Tom Sowanick
Co-President
Chief Investment Officer
tom@omnivestgrp.com
Tel: +1 609 921 7939

Ushering in A Greenspan Redux

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We are quickly approaching the one-year anniversary since the Federal Reserve (under Fed Chairman Ben Bernanke) first lowered interest rates to a range between 0% and 0.25%. Over the course of the year, financial markets have improved markedly. The economy's GDP has sharply rebounded from a very weak first quarter drop of 6.4%. Moreover, the US dollar has also partially reversed its 23.5% appreciation from July 2008 until early March 2009 - a move which was driven by fear.

There is a chorus of market observers who argue that risky assets have moved too far and too fast over a very short period of time. Moreover, the same observers are also making the claim that an excessively loose monetary policy and a weak US dollar are the result of a "carry trade" asset bubble. It is my contention that the so called "carry trade" is not promoting an asset bubble environment with regard to risky assets.

Instead, the asset bubble is more visibly observed in risk-free assets, commonly described as sovereign debt including US treasury debt. We do not dismiss the belief that a "carry trade" of some sort seems omnipresent in large institutional portfolios. It just so happens that Japan, Switzerland, UK, Sweden and the US are now able to promote "carry trades" based on their very low borrowing costs. Hence, it is illogical to blame the US alone for promoting such trades. Doing so may give a false sense of urgency to US policy makers. Forcing an unwinding of the dollar-based "carry trade" could create an artificial short-covering, resulting in a temporary appreciation of the US dollar.

When we take a closer look at the performance of markets globally, we can see that from October of 2008, emerging market equities have returned a very strong 70.8%. While this may look like a bubble, in reality, the 70.8% return is only a partial claw back from the previous 54.5% drop which occurred between October 2007 and October 2008. For the entire period, the MSCI emerging market index is down 22.35%, which is hardly characteristic of a market bubble.

From October 2007 to October 2008, the S&P 500 declined 42.45%. During the following year, it gained back only 21.4%. Over the entire period (October 2007 to October 2009), the S&P 500 lost 30.2% in value - again, no reason to sound the bubble alarm.

However, when we look at the change in risk-free interest rate levels, as measured by the US Treasury term structure, we can see that a formation of an asset bubble may be found in the US Treasury bond market. While most market investors believe that Treasury securities, by virtue of government guarantees, can not lose money, we beg to differ. In the above examples of emerging market equities and the S&P 500, we looked at the most recent period as only a partial reversal of the very negative preceding period.

If we do the same analysis with the US Treasury term structure and calculate the expected returns across the yield curve, we come up with some very startling results. Let's assume that Treasury yields reverse their 2-year slide and move back to the levels that prevailed in early October 2007. We further assume that interest rates reach these target levels over the course of the next 2 years. In that scenario, the total returns for each of the points along the yield curve are disturbingly poor (see table below).

Historical Yield Curve (10/05/07 - 10/29/09)

	10/5/2007	10/29/2009	Change
2 Year	4.074	0.976	-3.0981
5 Year	4.331	2.435	-1.8957
10 Year	4.636	3.497	-1.1383
30 Year	4.865	4.335	-0.5302

	Total Return	
	1-Year (Horizon)	2-Year (Horizon)
2 Year	-2.13	0.912
5 Year	-4.97	-1.25
10 Year	-5.22	-0.77
30 Year	-4.87	-0.125

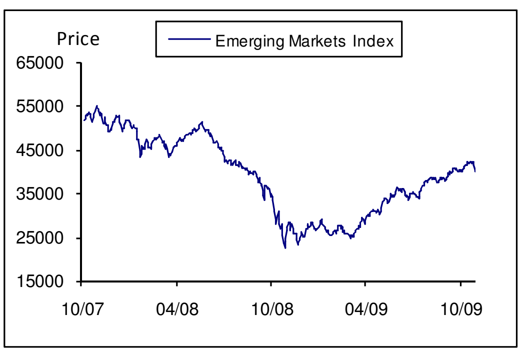
The fact that risk-free interest rates are so low should give little comfort to fixed income investors seeking shelter. An examination of the net inflows into US mutual funds, illustrates the "sticky" grip of fear and how this fear factor has dominated movement into mutual funds over the past 2 years. In 2008, investors withdrew $168.16 billion from domestic and international stock mutual funds, while adding only $33.56 billion to bond funds. We can only assume that the majority of the difference was invested in money market funds.

However, for the first three quarters of this year, bond funds have attracted $254.6 billion in net inflows, which is 93.2% of all inflows collectively to stock, bond and alternative mutual funds. Despite the very strong equity market returns since early March, inflows into equity mutual funds this year have been a paltry $14.52 billion. Moreover, investors who have demonstrated the courage to move back into the equity markets have focused primarily on international equity mutual funds. Out of the $14.52 billion invested in equity mutual funds in 2009, only $3.84 billion has been invested domestically.

All of this suggests that investors who have flocked to safety by investing in taxable bond funds may be in for a big surprise. The returns could prove to be very low, especially for government bond funds. Furthermore, it is difficult to describe the US equity market as a bubble without any evidence of additional participation by equity mutual fund investors.

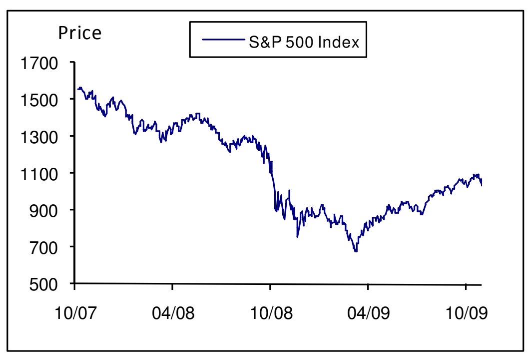
The Federal Reserve holds the key for fixed income investors. At some point it will start to normalize interest rates and in that process will materially impact total returns for bond mutual fund investors. The safety of the taxable fixed income mutual funds may become very costly once investors begin to notice that principal erosion is not covered by the interest income earned from coupon flows.

Emerging Markets Index (Oct. 2007 - Oct. 2009



Source: *Bloomberg*

S&P 500 Index (Oct. 2007 - Oct. 2009



Source: *Bloomberg*

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OmniVest provides strategic guidance on the economic and market trends that affect the performance of clients' portfolios. With an experienced team and a global perspective, OmniVest Group translates market information into actionable ideas that we can leverage to meet client's goals.

For More Information

- Call 609 986 1001 | Fax 609 921 1731
- Omnivest Group LLC
  47 Hulfish Street, Suite 210, Princeton, NJ 08542

OMNIVEST GROUP LLC