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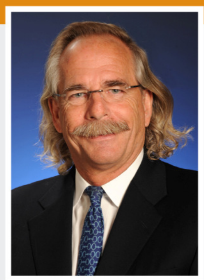

Tom Sowanick
Co-President
Chief Investment Officer
tom@omnivestgrp.com
Tel: +1 609 921 7939

Eleni Athanatos
eleni@omnivestgrp.com
Tel: +1 609 986 1001

Musical Chairs is a Dangerous Game

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The failure of the German 10-year bund auction last week (November 23rd) has had a pronounced impact on German yields and US - German yield spreads. To put it bluntly, Germany may have swiftly moved from being a “safe haven” in Europe to the next sovereign credit risk problem - at least in the eyes of short term investors (otherwise known as bond vigilantes).

Since November 22nd, the 10-year bund yields have risen from 1.92% to 2.37%, the highest since last seen in early August of this year.

The reasons for the increase in German yields are many, but in its simplest form Germany is playing a game of musical chairs and may soon find it is without a chair to sit on. Germany’s deficit as a percent of GDP is -4.3% and likely to move higher if the Eurozone heads into a recession.

German 10-year yields are now higher than those found in the UK, Sweden, Switzerland, Denmark and the US and they appear to be heading higher still. The stubbornness of Germany to compromise over the size of the EFSF, the role of the ECB and certain funding for the IMF may have left them vulnerable, especially if its own fiscal situation does not improve soon. Nonetheless, Germany still remains the best house on a very ugly block.

The US, which has enjoyed the status as the “safe haven” by virtue of the size of its economy, bond market and overall role of the US dollar in global trade could suddenly find itself in a similar predicament as Germany - a country that is now losing its “safe haven” status. For the US, losing its “safe haven” status and dominant currency position would clearly have a negative impact on US interest rates, and US economic growth.

A 57 basis point (bp) rise in German yields over a two-week period should send a strong warning to Fed Chairman Ben Bernanke, US Treasury Secretary Timothy Geithner and President Obama. The statement is that without working to improve your own fiscal house, the risk of a downgrade or multiple downgrades needs to be taken seriously.

Bond vigilantes have had a good “go” at it, roaming through the bond markets of Europe looking for their next target. At some point, these vigilantes will recognize that the US Treasury market is too large of a target to ignore. If so, the only safe haven that will be available for global investors is the very front of the yield curve which remains in control by the Federal Reserve.

Investors should now have learned from the ongoing sovereign debt crisis, that no sovereign credit is immune. The Fitch rating agency kept its AAA rating on US debt this past week but downgraded its outlook to negative from stable. The S&P rating agency downgraded the US from AAA to AA rating in August 2011. More cuts are likely, given the inability of the political parties to find room to compromise when the rest of the industrialized world is being forced to accept severe austerity measures.

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