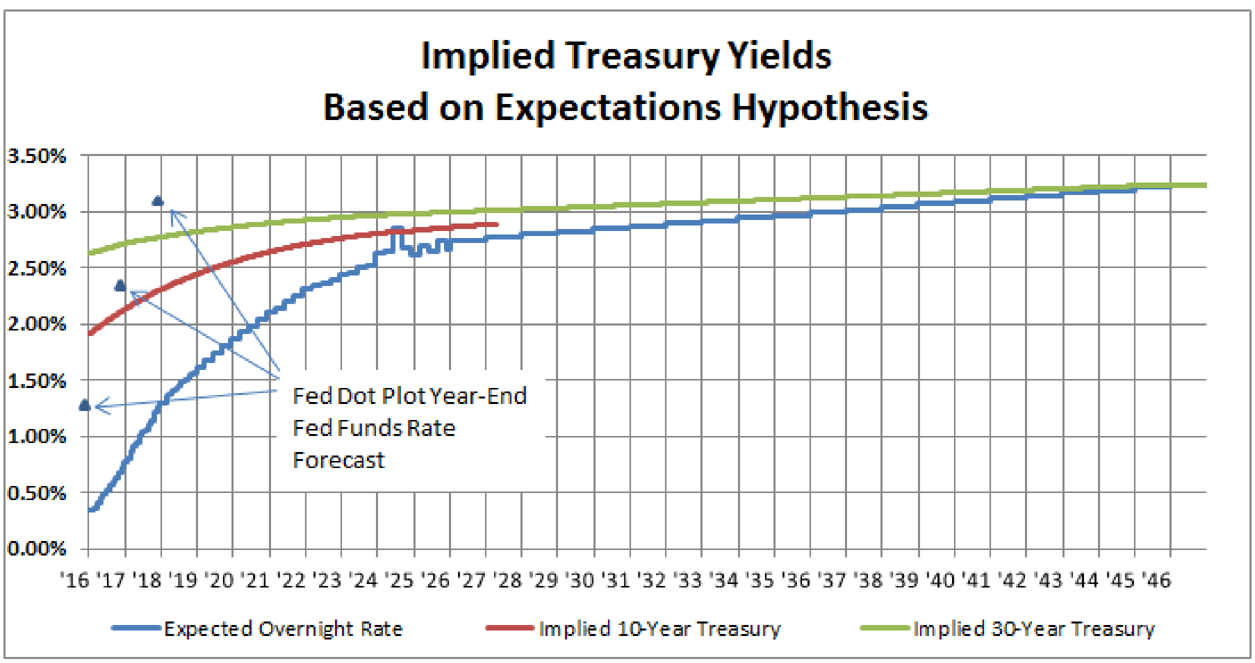
January 8, 2016

Fed's Policy Error = Today's Opportunity

The primary macro themes that Bretton Woods Research is pounding the table about are: 1) the global economy is entering a deflationary recession unless it is preempted by a significantly reflationary dollar and/or growth-supportive fiscal stimulus; and 2) financial conditions will get worse before they get better. The Federal Reserve is wholly out of touch with this reality, and out of step with current market expectations for future monetary policy. This is opening up opportunities *now* to get long Treasuries, and *ultimately* to get long equities.

The expectations hypothesis of the term structure of interest rates posits that long-term rates are determined by current and future expectations of short-term rates. For example, the current 10-year Treasury yield is determined by the current and future expectation of what the average overnight interest rate will be during the next 10 years.

With this concept in mind, a long-time Bretton Woods and Polyconomics client and friend has constructed for us the following chart, which illustrates the market's current expectation of what the overnight rate will be during the next 30 years – based on the fed funds futures market between now and 2018, the Eurodollar market between 2018 and 2026, and the 30-year Treasury yield between 2026 and 2046.



Utilizing the market's expected overnight rate during the next 30 years, one can ascertain the average expected overnight rate for any long-term bond. The chart illustrates that the 10 and 30-year Treasury yields (red and green lines, respectively) should presently trade at 1.95% and 2.6%, IF they were purely impacted by the market's current expectation of overnight rates.

As of Wednesday evening, however, the 10 and 30-year Treasury yields traded at 2.17% and 2.94%, respectively. The 22 and 34 basis point disparities are due to the Fed being wholly out of step with the market's present expectations of the future path for the fed funds rate. The blue triangles on the chart indicate the FOMC's current average expectation for the fed funds rate for year-end 2016, 2017 and 2018. The market must respect the public pronouncements of Fed officials because, after all, the central bank has monopoly power of the overnight rate (fed funds rate), and so the market is granting a higher yield today to the long-end of the Treasury curve.

Looking at the bond market through this lens raises three important investment conclusions:

1) **The Fed's Tightening Campaign Will End:** Fed officials are extremely out of step with market expectations of future monetary policy. And the market will not be proven wrong. The Fed will be required to shift its policy trajectory given: a) the deflation permeating the dollar and dollar-tied universe (e.g. the United States and China), and b) the emerging economic slowdown. More Fed tightening will bring more carnage, which will force the Fed to respond. We expect no other scenario whereby the Fed does not cede to the market -- absent a surprise pro-growth fiscal stimulus package being legislated by Congress during the next six months, which we view as a zero probability.

2) **Treasury Yields Should Decline in Anticipation of Fed Shift:** Amidst the current deflationary slowdown, the 10 and 30-year Treasuries are solid buys today. Consistent with our 2016 Outlook, we expect these yields to fall to less than 2% and 2.65% during the next six months. This steep decline in yields will be propelled by the financial market weakness and risk aversion that we expect. The median Fed forecast is for 4 more rate hikes by year-end. The market is currently pricing in two. As risk aversion rises, market probabilities of rate increases will likely diminish along with the Fed's blueprint for higher rates, helping to pull yields lower.

3) **Equity Rally Once Markets Begin to Sense a Shift Afoot at the Fed:** Consistent with our 2016 Outlook as well, once the Fed's and market's expectations for future monetary policy become more in sync, i.e. signaling a much more dovish Fed, equities will rally. This may begin as the Fed drop hints that a higher a cost of capital is not appropriate amidst the present deflationary slowdown. But this will take some time. More blood will need to pour into the

streets before the Fed actually shifts course, therefore equity speculators should carefully add exposure. We would note that Thursday, the Fed's leading dove Charles Evans (who does not vote until next year) did very little for the dove camp by saying that a 1% funds rate by year-end 2016 would support the Fed's 2% inflation goal.

While these investment implications are more 2016 in nature, another important investment theme is emerging. That is, even if or when relief comes on the funds rate outlook, the Fed is likely to do little to meaningfully stem the current dollar strength, perpetuating today's deflation by failing to match the supply of liquidity relative to demand. The Fed's balance sheet must expand to supply the market with necessary liquidity.

The current deflation will grind away at all asset prices and underwrite an economic slowdown, setting the Treasury market up for a long-term rally beyond 2016. Just as the Japanese and German 10-year government yields trade today at extraordinarily low levels of 0.25% and 0.55% respectively, the US 10-year yield is arguably at the brink of declining to similarly historic low levels as deflationary price pressures and economic malaise sink in, and the Fed turns toward more dovish policy. In 2016 and/or 2017, we believe it is highly likely that the 10-year Treasury yield will touch 1.75%, and if the Fed appropriately acts and reasserts quantitative easing to directly confront deflation, it will reach 1.5%.

Europe 2011 as the Analog

A useful analog to today's situation would be Europe in 2011. Following Jean Claude Trichet's overly aggressive policy at the ECB to raise its benchmark rate on April 7 and again on July 7, Bund yields began todecline and European equities sold off.

The ECB actions at the time were supported by Germany and a majority of the ECB policy committee, who agreed that a preemptive move against inflation was necessary. At the time, Mario Draghi, who was busy trying to convince Berlin hardliners that he was every bit the hawk as his northern European colleagues, even parroted Trichet, characterizing ECB policy as "very accommodative" one week after the first increase. This is exactly how the Yellen Fed speaks of U.S. monetary policy today.

But, of course, the ECB rate increases came at a terrible time.

Europe's growth outlook was deteriorating amidst growing and pervasive sovereign, banking and currency default risks, as well as the anti-growth austerian fiscal policies being foisted during the summer of 2011 on the European periphery and notably implemented in France under Nicolas Sarkozy and in Italy via the engineered exit of Silvio Berlusconi and ascension of tax-hiking technocrat Mario Monti.

The German 10-year Bund yield would "top" the very next day after the first ECB rate increase on April 7. The DAX would trade sideways until July.

Between the last rate hike on July 7 and early September, the DAX lost more than 30% in USD terms. By then, even Trichet had begun to indicate a change of heart on inflation, striking "upside" from his published comments on inflationary risks. On September 22, the 3-month Eurodollar rate, which had been forecasting a declining ECB benchmark rate in tandem with declining equities, had bottomed. By September 27, ECB officials such as Yves Mersch and Erkki Liikanen were dropping hints that the ECB's next move would be to lower rates. Draghi replaced Trichet on November 1.

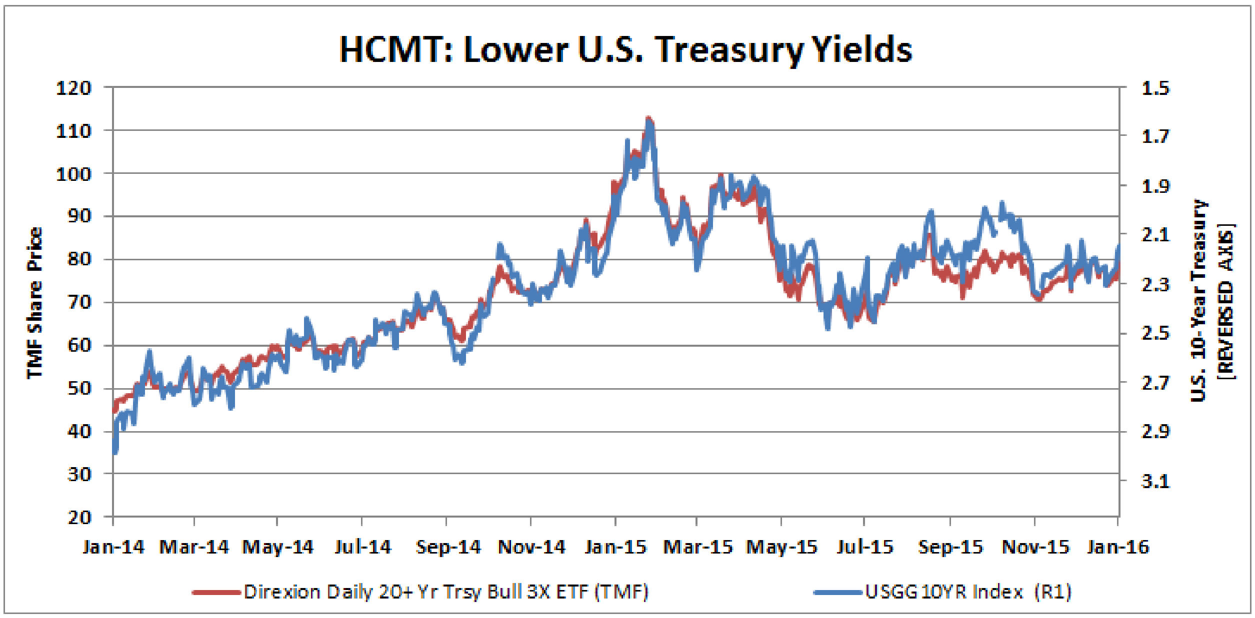
Relief swept in as ECB hawkishness began to get priced out of the marketplace. Between September 22 and November 1, the DAX rallied more than 28%.

In a similar pattern in the United States today, we could see continued equity weakness running in tandem with falling yields, so long as the Fed remains arguably committed to a higher funds rate. But once Fed policymakers begin dropping hints of a shift, we believe we will see a similar rally in equities.

Long Direxion Daily 20+ Yr Treasury Bull 3X ETF (TMF) – As a high conviction macro trade to underscore our belief that long-term U.S. Treasury yields are headed much lower, we recommend going long the exchange-trade fund, Direxion Daily 20+ Yr Trsy Bull 3X (Ticker: TMF), as of Friday's (today's) closing price.

TMF seeks daily investment results that correspond to 300% the daily performance of the NYSE U.S. 20-Year Treasury Index. TMF has a market cap of just $64 million, which is much smaller to similarly poised ETFs, such as iShares 10-20 Year Treasury Bond (ETF Ticker: TLH), with $445 million, or iShares 7-10 Year Treasury Bond (ETF Ticker: IEF) with $8.05 billion. Like those ETFs, TMF is inversely correlated with long-term Treasury yields, meaning when yields fall, TMF appreciates. But due to being triple-levered, TMF promises to deliver more 'bang for the buck.'

During the last twenty-four months TMF has enjoyed a 97.6% inverse correlation (r^2 coefficient of 95.3%) with the 10-Year Treasury yield. Given our belief that the 10-year yield will sink to 1.75%, we believe TMF can appreciate to more than $105/share, or more than 33% from TMF's Thursday close of $78.92/share.



As we were stopped out of all of macro trades for 2015, we start 2016 with a clean slate. We begin the year recommending a long position in TMF, observing a stop/loss threshold of 15% from Thursday's close of $78.92. We are instituting a price target of $101/share for an expected gain of 28%.

Bottom line: We recommend going long the exchange-traded fund, Long Direxion Daily 20+ Yr Treasury Bull 3X (TMF). Our target price is $101/share. Our stop/loss threshold is approximately $67.

Bretton Woods Research