<u>TWO-STEPPING: US GOVERNMENT SECURITIES</u>
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In the film noir “Double Indemnity” (Billy Wilder, director), Walter Neff describes the murder tale as “Kind of a crazy story with a crazy twist to it.”

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<u>OVERVIEW AND CONCLUSION</u>

Over the last seven years, through the last stage of the bloody worldwide economic crisis and the ensuing often fitful recovery, through dramatic and sometimes violent swings in assorted financial playgrounds, America’s heroic Federal Reserve ferociously has pinned the Federal Funds rate to the ground.

Many marketplace clairvoyants believe this widely-beloved guardian relatively soon will cautiously begin prodding the Funds rate higher. The next Fed gatherings are 12/15-16/15, 1/26-27/16, and 3/15-16/16. Maybe the courageous Fed will lift the rate up 25 basis points in its December 2015 meeting! In any case, as the widely-watched United States government two year note resides near the Fed Funds rate from the yield curve perspective, the two year US Treasury level and trend in part reflect marketplace opinions regarding Fed policy shifts and inflation.

In any case, the recent elevations in the two year US Treasury note a few basis points over .90 percent probably will not be broken by much in the near future. There indeed are some signs that United States inflation has edged toward the Fed’s two percent target. The Fed also proclaims its desire to normalize its highly accommodative policy. Yet the Fed embraces a gradual approach and does not want to make any missteps. Also, the international economy (look at the Eurozone and China) has slowed. So the Fed probably will patiently assess the consequences of its rate move for the United States (and global) economy and marketplaces (such as the S+P 500 and the US dollar).

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Yield levels and relationships obviously can fluctuate for all sorts of reasons. However, the falling rate trend for the US 10 year government note since early 2014 contrasts with the rising one for the UST two year note. The drop in 10 year UST yields, as it is occurring in the face of some US inflation and rising two year rates and artful Fed pillow talk about normalizing policy, arguably reflects economic weakness (mediocre GDP growth) in the US or elsewhere. In today’s interconnected world, feebleness elsewhere influences the American scene.

Note a related warning signal of actual or impending US economic weakness consistent with the fall in 10 year UST yields. Since the advent of money printing in the US in late 2008/early 2009, narrowing of the 10 year less two year spread roughly has coincided with the ending of that quantitative easing. This spread tightening (becoming less positive) in turn has reflected slower economic growth (or worries regarding potential weakness or recession). The agile Fed announced the actual first round of “tapering” (gradual ending of its latest QE venture) on 12/13/13, after several reductions in the QE program, tapering finished at end October 2014. The Treasury spread currently is close to its July 2012 depth.

Is a hunt for yield, fearful flight to quality, or need to own high-grade collateral more focused on the long end of the US government yield curve than the short end? Perhaps, but not necessarily. As the ECB extends its money printing program, is a shortage of long dated Eurozone government debt not only pushing yields there lower, but also thereby reducing yields for the UST long term instruments such as the 10 year? Perhaps. But economic weakness remains the most convincing reason for the sustained decline in UST 10 year yields since early 2014.

Consistent with the fall in the US 10 year yield and the narrowing of the 10 year versus two year yield spread, additional flags indicating weakness for the worldwide economy beckon. Although the S+P 500 remains high, emerging marketplace stocks in general and commodities continue to join hands in long-running substantial bear trends. The durable bull trend in the broad real trade-weighted dollar generally has danced in tune with the bear ones in emerging marketplace stocks and commodities.

US TREASURY TWO YEAR NOTE: SUPPORT AND RESISTANCE

The Federal Funds rate stumbled downhill during the global financial crisis, staggering under one percent to reach a paltry .09 percent as December 2008 departed. Though the Funds rate edged up to .25pc in mid-June 2009, it nevertheless thereafter has remained close to the floor and less than .25pc. The long-lasting low level, despite several rounds of gigantic money printing (quantitative easing), in large part reflects the Fed's determined yield repression policy. The Funds rate has lurked under .15pc since late August 2015.

This extremely narrow band for the Fed Funds rate has encouraged a constricted range for US government two year note travels. What are noteworthy support and resistance points for the two year UST?

The two year UST's current level around .90 percent hovers near the important 2011 tops around .90 percent; remember 2/5/11's .88pc and 4/1/11's .89pc. Resistance above this looms at 1.20pc; recall highs on 12/31/09 at 1.21pc and 4/5/10 at 1.18pc. The next roadblock is at 1.40/1.50pc (10 times the .14pc major bottom on 9/20/11 is 1.40; top 1.43pc at 6/8/09).

The "projected appropriate policy path" for the Federal Funds rate ("Economic projections", including Figure 2's dot distribution; 9/17/15) has a range of 1.1 to 2.1 percent for end calendar year 2016 and 2.1 to 3.4pc at end calendar 2017. The longer run range is 3.3-3.8pc. Given the Fed's determination to avoid "too low" inflation and attain and sustain its two percent inflation target, eventually the two year note yield may climb higher.

The next barriers for the two year UST are at 2.00 percent and 2.50/2.65pc (half the June 2006 major peak is 2.64pc). And underscore that the Fed's longer run range for the Fed Funds level clearly exceeds three percent.

Key support for the two year exists at .50/.60 percent. For example, see 9/6/13's high at .53pc, remember 12/17/08's important low at .60pc. Beneath that is major support at about .15/.30pc. Recall not only September 2011's major trough at 14pc. A second bottom in the two year UST occurred with 7/23/12's key trough at .19pc. Significantly, the two year attained this depth alongside the 10 year UST's major bottom on 7/25/12 at 1.38pc. The final low in the two year UST was at .19pc on 5/3/13 (thus close in time to another near key 10 year UST bottom, 5/1/13's 1.61pc).

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Does the UST two year have other noteworthy support and resistance yield levels to keep in mind, even if they currently appear very unlikely?

Maybe “too high” inflation, especially relative to current Fed signpost targets, will not appear anytime soon, until some now-distant long run arrives. US federal budget deficits have narrowed but not evaporated. Despite its smooth-talking politicians, will the US ever confront a debt crisis due to its major long-run federal budget problem? Thus players should not completely forget other historic much higher major pinnacles for the two year such as the twins during the wonderful Goldilocks Era (6/28/06’s 5.28pc, final high 6/13/07 at 5.13pc).

The Fed indeed is concerned about persistent insufficient inflation, but apparently less so recently. It no longer actively engages in frantic quantitative easing. In addition, it more strongly has hinted of its desire to normalize its policy. In general, American economic and political leaders, unlike those in the Eurozone and Japan, worry relatively little about deflation. The US currently enjoys a recovery, though it is not terribly strong. Thus negative interest yields for the two year US government note are not probable.

However, suppose the worldwide economy, including that of America, weakens substantially. How many people at the height of the Goldilocks Era believed a collapse in the Fed Funds rate and the two year UST yield to near zero was even somewhat likely? And how many players several years ago forecast negative yields for many key European government note instruments? The two year German government note currently yields about a negative .45pc.

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Two year UST yields often march alongside those quite a bit further down the Treasury yield curve. So players should monitor and identify important ceilings and floors for yardsticks such as the US Treasury 10 year note.

Major resistance for the 10 year UST looms around 3.05 percent (1/2/14 high). Above that stands 2/9/11’s 3.77pc plateau and several earlier summits around four percent. However, the late spring interim elevation on 6/11/15 at 2.50pc (roughly a 50pc leap in the yield level from 1/30/15’s 1.64pc take-off point) remains a noteworthy initial barrier. Important UST 10 year support exists around 2.04pc (12/18/08 major low) to 1.90pc. The 1.90pc lows occurred relatively recently, on 8/24/15 and 10/2/15; these 2015 UST yield depths happened around the times of notable S+P 500’s troughs, 8/24/15’s 1867 and 9/29/15’s 1872. Major support for the 10 year exists at 7/25/12’s 1.38pc major bottom.

US INFLATION

Stevie Ray Vaughan and Double Trouble sing in “Crossfire”:
“Money’s tight nothing free
Won’t somebody come and rescue me”.

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Given the long-running highly accommodative monetary policy of the Federal Reserve and its central banking allies, money in America for most financial pilgrims has been loose rather than tight. But maybe, partly due to Fed action, the easy money landscape may become a little tighter, particularly for less creditworthy borrowers. In any case, debtors generally applaud inflation. Nominal interest rate yields below inflation rates tend to cheat creditors and savers. Some judges may question whether popular schemes such as the Fed watchdog’s sustained yield repression and gigantic money printing ultimately are cost-free for the overall economy or only temporary fixes.

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The International Monetary Fund's October 2015 "World Economic Outlook" (Statistical Table A5) indicates consumer prices in advanced economies hop up merely .3 percent (less than one percent) in 2015, with 2016's advance only 1.2pc. America's CPI feebly creeps up .1pc in 2015, escalating 1.1pc in 2016. The Fed's "Economic projections" (9/17/15; next release in the December 2015 meeting) indicate that the central tendency (midpoint of range) for personal consumption expenditures ("PCE") inflation will be .40pc in calendar 2015, with 2016 at about 1.65pc and 2017 at 1.90pc. The so-called core PCE is about 1.35pc in 2015 (higher than PCE). The Fed predicts core PCE in 2016 and 2017 will be the same as that in the PCE.

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US consumer price, wage, and asset price data suggest the probability, though not a certainty, of a slight rise in the Fed Funds rate in the near future. This assumes headline American unemployment remains around Fed objectives (4.9-5.2pc is the longer run central tendency), economic weakness (slowdowns) overseas does not accelerate, and the S+P 500 does not decline substantially.

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The latest US consumer price index report (Bureau of Labor Statistics, 11/17/15), revealed that the CPI-U (all urban consumers, all items) ascended .2 percent month-on-month in October 2015 (seasonally adjusted). Annualizing this would make inflation around 2.4pc. However, October 2015's level over the last 12 months walked upwards only .2pc (before seasonal adjustment); thus prices year-on year essentially were flat. Since January 2015, this 12 month rate of change has meandered back and forth between -.2pc (falling prices) and .2pc.

Focus on a few CPI-U details The CPI-U index of all items less food and energy (which represented about 78.2 percent of the total index as of September 2015) climbed 1.9 percent in October 2015 year-on-year. In contrast, the energy sector (7.6pc of the index of all items) retreated 17.1pc in October 2015 versus the prior year period. Shelter is 33.1 percent of the CPI-U (all items). It rose 3.2pc year-on-year in October 2015 (Table 1).

The US Employment Cost Index (BLS, 10/30/15) rose .6pc (compensation; seasonally adjusted) for civilian workers for the three month period ending September 2015, and 2.0pc for the 12 month period ending September 2015. Perhaps the slow crawl upward in the two year UST note yield from its major low, especially over the past several months, reflects this.

So looking at the CPI-U without food and energy alongside this ECI wage variable, US inflation "in general" is showing some signs of nearing the Fed's two percent target.

Suppose the CPI-U index of all items except food and energy continues to rise close to two percent over the next several months. Suppose energy prices such as petroleum and natural gas at some point significantly reverse their current bear trends. Then the overall (all items) CPI-U may stride higher more substantially than many expect.

What about inflation trends in the key US housing and stock marketplace realms? The S&P/Case Shiller National Home Price Index, after adjusting for the CPI core rate of inflation, rose three percent from September 2014 to September 2015 (11/24/15). Also, although the S+P 500 remains slightly under 5/20/15's 2135 pinnacle, it also is more than triple its major bottom of 3/6/09 at 667.

THE US GOVERNMENT YIELD CURVE: 10 YEAR LESS TWO YEAR SPREAD

The Texas two-step is a country/western partner dance, consisting of a “leader” and a “follower”. The leader determines the movements and patterns of the pair as they move around the dance floor.

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Leadership and following concepts obviously extend outside the dance floor. Nowadays, Wall Street, Main Street, and politicians eagerly follow the Fed, reacting to that guardian’s nimble rhetoric and actions. Does one marketplace lead (or lag) another one, and why, when, and to what extent? Marketplace notions of leading and following can intertwine with opinions regarding convergence and divergence. Or, is a given marketplace “moving off on its own” and “jumping around every which way (“all over the place”)”, with no apparent (or strong) ties to potential marketplace partners?

Is the broad real trade-weighted US dollar leading the S+P 500 nowadays? Are US government yield patterns diverging from those of Germany? German two year government rates have gone negative, whereas US ones are positive and have been ascending for many months. Does the two year UST dance alongside the 10 year UST and how? To what extent does the two year UST lead (or lag) or converge with (diverge from) the 10 year UST?

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In marketplaces, observers often say “the facts” (statistics, data, evidence, information, factors) lead to conclusions. Yet in creating their probability assessments, marketplace watchers (including central bankers and virtuoso traders) do not necessarily share the same perspectives, arguments, or conclusions. In developing their analyses and expressing their opinions, they debate which variables to choose (what the relevant facts are), how to link such information into meaningful relationships, and what inferences and outcomes likely follow from this process.

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The Fed underlines its attachment to its legislative mandate, which it occasionally characterizes as “dual”. “Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability.” (10/28/15 Press Release). Former Chairman Ben Bernanke speaks of Fed’s “ability to pursue its dual mandate of maximum employment and price stability” (Cato Institute Monetary Conference, 11/14/07).

Actually, the Fed almost never mentions that the Federal Reserve Act goals are a trinity. They include “moderate long-term interest rates” (Section 2A). They sidestep that issue, perhaps believing such long term interest rates eventually will result from its ardent pursuit of maximum employment and stable prices. In any case, the statute does not include a goal of “moderate short-term interest rates”. Thus as part of its interpretation of its mandate, the Fed deftly has long engaged in yield repression across the US government yield curve. This policy to some extent thereby reduces corporate and other debt instrument yields.

Fed power, due to its substantial control over the Fed Funds rate, arguably is greater on the shorter end of the yield curve (picture US Treasury bills or the two year UST note) than the longer horizon (for example, the UST 10 year note). Nevertheless, yield curve continuity (sharing a rate structure) means that short term US government rates are attached to and thus dance with (to some extent and in various fashions) long term UST ones. US corporate and municipal yield levels and trends do not necessarily or always maneuver the same as comparable US government ones; however, in general, they are not divorced from the UST playing field.

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Fed monetary policy tightening (or growing marketplace faith that such will occur) of course tends to elevate US Treasury yields in general, but fearful flights to quality tends to reduce them. Yet the supply/demand situation for the two year UST and 10 year UST are not always the same. American interest rate levels and trends interrelate with key overseas central banking policies and interest rate elevations and patterns. Marketplace history does not necessarily repeat itself.

In any case, let's summarize a few aspects of the price history for the past several years of the two year and 10 year UST notes and their spread relationship.

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From end 2008 to roughly late 2013/early 2014, the two year and 10 year UST yields generally walked in the same direction around the same time. But divergence between the two year and 10 year UST notes has emerged since first quarter 2014. On balance, the 10 year Treasury yield has travelled on a southern route since then, while two year UST rates have ambled north.

Recall the 10 year's 1/2/14 key high at 3.05 percent. Its yield thereafter generally swung lower, with a later lower top at 6/11/15's 2.50pc. June 2015's plateau has not been surpassed since.

In contrast, the two year note despite numerous twists and turns, has promenaded higher from its 5/13/13 bottom. It made a very minor top at .43pc on 1/9/14 (around the time of the important high in the 10 year UST). It advanced from its 2/19/14 interim low at .29pc to reach an interim high at .59pc on 9/18/14. The two year briefly broke under its February 2014 low, touching .24pc on 10/15/14. Yet by 6/11/15, it had climbed to .75pc. Despite a small dip to .54pc (8/24/15 and 10/2/15; compare the timing of S+P 500 lows), the two year UST reached around .95pc in late November 2015.

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During the Federal Reserve's glorious money printing campaigns, the 10 year less two year UST spread tended to widen around when the Fed introduced QE and narrow when it removed QE. Widening of this government spread tended to indicate emerging or increasing US (or global) economic growth (or hopes for it), narrowing of the spread slowing American (or international) economic expansion (or fears of it).

**Fed announced QE1 November 2008/March 2009. Spread leaped from 125 basis points (10 year UST over the two year; settlement basis) on 12/26/08 to 291bp 2/22/10. QE ceased March 2010. The S+P 500 made an interim top on 4/26/10.

**Fed unveiled QE2 at end August/November 2010. Spread low 196 basis points on 8/26/10, expanded to 289bp on 2/4/11. QE2 ended June 2011; drop off in spread from 7/1/11's 271bp. The S+P 500 established an interim high 5/2/11 at 1371.

**Spread low 117bp on 7/24/12 (compare the 117bp 6/12/08 and 125bp 12/26/08 lows in the midst of the 2007-09 worldwide economic disaster). The Fed declared QE3 on 9/13/12, offering additional policy guidance (and money printing round four) on 12/12/12. Note the European Central Bank's "whatever it takes" speech 7/26/12 speech and its outright monetary transactions policy (OMT) of 8/2/12.

The 10 less two year UST spread peaked on 12/31/13 at 265 basis points, close in time to the UST 10 year pinnacle. The Fed heralded the actual first round of "tapering" (gradual ending of

QE) on 12/13/13. Several additional steps followed, with tapering finishing at end October 2014. Note the lower high in the spread at 206bp on 9/16/14. The spread has stayed beneath 200bp since late September 2014. The spread tripped down to 119bp on 1/30/15 (close to 7/24/12's crucial low). Though it bounded up to 176bp (6/10/15; close in time to the 10 year's 2.50pc minor top and not long after the S+P 500's 5/20/15 pinnacle at 2135)/178bp (7/13/15; S+P 500 high 2133 on 7/20/15), by late November 2015 it had staggered down to around 130bp, neighboring the July 2012/January 2015 bottoms.

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The Fed obviously does not stand alone. Although the Fed has laid aside its money printing baton, the European Central Bank thereafter eagerly has embraced money printing. Suppose the European Central Bank expands its current QE program or otherwise eases aggressively (perhaps eventually accompanied by even greater QE from the Bank of Japan). What if such measures do not propel the 10 year less two year UST spread significantly wider? This likely would indicate economic weakness in the US and elsewhere. And what if the 10 year less two year UST spread instead slid decisively beneath its July 2012/January 2015 troughs? Especially if a renewed slump in the S+P 500 accompanied that spread's narrowing, this probably would underscore the existence of such economic weakness.

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In principle and practice, flights to quality (or hunts for yields) can take place in various ways along a given government yield curve. For example, buying in a search for a safe haven may concentrate on the short end of the yield curve; such purchasing in the near term part of the curve perhaps in some circumstances might even occur alongside nervous liquidation at the long end. As the Goldilocks Era ended and the worldwide economic crisis emerged and accelerated, the 10 year less two year UST spread raced up and down violently.

Back in 2008, as the international financial crisis worsened, a continued sharp rally in the broad real trade-weighted dollar alongside growing economic weakness eventually helped to collapse the 10 year less two year UST relationship from 11/13/08's 262 basis point summit to 125bp on 12/26/08. The TWD established its major bottom at 84.2 in April 2008 (Fed, H.10; monthly average). Although the S+P 500's pinnacle occurred 10/11/07 at 1576, that benchmark attained its final high at 1440 on 5/19/08, around the time of the TWD's April 2008 low. The TWD trotted up to 88.8 in September 2008. The TWD spiked to October 2008's 93.9, peaking a bit above that with March 2009's 96.9 (recall the timing of the S+P 500's major low, 3/6/09 at 667).

The broad real trade-weighted dollar attained a new high in its bull move (since July 2011's 80.5) with November 2015's 98.0. The TWD previously had surpassed March 2009's summit with August 2015's 97.4.

Although broad real TWD information is available only as a monthly average, the Fed provides daily data on the nominal TWD. The nominal TWD's 5/15/15 interim low around 112.8 occurred shortly before the S+P 500's 5/20/15 peak at 2135. As the US dollar thereafter marched upward, the S+P 500 eventually toppled, falling 12.6 percent to its 8/24/15 low at 1867.

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