JVB FINANCIAL

Weekly Commentary
by Bill Sullivan, JVB Chief Economist

ABOUT
BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

Mr. Sullivan received his Bachelor of Arts Degree in Economics from Fairfield University.

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Can modest Treasury rally be built upon?

After a difficult December, the Treasury securities market has regained an element of stability in the opening weeks of the New Year. Indeed, over the final trading sessions of 2009, the selling pressure in the Government debt arena accelerated dramatically, pushing yields up to levels that had not been observed in more than six months. Since early January, a combination of dealer short covering and some retail purchases by institutional investors have helped to lower rates on intermediate and longer term maturities by approximately 25 to 30 basis points. Whether the modest rally can be built upon is certainly open to debate, but it is very clear several events need to occur for the recent improvement to continue.

Although the correlation can be weak at times, a prime force behind lower Treasury yields in the period ahead, in our judgment, would be for the equity market to continue its recent sell-off. It is no coincidence that the Treasury securities sector has reestablished some equilibrium against the backdrop of a relatively steep decline in the broad stock market averages. From its recent peak in mid-January to its intra-day low last Friday, the Dow Jones Industrial average dropped by over 900 points. No doubt, some investors were taking profits and placing the proceeds of those stock sales into Treasuries, which helped to firm bond prices. Effectively, the sharp pullback in share values created a renewed preference for quality and safety that set the stage for the moderate drop in Treasury yields over recent weeks. Clearly, such fixed income buying will continue should the stock market sustain its retreat.

The weakness in equities was of course partly attributable to the concerns generated by the budget crises in Greece, Spain and elsewhere in Europe. Fears of sovereign debt defaults, perhaps misplaced, generated some forceful selling of the debt instruments of those nations most suspect and prompted a movement of investment funds into German bonds as well as Treasury securities. Obviously, if there is a salient rescue effort for Greece and conceivably other countries as needed, the debt crisis in Europe will be perceived as being contained and lacking any meaningful contagion. Viable solutions to these financial stresses would remove some of the quality demand for Treasury debt that has been in place over the last few weeks and the U.S. Government bond market would lose some support, accordingly. It should be noted that the containment of the budget dilemma in Europe does involve some measurable costs for the global growth outlook. In order to solve their respective budget shortfalls, European governments must implement austerity programs that will act as headwinds against any ongoing recovery process. Thus, the solutions, should they be achieved, could result in a downscaling of growth estimates for Continental economies later this year and into 2011. An expected slower rate of

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economic expansion could eventually call into question equity valuations both here and abroad, a development that would ultimately prove supportive of the global bond markets.

Another possible force that could lower Treasury yields in the months to come would be economic reports that prove much weaker than expected. At present, consensus forecasts are calling for a domestic recovery process that will accelerate as the calendar year progresses. The outlook is consistent with visible gains in new hiring, rising incomes and stronger consumer spending. For sure, if upcoming reports in these critical areas fall well short of expectations, questions will naturally arise vis-à-vis the vigor and duration of the rebound. Any shortfall in activity would point toward Federal Reserve policy being on hold for a longer period than currently assumed. In addition, a recovery process that proves more sluggish than presently envisioned would set the stage for maintaining a low inflation environment well into the future, another bond friendly development. If these various events fall into place, the ten year note yield could fall to the 3.00% to 3.25% range before mid-year.

Needless to say, many observers strongly believe that a Treasury security rally any time during 2010 is a virtual impossibility. The negative assessment typically revolves around the huge volume of Government offerings that the markets confront, with that supply challenge inevitably requiring higher yields to attract investors. While that viewpoint is understandable, the Treasury's calendar must always be measured against competing credit demands. In the present setting, private borrowings remain subdued, indicating that total credit demand is holding at manageable levels. Moreover as suggested, the Treasury yield curve is never just a function of prevailing issuance. In particular, if perceptions build that the economy will lose momentum and the stock market responds with additional weakness, the pace of Treasury security purchases will rise sharply, generating the conditions for lower interest rates, notwithstanding the presence of record budget deficits. ■

William V. Sullivan, Jr.
Chief Economist
JVB Financial Group
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JVB Financial Group, LLC, member FINRA, SIPC
2700 N. Military Trail, Suite 200 / Boca Raton, FL 33431
(561) 416-5876 • www.jvbfinancial.com

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