

THE OMNIVEST MARKET VIEW

Investments



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G-20 Gives a Nod to Risk Taking

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The G-20 confab held in Scotland this past weekend unleashed a very powerful global equity market and commodity rally. It also returned the US dollar to its downward trend. Essentially, the G-20 finance ministers agreed to maintain low interest rates globally to ensure a strong and sustainable economic recovery. This means that, at least for now, investors have been given additional runway to take on incremental risk by investing in global equities and lower quality corporate bond credit instruments.

By acknowledging the desire to keep interest rates low and maintain generous fiscal policies, the group of finance ministers has implicitly argued for a continuation of the global carry trade. Therefore, countries with low yields are expected to nourish the financial platform and promote further gains from investing in emerging equity markets and high-yielding currencies. To wit, the Brazilian real reached fresh highs this morning and the Australian dollar is also flirting with new highs, whereas the US dollar index has dropped 1% on the day.

None of these financial market movements are surprising; rather, they show an acceleration of the trends that have been in place since early March. The finance ministers merely agreed to keep these trends in place, probably through year-end.

However, there is a cost associated with the amount of monetary and fiscal policy initiatives, most likely in the form of inflationary pressure re-emergence. The Federal Reserve continues to believe that the US will experience "subdued inflation trends and stable inflation expectations" and is therefore willing to keep interest rates at low levels for "an extended period". While the Fed truly believes that inflation expectations will remain low, there should be concerns about 1) the sharp increase in break-even inflation rates 2) the weakness of the US dollar and 3) the increased steepening of the Treasury yield curve.

While the Federal Reserve was concerned about the threat of deflation since last November, the 10-year breakeven inflation rates have risen from -0.02% to 2.22% currently. We recognize that inflation expectations are merely normalizing from last year's deflationary environment to a modest increase in inflation expectations. Should breakeven inflation rates move up to around 2.5%, the Federal Reserve would be hard pressed to keep its "subdued" inflation outlook without losing some credibility.

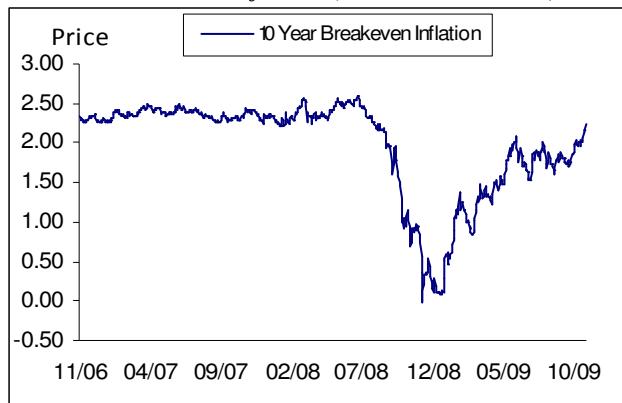
The steepening of the yield curve has threatened to reach new all time highs as investors shun long-term Treasury debt. Not only has the yield curve renewed its steepening trend, but it is doing so with rising long-term rates - a sign that bond vigilantes may be coming out of a long hibernation period.

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The weak US dollar, rising commodity prices, and the risk that global growth keeps upward pressure on commodities, raises the prospects of cost-push inflation as we move through 2010. If so, then the Federal Reserve and other Central Banks may find that they have to act much more quickly. We have to remind ourselves that moving interest rates from ultra-low levels doesn't have to be disruptive to equities, commodities or credit markets.

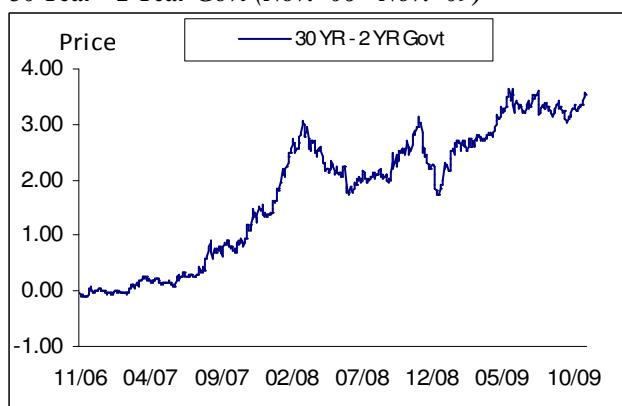
The process of normalizing official interest rates will be felt most heavily in short-dated government bond funds which have been the safe haven trade of the past 2 years. To put this into perspective, the year-to-date total return of the 2 year Treasury note is 1.38% and -0.47% for the 5 year Treasury note. Lackluster returns have been generated even though the Fed has maintained ultra low interest rates. Imagine what would happen to total returns for the short-dated safe Treasury notes if the Federal Funds rate would normalize to 3%.

10-Year Breakeven Inflation (Nov. '06 - Nov. '09)



Source: Bloomberg

30 Year - 2 Year Govt (Nov. '06 - Nov. '09)



Source: Bloomberg

About OmniVest Group LLC

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.

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