

## DEC 4, 2008: EPIC SHIFTS

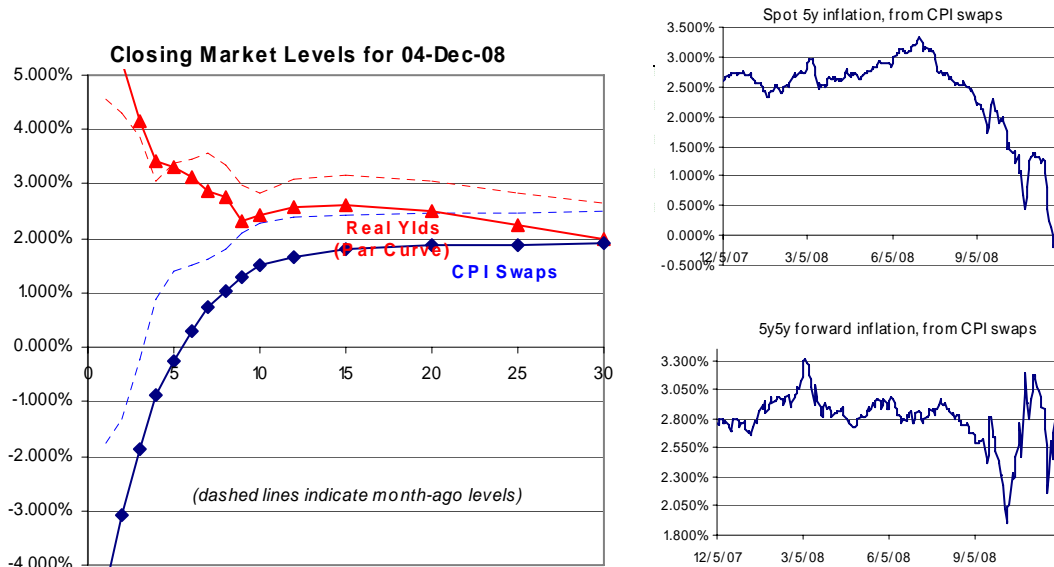
It has taken some time, but the world's monetary authorities and governments seem finally to be pulling on the same rope.

Now, we have to wait and see if it's the right rope.

Chairman Bernanke signaled clearly last week a desire to begin the "quantitative easing" endeavor in earnest, and posthaste. The Fed is (as he said today) able to buy mortgages "in bulk" and to buy long-term Treasuries, essentially monetizing the debt. Today, following 100bps of rate cuts in the U.K., 50bps in Europe, and several other substantial rate reductions worldwide, the ECB also mentioned that it believed it could also purchase assets.

Such a loud declaration of war on lenders in favor of debtors has not been heard this side of Marx. TIPS investors appear to be listening (more on this later).

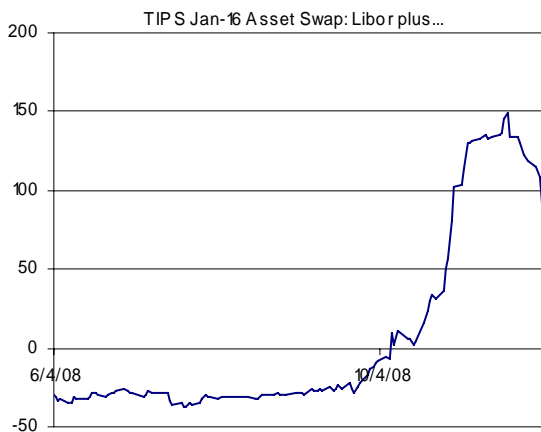
## CLOSING MARKET LEVELS AND TRENDS



Source: Natixis FP

Meanwhile, perhaps because it has more flexibility the Treasury has still not settled on a single approach that makes sense, but at least they're moving generally in the right direction. The recently-floated possibility that Fannie and Freddie could be ordered to lend money at 4.5% to new mortgagees is a bad idea, though, on many levels. For one thing, whether the mortgage is at 4.5% or 5.5% is immaterial if the property value is falling at 20% per year, or even 5% per year. For another, it does nothing to help current mortgagees – although presumably a cottage industry will quickly spring up where lenders will buy a house and immediately re-sell it to the same homeowner, making it a "new mortgage," for a nice fee. But the biggest problem is that the housing problem is not the "root

cause” of the depression as many people seem to think it is, but merely the first symptom of the credit crisis. The Treasury is basically putting a bandage on the first sore that appeared on a patient who has hemorrhagic fever. Still, at least they’re trying, and since the Fed is going to monetize any debt the Treasury issues, there’s no big penalty for trying.

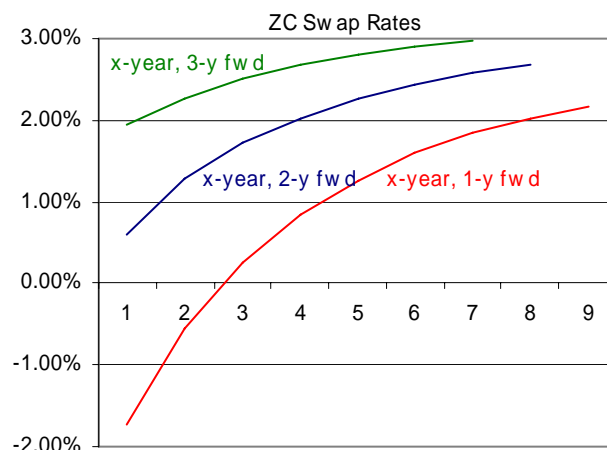


The urgency of the moves by the monetary authority are coming none too soon, and the TIPS market is starting to catch on. TIPS abruptly are becoming richer, dramatically, by the day relative to inflation swaps. Breakevens are heading higher while inflation swaps are going down or remaining unchanged; the result is that the cash TIPS are now asset swapping at dramatically closer-to-normal levels now than they were just a week ago. The chart at left (Source: Natixis) shows the Jan-16 TIPS asset swap since June. For a long time, it traded in the neighborhood of L-30. The Lehman collapse and the subsequent evisceration of market liquidity and nausea over any bond position that might claim “balance sheet” caused cash

TIPS to move, in this bond’s case, to L+150bps at one point last week. As of today, that bond is around L+75. That’s an enormous richening, and while I had no doubt it would happen I am shocked that it is happening so quickly.

Disinflationary and deflationary forces continue to grow, there is no doubt. The Beige Book mentioned pressures in some cases to lower prices, and those pressures will continue to grow. Tomorrow’s big jump in the Unemployment Rate (6.8% is the consensus, from 6.5%, but some dealers are forecasting a one-month jump to 7.0%) will reinforce the notion.

But while long-term breakeven inflation remains incredibly low (10y BEI around 0.30%), the market isn’t exactly forecasting a lengthy deflation. It would be more accurate to say that the inflation market, quite the contrary, is expressing a surprising amount of faith in the ability of monetary authorities around the world not only to arrest the deflationary forces, but also to pull back on the liquidity provision in time to restrain an inflationary outcome. The chart at right (Source: Natixis) illustrates that most of the deflation is actually expected to occur in the next year or two...but the severity of that deflation is so severe that it pulls down the long-term average rates of inflation considerably. This chart shows forward ZC inflation swap curves: 1y, 2y, and 3y forward. The spot curve is on the first page of this



commentary and there is a 6% range between the 1y and 10y inflation swap points. One year forward, the inflation swap curve is still negative at 1y and 2y points. Two years forward, it has a fairly reasonable slope and at 3 years, *the curve is entirely between 2% and 3%*. That is, the forwards are suggesting a severe year or two of deflation followed by a return to the Fed's target range!

That's more confidence, I think, than is warranted. I think the entire curve is too low, from the short points (we are unlikely to have 3% deflation for 2 whole years, since most of the energy unwind is behind us) to the long points (the monetization of the debt is extremely inflationary and I don't have much confidence in the Fed's ability to unwind that with the perfect timing that will be required). Certainly, *the market's confidence that the Fed can restrain the incredible liquidity they have unleashed is at odds with the extremely low level of nominal rates, which surely will have to rise dizzyingly at some point if inflation is to stabilize at 2-3%*.

But this is the nature of markets: they overshoot.

Recently it has become *de rigueur* to compare the "commodity bubble" to the tech bubble of a few years back. But, other than the fact that both went up and both went down, there is almost no comparison between them. Arguably, there wasn't even much of a bubble in commodities.

What happened to the commodity complex on the run-up and the subsequent collapse was a function (as I pointed out on the way up) of a rapidly-moving demand curve operating on a vertical or nearly-vertical short-term supply curve. Rapid world growth, especially in emerging economies, moved commodity prices steadily higher until that vertical point was reached: when producers were producing as much tin, corn, oil, and so on as they could without digging new mines, planting new acreage, or finding new oil, the price being determined at the margin meant that the now-scarce resources were being auctioned off to the highest bidders and to the highest-valued uses rather than the resource being available to all uses.

When growth began to move the other way, all of a sudden there was plenty to go around, and prices fell back.

The tech bubble was completely different. In tech, the bursting wasn't caused by a decline in demand – on the contrary, demand for technology continued (and continues) to grow. But the *multiples* put on the companies involved in the tech space were just not sustainable. As it happens, that was also true for the broader market, which is why the entire market, and not just tech stocks, declined.

Commodities will go back up again, and in fact they may go up relatively soon if the Fed and the Treasury succeed in monetizing the debt and sinking the dollar.

This isn't saying necessarily that commodities are the best investments at the moment. Very little of the long-run return of a commodity index comes from the price change of the commodity, actually, and much more from the T-bill return that collateralizes the futures, the rebalancing return, risk premium, convenience yield, and expectational variance. Many of those components continue to argue for an investment in a commodity index, if not commodities.

However, over the last decade or so it has paid to be in cash given the high valuations (and therefore low expected returns given the risk) in many asset classes. Given the global lurch towards quantitative easing, I think that in a couple of years or less it will pay to be in almost any asset class

except cash as valuation levels become more reasonable and inflation causes the real return of cash and cash equivalents to become very unfriendly.

These are epic shifts, and they do not happen overnight (except perhaps in the case of TIPS asset swaps!). But I think they are going to happen.

**QUESTION OF THE DAY:** In the 'Lisa the Vegetarian' episode of *The Simpsons*, Lisa becomes a vegetarian. What guest star in that show made as a condition of his guest-starring that Lisa remain a vegetarian for the rest of the series?

**ANSWER TO PREVIOUS QUESTION:** The question was, "What war-related word was spawned by the attacks of Spanish insurgents on Napoleonic French soldiers in 1807?" The word, which means literally "little war," is "guerrilla."

### **DISCLOSURE**

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