

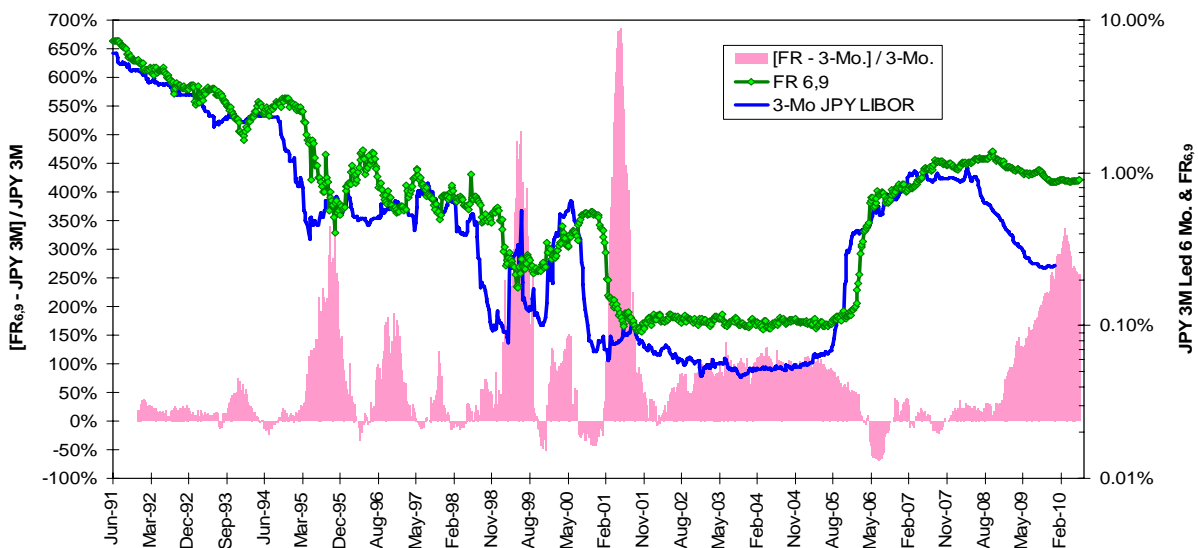
Investing Under A Constant Expectation

There's really no sense in hanging around to see how the Sword of Damocles legend turns out, and we know from more recent history how constant fear must be ignored to maintain sanity. Consider how quickly Americans learned to ignore the Department of Homeland Security color-codes instituted in March 2002, and how many of you have ever spent a day when an intercontinental ballistic missile was not pointed at your nether regions?

Markets can get this way as well. One of the difficulties in teaching a topic such as backwardation is conveying to students how a rising market is populated by buyers and sellers who both regard the current price and trend as unsustainably high. Or, more to the point here, how a situation wherein short-term interest rates have been forced artificially low can lead to a near-permanent expectation they will rise at some point in the indeterminate future.

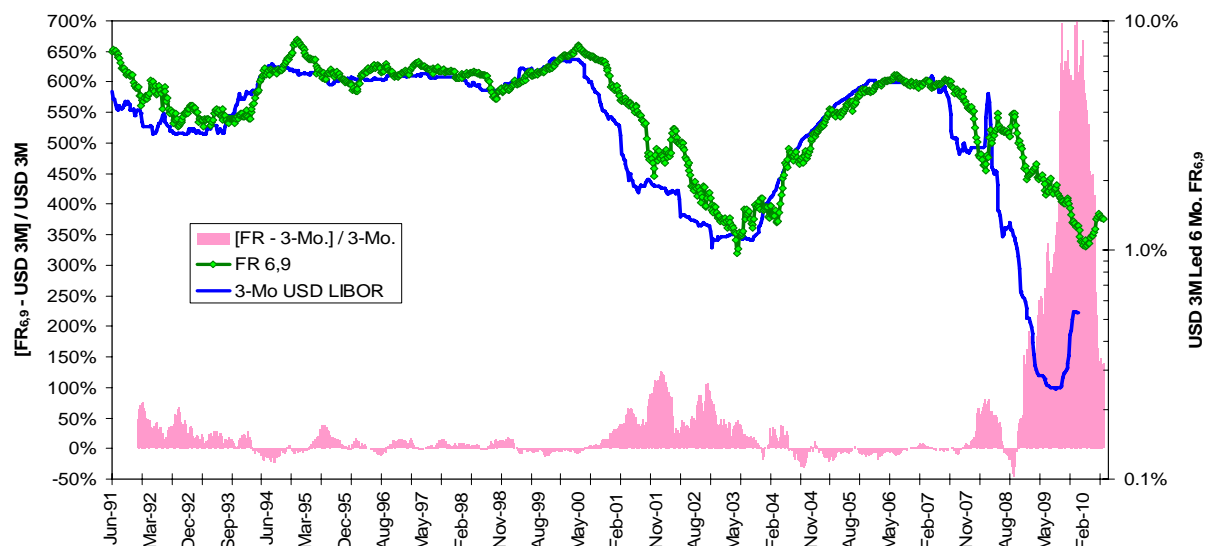
This has been the case in Japan for almost twenty years, and it became the case in the U.S. during 2009. We can illustrate it fairly simply by comparing the forward rate between six and nine months, the rate at which we can lock in borrowing for three months starting six months from now, to the actual three-month rate as it existed six months later. Even though the role of a market is to measure and not to forecast, the forward rate tells us where the market's traded and tradable expectations were at a given time. In the case of Japan, we can see how the gap between expected three-month rates and actual three-month rates six months later shot higher both after the move to zero percent interest rates in February 1999 and especially after the moves to quantitative easing both in March 2001 and later in December 2008. This state of affairs has become near-permanent.

The Persistently High Bias Of Japanese Forward Rates



The U.S. has had a shorter but more violent history of such an expectational bias. Prior to 2009, the only episode of persistent expectations occurred during the 2001-2003 rate-cutting experiment. Once the Federal Reserve cut its target rate toward 0% in December 2008 and then began quantitative easing in March 2009, the gap between expected three-month rates and actual three-month rates six months later shot to levels higher than seen in Japan. This expectations gap has retreated in 2010 as current short-term rates in the U.S. are no longer as *unexpectedly* low as they had been in 2009, but the gap is still higher than anything seen previously.

U.S. Short-Term Rates No Longer Unexpectedly Low



Investing During And After The Gaps

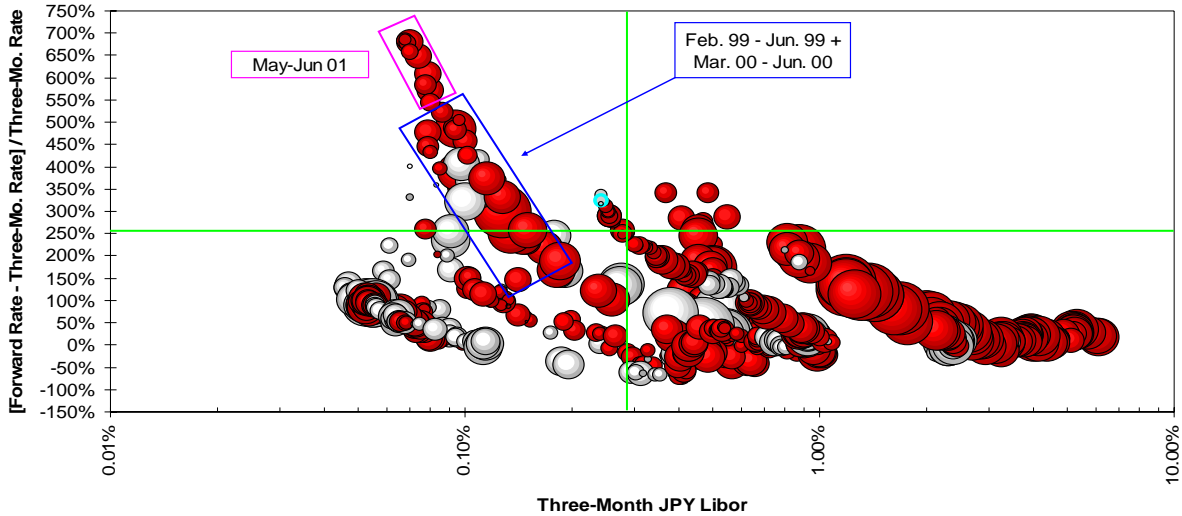
The concept of a sugar buzz or a brush with various controlled substances is familiar to many; the cheap thrill can last until it wears off, and then a reckoning must be faced. Financial markets are no different. As economies in trouble have, almost by definition, a great deal of slack capacity, official attempts to stimulate growth via monetary ease cannot work through the investment mechanism. Moreover, the risk-averse are unlikely to make long-term investment in plant and equipment based on low short-term interest rates.

The net result is created money flows into financial assets, paper representations of productive assets, first. This means the monetary authorities can create a warm glow of prosperity without doing anything to correct underlying economic imbalances. If any of this sounds familiar, it is because this is how the recently lapsed decade's economies and markets unfolded.

We can illustrate how this exercise in money illusion worked for both 7-10 year government bonds and for equities in both Japan and in the U.S. In all charts below, the three month-ahead total return for both the bonds and the stocks will be mapped against the rate gap and the ordinal level of three-month LIBOR. Positive returns are depicted in colored bubbles; negative in white bubbles. The diameter of the bubble corresponds to the absolute magnitude of the return. The datum three months prior to the last gap/rate pair is highlighted with a different color and the current rate/gap intersection is noted with a bombsight.

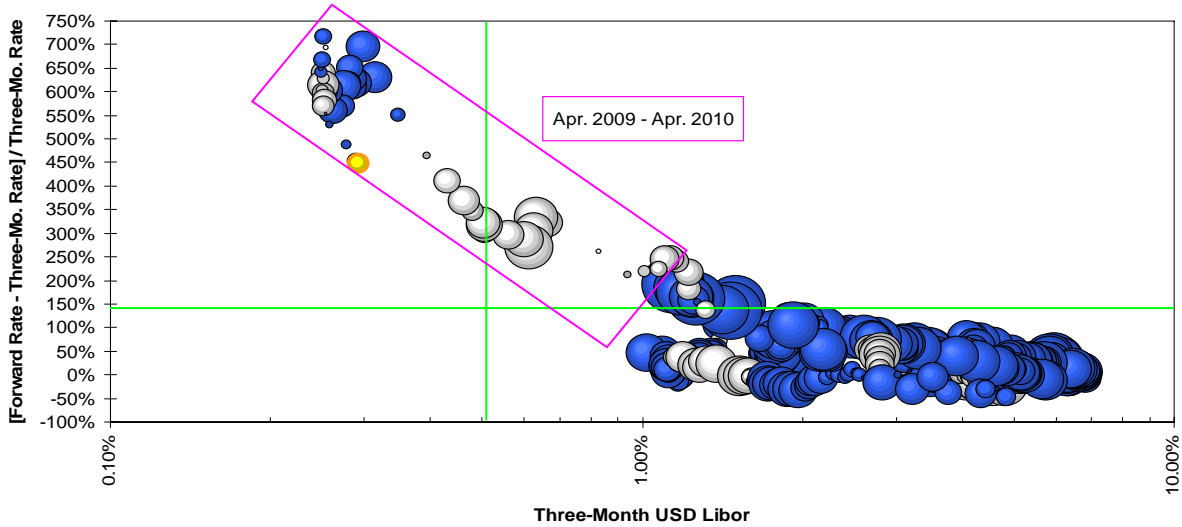
In the Japanese bond case, the periods following the move toward zero interest rates and the 2001 quantitative ease are highlighted with rectangles. The monetary stimulus resulting from unexpectedly low short-term interest rates worked for Japanese bondholders.

**Japanese Three Month-Ahead 7-10 Year JGB Returns As A Function Of
Three-Month LIBOR And Forward-Rate Gap**



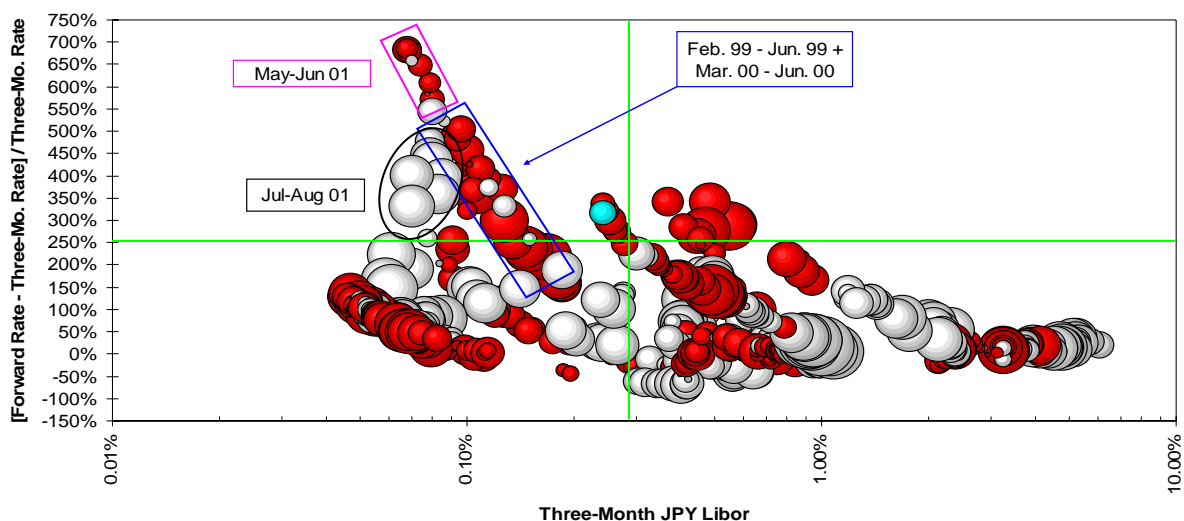
The case in the U.S. is different. Here the largest bond gains occurred during the long slide in short-term interest rate carrying costs regardless of the rate expectations gap. The period between the March 2009 quantitative ease and December 2009, included in the magenta rectangle, is filled with white bubbles indicating negative returns. Indeed, 2009 was one of the worst years on record for holders of long-term U.S. Treasuries. While the U.S. was able to finance its deficit in 2009, its policy of quantitative ease did not reward its bondholders. Bondholders were rewarded only in the second quarter of 2010, which began only after last datum used was recorded at the beginning of April 2010. Much of the reward to U.S. bondholders came at the expense of returns on risky assets.

**U.S. Three Month-Ahead 7-10 Year UST Returns As A Function Of
Three-Month LIBOR And Forward-Rate Gap**



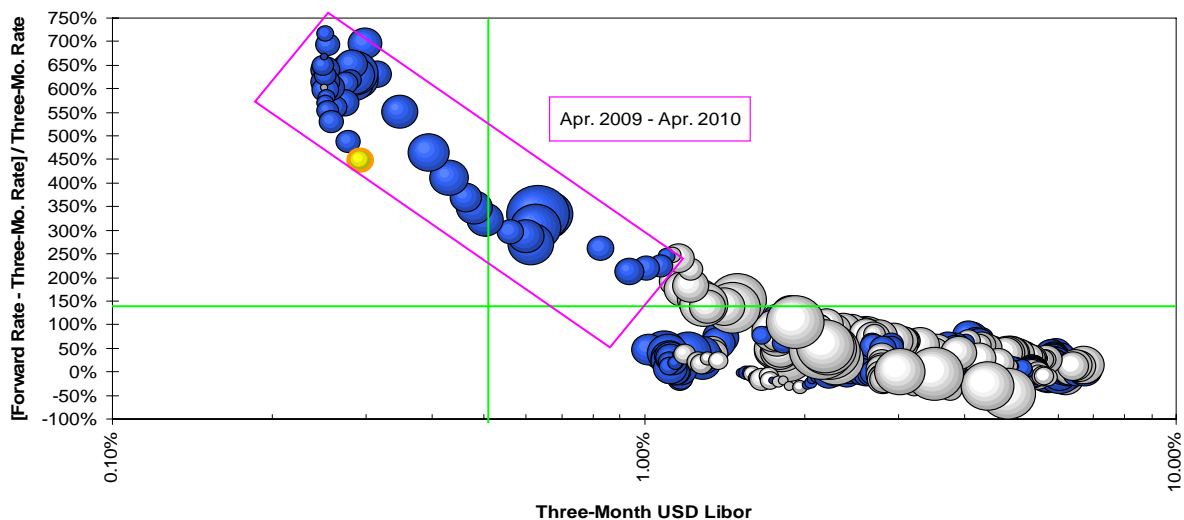
Now let's move to the stock side. The last twenty years comprised Japan's Lost Decade, and stock rallies were few, far between and short-lived. However, the unexpected declines in Japanese short-term rates were sufficient to produce three month-ahead clusters of positive returns.

Japanese Three Month-Ahead Equity Returns As A Function Of Three-Month LIBOR And Forward-Rate Gap



The U.S. stock investor, in contrast, really took the bait and then some following the Federal Reserve's drive to zero percent cum quantitative ease. The fourteen-month period following the quantitative ease of March 2009 produced some of the strongest and most sustained returns on U.S. equities since the 1930s. Those returns ended abruptly at the end of April 2010 and were, as noted above, transferred to U.S. bondholders.

U.S. Three Month-Ahead Equity Returns As A Function Of Three-Month LIBOR And Forward-Rate Gap



After The Buzz

By mid-2010, American investors were waking up from the hangover induced by the preceding monetary bender; counterfeiting one's own currency sounds can be fun all the way up until the time the police knock on the door and ask you to rethink your ways. As the Japanese experience has shown, cheap money gets borrowed from such an economy and lent elsewhere at a higher rate of return. A country that tries to paper over its problems thus finances others and hollows out its own capital base via the shortening of investment horizons. By June 2010, the U.S. was getting lectured by Europeans, of all people, on the evils of deficit spending.

At the risk of sounding moralistic, policies of short-term gain paid for with long-term pain are remembered more for the pain part in later years. An active trader has the advantage of being able to focus on both the party on the way up and the bust on the way down. But what is good for an active trader may not be good for a corporation and what is good for a corporation may not be good for a country. National stewardship requires a sense of adult behavior and, as all traders know, a willingness to take a small loss now to avoid a catastrophe later.