MARKETPLACE YIELDS: THE RIGHT OF WAY

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In Frank Norris's 1934 novel "The Pit", Cressler observes regarding Chicago commodities trading: "I tell you the fascination of this Pit gambling [Cressler says you can call the gamblers 'speculators'] is something no one who hasn't experienced it can have the faintest conception of. I believe it's worse than liquor, worse than morphine. Once you get into it, it grips you and draws you and draws you, and the nearer you get to the end the easier it seems to win, till all of a sudden, ah! there's the whirlpool…"

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LEAVING PORT

Not only since the acceleration of the worldwide economic crisis in 2008, but also during the United States and global recovery up to the present, the Federal Reserve Board ardently has engaged in an assortment of highly accommodative monetary policies. The Fed's friends such as the European Central Bank, Bank of Japan, Bank of England, and China's central bank also have displayed significant sustained easing over the past several years.

Focus briefly on the widely-beloved Fed. Acting according to its interpretation of its legislative mandate, the Fed has embarked on several rounds of massive money printing (quantitative easing) and kept policy rates (Federal Funds) pinned to the ground. Its sustained yield repression campaign, by keeping short-term yields depressed (such as the two year US Treasury note), this widely-praised marketplace guardian has tended to keep longer term rates (such as the 10 year UST) rather low.

Fed navigators also aim to promote audience confidence, particularly in "investors", via its forward guidance and exit strategy rhetoric. After all, "investment" is an inspiring word linked to buying and generally associated with language of rationality (reasonableness, logic, intelligence, common sense) and goodness. Wall Street, Main Street, economists (including central bankers), business schools, real estate dealers, politicians, and so forth are enamored of the investment term and its application. Wall Street especially enjoys wooing so-called investors into owning investment quality instruments in stocks and interest rate domains. Are investors necessarily more reasonable than speculators or gamblers?

Anyway, surely the Fed is (at least substantially) in control of "the economic situation" or quickly can manage to be so, right? Surely the Fed will not permit US government rates to spike too fast or too high, correct? That wizard also will never ever allow the S+P 500 to capsize and sink too far, right?

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The Fed meets 12/17-18/13, 1/28-29/14, and 3/18-19/14. Many wonder if it will taper its gigantic debt securities buying scheme at its next meeting.

KEY INTEREST RATES- RIDING THE WAVES

The Federal Reserve Board, other central banks, and numerous marketplace promoters may have encouraged significant complacency in many trading arenas. However, they of course have not abolished marketplace risk.

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In several major government note marketplaces- and despite ongoing interest rate repression by the Fed, the ECB, and others- long term yields have floated higher since summer 2012. Interest rates began ascents in America, Germany, and China. Major bear trends are underway and intertwined in these three countries. Even Japan since spring 2013 has shown signs of higher rates, although its enormous bond buying program may keep its 10 year JGB low.

In any case, higher inflation helps to boost interest rates. So keep in mind the determination of the Fed, the ECB, and the Bank of Japan to achieve around two percent inflation, as well as China's long-running lax credit policies.

The Fed repeatedly tells audiences that inflation expectations are well-anchored at low levels. Rate increases should make observers wonder about the durability of this anchor, especially given the Fed's long-running deluge of money printing.

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Note the pattern of and similar timing for rising rates in US, German, and Chinese 10 year government securities.

The 10 year UST note established a major bottom at 1.38 percent on 7/25/12, achieving another noteworthy depth at 1.61pc on 5/1/13. Though it made a high at 3.01pc on 9/6/13, its yield has climbed up from 2.47pc on 10/23/13 toward that September 2013 resistance, reaching 2.93pc on 12/6/13.

How eagerly will current owners (particularly foreigners) of long-dated UST and other debt securities want to hold on if American interest rates advance further? Suppose foreigners become net sellers of UST and other debt instruments. The broad real trade-weighted dollar remains rather weak, standing at 84.7 in November 2013 (monthly average Federal Reserve, H.10).

The German Bund yield made a major low at 1.13 percent on 7/23/12 (and 6/1/12). Its 1.15pc bottom on 5/2/13 likewise occurred at almost the same time as the one in the UST, as did its 1.65pc low on 10/31/13. Compare the timing of the Bund's 2.09pc high on 9/11/13.

What about China's 10 year government note? Its trend also is bearish. This note established important (and rising) yield bottoms around the times of those in the UST and Bund. See the yield lows at 3.24pc on 7/12/12, 3.41pc on 5/10/13, and particularly the sharp advance from 10/8/13's 4.02pc. On 11/21/13, the China 10 year rate reached 4.70pc. It is around 4.60pc now.

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Survey a couple of other US debt marketplace trends and the timing of their moves alongside the UST 10 year. The two year UST note made a crucial final double bottom at .19pc on 7/23/12 and 5/3/13 (it actually hit the floor a bit earlier and lower than summer 2012, on 9/20/11 at .14pc).

See the widening of the UST 10 year less two year spread relationship since late July 2012. Is this a sign of economic growth? Or does it signal emerging inflation (or fears of it) or reduced net buying or even net selling by UST (especially 10 year UST) owners? The 10 versus two established a major low at 117 basis points on 7/24/12. Yields for the 10 year continued to climb relative to the two year, with the spread moving to 134bp over the two year on 11/16/12 (the 10 year UST made an important low at 1.55pc on 11/16/12). Note this yield spread's subsequent lows at 143 basis points on 5/1/13, and 219bp on 10/29/13. The spread is swimming toward

major resistance around 260 to 290 basis points. Its 12/5/13 high was 257bp. Recall the 11/13/08's high at 262bp; remember the wall of 2/22/10's 291bp and 2/4/11's 289bp.

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Japan's 10 year government note made a significant low on 4/5/13 at .33pc (briefly breaching the major trough of .44pc made about a decade earlier, on 6/11/03). The early April 2013 depth in Japan's 10 year note occurred about a month or so before those in the UST, Bund, and Chinese 10 year. However, although the JGB advanced to a high on 5/23/13 around one percent, it then traveled a bit lower. Perhaps- especially given the Japanese government's fierce determination to create sufficient inflation- the .59 low on 11/8/13 will turn out to roughly coincide with the October 2013 ones in the other three countries.

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Finally, monitor rising interest rate trends in emerging and developing lands. For example, in summer 2013, India's 10 year government note challenged major resistance near 9.50 percent.

YIELDS, LEVERAGE, and RISK

The Bank for International Settlements recently warned ("Quarterly Review", 12/8/13): "Since mid-2012, low interest rates on benchmark bonds have driven investors to search for yield by extending credit on progressively looser terms to firms in the riskier part of the spectrum." "The trend toward riskier credit was fairly general." See also the BIS's 12/5/13 media briefing by the Head of its Monetary and Economic Dept. "After a brief pause, the search for yield has continued largely unabated." Maybe many are not worried much by such comments. Though the Financial Times headlines "BIS says hunt for yield spurring loose credit conditions" (12/9/13), this article is on page 22, not page one.

Keep in mind the trend of rising rates noted above since July 2012 for US, German, and Chinese government 10 year rates in the context of the BIS comments about investors hunting for yield since mid-2012.

Also, underscore the timing of the narrowing of the Spain less Germany 10 year government spread; its peak was 638 basis points on 7/24/12. The narrowing of this sovereign spread surely partly relates to the valiant efforts of the ECB to solve (or at least contain) the European debt and credit crisis. However, that spread differential has tumbled substantially, falling to around 220bp on 12/20/13. The high in the Italy less Germany 10 year government relationship shows a similar pattern. It established its final plateau at 536 basis points on 7/24/12 (11/9/11's peak was 553bp), slumping to under 225bp in December 2013. Some of the collapse in these two European government yield spreads probably fits the search for yield noted by the BIS.

In addition, especially with mid year 2012 in focus, review the trend of United States 10 year BBB corporate (industrial) yields less those of the comparable UST. This spread has gradually narrowed since end 2011 and June 2012 and even further after end June 2013. The spread of the US 10 year general obligation municipal note relative to the 10 year UST likewise manifests lower and lower tops in the past couple of years, narrowing after highs of late September 2011, early June 2012, and end June 2013.

Interest rate payments and debt marketplace yield levels (and stock dividend payments) are not the only form of "yield". If the S+P 500 advances, owners of rising stocks receive a "return" in addition to any dividend payment they may receive. So price movements in debt instruments,

equities, currencies, and commodities allegedly offer ("yield") "returns". Of course from this vantage point involving the financial instrument's price movement, some of these yields/returns may be losses (negative returns).

In any event, though many marketplace mariners may not fear growing credit risks and leverage, people should look at some other remarks and indicators. The Financial Times notes "Indebted companies can borrow cheaply and on their own terms" (10/23/13; article buried deep in the newspaper at p22). "Riskier 'covenant-lite' loan slices hit record levels" (Financial Times, 11/19/13, p24). The NYTimes underlines the "New Boom In Subprime Lending (11/27/13, ppB1-2). The FT states: "Buyout debt returns to levels of pre-crisis boom in US" (10/9/13, p13).

The NYTimes headlines "In Silicon Valley, Partying Like It's 1999 Once More" (11/27/13, pB1). A NYTimes article (by Gretchen Morgenson in "Sunday Business", 11/10/13, pp1, 6) is titled "Earnings, But Without the Bad Stuff". It states: "Twitter's red-hot stock offering last week makes clear that, as in the first Internet Bubble, investors will pay up for a company even if it hasn't turned a profit. And managers of companies that have generated only losses, like Twitter- and even those that are profitable- are happy to suggest metrics that they think are better suited for assessing their operations. Managements' recommended measures, typically not found in generally accepted accounting principles, have an uncanny way of burnishing a company's results."

NYSE margin debt recently established a new all-time high in October 2013's at $412.5bb (end month). This decisively exceeds July 2007's $381.4 billion plateau, reached shortly before the major pinnacle in US stocks (S+P 500 high 10/11/07 at 1576). Compare the margin debt low of $173.3bb in February 2009, reached just before the S+P 500's major bottom on 3/6/09 at 667. Even though stock prices are higher now than in 2007, and although US nominal GDP has risen over the past several years, the October 2013 NYSE margin debt level still represents substantial leverage.

Equity bulls nowadays assemble fleets of reasons justifying higher US stock prices. Maybe the S+P 500 will travel above its joyous 1814 high, reached on 11/29/13, the day after Thanksgiving. The happy high of 1814 hovers about 15 percent above its October 2007 Goldilocks Era pinnacle. The S+P 500 also has raced far over relatively recent lows such as 11/16/12's 1343.

History nevertheless displays that significant US government yield rises sometimes precede ("lead") important American stock price bear moves. The sustained increase in US 10 year government note yields since July 2012 arguably is leading to a decline in the S+P 500 (admittedly this leading process is taking quite a long time). A decisive and sustained march in the 10 year UST through its three percent barrier probably will be bearish for the S+P 500 (and many other stock marketplaces). In addition, keep in mind the ongoing bear trends in emerging stock marketplaces "in general" and in the "overall" commodities marketplace that started in spring 2011.

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Indeed, if "investors" these days cannot find good (reasonable, satisfactory) returns (yields) in financial marketplaces, why not invest in fine art (or maybe just art)? A Francis Bacon triptych painting from 1969 recently sold for over $124 million, the most expensive artwork ever dealt at auction (NYTimes, 11/13/13, pA27).

Or perhaps yield (return)-seeking enthusiasts should take advantage of other paths (opportunities). Look at the Financial Times's own promotion: It advertises: "Start investing in

your wine collection today"; "Join the FT Fine Wine Plan today". Why do this? "For investing, for future drinking, or both". Is it a high cost to get in there and participate? Not for many players. The cost is "From just 250 British Pounds per month", and you even get "Advice from a personal Plan Manager". (Financial Times, 11/25/13, p23).

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