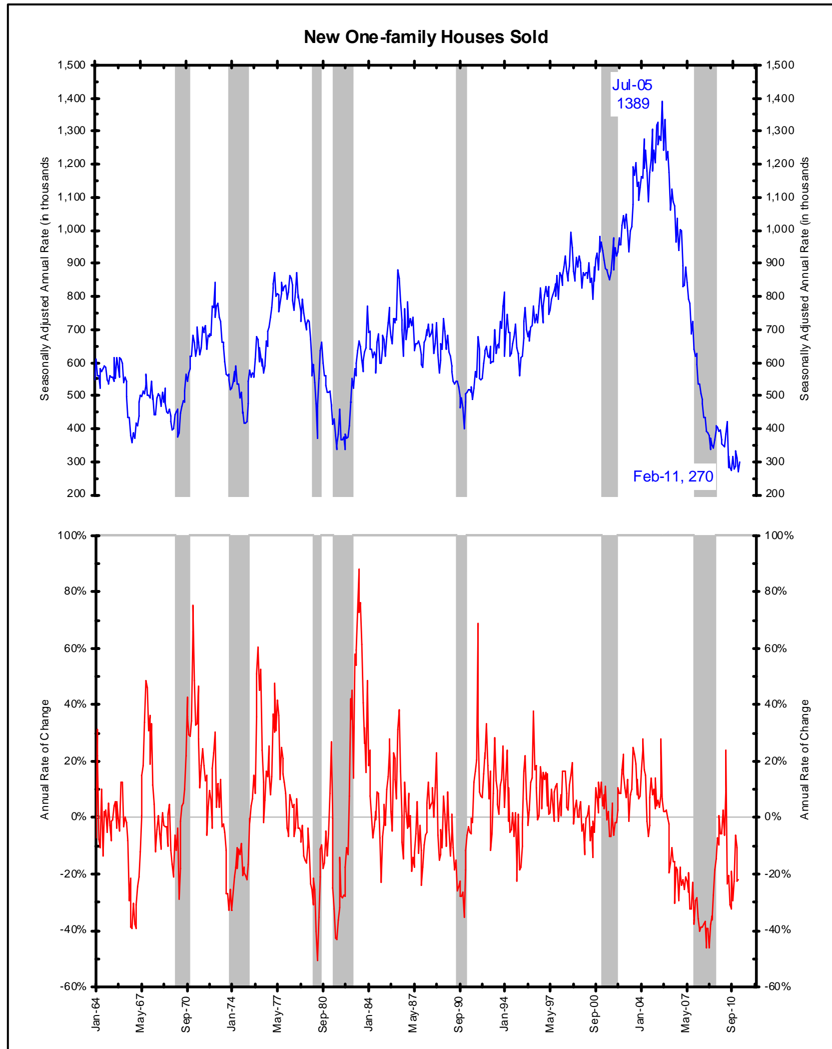
Many stories are noting that the current housing decline is greater than the decline of the Great Depression. This comes from the Case/Shiller Annual Index which goes back to 1890. Case/Shiller used the Grebler-Blank-Winnick data from 1890 to 1947 (explanation, data). This data shows home prices fell 30% during the Great Depression (1925 to 1933) and the median price of a Washington DC home fell 27% over the same period. So, while Barry Ritholtz's Big Picture post below is conceptually correct to point out that every other price index fell 75% to 90% during the Great Depression, Grebler-Blank-Winnick's housing data from that period does not show house prices fell to quite that extent.

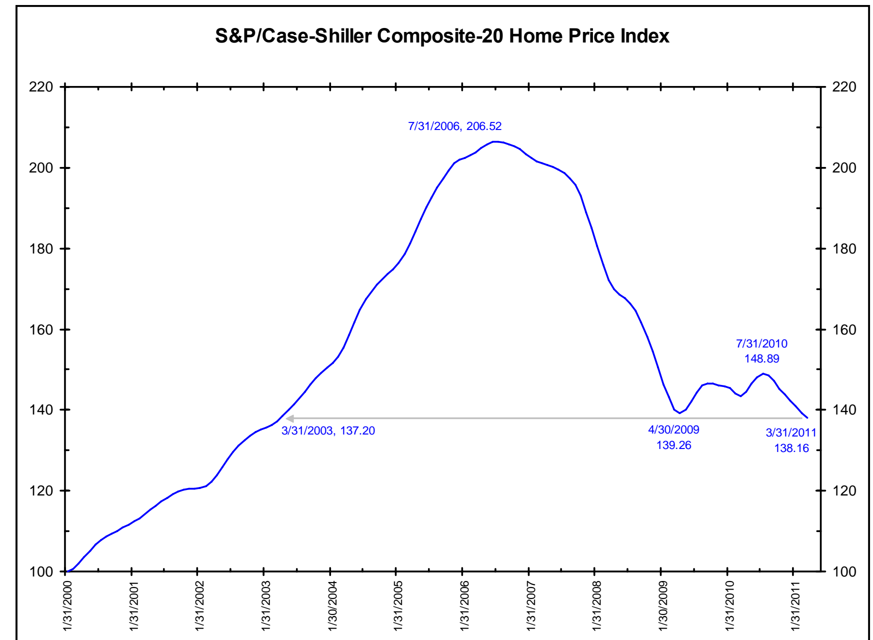
Knowing this, let us take a stab at explaining why housing fared so much better than other prices during the Great Depression:

> Home-ownership levels were much lower during the Great Depression. In 2006 ownership levels peaked around 70%. In the 1930s they were never above 50% (data).
>
> More homes were owned outright (no mortgage) in the 1930s versus today. The typical mortgage in the 1930s required a 50% down payment and carried a 5-year term. The percentage of homes owned outright in the 1930s was much higher than it is today (source).
>
> Given the two points above, there were fewer forced liquidations in the 1930s compared to today. Underwater mortgages were a rare event, not the common event that they are today.

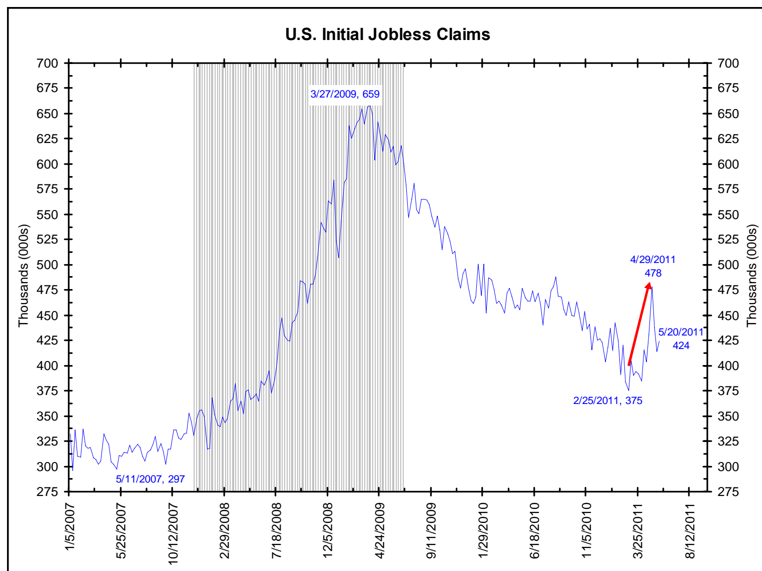
In other words, housing was a source of strength during the Great Depression while it is the weak link dragging down the economy during the Great Recession and its aftermath

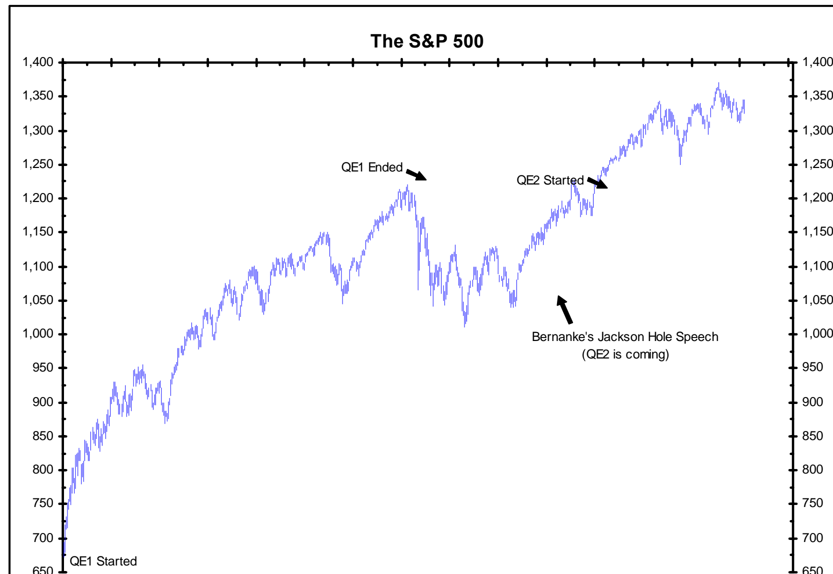
Housing – What "Double Dip"?

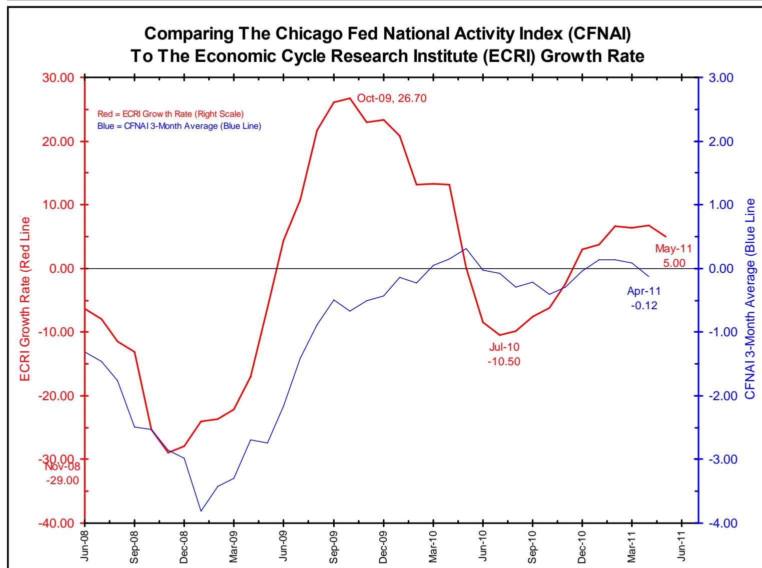


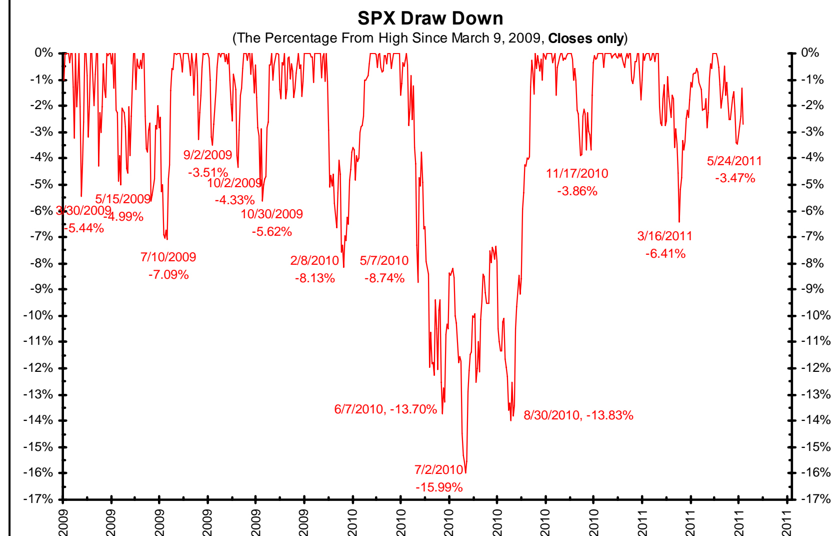


Is The Economy Softening?

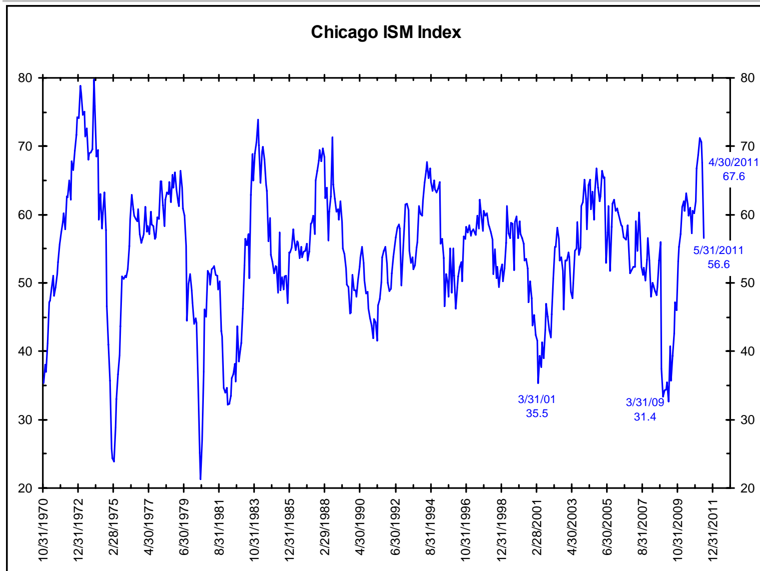


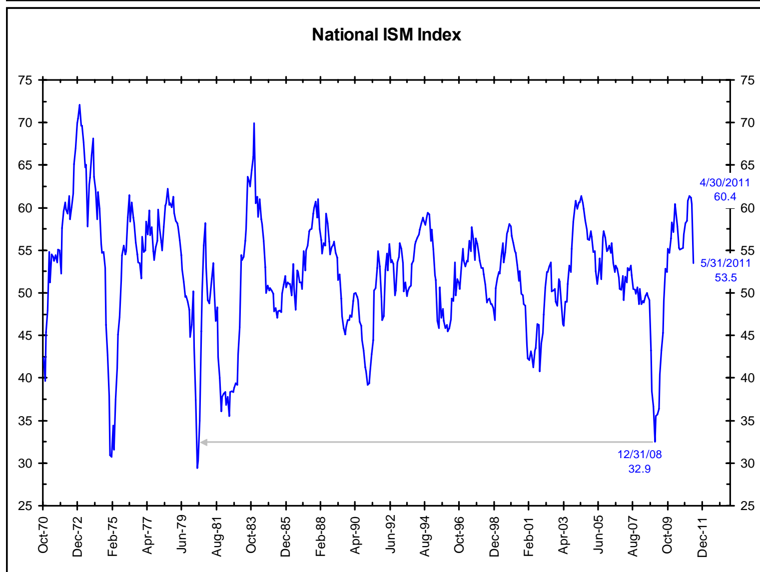


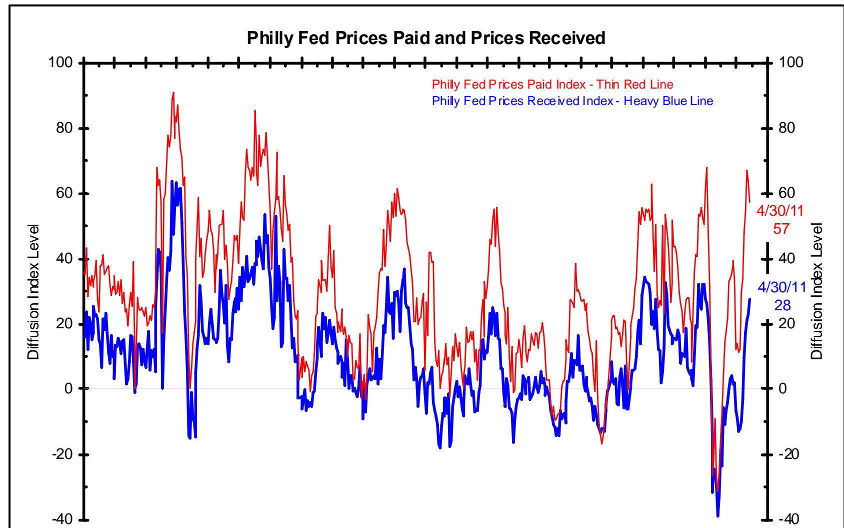


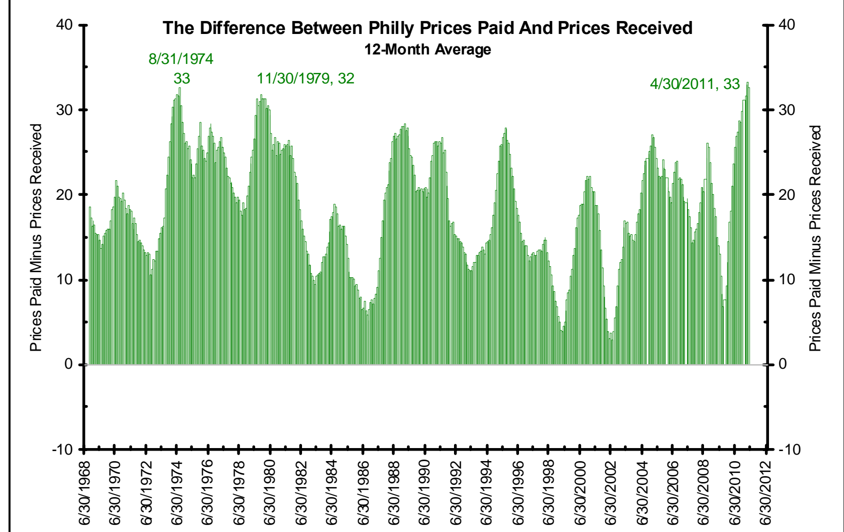


Is The Economy Softening? - 2



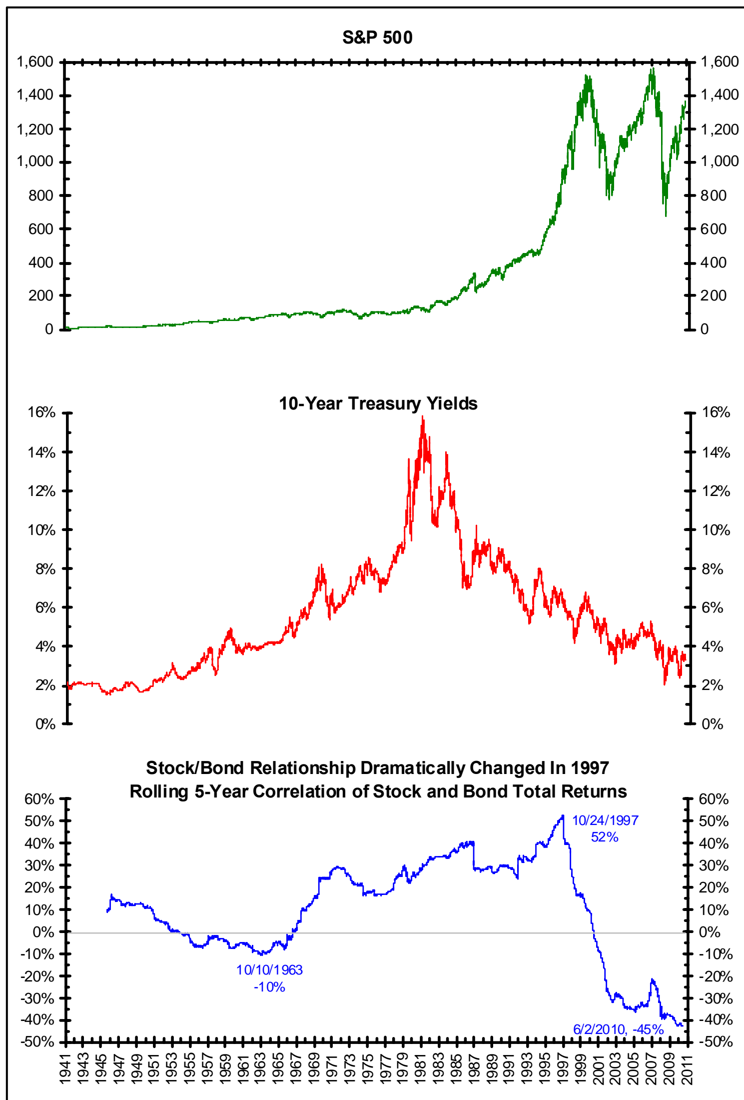






The Correlation Between Stocks & Bonds

From Our **Newsclips/Daily Commentary**



It is too early to say the stock/bond relationship is changing. Even the chart to the left shows this correlation has had several such divergences in the last nine months.

In our stock/bond charts, we correlate price movement (not yield) to stock prices. This gives us a negative correlation.

As the third panel of the chart to the left shows, the correlation between yields and stocks has been negative since 1997. This followed a period from the early 1960s to 1997 during which the stock/bond relationship was generally positive.

(continued on the next page)

The Correlation Between Stocks & Bonds - 2

From Our **Newsclips/Daily Commentary**

(continued from the previous page)

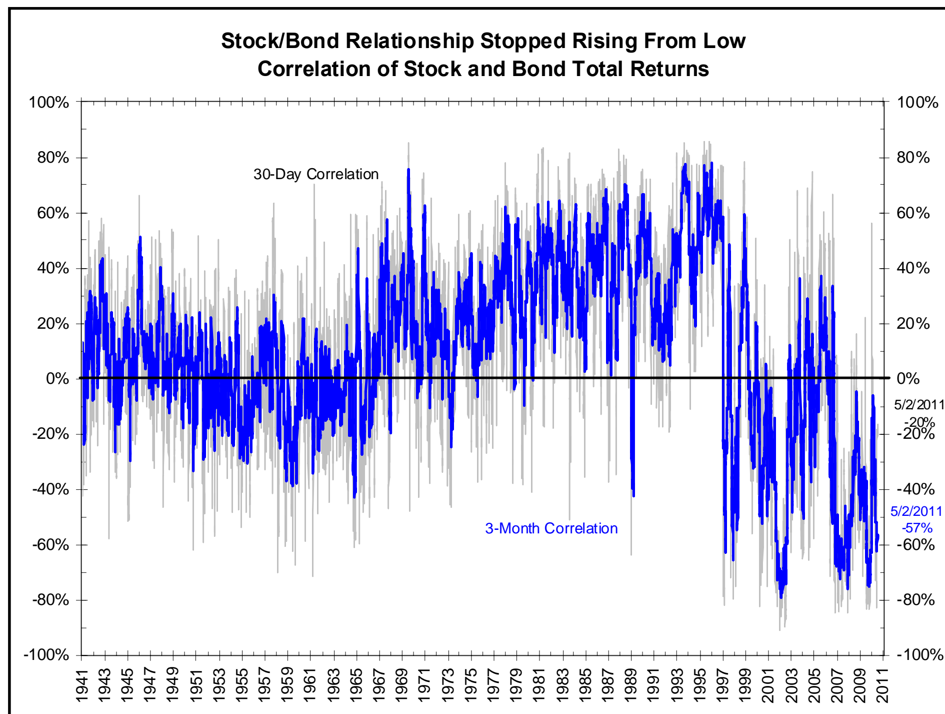
This chart shows a rolling 3-month and 30-day correlation. These correlations are volatile but we do not believe that they are showing signs the stock/bond relationship is changing.

You could make the case that QE2 or the aftermath of the Great Recession should have changed this relationship, but we have not yet seen evidence this is actually happening.

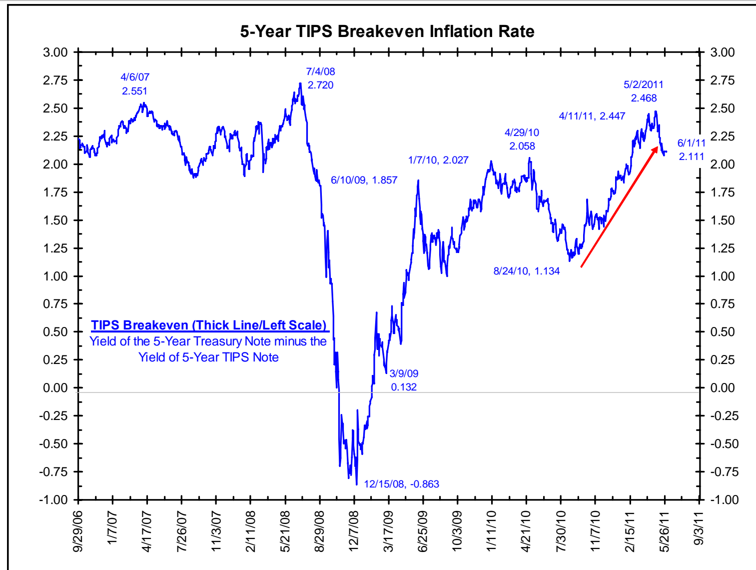
Why did this relationship flip in 1997? As we detailed in in our September 2009 Conference Call:

> The takeaway from these charts is that, once the productivity miracle was accepted in the late 90s, and Greenspan said we could run interest rates much lower than we normally would, the relationship between stocks and bonds inverted. The stock market is driven by carry, like so many other asset markets. So, low short rates (which often occur with a steep curve) drive stocks higher and higher short rates (which often occur with a flatter curve) drive rates lower.

Our guess is that this relationship ends at the inflection point. In other words, interest rates will rise as stocks fall, marking a return to the pre-1997 correlation. We would argue that the event that turned the relationship in 1997 was the real possibility of deflation. Perhaps inflationary fears will change it back to a pre-1997 relationship.

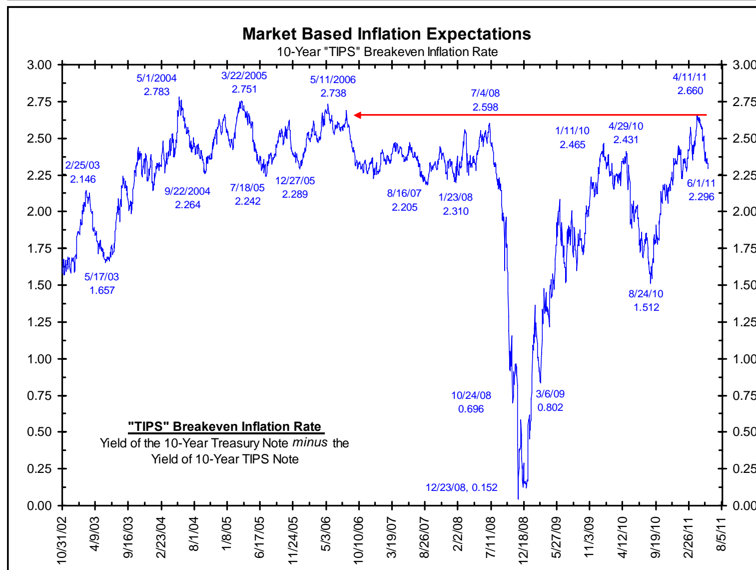


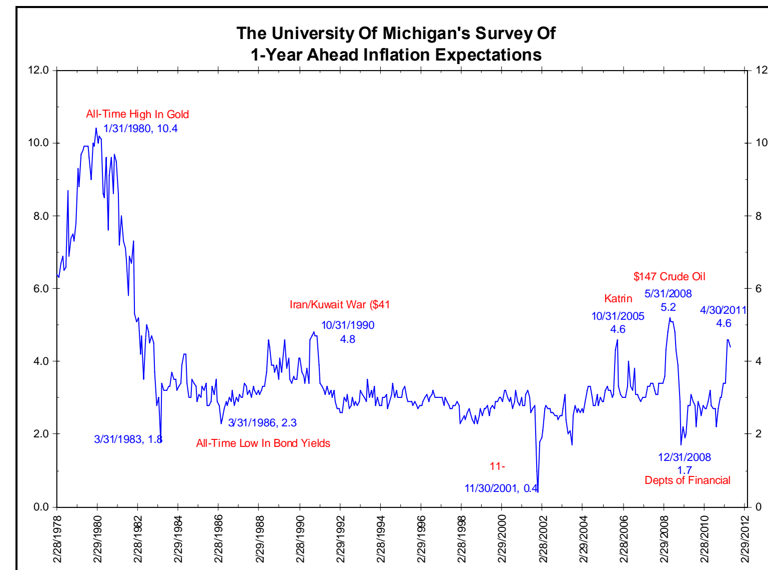
Medium-Term Inflation Expectations



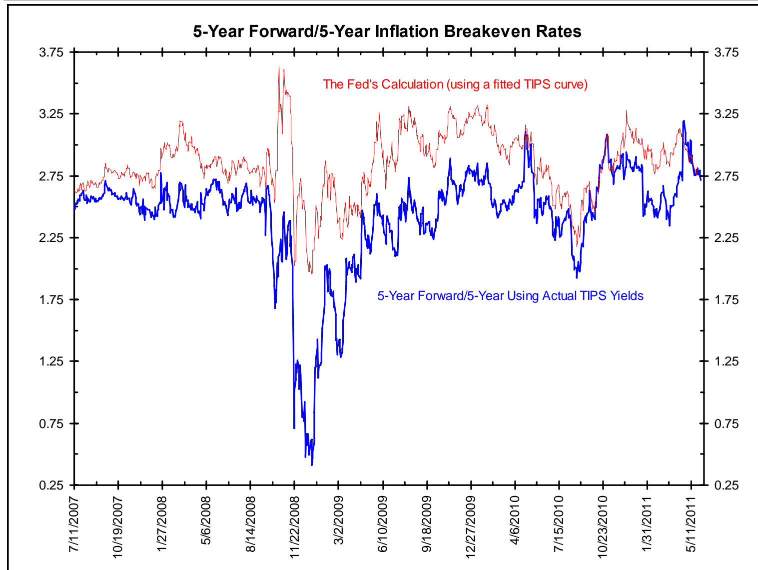
Medium term expectations can be gauged via the 5-year TIPS inflation breakeven rate (first chart), the 10-year TIPS inflation breakeven rate (second chart) and the University of Michigan's 1-year inflation survey (third chart below).

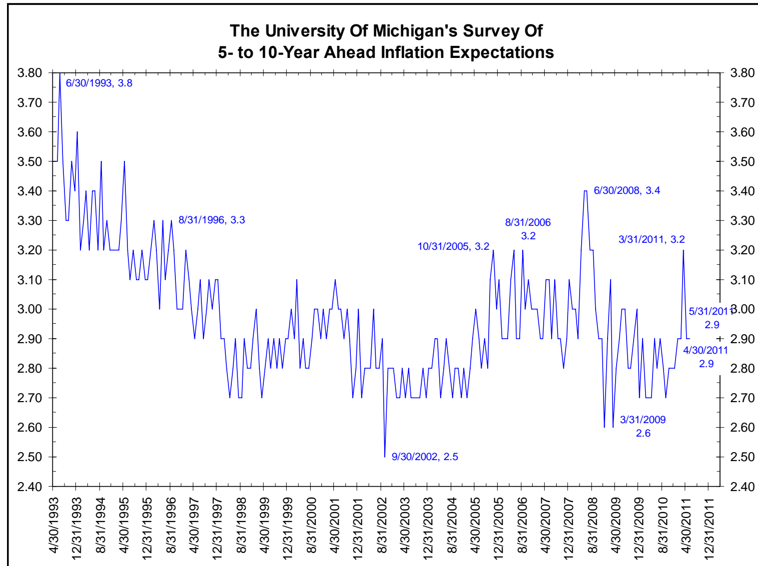
All these measures have approached the upper end of what is deemed acceptable. We previously have noted that Bernanke's comments seem to agree with this characterization. However, we disagreed with Bernanke's assessment that these measures are "stable." Below we see strong uptrends which, if they continue, could result in inflation reaching unacceptable levels by the end of the summer or the fall.





Long-Term Inflation Expectations





The Federal Reserve also watches long-term inflation expectations. These include the 5-year forward/five-year TIPS inflation breakeven rate (first chart), as explained above, and the University of Michigan's five-year inflation survey (second chart).

These measures are a lot more difficult to gauge. As the first chart shows, there are two measures of 5-year forward/five-year inflation breakeven rates. The red line shows the Federal Reserve's preferred measure using fitted yield curves in its calculation. The blue line uses actual measures.

In the end it should not matter which measure one uses as they should give roughly the same answer. They both currently show expectations of a 3% inflation rate between 5 and 10 years from now. This is very close to the Michigan survey that shows 2.9%.

The Wall Street Journal and the Federal Reserve will tell us that 3% is an acceptable number. We see a few problems with this conclusion.

As we noted previously, these measures are not very good predictors of what will actually happen. This was confirmed by a New York Federal Reserve study in 2008 that said the University of Michigan's 5-year survey is a poor indicator. We agree. See the chart above. It seems like this measure shows nothing but noise around 3%. How the Federal Reserve can say they need to tighten when this measure is above 3% and everything is OK below 3% is beyond us.

The Fed - Is QE2′s Purpose To Create A Stock Market Bubble?

Bernanke from his November 4, 2010 Washington Post op-ed.

> This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. **Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.**

Bernanke's "virtuous stock market cycle" can also be described as a stock market bubble. To be clear, manipulating stock prices higher in hopes that stock prices alone will change beliefs (confidence) and behavior (spending) is a bubble. Bernanke did not say he is trying to ramp the economy higher and that will support higher valuations. This would not be a bubble.

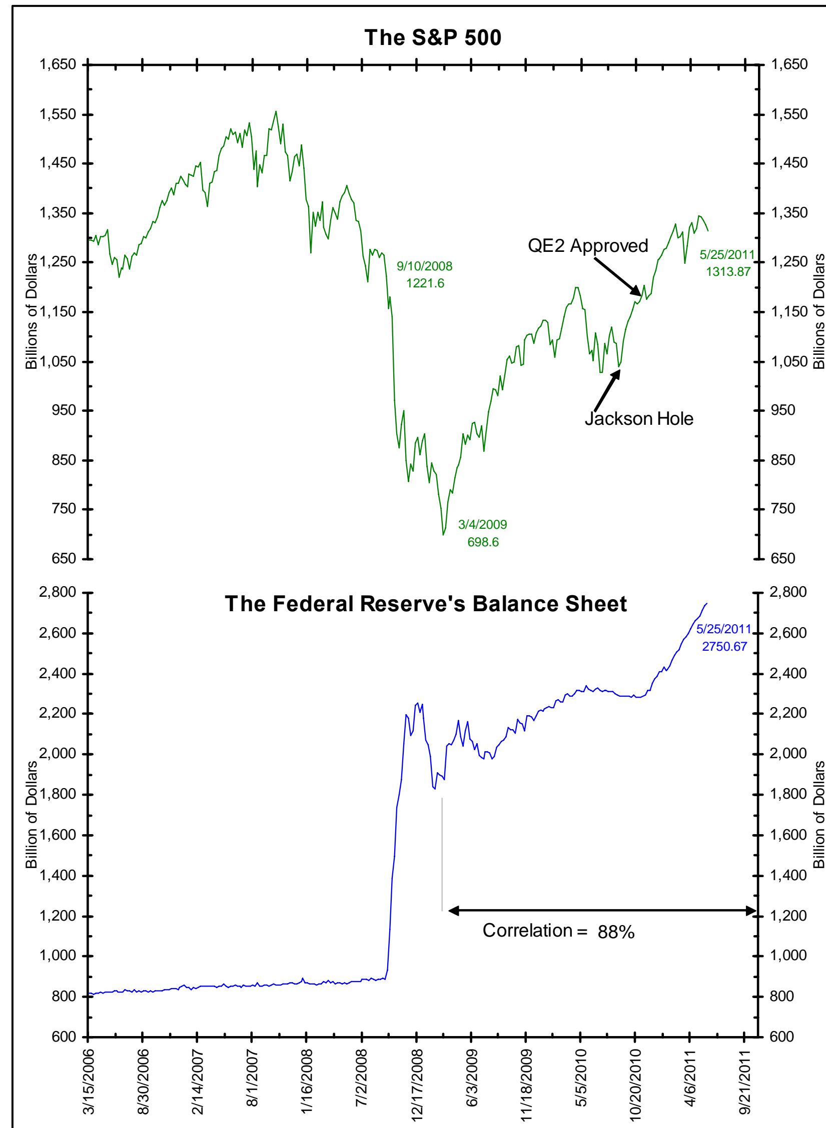
On January 25, 2011 CNBC ran a clip of Bernanke crowing about the successes of QE2 (starts 35 seconds in):

> Bernanke: The policies have contributed to a strong stock market just as they did in March 2009 when we did the last iteration of this. The S&P 500 is up 20% plus and the Russell 2000, which is about small cap stocks, is up 30% plus.

On November 16, 2010 New York Federal Reserve President Bill Dudley said:

> "What we're trying to do through our large-scale asset purchase programs is to remove Treasuries from the market, and force private investors into other assets."

The Fed - Stocks Love QE2



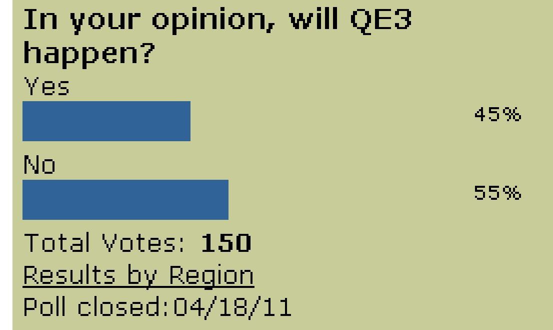
What Are The Odds Of QE3?

Comment

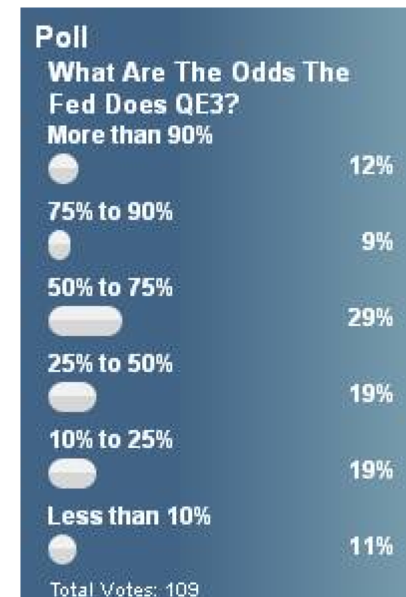
Last month in a post titled "Does The Federal Reserve Talk To The Wrong People?" we wrote:

> Steve Liesman described this group of 69 respondents as having "a predilection to support the Federal Reserve." In other words, these are Federal Reserve supporters who generally go along with whatever the Federal Reserve suggests.

Highlighted above in this month's survey, only 18% of the 62 respondents believe QE3 will happen. However, see our poll to the right. The 95 respondents of this poll opened last Friday are customers of Bianco Research with access to this password protected area.



Our poll shows 49% of the respondents believe QE3 is possible while only 18% of CNBC's respondents answered likewise. On a weighted basis, the probability of QE3 is 46%. This is not much different from our April 18th poll that put the odds of QE3 at 45%.



Note that a year ago, we ran a similar survey about the possibility of QE2 (or a resumption of mortgage purchases as it was called in the spring of 2010) and 60% said the program would continue if the markets took a turn for the worse. At the time Federal Reserve watchers thought the probabilities of the QE2 were very low. As we know, the markets weakened and QE2 became a reality.

What would prompt the Federal Reserve to initiate QE3? As we wrote last week:

> Sum up the above passages and and if the economy slows, financial markets weaken and inflation expectations decline, the necessary ingredients would be in place for QE3.

For the moment this appears to be happening. This does not mean QE3 will happen, but it also means it cannot be dismissed to the level that the CNBC survey of Federal Reserve supporters suggests.

Could the problem be that the Federal Reserve is telling its supporters what it will do (no more QE) instead of listening to what they think (more QE will happen if the markets/economy turn south)? The Federal Reserve doesn't need more transparency, it needs a listening tour of a broader base of market participants.

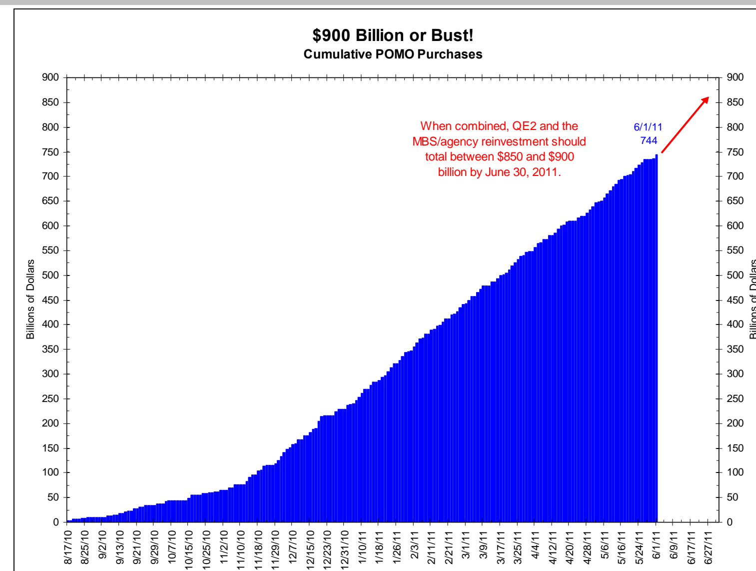
The Fed - POMO

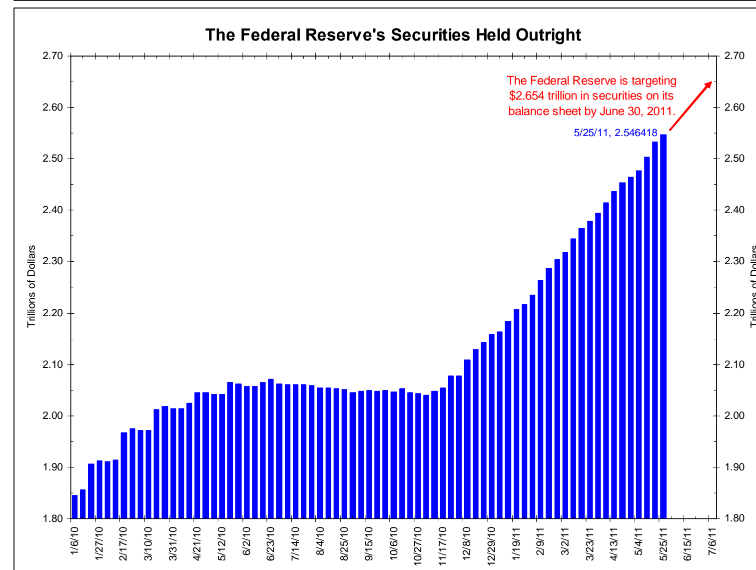
From Our **Newsclips/Daily Commentary**

On November 3, 2010 the Federal Reserve announced its intention to buy $600 billion of Treasury securities by June 30. To help illustrate the march toward this announced goal, we often highlighted a chart showing the cumulative POMO purchases since that date. However, as the New York Federal Reserve further elaborated that same day, an additional $250 billion to $300 billion in agency and MBS reinvestment was also targeted and would be included as part of its daily POMO activity.

Because both the agency/MBS reinvestments and the outright Treasury purchases of QE2 are lumped together in the Federal Reserve's daily POMO activity, there is no simple way to tell how close QE2 is to its completion of $600 billion in Treasury purchases. Rather, combining these two operations gives us a goal of $850 billion to $900 billion in total POMO activity by June 30, 2011. According to this measure, the Federal Reserve still has roughly $150 billion to $175 billion in Treasury purchases left to go. The Federal Reserve's balance sheet offers yet another way to help determine how much stimulus could still be injected into the system by mid-year. As of May 18 (latest data available), the Federal Reserve held $2.532 trillion in securities on its balance sheet. In a January 11, 2011 announcement, the Federal Reserve set a target of $2.654 trillion in securities to be held on its balance sheet by June 30, 2011. The need for an additional $130 billion in purchases according to this measure further confirms the general range stated above.

While this may seem to be splitting hairs to most, the inclusion of agency/MBS reinvestments are an important point to note when attempting to answer questions such as, "How much more liquidity will the Federal Reserve inject into the markets by June 30?" Based on the measures shown above, it appears the Federal Reserve still needs to buy anywhere from $130 billion to $170 billion of Treasury securities before reaching their desired goal.





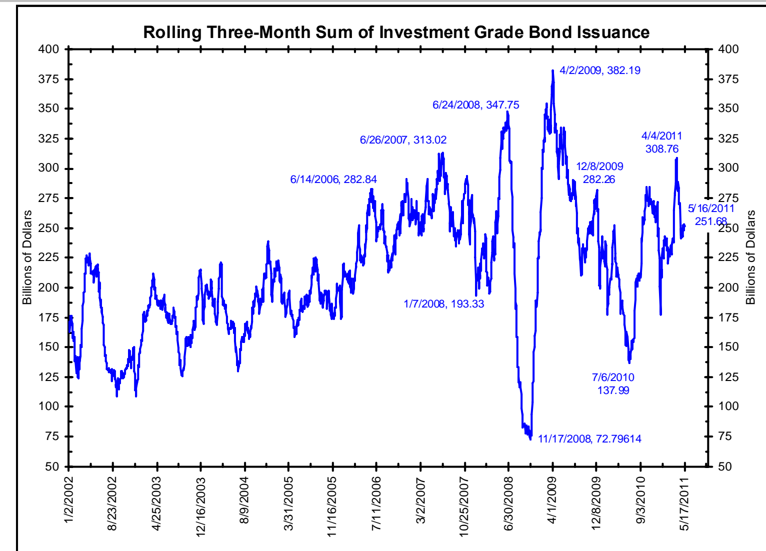
Corporate Bond Issuance, The Only Credit Channel Working?

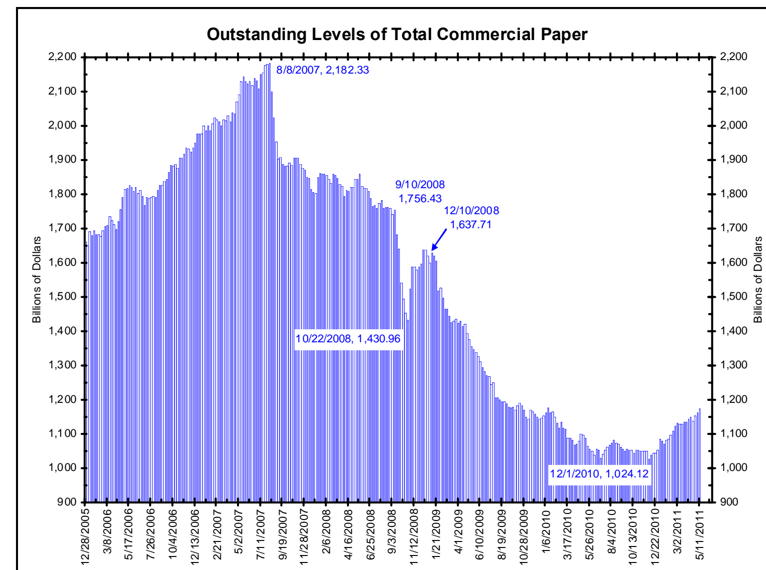
Comment

One of the reasons corporate bond issuance is booming is that it is the only credit channel still open. In a detailed look at the credit market last December we concluded:

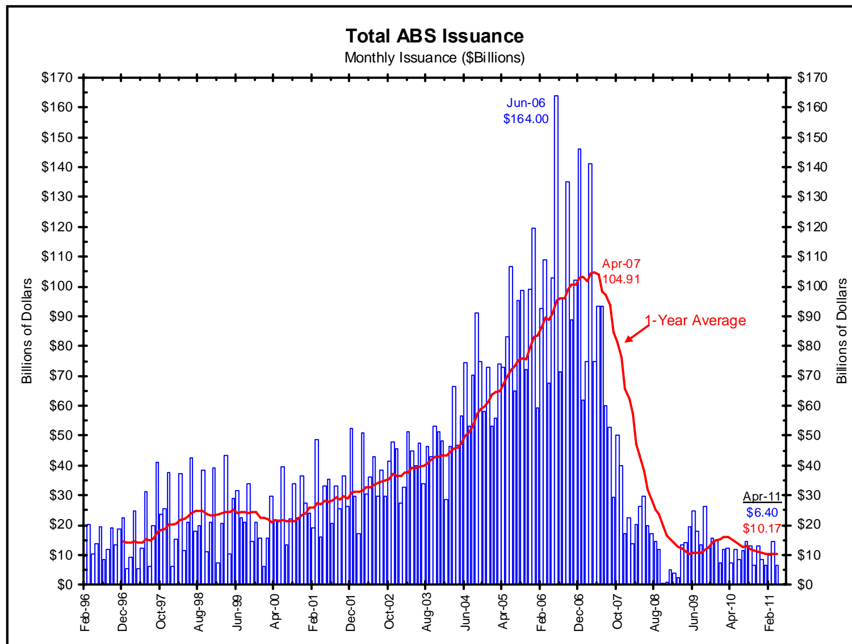
> Bottom line, issuance in the corporate bond market is improving but it appears little else is operating anywhere near the pre-2008 levels. In fact, the surge in corporate bond issuance might be partially due to the dearth of activity in these other markets. Corporate bonds are the only game in town right now.

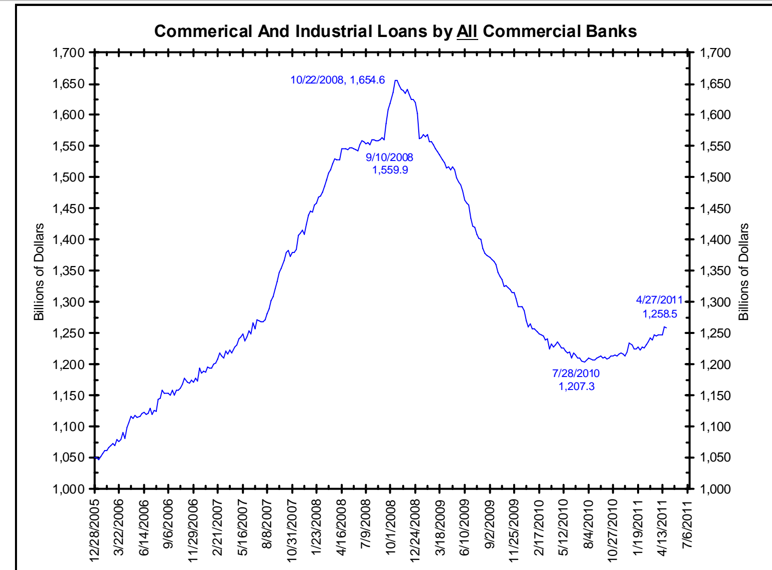
As the charts on this slide and the next show, this is still the case.

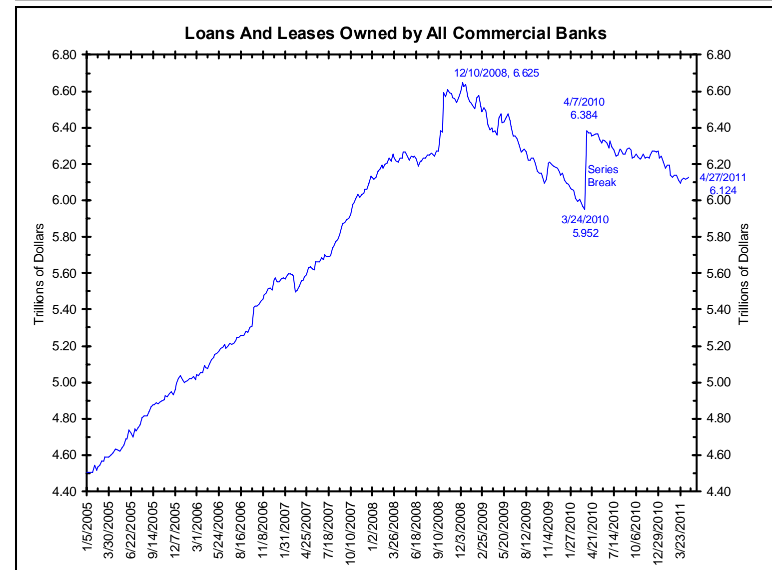




Corp. Bond Issuance, The Only Credit Channel Working? -2







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