STEPPING HIGHER: UST TWO YEAR NOTE YIELDS
© Leo Haviland, 646-295-8385 September 21, 2014

"Steppin' Out" is an instrumental tune performed by the rock group Cream

****

US TWO YEAR GOVERNMENT NOTE YIELDS; STEPPING UP

The Fed's relentless yield repression quest over the past several years has assisted debtors (and borrowers), though it has been far less popular with creditors (and savers). In an environment with US inflation running in the ballpark of about 1.50 to two percent, much of the US Treasury yield curve in recent times has offered negative or only mediocre real returns.

Despite the Fed's yield repression scheme, yields for the two year United States Treasury note have slowly walked upstairs over the past few years. The two year UST note established a major bottom at .14 percent (way under one percent) on 9/20/11. It created final bottoms at .19pc on 7/23/12 (major bottom in UST 10 year 7/25/12 at 1.38pc; major low in UST 30 year 7/26/12 at 2.44pc) and 5/3/13 (10 year trough 1.61pc 5/1/13). In recent weeks, the two year UST yield has edged up to almost .60pc, still relatively distant from its 1.43pc 6/8/09 elevation.

Of course the two year yield, even after its recent hop upward, remains tiny from a longer run historical perspective. Recall the two year UST's 6/13/08's 3.11pc summit during the midst of the worldwide economic crisis. Remember the two year's major peaks over five percent during the later stages of the wonderful Goldilocks Era: 6/28/06's 5.28pc and 6/13/07's 5.13pc final high. Compare the timing of the UST 10 year note pinnacles: 6/28/06 at 5.25pc and 6/13/07 at 5.32pc (6/13/07 high in the UST 30 year 5.44pc). The two year UST note's 9/20/11 depth represents a three decade decline from the mountainous yield peak of 16.96pc of 9/8/81 (UST 10 year note record peak 15.84pc on 9/20/81).

THE FED'S BABY STEPS: LOOKING PAST YIELD REPRESSION

"Yes, there are two paths you can go by, but in the long run
There's still time to change the road you're on.
And it makes me wonder. "Stairway to Heaven", by Led Zeppelin

****

The widely-beloved Federal Reserve Board, long enamored of its spectacular quantitative easing (money printing) and yield repression programs, announced on 12/18/13 the first reduction in its net purchasing of longer term United States Treasury and agency mortgage-backed securities. It slowly tapered its debt acquisitions over ensuing months. This earnest economic gatekeeper will complete its current money printing scheme spectacular in October 2014.

For almost six years, since December 2008, the highly accommodative Fed has pinned the Federal Funds rate nearly to the ground, holding it under .25 percent (monthly average, Fed H.15 statistics). The Fed reiterated in its 9/17/14 assembly that it "likely will be appropriate to maintain the current target range [zero to .25pc] for the federal funds rate for a considerable time after the asset purchase program ends", hedging itself with references to its maximum employment and price stability mandate and underlining its inclination to "take into account a wide range of information". The Federal Open Market Committee's "Summary of Economic Projections" (midpoint of central tendency; Table 1, 9/17/14) estimates personal consumption expenditures

(PCE) inflation at 1.60pc for 2014, 1.75pc for 2015, and 1.85pc for 2016, below the Fed's two percent longer run goal.

Despite references to "considerable time" and faith that PCE inflation will persist below the two percent objective across the 2014-2016 horizon, the Fed sheriff intends to finally step out on the rate increase highway and abandon its yield repression policy. See the two versions of Figure 2, "FOMC participants' assessments of appropriate monetary policy" in the Fed's Economic Projections. At end calendar 2015, on balance (looking at roughly the midpoint of the distribution of the individual member projections and rounding to a quarter of one percent), the participants expect a Fed Funds rate around 1.25 to 1.50pc. The range of FOMC opinions for 2015 runs from under.25pc up to nearly 3.00pc. As for the end of calendar 2016, Fed Funds around 2.75 to 3.00pc represents a rough estimate of the assessments (predictions), which vary from under .50pc up to 4.00pc. These wide ranges imply substantial uncertainty among even experts regarding the outlook for the American (and worldwide) recovery.

Interest rate marketplace clairvoyants do not agree as to exactly when a cautious but undoubtedly prudent Fed probably will commence raising the Federal Funds rate. However, to meet end calendar 2015's apparent Fed Funds assessment objective, many believe it will begin tightening around the end of first or second quarter 2015.

****

Once the Fed begins boosting the Fed Funds rate, how far and fast could that benchmark climb? Obviously numerous entangled economic and political variables influence this. In any event, based on the Fed's current statements, Fed Funds increases probably will be slow but steady for many months. Assume decent economic expansion, around two percent inflation, as well as the Fed's likely desire to (finally) offer UST owners across much of the yield a real return. Then a Fed Funds rate move by end 2015 to about 1.25-1.50pc would appear probable to most marketplace watchers. A venture north of two percent by the end of calendar 2016 likewise will appear fairly probable to numerous observers, even if it happens to falls somewhat short of the implicit 2.75-3.00pc target.

However, economic weakness, including insufficient inflation or lack of headway on the employment front (conditions in not only the US, but also overseas, matter) could stall that upward Fed Funds movement. In that regard, the ability of the two year UST to break decisively above resistance will reflect economic conditions and thus probably Fed policy responses and inclinations. Not only is the .60pc ceiling (12/27/08 low .60pc; compare recent highs just beneath this) important. Whether or not the two year UST can smash through important resistance around .90pc (2/5/11 high .88pc, 4/1/11 top .89pc) and challenge 6/8/09's 1.43pc summit will help to signal the likely course of Fed Funds.

The Federal Funds and two year UST rates probably will not move in lockstep fashion and to an identical level. However, sustained yield levels for both probably will be relatively close. Assuming a positive yield curve, the two year interest rate will be somewhat higher than the Fed Funds level. Suppose this relationship exists for guideline estimates of two year UST yields as the Fed propels the Federal Funds rate higher.

****

The two year and 10 year UST notes often move in the same direction and around the same time. In any case, the ability of the UST 10 year note to move decisively above its key resistance of around 3.00-3.50 percent likewise represents an important factor for assessing the likely path of Fed Funds increases. Recall the 3.01pc high on 9/6/13 and the 3.05pc top of 1/2/14. Suppose the

two year UST note yields .60pc. The widest difference in recent years in the 10 year less two year spread has been about 290 basis points (2/22/10 and 2/4/11, settlement basis); adding 290 basis points to the .60pc two year yield gives 3.50pc for the UST 10 year. Major resistance in the UST 10 year looms at 3.75/4.00pc (2/9//11 top 3.77pc, 4/5/10 high 4.01pc, 6/11/09 high 4.00pc) to 4.30pc.

****

Alternatively, suppose the US economic recovery speeds up considerably faster than most gurus expect and that inflation rises sufficiently to please the Fed. Assume that GDP in lands such as the Eurozone begins to grow adequately, with inflation moving to heights their central bankers deem acceptable. Keep in mind that the prevailing "longer run" Fed Funds target falls just short of four percent, with end calendar 2017's around 3.75pc (see Figure 2, Economic Projections). Or, what if significantly greater inflation than the Fed now expects emerges? In both situations, Federal Funds increases may occur relatively more quickly than many marketplace watchers believe. Thus interest rates for the two year UST note (and the UST 10 year) correspondingly would rise further and faster than many anticipate.

History need not repeat itself. The current American and international environment does not mirror that of 2003 and the years succeeding it. But recall the pace and extent of Federal Funds jumps after 2003. The rate rested on its floor around one pc from July 2003 through June 2004 (monthly average; H.15). It moved over two percent in December 2004 (2.20pc that month) and to three pc in May 2005. By November 2005, Fed Funds touched 4.00pc, attaining 5.00pc in June 2006. The history after 2003 hints that the eventual pace of Fed Funds and two year UST note increases might accelerate, particularly after 2015, even if it does not do so as quickly or dramatically as in that previous era.

IT TAKES TWO TO TANGO: UST 10 YEAR LESS TWO YEAR SPREAD HISTORY

"Get your motor runnin'
Head out on the highway
Looking for adventure
In whatever comes our way". Steppenwolf, "Born to be Wild"

****

The US Treasury two year and 10 year notes over the past several years have made many important marketplace turns around the same time. The yield spread relationship between those instruments provides insight into and offers guidance regarding Federal Reserve policies. Although other variables of course are relevant, this spread offers indications regarding the extent of American (and international) economic strength or weakness.

Important trend moves in the 10 year less two year United States government yield spread often have roughly coincided with significant Federal Reserve Board policy decisions (sometimes assisted by major ones by the European Central Bank and others). Especially since around the time of its mid-December 2008 low around 125 basis points (10 year yield higher than two year; a positive yield curve), and thus during the Fed's yield repression and quantitative easing era, the 10 year less two year spread has tended to widen (become more positive) during times of US economic growth (or notable signs or hopes for it) and decline during times where economic expansion slows or slumps (or when fears rise that this will occur). Fed quantitative easing moves link up with a widening of the yield spread (particularly via boosting the 10 year UST yield). The ending of the Fed's money printing ventures have tied to narrowing of the yield spread

(especially via falls in the UST 10 year yield). A narrowing pattern in this spread and the UST 10 year itself after the ending of QE (including the current tapering round) suggests that noteworthy "underlying" weakness remains in the US economy. See "Bond Yield Perspectives: Easing Comes: Easing Goes" (9/1/14) and related essays.

However, since the UST 10 year's 1/9/14 plateau at 3.05pc, its yields on balance have moved sideways to down, whereas the two year yield pattern seems sideways to up over that period. The slip in the 10 year yield since then, given the Fed's determination to increase inflation, indicates less than robust US (worldwide) economic growth. The increase in two year yields may reflect Fed plans more than notable overall economic strength (or the Fed's faith that such strength is or will soon emerge). Yet will yields for both UST notes keep moving higher since their mid-August 2014 lows?

****

From the depths of the international economic disaster through most of the succeeding years, these US Treasury yield curve ventures (trend changes) generally have occurred around the same time as significant moves not only in the US Treasury 10 year note but also in the US stock marketplace (S+P 500). Many lows in the 10/2 UST yield curve spread have tied up with (occurred within a few months of) important S+P 500 bottoms; pinnacles in the spread likewise connect somewhat closely in time with plateaus in the US stock landscape.

However, whereas the 10 less two year spread and the 10 year yield itself have declined in recent months (265 basis point high in the yield spread 12/31/13; 3.05pc high on 1/2/14 for the UST 10 year), the S+P 500 this year has ascended to new highs over 2000. Thus the S+P 500's relationship relative to the 10 less two year spread and the UST 10 year itself seems to have diverged from its prior pattern.

****

From the later stages of the glorious Goldilocks Era to the present, review the scorecard for the key highs and lows in the US Treasury 10 year less two year yield spread, the UST 10 year note, and the S+P 500 in the context of Federal Reserve policy activity. Several European events are included as well.

****

US Treasury Spread (basis points): <u>10 Year less 2 Year</u>	**Federal Reserve Policy, UST 10 Year Yield (percent), <u>S+P 500, other factors</u>**
Negative 19 basis points 11/27/06 (negative yield curve)	Goldilocks Era continues.
3/6/08 initial top 208bp (positive yield curve)	Goldilocks Era ends: mid-2007 to spring 2008. UST peak 6/13/07 at 5.32pc (then 10/15/07 at 4.72pc). Final S+P 500 top 5/19/08 1440 (10/11/07 peak 1576).
Slide to 117bp 6/12/08, then spike to 262bp 11/03/08	Stocks tumble. UST moves sideways, lows 3.28pc on 3/17/08 and 3.24pc 9/16/08, highs 4.27pc 6/13/08 and 4.10p 10/5/08. Acceleration worldwide economic crisis; Lehman bankruptcy.
Dive to 125bp 12/26/08	"Flight to quality" in UST, 2.04pc bottom 12/18/08.

	Fed finishes crushing the Fed Funds rate; it has resided around .25pc or less since December 2008.
<u>US Treasury Spread (basis points): 10 Year less 2 Year</u>	**<u>Federal Reserve Policy, UST 10 Year Yield (percent), S+P 500, other factors</u>**
Explosion to 276 bp 5/27/09	QE1 money printing announced November 2008 and March 2009, start economic rally. S+P 500 major low 3/6/09 at 667. UST high 6/11/09 at 4.00pc.
Final high 291bp 2/22/10	QE1 ends March 2010. UST plateau 4/5/10 at 4.01pc. S+P 500 high 4/26/10 at 1220.
Fall to 196bp 8/26/10	Fed wizards unveil QE2 end August/November 2010. Final low S+P 500 8/27/10 at 1040. UST low 10/8/10 at 2.33pc.
Curve steepens to 289bp 2/4/11, then drops off from 271bp 7/1/11	QE2 closes June 2011. S+P 500 top 5/2/11 at 1371, then 7/7/11 at 1357. UST peak 2/9/11 3.77pc, then 3.61pc 4/8/11 and 3.22pc 7/1/11.
Lows 152bp 9/23/11, 158bp 12/19/11	Operation Twist 9/21/11 announced. This policy of selling the short end of the UST curve while buying the long end tends to boost short term yields and reduce long rates. Yet since Operation Twist aims to produce economic growth while the Fed also (alongside Twist) still violently represses short rates, arguably Twist in practice has a countervailing tendency, in which long term UST rates rise relative to short term ones. Anyway, 10 year UST yields go sideways to up after Twist (lows 1.67pc on 9/23/11 and 1.79pc on 1/31/12; tops 2.42 on 10/28/11 and 3/20/12 at 2.40pc). S+P 500 low 10/4/11 at 1075 just after Operation Twist unveiled. European Central Bank long-term refinancing operation (LTRO) of low interest loans announced 12/8/11 (two rounds, 12/21/11 and 2/29/12). Akin to money printing, this ECB policy assisted confidence in European (and thereby US) recovery and thereby helped UST 10 year yields to rise). Note the timing of Operation Twist and the LTRO alongside the 9/23/11 and 12/19/11 UST spread lows.
Highs 209bp 10/27/11; 200bp 3/19/12	UST highs 10/28/11 at 2.42pc and 3/20/12 at 2.40pc. S+P 500 interim high 4/2/12 at 1422.
Key bottom 117bp 7/24/12	ECB President's 7/26/12 "whatever it takes" speech to preserve the Euro. Peak in Spain less Germany

sovereign 10 year spread 638 basis points 7/24/12.
Major low 10 year UST 1.38pc 7/25/12.
ECB's Outright Monetary Transactions (OMT) announced 8/2/12 (framework 9/6/12).

US Treasury Spread (basis points): <u>10 Year less 2 Year</u>	**Federal Reserve Policy, UST 10 Year Yield (percent), <u>S+P 500, other factors</u>**
	Also recall some earlier price action and relationships close in time to the 117bp bottom in the 10/2 UST spread. The 10/2 spread made an initial low on 6/1/12 at 121bp. See the UST's initial low on 6/1/12 at 1.44pc alongside German Bund's bottom that day at 1.13pc. S+P 500 low 1267 on 6/4/12.
Interim bottom 134bp 11/16/12	On 9/13/12, the benevolent Federal Reserve began yet another round of money printing, unleashing QE3 on 9/13/12. Yet the 10 year less two year spread, rather than widening due to this helpful Fed effort, dropped from 162bp on 9/13/12 to 134bp on 11/16/12. The UST likewise moved lower from its 1.89pc minor top on 9/14/12, touching 1.55pc on 11/16/12. This pattern beginning in mid-September ominously broke the previous ones. This surely displeased the kindly and eternally vigilant Fed; it warned of the fragility of the recovery and the fading efficacy of Fed money printing efforts. The S+P 500 similarly retreated. From its 9/14/12 top around 1475, rather than joyously rallying, it fell to 1343 on 11/16/12, thus heading toward its 6/4/12 low at 1267. The resolute Fed decided to underscore its lax money policy yet another time. On 12/12/12, this guardian angel offered even more money printing (QE4) plus a bonus of additional forward policy guidance details (inflation and unemployment number specifics). It felt brave enough to allow Operation Twist to expire gracefully at the close of calendar 2012.
265 basis points high 12/31/13	Since the Fed scrambled into action in mid-December 2012, the UST 10 year less two year spread widened, creating optimism about a satisfactory US (and worldwide) economic recovery. After edging up to 180bp (3/11/13) and sliding to 143bp (5/1/13), it accelerated to a high at 265 basis points on 12/31/13. The 10 year UST yield ascended to 3.05pc on 1/2/14 (3.01pc on 9/6/13). The Bank of Japan's devoted easing during this period, particularly its introduction of quantitative and qualitative monetary easing on 4/4/13, surely assisted the widening of the UST 10 less two year spread.

US Treasury Spread (basis points): 10 Year less 2 Year	Federal Reserve Policy, UST 10 Year Yield (percent), S+P 500, other factors
	The 10 year less two year UST has tumbled lower as US QE process has ended. Yet whereas the two year UST note yield has risen, the 10 year UST yield on balance has moved lower since the Fed began tapering (first round 12/18/13, second round 1/29/14).
	What does the decline in the 10 year UST say about the American (and international) recovery? After all, shouldn't that interest rate rise during a sustained expansion where the central bank targets two percent inflation?
	The S+P 500 not only jumped higher over the course of calendar 2013. It also has voyaged higher during calendar 2014, even after highs in UST 10 year and 10 less two year UST spread at end December 2013/start January 2014. After the beginning of tapering, the S+P 500 briefly dipped from 1851 (1/15/14) to 1738 (2/5/14; 228bp interim low in 10 less two UST on 2/3/14). But although the 10 versus two year UST spread headed down from 2/14/14's 243bp, the S+P 500 kept leaping higher.
184 basis points low 8/28/14	European Central Bank introduces asset backed securities purchasing plan (QE/money printing) on 9/4/14. Introduced negative rates on the deposit facility and announced plans for targeted longer-term refinancing operations (TLTROs) on 6/5/14.

****

The range for the 10 year less two year UST spread during the Fed's yield repression era (from December 2008 to the present) has been about 120 to 290 basis points. The continuation of this pattern is not inevitable. However, suppose for the sake of argument that this range persists. Then one can take the two year UST yield and derive an estimate for the potential yield of the UST 10 year. Thus if the two year note yields 1.00 percent, a hypothetical yield range for the 10 year is 2.20pc to 3.90pc.

SKETCHING A LIKELY SCENE

In the intertwined global economic scene, America is not an island. United States government and other interest rate marketplaces entangle with other key ones around the world. Also, interest rate levels and trends interrelate in various ways and extents with stock, currency, commodity, and other marketplaces. Many relationships alter, sometimes slowly, yet often rather rapidly. Crucial variables such as inflation, unemployment, and GDP in the US and elsewhere can and do change their levels. And political and social factors and developments influence economic ones.

****

Obviously observers differ in their perspectives on the current situation and potential outcomes (whether near term or long run) for benchmark marketplaces such as US government notes, the S+P 500, and the US dollar. Nevertheless, suppose we focus on US debt and stock marketplace patterns in light of Federal Reserve monetary policy since the darkest days of the worldwide financial crisis. Let's walk down one primary road (with some related short detours) to underscore a few points and suggest one possible and arguably the most probable picture for the next several months and perhaps longer. This walk admittedly will not be comprehensive.

****

The Fed's inclination to eventually ratchet up the Fed Funds rate from current extraordinarily low ones indeed may result in steadily rising Fed Funds rates. The stronger the economic recovery, the greater becomes the likelihood of noteworthy Fed normalization and higher US interest rates. The inching upward of the two year UST note yield, especially since its .19 (5/3/13) and .26pc (11/20/13) troughs, hints that the Fed indeed will raise the Fed Funds rate. So do the Fed's own (implicit) projections and rhetoric from most marketplace participants.

But the Fed's implicit forecast via its economic projections, whether for 2015, 2016, or the longer run, does not mandate the emergence of Fed Funds levels (or two year or 10 year UST yields significantly higher than current ones.

Instead, although it is a difficult call, increases in the Federal Funds rate over the next couple of years, and perhaps even in 2015, probably will be less than many viewers expect. The Fed is probably too optimistic regarding rate rises for 2016, 2017, and the misty long run. One key factor for this viewpoint is rather weak growth in the US and overseas. Weaker (slower) growth means that the Fed probably will not raise policy rates as fast or as much. Marketplace considerations related to this growth one also are discussed below. In any case, important resistance for the two year UST exists at .90 percent, with significant resistance around 1.50 percent (1.43pc the 6/8/09 high).

Significantly, the rise in two year note yields since very late 2013/early 2014 contrasts with the fall in the UST 10 year yield and the narrowing of the 10 less two year spread. Since end December 2008, roughly simultaneous declines in the 10 year note yield and the 10 less two year UST spread have been associated with a relatively weak US economic situation (or fears that such feebleness will emerge; international players such as the Eurozone affect this picture).

This slide in the 10 year note and the 10 less two year UST spread connects with the end of Federal Reserve money printing festivals, including the current one. Thus the US may be economically weaker (or more vulnerable to such feebleness) than many marketplace players or even the Fed (judging from its Fed Funds projections) perceives.

What's the bottom line for the UST 10 year? It probably will not venture over the 3.00 to 3.50pc band unless economic growth accelerates, which does not look likely for at least the near term.

****

Some gurus may argue that the US economy nowadays is healthy enough to sustain GDP growth, so there is no need for US quantitative easing. The falling US unemployment rate, increased consumer net worth, great S+P 500 strength and strong corporate earnings, and other indicators suggest the US is doing rather well. Thus in a sense, going forward, economic expansion and related yield rises (particularly in the UST 10 year) can derive entirely from "genuine" economic growth/recovery factors rather than being assisted by money printing (the QE regime passes away, the "true recovery" domain stands on its own). Thus the Federal Funds rate can steadily

rise. These pundits may assert that the 10 year UST's decline in 2014 is temporary, and that sustained yields definitively over 3.05pc (1/2/14 high)/3.50pc should appear without too much trouble.

****

Yet how truly robust is the American economy? Note that Fed Funds have been kept below 2003's one percent bottom, which lasted about a year, for almost six years. Anyway, the Fed's modest real GDP growth projection is 2.8pc for 2015 (midpoint of central tendency; 2014's at 2.10pc) and 2.75pc for 2016. However, GDP increases slow to 2.40pc in 2017, with the murky longer run only 2.15pc.

Perhaps the European Central Bank's recent easing measures, especially its ABS money printing announcement of early September 2014, will help lift the UST 10 year above its January 2014 elevation. Time will tell, right?

Nevertheless, the longer the UST 10 year yield does not sustain a climb above 3.05pc, the more ominous becomes the outlook for US economic strength. At present, Eurozone and Japanese economic weakness make a relatively gloomy scene for the US more likely. This overseas situation makes it more difficult for long term UST rates to sustain a climb.

In addition, growth in emerging marketplace economies is slowing down. An International Monetary Fund blog (posted 9/18/14 by iMF direct) states: "emerging markets...have been slowing down for some time now. GDP growth has declined from 7 percent during the pre-crisis period (2003-8) to 6 percent over the post-crisis period (2010-3) to 5 percent, in our projections, over the next five years (2014-18)." Watch for the International Monetary Fund's early October 2014"World Economic Outlook". Reports about an ongoing reduction in Chinese GDP growth have become increasingly widespread. What occurs in key emerging marketplaces such as China of course will influence the growth levels and trend in America and other advanced nations. This emerging marketplace outlook makes it that much more difficult for the UST 10 year rates to sustain advances over its 2014 top.

****

Recall that the S+P 500's continued rally in calendar 2014 represents a divergence relative to 2014's decline in the UST 10 year yield and the narrowing of the 10 less two year UST relationship. The S+P 500, aided by the hunt for yield (return) frenzy inspired by central bank yield repression, share buybacks, and strong corporate earnings, has flown higher even though the Fed has tapered for many months.

Emerging stock marketplaces have not followed the S+P 500 up to record highs. Given the slowing of economic growth in those economies, this represents a warning that the massive bull move in the S+P 500 may not continue forever. Look at the "MSCI Emerging Stock Markets Index" (from Morgan Stanley: MXEF). The MXEF over the past year or so has advanced from lows near in time to those in the S+P 500. Note the MXEF troughs at 878 on 6/25/13, 905 on 8/28/13, and 914 on 2/4/14. However, the MXEF remains below its Goldilocks Era pinnacle at 1345 (11/1/07), as well as 4/27/11's 1212 plateau. In addition, it has started to fade from its recent top at 1104 on 9/4/14 (despite the ECB's monetary easing action). If the MXEF starts to step significantly lower (keep an eye on 2/29/12's high at 1085 and 1/3/13's one at 1083), that will suggest increasing risks for the S+P 500 (especially if the UST 10 year yield also is unable to breach the 3.05pc level). Renewed weakness in emerging stock marketplaces increases the odds that the continued S+P rally will end (S+P 500 divergence from UST 10 year and 10 less two year trends will cease).

The S+P 500 eventually dropped after QE1 and QE2 ended. Since the current round of US quantitative easing will end in October 2014 (tapering of purchases will finally finish), one should be especially watchful for a reversal (even if it is modest) of the S+P 500's epic bull trend.

Another sign of sluggish economic growth, particularly in emerging marketplaces, has been the decline in commodities "in general" since spring 2011 (broad Goldman Sachs Commodity Index/GSCI). The GSCI peaked at 762 on 4/11 and 5/2/11. Since then, it generally has displayed a pattern of declining (lower and lower) highs. It recently made an interim top around 673 on 6/23/14, slipping to 582 on 9/15/14.

****

What about the United States dollar in this economic growth context? Some have hailed the dollar's sharp rally against the Euro FX and Japanese Yen in recent weeks as a sign of confidence in the US economy (that the US economy will be rather strong). However, relatively strong growth is not necessarily the same as strong growth. One also could interpret the Euro FX and Yen currency cross rate trends versus the dollar merely as a sign of dismay regarding Eurozone and Japanese GDP prospects relative to America's. Moreover, the broad real trade-weighted dollar (Federal Reserve statistics, H.10) remains relatively feeble from the long run perspective even after its recent rally against various key trading partners.

Moreover, a fairly substantial rally in the broad real trade-weighted dollar (TWD) is not necessarily a bullish sign for US and worldwide economic growth. During the global financial crisis, the TWD rallied from 84.2 in April 2008 (final high in S+P 500 5/19/08 at 1440) to 96.9 in March 2009 (S+P 500 low 3/6/09 at 667).

10 YEAR LESS 2 YEAR: YIELD SPIKE CONSIDERATIONS

The 10 year less two year UST interest rate spread probably will continue generally to remain within its current 120 to 290 basis point range. Yet even if it does not, suppose that at some point the United States (or the world in general) suffers through a major financial crisis. This probably will not happen in the near term, but one should never say never. The United States as a whole remains a debtor nation, and it confronts serious long run fiscal challenges.

If such an economic crisis emerges, there's potential for a spike (widening) in the 10 less two year UST relationship. Recall the dramatic shift from 6/12/08's 117 basis point low (interestingly, the same as 7/24/12's) up to 11/13/08's 262bp top as the financial crisis raced forward (Lehman Brothers bankruptcy 9/15/08). America's housing and financial leverage (banking system) problems were critical issues (though of course not confined to the US), even though the US (and the world in general) did not in mid-2008 yet face major near term fiscal troubles.

In an interest rate spike situation, the US may have to "pay up" (raise rates, especially long ones) to attract capital. Recall that in the deep gloom of Europe's recent (and ongoing) debt crisis, interest rates for many sovereigns (such as Greece, Portugal, Ireland, Spain, and Italy) flew higher.

10 YEAR VERSUS TWO YEAR YIELDS: A GREAT RECOVERY SCENARIO

The Fed watchdog probably will continue to substantially repress the Federal Funds rate relative to its so-called normal level (and relative to inflation) for at least many more months even if it

raises that rate some. Suppose there is decent but not remarkable US GDP growth. Keep in mind the weakness in Eurozone output (and slowdowns elsewhere).Suppose US inflation rates are around 1.50pc (or even somewhat higher). Based on the history of the 10 year less two year spread since end 2008, it probably will be difficult for the 10 year less two year UST spread to fall much under its (positive slope) support around 120 basis points.

Or, assume instead that the "Sketching a Scene" viewpoint or something like it prevails for the US and (worldwide) economy. Then the Federal Funds level (and the two year note) are even more unlikely to rise significantly. The Fed probably would continue to support its yield repression scheme more fervently and for a longer time span. Then the 10 year less two year spread will not easily move beneath the 120 point support level.

****

Though the positive slope and its range for the 10 year less two year spread during the Fed's yield repression era (from December 2008 to the present) of about 120 to 290 basis points probably will continue for roughly the next year (or even longer), that situation is not necessarily eternal. The yield spread could sustain a fall under 120 basis points. Moreover, yield curves (or sections of them) are not inevitably positively sloped. If the 10 year UST yield falls under than two year UST rate, that would create a negative yield curve.

So let's examine a potential even if more distant future. Suppose that after various trials and tribulations, and after an extended passage of time relative to the present day, the Federal Reserve Board and US politicians (with the help of crucial foreign central banks and political domains), managed to generate an apparently or genuinely enduring American GDP recovery.

Recall that in the Goldilocks Era with its booming GDP, the 10 year less two year UST spread narrowed to a negative 19 basis points on 11/27/06. The S+P 500's eventual pinnacle occurred about a year later, on 10/11/07 at 1576. In first half 2000, relatively near to the end of a business expansion period, the US yield curve also became negatively sloped. The 10 less two year spread reached a bottom of negative 51 basis points on 4/7/00 (S+P 500 high 3/24/00 at 1553).

****

As a footnote, recall also the negative slope of 32 basis points in March 1989 (Fed H.15, monthly average); the two year UST yielded 9.68 percent, the 10 year 9.36pc. In the ancient era of the early 1980s when the Federal Reserve ferociously battled inflation, the yield curve became very negative for quite some time. For example, the two year UST note yield in March 1980 was 14.88pc, the 10 year's 12.75pc, a 213 basis point difference. In September 1981, the two year UST yield averaged 16.46pc, the 10 year UST's 15.32pc, a negative 114 point differential.

****

This essay is furnished on an "as is" basis. Leo Haviland does not warrant the accuracy or correctness of this essay or the information contained therein. Leo Haviland makes no warranty, express or implied, as to the use of any information contained in this essay in connection with the trading of equities, interest rates, currencies, or commodities, or for any other use. Leo Haviland makes no express or implied warranties and expressly disclaims all warranties of merchantability or fitness for a particular purpose. In no event shall Leo Haviland be liable for any direct, indirect, special, incidental, or consequential damages (including but not limited to trading losses or lost profits) arising out of or related to the accuracy or correctness of this essay or the information contained therein, whether based on contract, warranty, tort, or any other legal theory.

All content copyright © 2014 Leo Haviland. All Rights Reserved.