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.

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JVB FINANCIAL

Weekly Commentary

by Bill Sullivan, JVB Chief Economist

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Treasuries during December

The month of December gets underway tomorrow, indicating that the year-end statement date is now just 31 days away. For 2009, the year-end is particularly interesting as the date entails a settlement period that extends over four days, with the New Year's holiday occurring on a Friday. Whether the lengthier than normal period for year-end money will create any unusual distortion in the financial markets is certainly open to debate. Indeed, a common perception is that the final weeks of the year are thinly traded and that price changes are typically limited. While some arenas may hold relatively stable over this period, recent history indicates that the market for U.S. Treasury securities can be quite volatile as the year comes to a close and that big price swings are not unusual.

CHANGE IN TREASURY SECURITY YIELDS DURING DECEMBER

	2 year	10 year	30 year
2002	-46	-40	-26
2003	-19	-7	-6
2004	+6	-14	-19
2005	-2	-10	-17
2006	+19	+23	+24
2007	+4	+9	+7
2008	-23	-70	-75

Source: U.S. Treasury Department. Change measured in basis points.

The potential for significant price adjustments during December is fully captured when reviewing the performance of the Treasury market during the seven years extending from 2002 to 2008. This particular period encompasses a wide range of events, including boom times for the economy as well as recession. In addition, there have been Decembers since 2002 in which the Federal Reserve has actually tightened monetary policy and there have been several instances when the Committee lowered their interest rate target in the final weeks of the calendar year. Moreover, a diverse pattern of supply has been noted since earlier in the decade in which the Treasury was paying down debt in December but in other years was raising a record volume of fresh funds. Despite these varied circumstances, it is apparent that the Treasury market, more often than not over recent years, has rallied during the month of December. The tendency to register price improvements suggests a pattern of seasonal purchases that is of sufficient magnitude to offset any negative challenges that may be in place for the Treasury sector.

The back-end of the Treasury yield curve has done especially well over recent years during the December period. As detailed, both the ten year note and the thirty year bond have rallied in five of the last seven years during December. In only one year, 2006, was a sizeable drop in long-term debt prices recorded, while the sell-off in the final weeks of 2007 was modest at best. Several of the year-end rallies have been huge by any standard. In December, 2002, the two year note yield plunged by 46 basis points while the ten year declined 40 basis points. The thirty year bond lagged in relative terms with the yield on this benchmark falling 26 basis points. The rally

(Continued on page 2)

(Continued from page 1)

last year was, of course, spectacular and was driven by fears of a widening in the financial meltdown. Also, the Federal Open Market Committee lowered the Fed funds target to 25 basis points or less in response to the ongoing deterioration in the credit markets and the economy. The change in policy was not fully anticipated and gave an additional lift to Treasury prices over the final sessions of the year. Despite the significant relaxation in monetary policy, the yield curve experienced a dramatic flattening last year as inflationary expectations diminished considerably throughout the month. Specially, the spread between the two and ten year notes fell from 192 basis points on the final day of November to 145 basis points by New Year's Eve.

Obviously, history is not guaranteed to repeat over the weeks ahead. As an example, the Federal Reserve won't be easing policy this month as was the case last year. There are six coupon auctions before year-end that could weigh on the market. Equally important, the economy is displaying a firmer tone and it is always possible the data for November that will be released as the month progresses exceeds expectations and in turn creates a more bearish setting for Treasuries as the year-end approaches. These challenges however may be easily offset by the continued need for institutions to show highly liquid assets on their balance sheets, which could prompt aggressive retail purchases of Treasuries during the month. Moreover, credit tensions have obviously resurfaced, given the decision by a Middle Eastern emirate to postpone interest payments on outstanding debt. This situation could eventually rekindle a moderate flight to quality that benefits the Treasury market, accordingly. Another important determinant of whether a year-end rally in Treasuries will be repeated will be the performance of the equity markets for the balance of December. Should the broad averages maintain their recent upward momentum, the Treasury market would undoubtedly be placed in a more defensive posture. Conversely, if investors decide to lock-in profits and the selling pressure in the equity arena intensifies, the pull-back would help the bond market and would bolster the odds of another year-end rally for Treasury securities. Similar to last year's experience, a 2009 December rally would most likely be associated with a renewed flattening in the Treasury yield curve versus late November readings. ■

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