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## Treasury Yields Breakout to the Upside

Intermediate and long-term Treasury yields recently broke out of their relatively tight 4.5 month trading ranges. Since November 2011, the 10-year Treasury yield traded between about 1.8% and 2.1% before breaking out to a near-term high of 2.38% on 3/19/12. Over the same time period, the 30-year Treasury traded between about 2.8% and 3.2% before hitting a near-term high of 3.48% on 3/19/12. The catalysts for the back-up in rates have been stronger US economic data and lowered concerns about a Lehman-like event in Europe.

We sold our portfolios' entire position in long Treasuries on 2/22/12, after the 30-year Treasury yield closed above its 4.5 month trading range. We had been holding a position in long Treasuries as insurance against the tail risk<sup>1</sup> of a financial collapse in the European banking system. Longer-term Treasuries had proven to be a reliable hedge for riskier assets during the frequent "risk-off" periods over the past few years. However, the cost of this hedge became increasingly expensive as Treasury yields fell to all-time lows. Below we lay out the increasingly negative environment for longer-term Treasury yields.

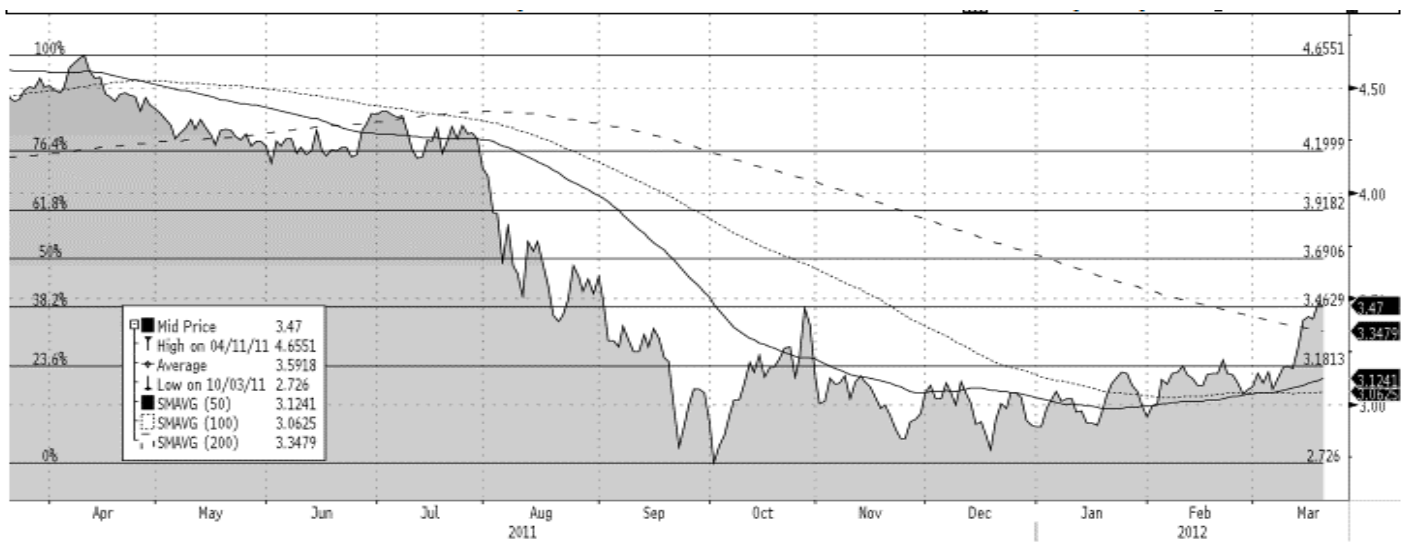
### Negative for Longer-term Treasury Yields

- The turmoil in Europe has settled down (for the time being).** We believe that the near-term risk of a Lehman-like event and financial meltdown in Europe has been sharply reduced by the more forceful response from new European Central Bank (ECB) President Mario Draghi. In late December, the ECB implemented its first long-term refinancing operation (LTRO), offering unlimited 1%, three-year loans to European banks, secured by a broad range of collateral (including troubled European sovereign debt). Banks borrowed almost €490 billion during the first round of LTRO. During the second LTRO on 2/29/12, 800 banks participated and borrowed €530 billion. We believe that the LTROs have significantly improved liquidity and lowered funding risk in the European banking system (thus improving solvency), and have markedly lowered the risk of a near-term banking crisis. The resolution of the Greek debt exchange in a relatively orderly fashion has also been a minor positive for the markets.
- All major central banks are pursuing some form of monetary accommodation.** In addition to the Fed, the European Central Bank (ECB), the Bank of England (BOE), and the Bank of Japan (BOJ) are all pursuing some form of quantitative easing. In addition, China continues to ease the reserve requirements for its banks. The massive amounts of global liquidity being created could eventually heighten inflationary pressures.
- Operation twist winds down in June.** The Fed began to implement Operation Twist in October 2011 in an effort to lower long-term interest rates. The program, in which the Fed will ultimately sell \$400 billion of its shorter-term holdings and buy a like amount of longer-term Treasuries, is scheduled to end in June 2012. The 30-year Treasury yield is currently around the same level as it was slightly before operation twist was announced in September 2011.
- Technicals for 30-year Treasury yield are deteriorating.** The chart on the next page shows a deteriorating technical picture for the 30-year Treasury yield: (1) the yield hit a near-term peak of 3.48% on 3/22/12, its highest level since early September 2011, (2) the yield has set a series of higher lows, since mid-December 2011, and (3) the yield's 50-day moving average (DMA) began to rise in January and crossed above its 100 DMA in early March 2012.

### Positive for Longer-term Treasury Yields

- **The Fed remains concerned about the US housing market.** Fed Chairman Ben Bernanke has repeatedly expressed concerns about the fragility of the US housing market and is unlikely to tolerate a major increase in the 10-year Treasury yield (which serves as a benchmark for pricing 30-year fixed rate mortgages), in our view.
- **Ned Davis sentiment indices for US Treasury Bond Futures have dropped from extreme optimism.** The Ned Davis Interest Rate Futures Bullish Sentiment Index has fallen from extreme optimism to just above neutral.
- **European problems will remain a concern, and Spanish and Italian bond yields have risen significantly.** Italian 10-year Treasury yields have risen almost 0.30% in the past two weeks to 5.07%. Spanish 10-year yields have backed up about 0.62% since 3/1/12 to 5.45%.

30-Year US Treasury Yield



Source: Bloomberg

### CONCLUSIONS

- We believe that the longer-term trend for yields is higher. However, the Fed is unlikely to tolerate a 10-year Treasury yield above 3% while the US economy and housing market remain fragile. In a scenario in which the 10-year yield backs up to 3%, we could realistically see the 30-year yield back up to 4.25% (where it was as recently as the end of July 2011). This move would effectively wipe out last year's large price gains. In the near term, rates are likely to remain in trading range, but at a higher level than the past 4.5 months.
- We continue to favor credit risk over duration risk as a way to generate income within our portfolios.

1. Tail risk is a form of portfolio risk that arises when an investment's return is likely to have a greater than average deviation from the mean than is shown by a normal distribution.

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