



A Canary in the Mine?

In the old days, miners would take a canary with them into the mines as a way of detecting harmful gas fumes. A singing canary would signal that there are no harmful fumes while a dead canary would mean that there are fumes in the mines (I imagine this will not sit well with the animal activists today). This relates to recent statements from former US Federal Reserve chairman Alan Greenspan who described the movement in US Treasury yields as a 'canary in the mine' since it can signal that US interest rates are going to rise, which would have an impact on the struggling housing market and the economy as a whole. Are these recent moves in Treasury yields really an indicator of things to come or are there other factors in the mix? A closer look at some of the US economic data and the recent trends in Treasury auctions may reveal that this is not really due to an economic recovery at all but really a result of demand and supply.

The US issued a significant amount of Treasury notes over the past two years. In 2010 alone, 10-year note auctions averaged US\$22 billion per month while last year the average was US\$20 billion per month and there have been auctions every month since January 2009. The total issuance of 10-year notes since January 2009 to current has been US\$330 billion. To put this in perspective this is roughly equivalent to the total amount of 10-year notes issued between August 2005 and December 2008. With this amount of US notes in the market required to fund a ballooning deficit, it is no surprise that the yield on the 10-year notes have increased by over 100 basis points. Many countries of the world hold US treasuries as a form of reserves, one of the most notable is China. Despite this, it seems as though supply is outweighing demand. This is evident by the record number of issues in addition to a fall in foreign Treasury sales; in 2009 the average monthly purchase of Treasury notes by foreigners fell to US\$966 billion compared to the US\$1200 billion in 2007 and 2008.

So is the canary dead in the mine, are these rising Treasury yields an indication that the Fed will start increasing rates soon? Economic data coming out of the US have been lukewarm at best; the conditions still do not justify rising interest rates. While GDP growth has been on an upward trend in the last two quarters, it is starting from a low point after recording negative growth for five consecutive quarters. US unemployment is at 9.7% and until this starts to fall there will not be a significant increase in consumer demand which largely fuels the US economy. Prices are still low with the inflation rate at 2.3% (year on year) and core CPI at 1.1%. The housing market has not yet recovered with new and existing home sales down for the year and the change in mortgage applications actually negative for most of 2009 and 2010. If the Fed raises rates too soon, there is a high possibility that the housing market will remain stagnant. Indeed, the last few statements spoke to high unemployment, the depressed housing market and subdued inflation levels. It also noted that these conditions "are likely to warrant exceptionally low levels of the federal funds rate for an extended period". Any changes to this language should be closely monitored and would suggest a change in the stance of the Fed.

Being a firm believer in numbers, one of the key market indicators of interest rate expectations is the Fed Funds Futures. These futures are really contracts for the delivery of interest at a specified rate on a notional amount of five million dollars on a specified date in the future. This allows investors to speculate on what interest rates are going to be in the future and from these transactions the expected probability of rate changes can be determined. The table 1 below shows the probability of rates increasing at each of the Fed meetings for the rest of the year. It shows that the current expectation is for the Fed Funds rate to remain in the 0%-0.25% range until August 2010. From September to November the probability of the rate rising to 0.50% and 0.75% increases. The market clearly does not expect the Fed Funds rate to reach 1% in 2010. This expectation is consistent with the current economic situation discussed earlier, however it is important to note that this is based on data as at 13 April and can change if the US shows signs of a faster than expected recovery.

Table 1

Fed Funds Rate Probabilities as at 13-Apr-10				
Meeting Date	0% - 0.25%	0.50%	0.75%	1.00%
28-Apr-10	100%	0%	0%	0%
23-Jun-10	88%	6.6%	4.5%	1.1%
10-Aug-10	87%	10.4%	3.1%	0%
21-Sep-10	71.8%	24.0%	2.5%	1.7%
3-Nov-10	42%	33.9%	24.3%	0.0%

Source: Bloomberg

Impact on Emerging Markets

At the peak of the crisis (following the crash of Lehman Brothers), prices of emerging market (EM) securities suffered along with most other financial assets as a result of the dramatic flight to quality. This caused an increase in demand for US Treasury notes, which in turn caused prices to rise and yields to fall. This resulted in a widening of credit spreads (or risk premium) for EM securities. This can be gauged by the JP Morgan Emerging Markets Bond Index (EMBI) which measures the average spread of EM bond yields over US treasuries of equivalent tenor. The EMBI spread was as low as 149 basis points in June 2006 and peaked at 862 basis points in October 2008, an increase of over 700 basis points in two years, levels not seen since the US recession of the early 2000's. In spite of this, EM's still performed better than other asset classes in 2008, returning -11% while the S&P returned -37%, and in 2009 EM returns were 28% while the S&P returned 26%, clearly showing that EM's outperformed the S&P. Currently spreads have tightened to 230 basis points as EM countries have showed remarkable economic resilience over the past two years as well as promising fundamentals.

As US interest rates rise it is a common mistake to think that any EM bonds that are issued in US dollars will start to fall in price as their yields will also rise. This is not entirely true; it is not the only factor that will affect EM yields. The credit spread will also be a major factor. When the US is recovering, demand for goods from these EM countries will increase. This will improve the economic prospects and their credit rating which would lead to lower credit spreads. For example the current US 10-year treasury yield is 3.85% and the credit spread for Brazil is 168 basis points, which means a 10-year Brazil bond should have a rate of 5.53%. However if the 10-year US Treasury yield rises to 4% and due to Brazil's improved economic performance and positive outlook the credit spread drops to 145 basis points, the required rate becomes 5.45%. This is a lower rate (which means a higher price) than before even though the US rates increased.

Another interesting factor will be the shifting of the world's foreign exchange reserves away from US dollar denominated assets. A look at the credit profile of the countries that make up the EMBI+ index shows that most countries have strengthened since the last time the Fed started increasing interest rates back in 2003 and half of them are now investment grade. See table 2 below. The growth expectations for EM countries are much more favorable than that of the developed countries. With the US now emerging from recession and financial troubles surfacing in various parts of Europe, there should be more inflows into EM's. If countries start holding reserves in strong EM countries like Brazil the impact on EM spreads and prices will be very favorable.

Table 2

	Argentina	Brazil	Ecuador	Mexico	Panama	Philippines	Peru	Russia	Venezuela	Colombia	Turkey
2003	SD	B+	CCC+	BBB-	BB	BB	BB-	BB	B-	BB	B+
2010	B-	BBB-	CCC+	BBB	BB+	BB-	BBB-	BBB	BB-	BBB-	BB

Source: Bloomberg

In summary, it seems as though the canary is still singing, at least for now as I do not believe that the recent moves in treasury rates suggest that Fed will start increasing rates in the short term. The amount and pace of the increases will depend on how quickly the economy is recovering. The dynamics in the developed and EM markets are now very different from the last rate increase cycle; do not be surprised if EM bonds surpass their previous highs of 2007.

FINANCIAL & ECONOMIC INDICATORS

As at 15 April 2010

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	93.03	93.38
Euro	1.36	1.34
Jamaica	89.33	89.45
Guyana	204.40	204.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	85.51	85.39
Natural Gas (US\$/mmbtu)	4.16	3.92
Gold (US\$/Troy Ounce)	1,159.25	1,150.55

Eurobond Indices (As at 15-04-10)

JP Morgan EMBI+ (Basis points)	230
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	7.9

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0.25	0.25
Euro Zone	1.00	1.00
Japan	0.10	0.10
Brazil	8.65	8.65
Trinidad	5.00	5.00
Jamaica	10.00	10.00
Barbados	2.50	2.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.15	0.16
US 10-Yr Treasury	3.83	3.89
3-month UK Libor	0.65	0.65
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	9.45	9.25
TT 90-day T-Bill	1.28	1.32
Jamaica 90-day T-Bill	10.18	10.63
Barbados 90-day T-Bill	3.32	3.30

Sources: Bloomberg, J.P. Morgan, CMMB Research Center, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados

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