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The Deflation Put

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Higher equities, Higher Long Term Rates

- There are 4 distinct risk premiums that will drive long term Treasury yields higher
 1. A Fed driving inflation expectations higher
 2. A federal fiscal train wreck
 3. A balance sheet unwind of epic proportion
 4. A forced rethink on funding of mercantilist trade policies
- These same risk premiums will also drive hard asset prices higher and credit spreads tighter

Bernanke Wants Higher Inflation Expectations

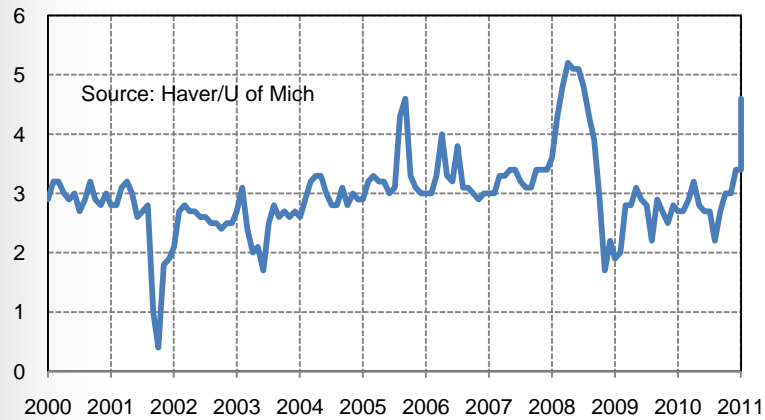
"Deflation: Making Sure It Doesn't Happen" – *The title of Bernanke's speech on November 21, 2002*

"...when nominal interest rates are at or near zero, the central bank can lower the real rate of interest only by creating expectations of inflation on the part of the public." - *Before the Japan Society of Monetary Economics, Tokyo, Japan May 31, 2003*

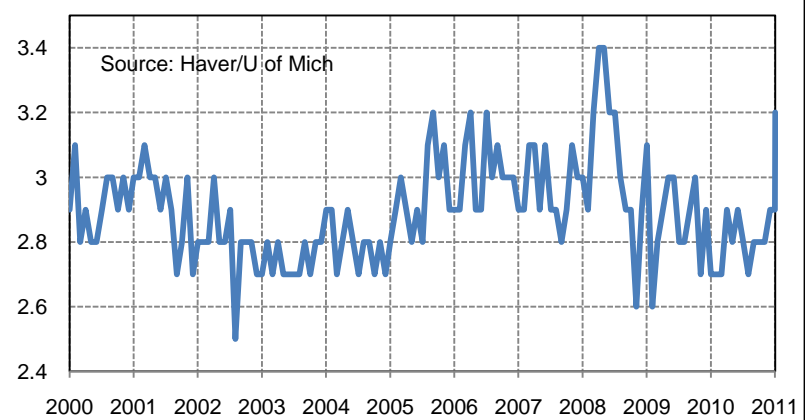
"The Federal Open Market Committee will strongly resist deviations from price stability in the downward direction," - *In a speech at Jackson Hole Summer 2010*

And He's Getting It!

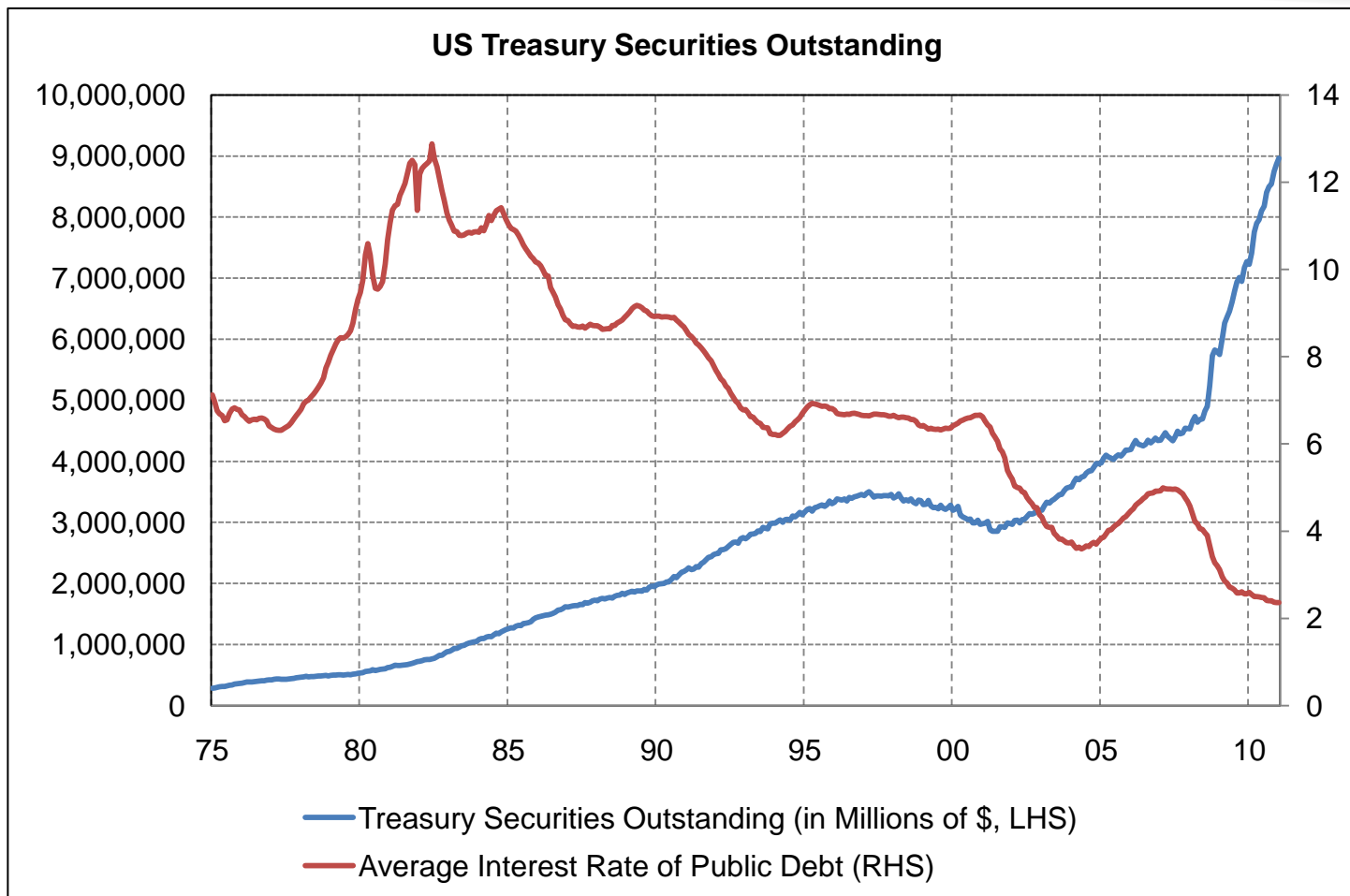
University of Michigan 1yr Ahead Inflation Expectations



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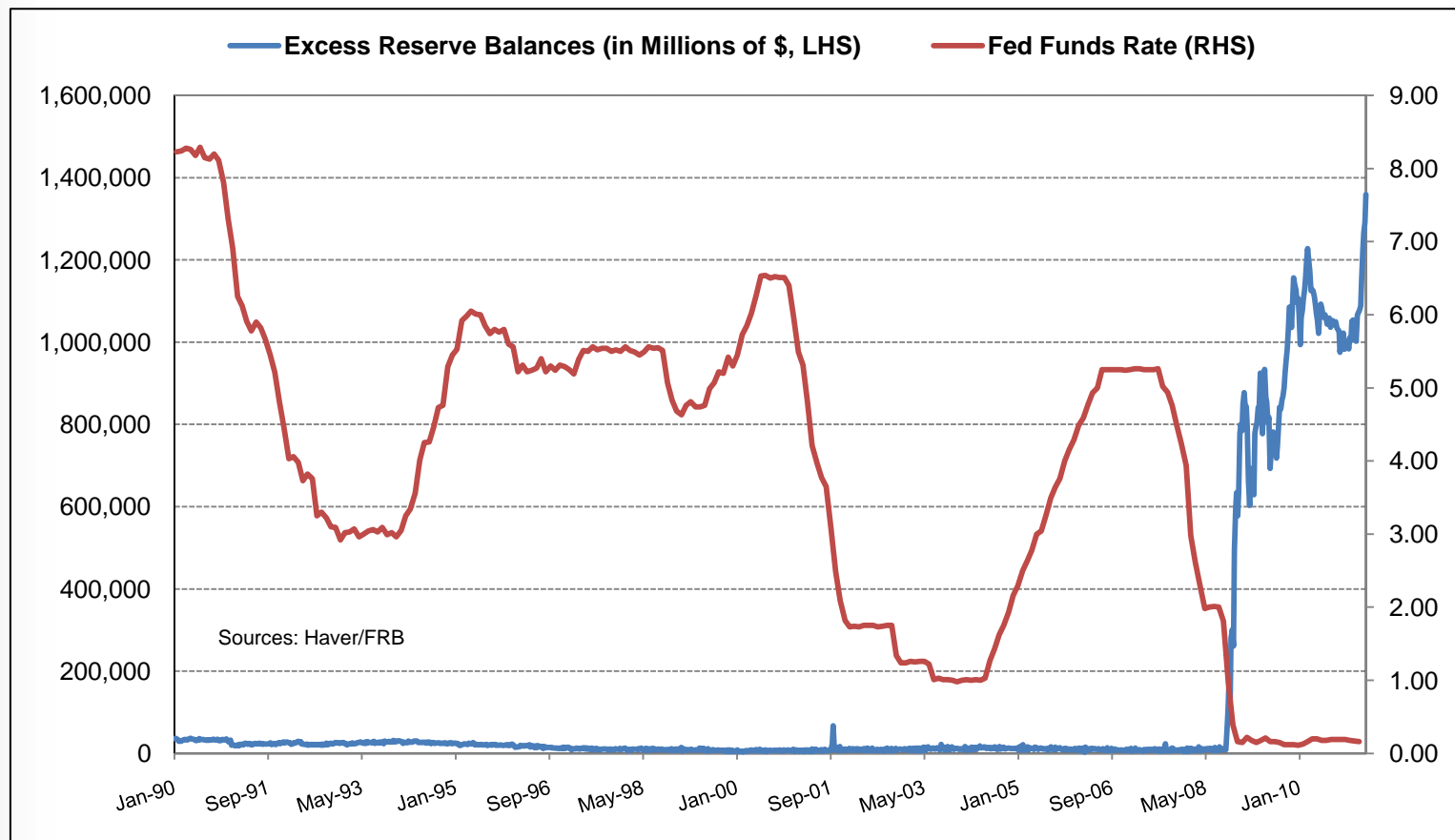


A Federal Fiscal Train Wreck



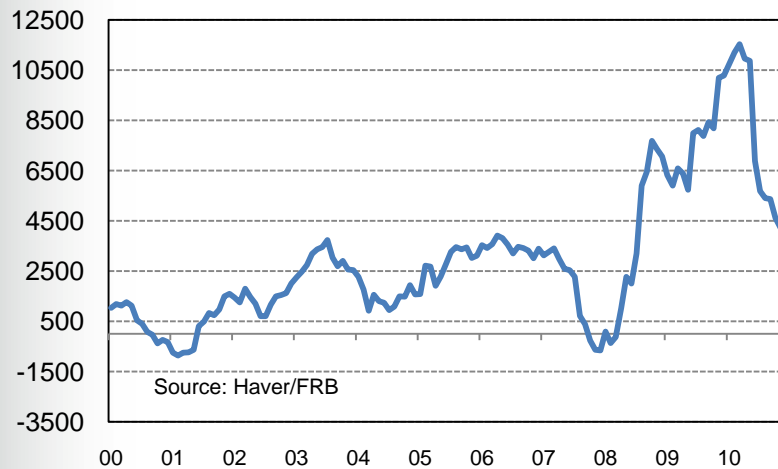
Sources: Haver

A Balance Sheet Unwind of Epic Proportions

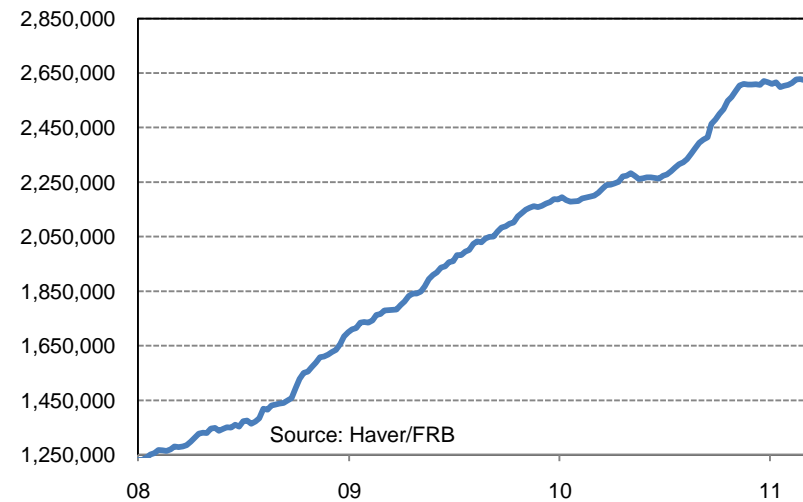


Rethinking Mercantilist Trade Policies

Official Chinese Net Transactions in Long-term US Treasury Bonds/Notes (12m Moving avg, in Millions of \$)



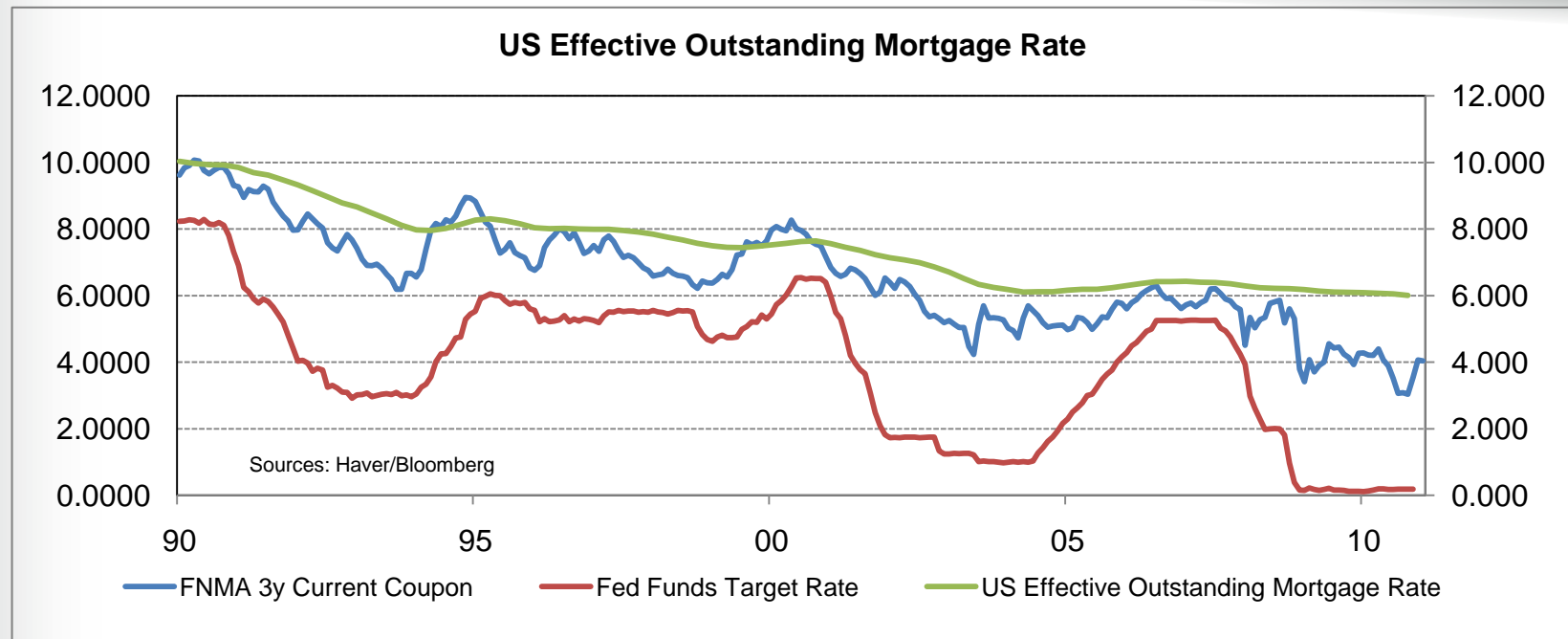
US Treasury Custody Holdings (in Millions of \$)



Summary of Risks to the Bond Market

- Inflation risks premiums and inflation expectations are being driven higher.
- The US is a country that has a huge incentive to inflate away the value of its debt given the heavy foreign ownership of its debt.
- Over half the marketable USTs outstanding are held by foreigners and large portions of the US mortgage/corporate debt markets are held by foreigners.
- When the US inflates its a direct transfer of wealth to the US from foreigners.
- The Fed balance sheet unwind will be a huge duration event.
- The largest marginal buyers of Treasuries have been foreign mercantilists. This policy will be too costly to follow with a Fed following a reflationary path. They will likely move from USTs to riskier assets as a means of funding their mercantilist trade strategy.

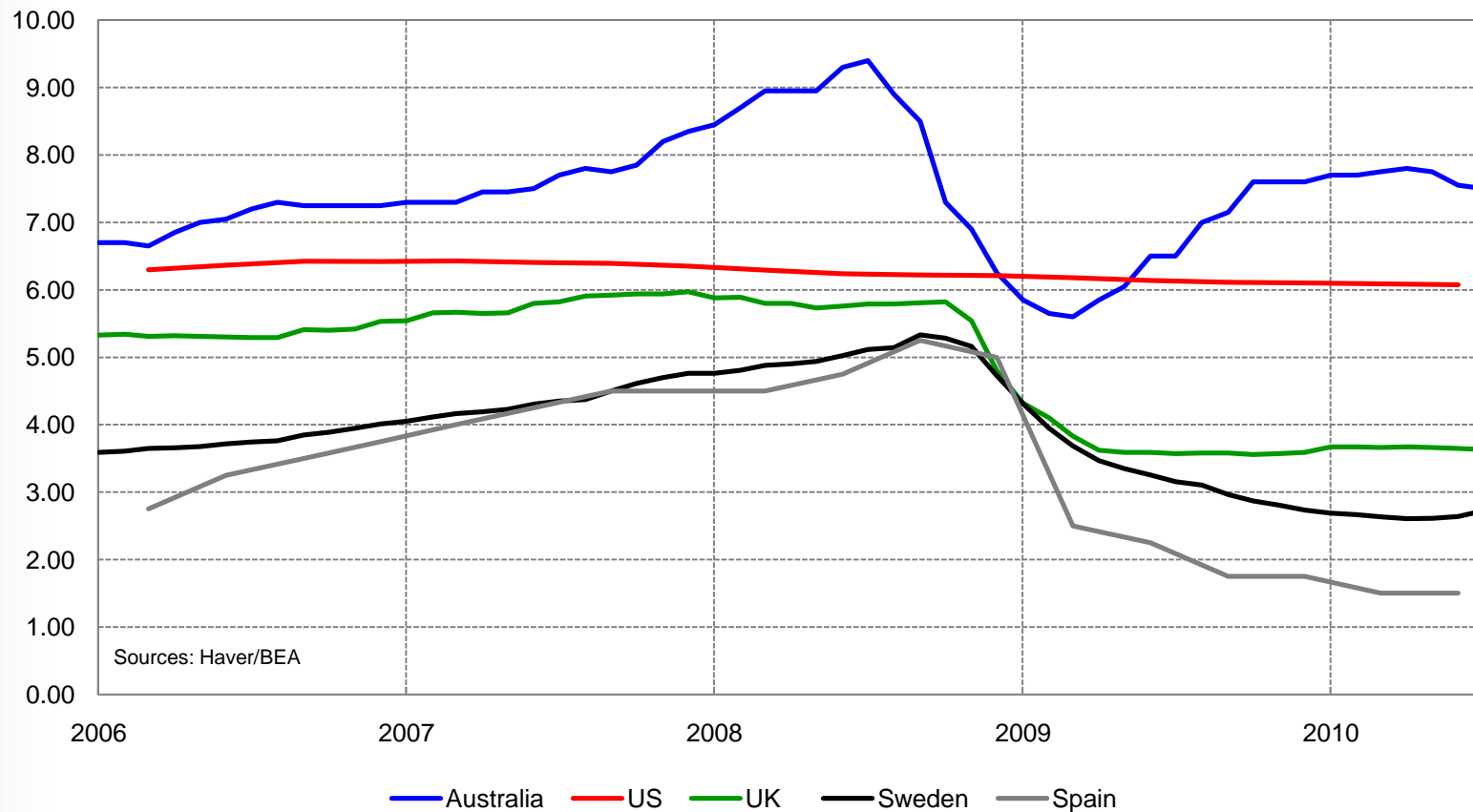
Why Is The US Recovery Taking So Long?



- While the Fed has lowered funding costs for banks, domestic corporates and foreign firms funding in USD, they left the liability side of the consumer balance sheet unaffected.
- There was no TLGP, AMLF, TALF, TAF, PDCF, CPFF or currency swap for Mom and Pop.
- The saddest statistic in the US macroeconomic data is that the effective mortgage rate outstanding is still 6% - right where it was in 2007.

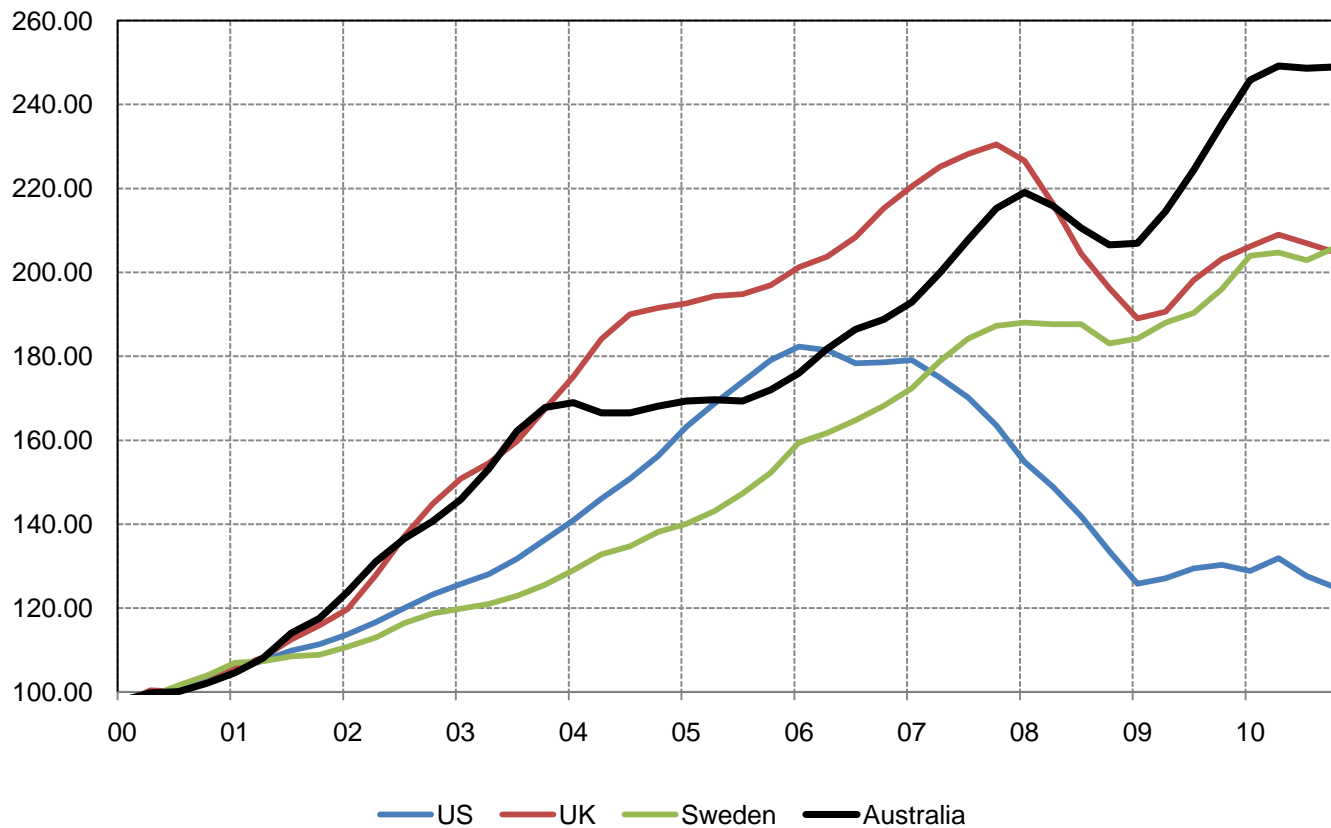
US Mortgage Market Structure Is To Blame

Cross Country Effective Mortgage Rates Outstanding



And House Prices Have Suffered Accordingly

Cross Country Home Price Indices (2000 = 100)

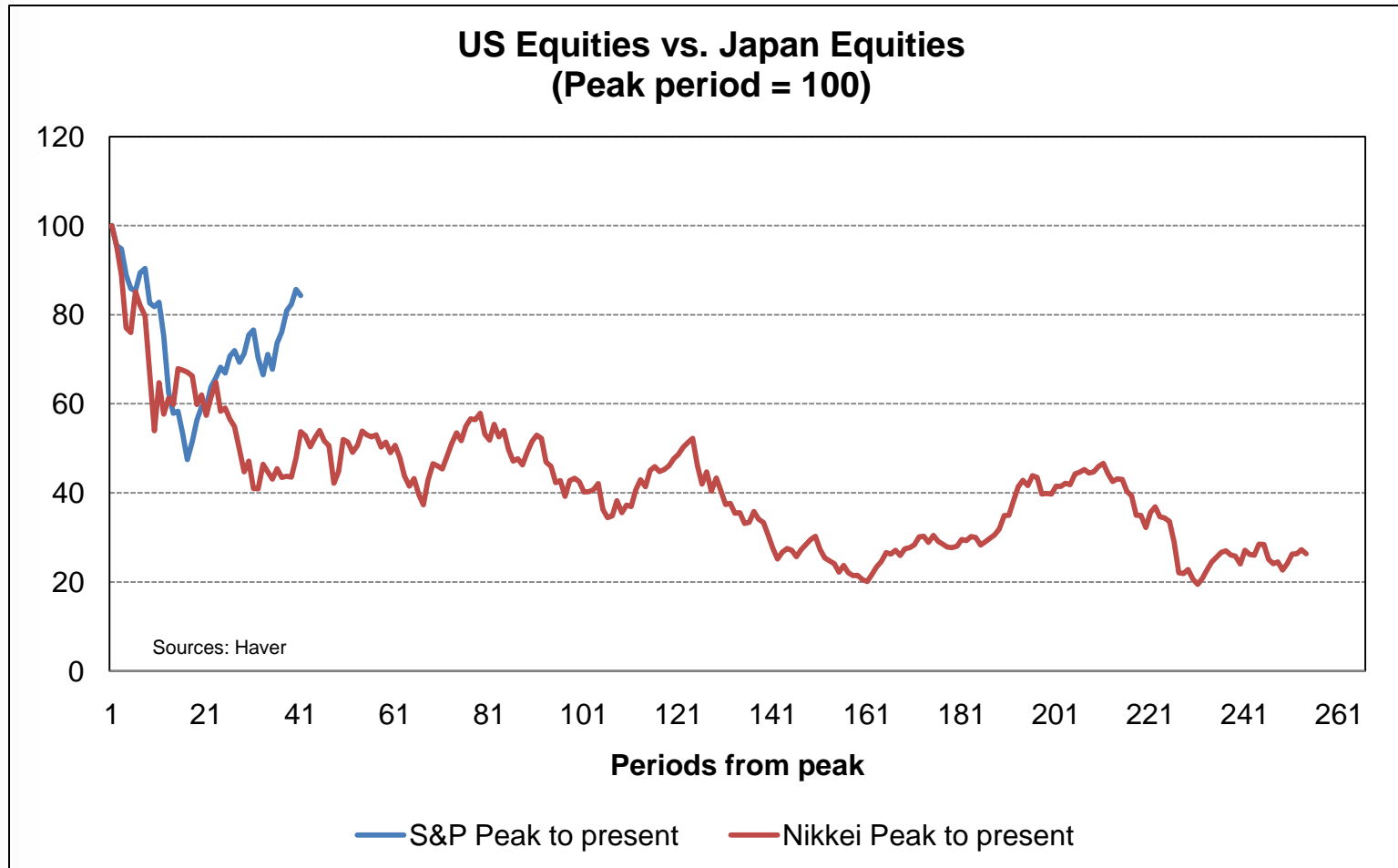


Sources: Haver

QE2 Will Work On The Asset Side Of The Consumer Balance Sheet

- With the liability side of the consumer's balance in a horrific state (and unaffected by rate cuts), Fed policy has moved to targeting the asset side of the balance sheet
- The Fed is actively pursuing a a reflationary policy that will drive nominal asset prices higher (equities, real estate, commodities).
- Fed policy will also push nominal income growth higher.
- The combination of higher asset prices and income growth will repair the asset side of the consumer's balance sheet even with the liability side untouched.
- Sadly, this "repair" will generate many policy externalities and the potential for future bubbles. A short term fix with longer term negative consequences – this has been the story of monetary policy for over 2 decades.

We are NOT Japan



Disclosures

Important Disclosures

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