Louise Yamada
Technical Research Advisors, LLC

LOUISE YAMADA

Alan R. Shaw - Consultant Emeritus

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Special Educational Series: Setting the Stage …Preparing a *Mind-Set* for a New Structural Rising Interest Rate Cycle.

Louise Yamada, CMT
louise.yamada@lyadvisors.com

Jonathan T. Lin, CMT, CFA
jonathan.lin@lyadvisors.com

Lori Altenburger
lori.altenburger@lyadvisors.com

Noreen Lennon
noreen.lennon@lyadvisors.com

Jeanne Crisci
jeanne.crisci@lyadvisors.com

SPECIAL EDUCATIONAL SERIES: Setting the Stage … Preparing a *Mind-Set* for a New Structural Rising Interest Rate Cycle.

Introduction

In 2000, following a two-decade structural bull market in stocks, we wrote an educational piece called "Expectations of a *Structural Bear* Market," understanding that many participants in the equity market over the prior 18 years had only experienced a structural bull market environment, which in some cases covered their entire careers!

Once again, we anticipate that a similarly *reversing structural situation* for the Bond Market is closer in time. Most bond market participants today have only experienced a 29-30-year *structural* Bond Bull market (an extended period of falling rates) and the corresponding price profitability. But they may never have experienced the opposite – a *Structural Bond Bear* market (an extended period of *rising interest rates*) in which bond *price continuously declines*.

Therefore, the implications of an eventual *structural* rising rate cycle on the price of bonds themselves (and eventually on stock behavior) might be worth an educational series in advance of the actual reversal event.

Note: *The bond bull market remains technically in place today as long as rates trade below 5.5%.* But technical buds are beginning to emerge suggesting we should be *preparing a mind-set* for, and educating ourselves to understand, an eventual shift in interest rate behavior, particularly at the long end, 30-year U.S. Treasuries (where technically we think the rise will begin) over the months / year(s??) ahead.

Basics

The simplistic basic understanding is probably a given for all: **That interest rates (*yields*) and the corresponding *price* of bonds move inversely.** Therefore, the tremendous price gains achieved by the bond market over the past 29 years, particularly at the long end, were the direct result of a multi-decade *decline* in interest rates. But as that falling interest rate cycle transitions, and is reversed into the next structurally rising rate cycle, that same inverse relationship implies that *bond prices will fall, as interest rates rise*.

Begin to Lighten Long Positions and Shorten Duration

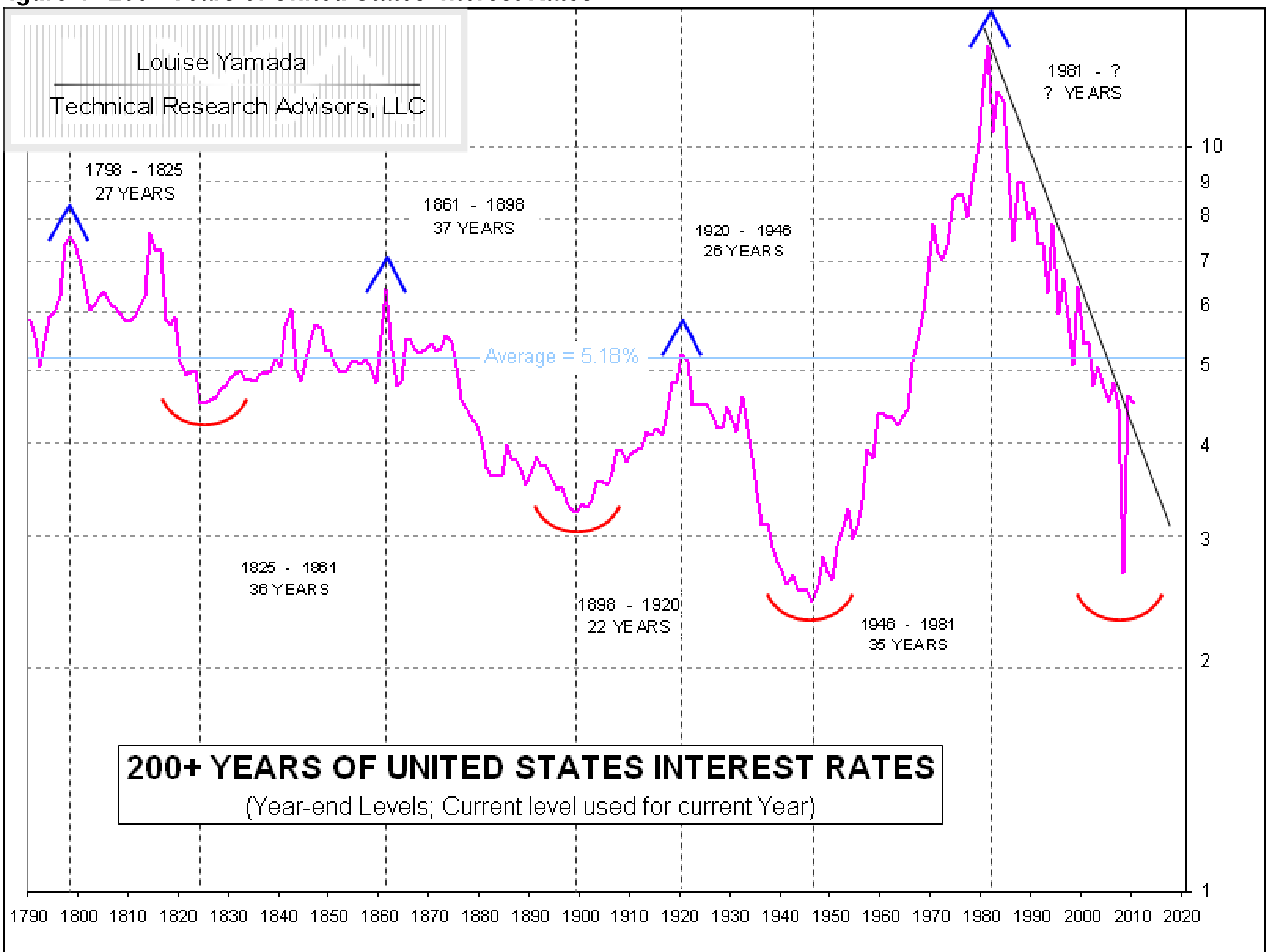
Therefore, from a bond investment perspective, once a structural rising rate cycle has begun, a long-term *Buy* and *Hold* investment in the bond market should no longer prove profitable, but instead will carry *credible risk of capital* over the years (decade-plus) of the expected future rising rate cycle. As the new cycle becomes evident and progresses (with any eventual penetration of the 5.50% level), moving away from the long bond as a long-term investment vehicle, and into shorter durations, should prove prudent for preservation of capital.

Thus, one would *consider using ensuing drops in yields as an opportunity to lighten long bond investment positions, and move toward the mid-to-short end, in anticipation of a new cycle of sequentially rising interest rates.*

Structural Interest Rate Cycles: 200-Year-Plus U.S. Bond History Review

Indeed, this interest rate cycle has been the best bull market for bonds *ever* in the 200-plus year history (and only the seventh cycle) of interest rates in this country (see Figure 4). This extraordinary bond bull market also encompassed the greatest structural *equity* bull market in our country's history (from 1982-2000). But all cycles eventually come to an end.

Figure 4. 200+ Years of United States Interest Rates



Data Used in Chart:

Foreign loan made to U.S. government: 1790, 1792, 1794.
Average foreign loans made to U.S. government: 1791.
Federal government bonds: 1798-1820, 1860-1.
Federal government average new issue: 1841.
Federal government average market yield: 1842-8.

New England municipals: 1821-5, 1827, 1829-30, 1832-40, 1849-59, 1865-1884.
Highest grade corporates (RR): 1862-4, 1885-98.
30-year prime corporates: 1899-1976.
30-year treasury bond yield: 1977-present.
Interpolated: 1793, 1795-7, 1822, 1826, 1828, 1831.

Note: 1821 - U.S. debt insignificant. 1833 - No federal debt all all.

Reversals

We can see (Figure 4) that interest rate cycles in our 200-plus year history have been long, ranging from 22 to 37 years. *The question has never been "if" the interest rate trend would reverse, but more a question of "how" or "'when."* The 200-plus year history of interest rates offered some clues; but reversal styles differ greatly.

One can note that *rising* rate cycles historically have reversed to *falling* rate cycles in sharp inverted "V" patterns, as they did in 1981, 1920, 1861 and 1798. But *falling rate cycle reversals* have been very slow, saucer-like, multi-year transitional affairs (see saucers).

Notice that the last cycle of rising rates began in 1946. As a matter of market history, considering the immediately preceding 25-year structural bond bull market cycle (declining interest rates) from 1920 to 1946, we know the 1929 *equity* bear market pivot low was achieved in 1932, yet *rates continued to fall for 14 years beyond* that market low, into 1946.

The next *prior* structural bond bull market cycle (declining rates) of 37 years from 1861 to 1898 contained an equity market low in 1896, yet yields declined further through 1898, *or two years beyond* the equity market low.

The earliest structural bond bull market (declining rates) on record ran for 27 years, from 1798 to 1825 and experienced an equity market low in 1812-13, yet rates continued to decline into 1825, or for *another 12 years after* the equity market low.

Theorizing – Why the Saucer Pattern?

The technical study of price in evaluating the forces of supply and demand does not immediately present the reasons *why* a trend exists. Since the market is a discounting mechanism, those reasons are unlikely to clearly emerge until many months, even years, later. But we can hypothecate and ask questions.

History shows *these slow transitions from falling to rising rate cycles have all occurred in deflationary and quasi-deflationary environments.* Maybe cycle shifts from falling to rising rate cycles take a longer, more gradual period of time to reverse because the worry of potential pockets of deflation keep popping up periodically in the daily economic noise (not unlike the 2007-09 Financial crisis which has precipitated lower rates again within our transitional trading range from 2003).

Consequently, the forces of inflation cannot fully ignite, resulting in a very slow process of interest rate reversal. *Simply stated, falling rate cycles may take more time to reverse because each has been accompanied by some deflationary characteristics and, given that more fragile underlying environment, may take longer to dissipate those pressures, keeping rates low.* The current environment has fit this pattern *so far*, but …

Current Profile

In our current interest rate cycle, the shift from falling rates to a new rising rate cycle has been in transition since 2003 when we suggested the development of a similar saucer-like, multi-year *transitional trading range* below 5.5% … still in effect.

The definition of 2002 or 2009 as the equity bear market pivot low (or double dip) would introduce an anomaly this time versus the prior three experiences. But anomalies have abounded this past decade. *Our best technical evidence suggests a structural bond bear market developing first at the long end – the 30-year bond (no one wants our burgeoning debt??), but perhaps not simultaneously at the short end,* as the Fed will remain unable to raise short rates significantly due to lingering deflationary pressures (wages, prices, housing, etc.).

Yet whenever the new rising interest rate cycle emerges, even if the first evidence comes with long rates moving through 5.5%, the interest rate history suggests the longevity of the new rising rate cycle could span for two decades.

We should note and recognize that U.S. *long rates* (as opposed to short rates) *are no longer in our control, as a tremendous amount of our debt is held by foreigners / other nations.* This dependency on their good will, as well as the weaker U.S. dollar over the decade encouraging further currency diversification among foreign U.S. long bond holders, may result in a slightly altered transitional phase, prior to a uniform structural rise across the broader U.S. interest rate spectrum.

Characteristics

A close-up view of our current ***falling interest rate cycle*** (see Figure 5, Bond Composite with yield plotted inversely) demonstrates that throughout the current falling rate cycle (1981-present), each back-up in rates *failed to exceed* the level of the prior back-up in rates, creating a series of higher lows (see saucers), and each time offering another opportunity to *buy* bonds. Those back-up in rates represent the cyclical contratrend (temporary move in the opposite direction from the major trend) events that take place along the course of every major structural price trend (in this case, for bonds).

(Note that the inverse plot for interest rates presents a visual profile of the actual direction of bond *price*: Thus the 1981-present trend, as depicted, reflects the direction of price – *up* – as rates fall.)

In a ***rising interest rate cycle***, the opposite effect can be expected, similar to the immediately prior 1946-81 rising interest rate cycle on the chart. (Note again, the inverse plot of yields on the chart presents a profile of the actual direction of bond *price*: Thus the 1946-81 trend, as depicted, reflects the direction of price – *down* – as rates rose.)

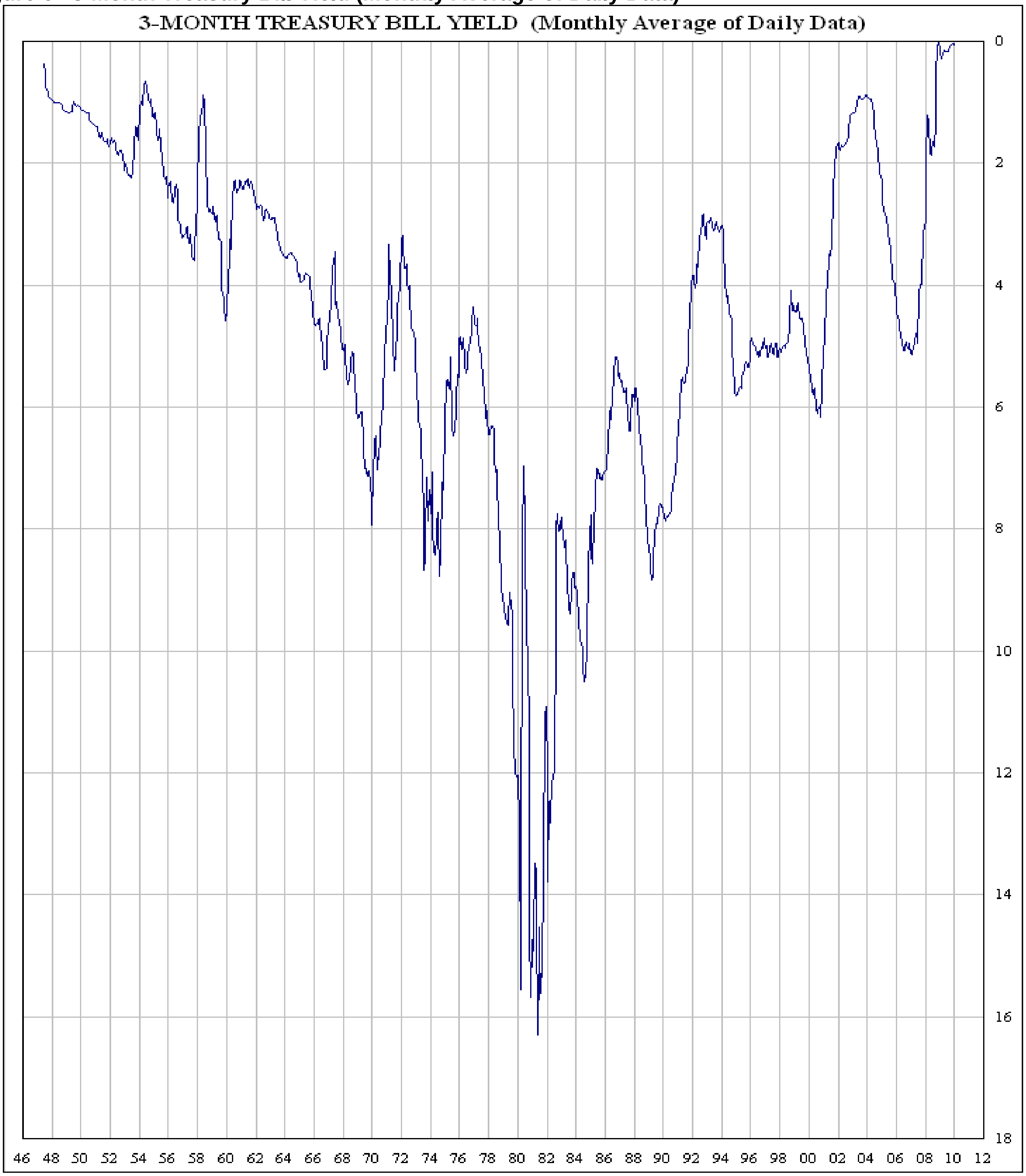
In other words, in a rising rate situation, each advance in rates carries yield to a *higher* yield level (and carries the bond *price* to a *lower* level); and each cyclical contratrend rate decline (short-term move in the opposite direction to the major rising interest rate trend) carries the interest rate *temporarily* lower (bond price *temporarily* higher), offering an opportunity to *sell* bond positions. But note that those events never carry the rate *sustainably* lower (or the price *sustainably* higher) than the prior contratrend cyclical rate decline (within the *structural rising interest rate* cycle).

Figure 5. Long-Term Treasury Yield (10-, 20- & 30-Year Composite, Monthly Average of Daily Data)

Source: Bloomberg and LY Advisors

A similar profile can be noted in the **3-month Treasury bill yield** (see Figure 6). Please note that at this time we do *not believe the short end is poised to reverse*, nor will it be until the Fed is able to raise short-term rates initially. Nevertheless, from an educational perspective, this series demonstrates another observation of a *rising rate cycle* pattern from 1946-81 (and the corresponding *fall in price*). The technical observations are similar to those above.

Figure 6. 3-Month Treasury Bill Yield (Monthly Average of Daily Data)



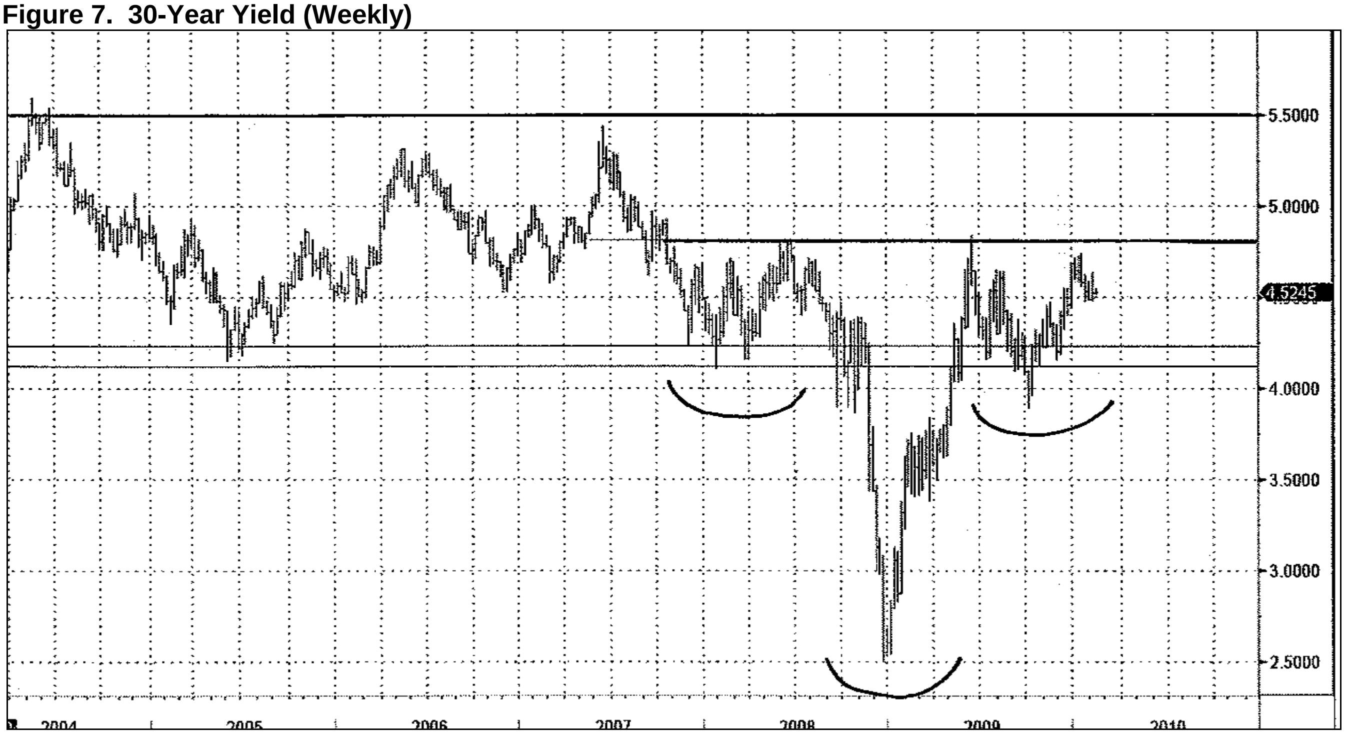
Source: Bloomberg and LY Advisors

Therefore, *in a structurally rising interest rate cycle, any drop in rates should be considered another opportunity to sell longer positions*. (Similarly, from a trading perspective in a rising rate cycle, taking a long position in bonds, in anticipation of any such interim contratrend rate decline, should be considered a temporary short-term trade, rather than an investment for the long term.)

Long Bond View

As referenced in our *Outlook 2010*, the diverse technical patterns on the 30-, 10-, 5- and 2-year bond / note patterns suggest both the deflationary pressures preventing short rates from rising, and the inflationary, or supply, pressures at the long end which we continue to believe will eventually lead interest rates higher over time. We reiterate here (see Figure 7) the 30-year U.S. Treasury bond as depicting an apparent “head-and-shoulders” reversal pattern in progress toward higher rates over the months ahead.

Figure 7. 30-Year Yield (Weekly)



Data Source: Bloomberg

A breakout through 4.8% would imply an eventual potential target (measured from the “neckline” to the “head” and projected upward from the “neckline” an equal distance) toward 7.1% over months to years. A definable lift, in the process, through 5.5%, our trend reversal threshold, would provide the first rise through our seven-year transitional trading range, and define the end of the falling rate cycle and the initiation of a new rising rate cycle.

Note: Unfortunately, with the baby boomers looking for unearned income moving into retirement years, assuming they can retire, they may erringly move into longer-term bonds (reaching for yield) just as this falling interest rate cycle transitions toward a rising interest rate cycle), and the capital may be put at risk. (We are also watching the plethora of new bond fund openings with a concerned eye.)

Louise Yamada

LOUISE YAMADA TECHNICAL RESEARCH ADVISORS, LLC
530 Fifth Avenue – 26th Floor
New York, NY 10036
(212) 944-6200

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