

OPERATION TWIST IS UNDER WAY

2008.06.13

Operation twist was the verbiage used by the Federal Reserve during the Kennedy years (the good Kennedy, John F.) to describe the policy of the Federal Reserve keeping short-term interest rates high, and long-term rates low. This was done for balance of payment purposes on the short end, and domestic economic purposes on the long end (more on that later).

Now let's turn the clock forward from the 1960's. We believe that this "operation twist" was the beginning of the inverted yield curve, i.e. higher short-term rates than long. Maybe the Fed was the instigator, or maybe private bond market participants were, or perhaps both were in the mix.

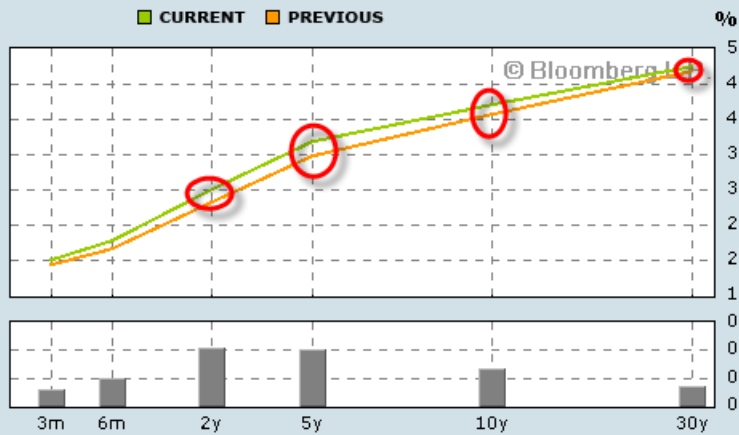
Now what's all this about? Short-term rates protect the dollar and facilitate foreigners buying our treasury debt. That's good—we need them to. However, the most important rate for economic growth purposes is low long-term rates. That facilitates savings and investment.

Why bring this up? We believe that the bond market is now undergoing an "operation twist", whereby—before this move is over—long-term rates will be lower than short. In other words, an inverted yield curve is on the way. That will occur when the consensus figures out that inflation is a non-starter and the economy is in recession: once again, a grand opportunity to buy long-term government bonds is upon us. My, my, the chances we have had!

Please note the chart below. For three days last week, the two-year government bond has advanced in yield far more than the 30-year. This chart notes one of those days. Such a move has occurred since 1975 only 0.5% of the days the market has been open. This is a huge deal! Look for many hedge funds that have bet on an increasingly steep yield curve to blow up.

NOTES/BONDS

| | COUPON | MATURITY DATE | CURRENT PRICE/YIELD | PRICE/YIELD CHANGE | TIME |
|----------------|--------|---------------|---------------------|--------------------|-------|
| 2-YEAR | 2.625 | 05/31/2010 | 99-08½ / 3.01 | -0-12+ / .203 | 15:24 |
| 5-YEAR | 3.500 | 05/31/2013 | 99-06+ / 3.68 | -0-29½ / .205 | 15:24 |
| 10-YEAR | 3.875 | 05/15/2018 | 97-11¼ / 4.20 | -1-01+ / .130 | 15:24 |
| 30-YEAR | 4.375 | 02/15/2038 | 93-28 / 4.76 | -1-00% / .067 | 15:23 |



INFLATION INDEXED TREASURY

| | COUPON | MATURITY DATE | CURRENT PRICE/YIELD | PRICE/YIELD CHANGE | TIME |
|----------------|--------|---------------|---------------------|--------------------|-------|
| 5-YEAR | 0.625 | 04/15/2013 | 97-22 / 1.12 | -0-27 / .181 | 15:23 |
| 10-YEAR | 1.625 | 01/15/2018 | 99-16 / 1.68 | -1-01 / .118 | 15:23 |
| 20-YEAR | 1.750 | 01/15/2028 | 91-17 / 2.29 | -1-05 / .078 | 15:23 |
| 30-YEAR | 3.375 | 04/15/2032 | 120-29 / 2.24 | -1-16 / .073 | 15:23 |

Adapted from FinancialSense.com