



**ABOUT
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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.

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JVB FINANCIAL

Weekly Commentary by Bill Sullivan, JVB Chief Economist

August 17, 2009

Overlooked Anchors for the Ten Year Note

Many factors influence the returns that are available on longer dated U.S. Treasury securities at any given point in the interest rate cycle. Lately, there has been deep concern regarding the sizeable quantity of new cash that the Federal Government will have to raise in the capital markets over the years ahead. The focus on supply is understandable, as investors have never confronted a financing task this large, especially in terms of the volume of coupon issues that will be auctioned for the indefinite future. If anything, the supply challenge is so huge by any past standard that a high degree of bearishness has seemingly developed vis-à-vis the outlook for Government debt. Admittedly, some premium in the Treasury yield curve may be necessary to attract potential buyers in this environment. However, the nearly exclusive concentration on the auction calendar could be diverting attention away from several strong supports for intermediate and long-term Treasuries. Specifically, a huge volume of positive carry along with a nascent trend toward disinflation could prove to be genuine anchors for the Treasury market, especially for the benchmark ten year note.

	2005	2006	2007	2008	Current
10 year note	4.29%	4.80%	4.63%	3.66%	3.50%
Fed funds	3.22	4.97	5.02	1.92	0.17
Difference	+107	-17	-39	+174	+333

Source: Federal Reserve Board. Yearly data are annual averages.

Needless to say, longer-term Treasury securities are rarely viewed as carry vehicles, but the persistence of record low money market rates may be altering that attitude. Indeed, through the decades, investors have borrowed short-dated funds

and placed the proceeds in higher yielding fixed-income assets to earn the difference or the spread between these instruments. Traditionally, the carry trade emphasized shorter maturities as most participants wanted to avoid the price risk that was associated with longer-term issues. However, the dynamics of this approach may have changed in view of the tremendous differential that now exists between the expense of short-term borrowing versus the yields that are currently available on intermediate maturity Treasury debt.

As the data in the table reveal, the effective Federal funds rate over recent sessions has averaged about 17 basis points while the ten year note yield has been in the 3.50% range. Effectively, investors can gain more than 330 basis points in additional income by borrowing overnight money and employing the cash to purchase a ten year Treasury security. When viewing the carry experience over the last few years, it is quite apparent that the gap has never been close to the present differential. As an example, the Federal funds rate during calendar year 2005 averaged 3.22%. Over the same twelve months, the ten year note posted a 4.29% average yield or 107 basis points above the effective rate on overnight money. While the annual averages obviously don't capture the extreme carry spreads that existed during a particular year, they nonetheless provide some sense of what investors confronted. Against that backdrop, it is interesting to observe that during 2006 and 2007, the ten year note return was under the going funds rate providing a negative carry of roughly

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28 basis points for this twenty-four month period. A positive spread was restored during 2008 when the Federal Open Market Committee began to ease monetary policy in an aggressive fashion and, according to central bank statistics, the ten year note yielded 174 basis points above the going funds target, still barely half the positive carry that is in place as August, 2009 comes to a close.

A key question for investors regarding carry trades is whether the Federal Reserve is likely to adjust monetary policy anytime soon, a development that would clearly impact the differential between Fed funds and the ten year note yield. At present, it appears highly unlikely that the Committee will be raising the Federal funds target, a situation that will preserve the tremendous positive carry that is now available. Encouraging the Fed to maintain a historically low target for overnight money is the potential for the nationwide unemployment rate to continue its upward climb, perhaps reaching ten percent by year's end. Conceivably, an overlooked force in formulating Federal Reserve strategies in the second half of 2009 is the gradual drift towards disinflation that seems to be developing in the U.S. economy. In particular, with consumer spending erratic at best and household incomes still moving lower, it is increasingly apparent that business firms have little or no pricing power. In response to this reality, many retailers are lowering prices to stimulate demand. The discounting is being captured in a broad array of expenditure categories that are part of the Consumer Price Index. Over the last few months, price cutting has been

especially evident in lodging, motor vehicle parts, airline fares, information technology and personal care. Supplementing these reductions has been a distinct moderation in price changes for rents, food and medical care, sectors that were experiencing decent gains just several months ago. Whether the downward bias to the cost of living becomes more widespread is certainly open to debate, but the basic pattern surely weighs against a higher Fed funds target in the foreseeable future. Of course, the diminution in inflationary pressures bolsters the value of the ten year note yield in real terms, which may operate as another supporting influence for this maturity segment, in addition to the strong positive carry that is now in place. ■

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August 17, 2009*

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