DECISION ECONOMICS, INC.

*Information for Decisions™*

January 9, 2012

# DE Financial Market Highlights

Andrew Husby
Economist
212-884-9447

| | |
|---|---|
| Treasuries and Yield Curve | 3 |
| Fed Funds, GDP Expectations | 4 |
| Inflation Expectations | 5 |
| Volatility and Implied Risk Measures | 6 |
| Equities, Risk, Sentiment | 7 |
| S&P 500 Sector Returns | 9 |
| Liquidity and Money Market | 10 |
| Credit Conditions, Quality Spreads | 11 |
| Munis, Mortgages | 12 |
| Global Sovereign Spreads | 13 |
| Commodities, Gold, Dollar | 14 |
| Currencies | 15 |

# Decision Economics: *Treasury Yields and the Yield Curve*

Chart 1: Treasury Yields (Percent)

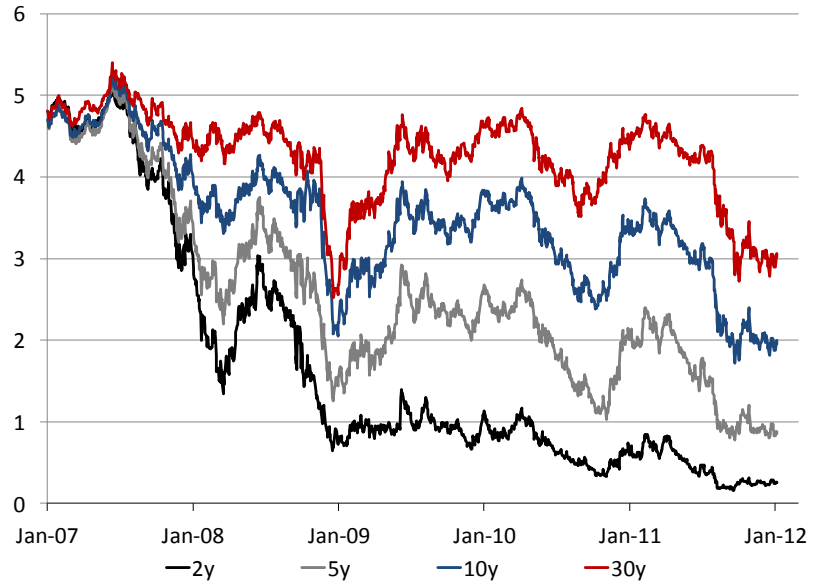
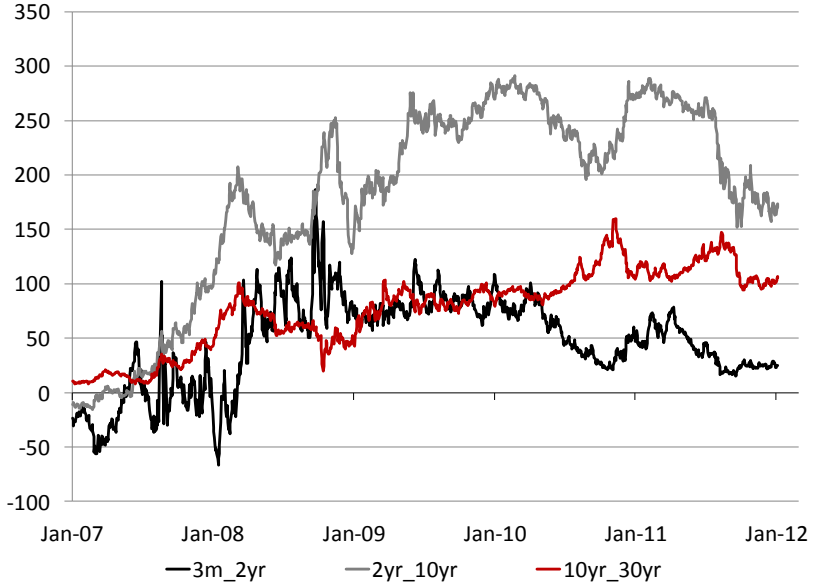



Chart 2: Treasury Yield Curve (bps)




Yield curve flat despite better data. Fed buying, safe-haven flows, and investors' belief in potential for QE3 keeping rates low.

Fed's hope –for quite some time – is that interest rate sensitive sectors of the economy respond, and recent signs are tentatively encouraging.

But, doubts about the transmission mechanism – given households are paying down debt, and businesses eyeing policy uncertainties – will remain.

Treasury Yield Curve Matrix (bps)

**Spread Levels**

**1/9/2012**

| | 6m | 2y | 5y | 10y | 30y |
|---|---|---|---|---|---|
| **3m** | 3 | 24 | 83 | 194 | 300 |
| **6m** | -- | 21 | 80 | 191 | 297 |
| **2y** | | -- | 59 | 170 | 276 |
| **5y** | | | -- | 110 | 216 |
| **10y** | | | | -- | 106 |

**Month Ago**

| | 6m | 2y | 5y | 10y | 30y |
|---|---|---|---|---|---|
| **3m** | 4 | 22 | 89 | 206 | 311 |
| **6m** | -- | 19 | 85 | 202 | 307 |
| **2y** | | -- | 67 | 184 | 288 |
| **5y** | | | -- | 117 | 222 |
| **10y** | | | | -- | 105 |

**Change**

**One Month Chg. (bps)**

| | 6m | 2y | 5y | 10y | 30y |
|---|---|---|---|---|---|
| **3m** | -1 | 2 | -6 | -12 | -11 |
| **6m** | | 2 | -5 | -12 | -10 |
| **2y** | | | -7 | -14 | -13 |
| **5y** | | | | -7 | -5 |
| **10y** | | | | | 1 |

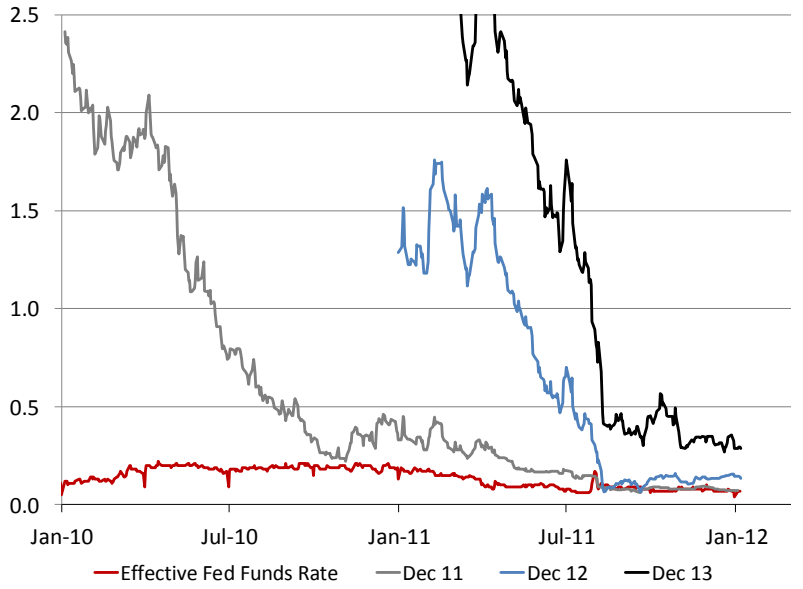
**YTD Chg. (bps)**

| | 6m | 2y | 5y | 10y | 30y |
|---|---|---|---|---|---|
| **3m** | -2 | 1 | 1 | 7 | 11 |
| **6m** | | 3 | 3 | 9 | 13 |
| **2y** | | | 0 | 6 | 10 |
| **5y** | | | | 6 | 10 |
| **10y** | | | | | 4 |

*Sources: Bloomberg and Decision Economics, Inc*

# Decision Economics: *Fed Funds, GDP Expectations*

Chart 3: Fed Funds Futures – Implied Rate at Year-End




US GDP expectations have actually ticked higher, for Q4 and Q1, despite turmoil in Europe.

No move to QE3 by the Fed.

Chart 4: 2012 GDP Forecasts Still Holding Up In North America, Despite Deterioration in Europe

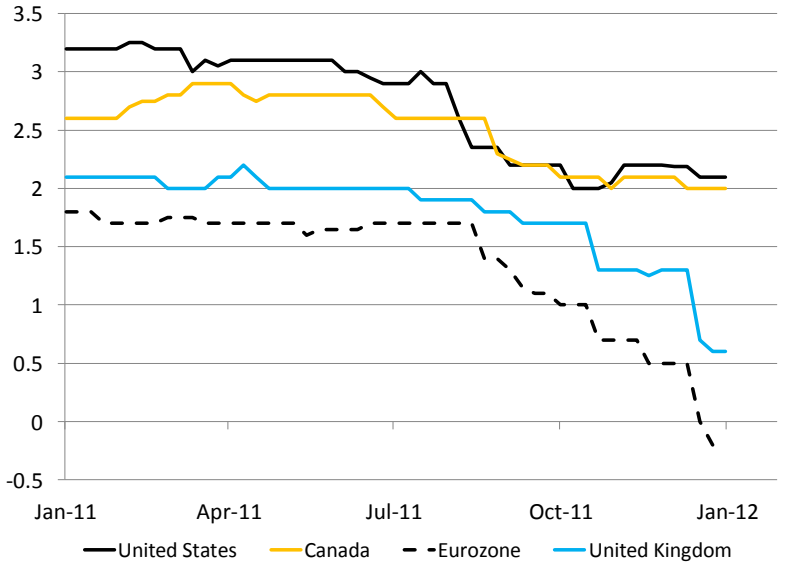
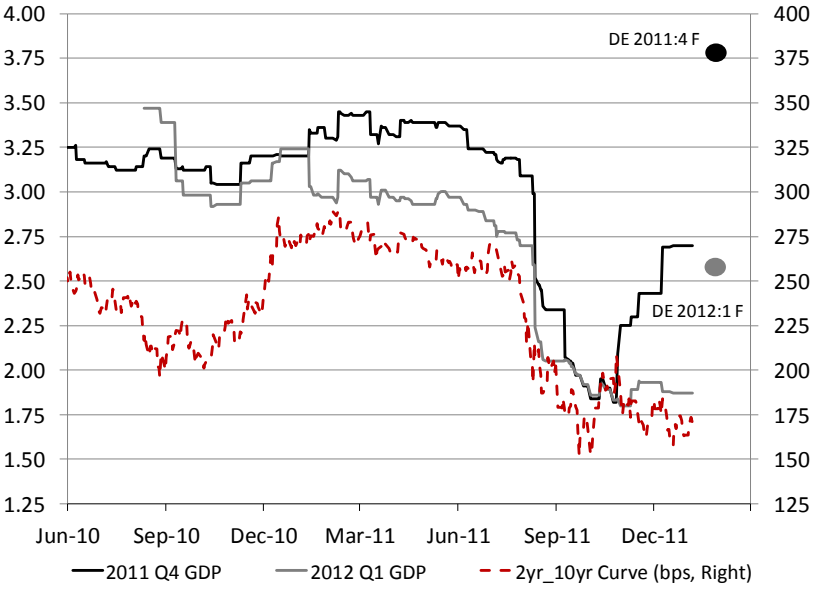



Chart 5: Bloomberg Consensus US GDP Expectations, and the Yield Curve (Percent annualized, and bps)




*Sources: Bloomberg and Decision Economics, Inc*

# Decision Economics: *Market Inflation Expectations – Still Tame*

Chart 6: Inflation Breakeven Rates (Nominal Treasury Yield less Inflation-linked Yield, Percent)

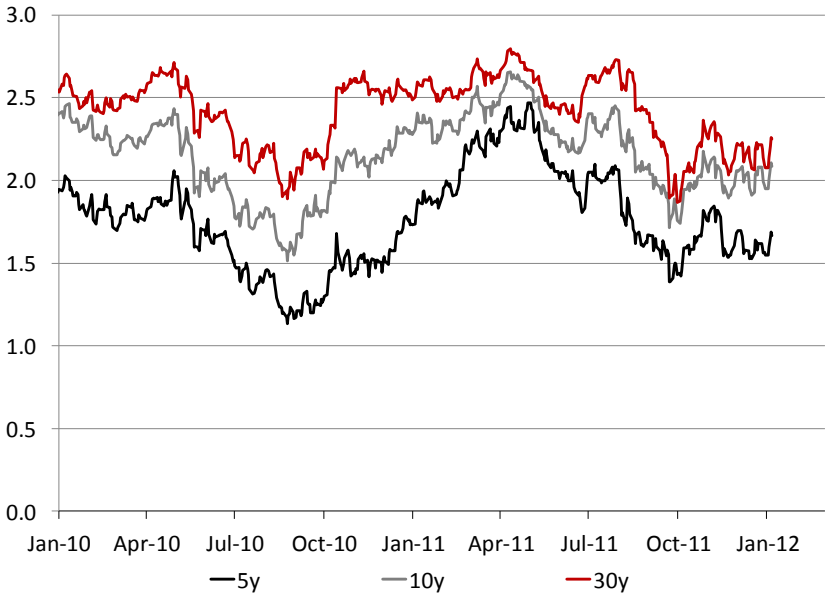
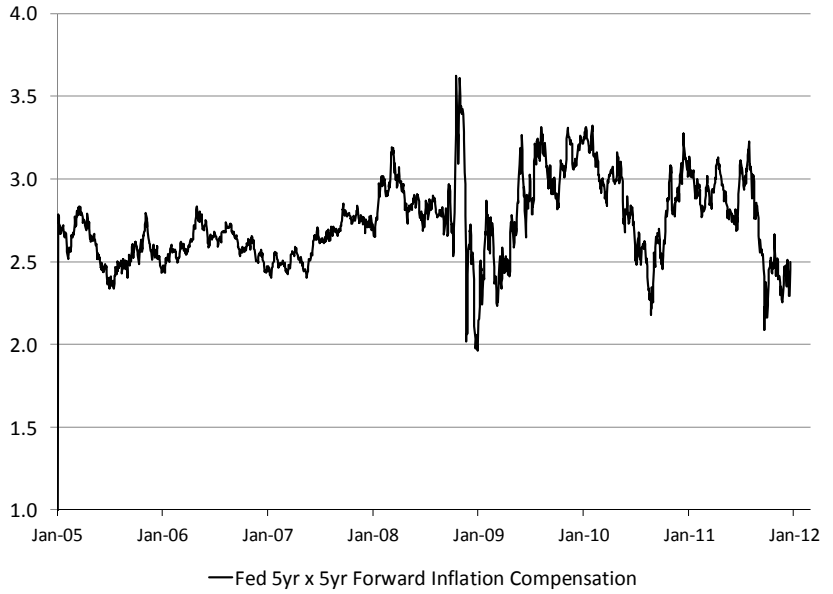



Chart 7: Fed 5yr x 5yr Forward Breakeven Inflation (bps)



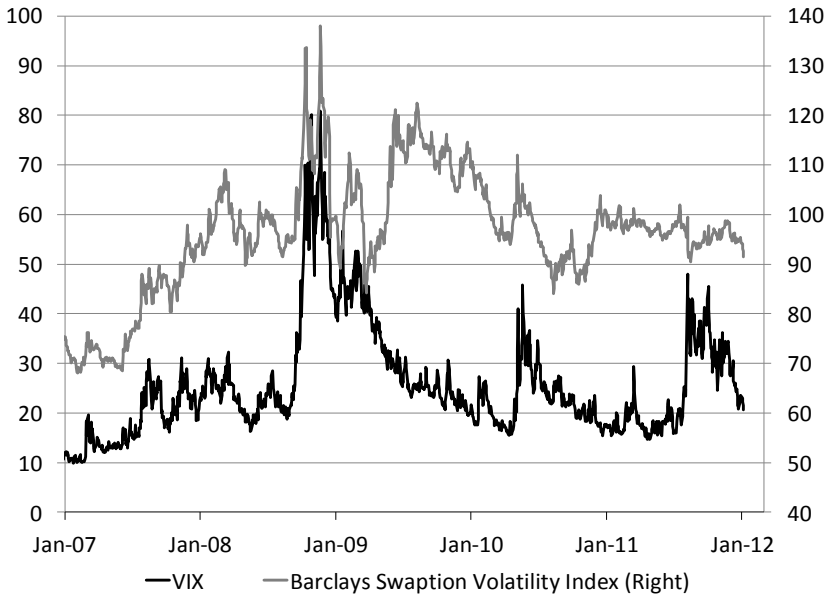

*Sources: Bloomberg, Federal Reserve, and Decision Economics, Inc*

Market inflation expectations signal little in the way of inflation worries.

Global deleveraging a deflationary force. Fresh stimulus measures in an attempt to stave off a global downturn could reignite those worries, in a replay of early 2011, but…

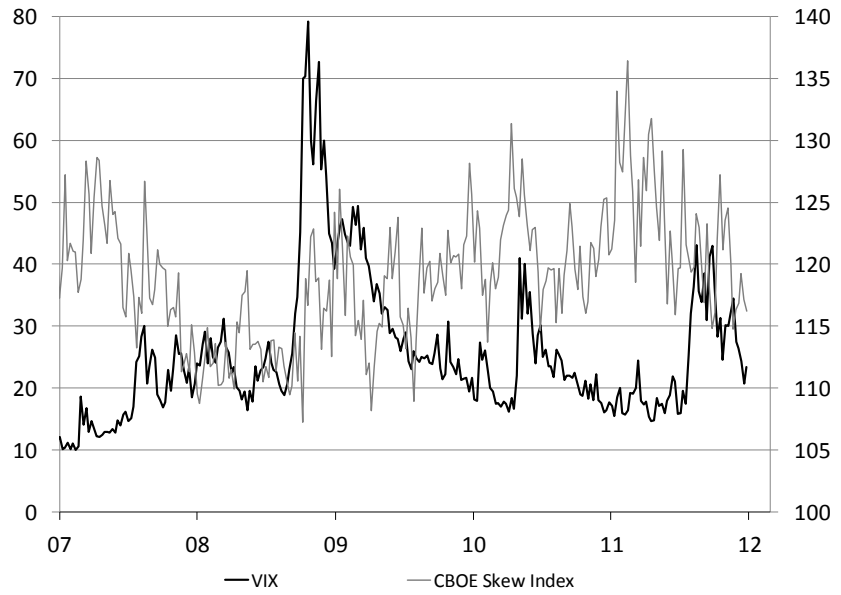
…markets so far appear to be less credulous this time around, recognizing that quicker commodity price inflation is ultimately a drag on growth.

Chart 8: Implied Volatility Measures




Implied equity volatility declined sharply at year-end.

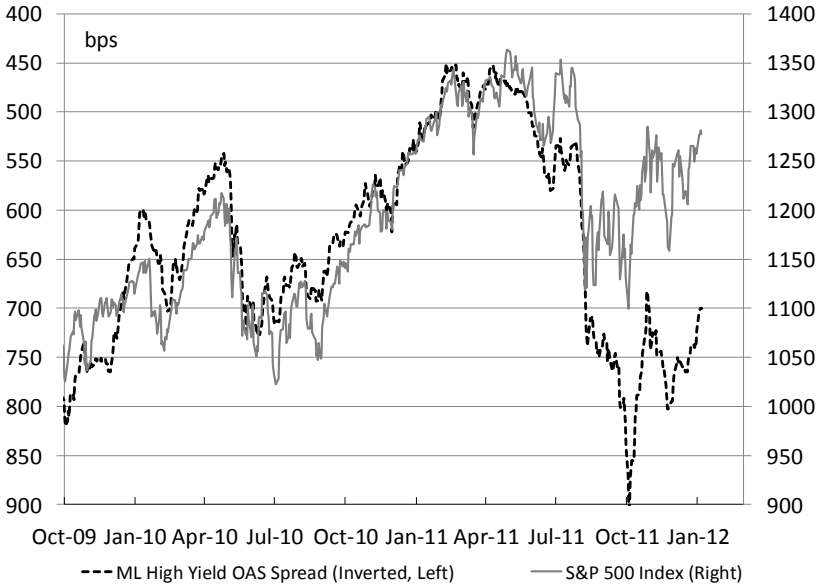
Chart 9: CBOE VIX and Skew Indices




Lower implied volatility, and investors pricing in better balance of upside to downside risks.

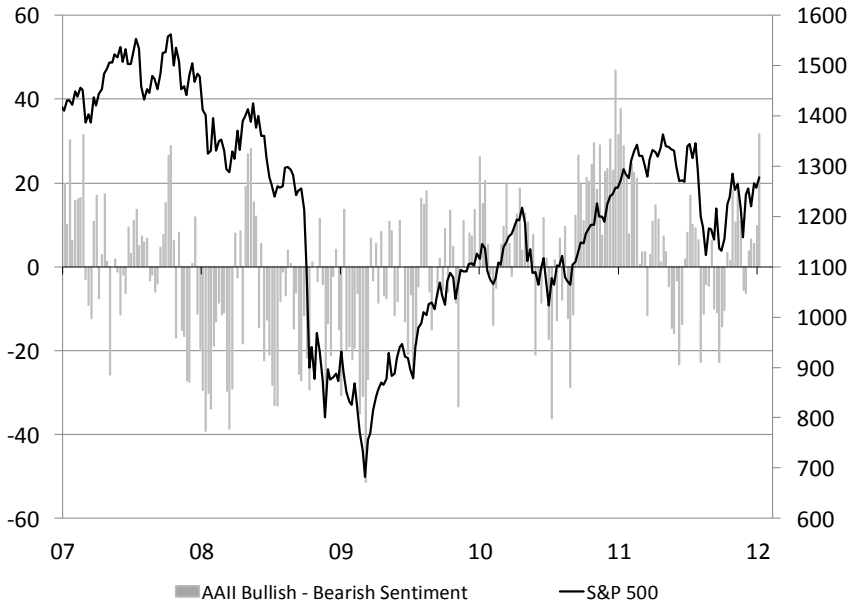
*Sources: Bloomberg and Decision Economics, Inc*

Chart 10: Snap-Back in Credit Less Pronounced Than Equities




Equities retraced more than half of 2011 decline, credit spread a bit less, suggesting a less rosy view of the recent turn toward optimism.

Chart 11: US Investor Sentiment (Percent Bullish less Bearish Over the Next Six Months)




Surge in net bullish sentiment.

*Sources: Bloomberg, Merrill Lynch, and Decision Economics, Inc*

Chart 12: Small Caps vs. Large Caps – Ratio of Russell 2000 to S&P 500 (Dec 2007 = 100)

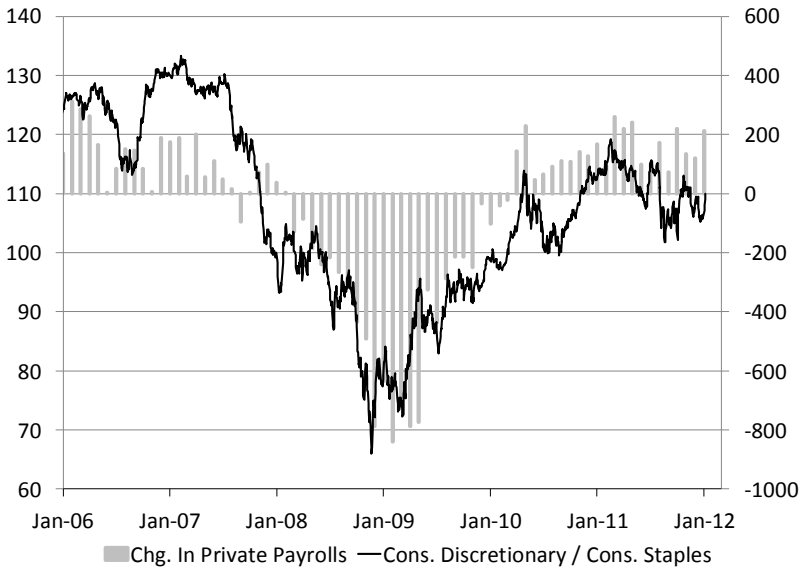



Small cap outperformance topped out in early 2011.

Chart 14 hints that firmer payroll growth, perhaps not even out of line with that seen in December (+200K), could help relative consumer discretionary sector performance.

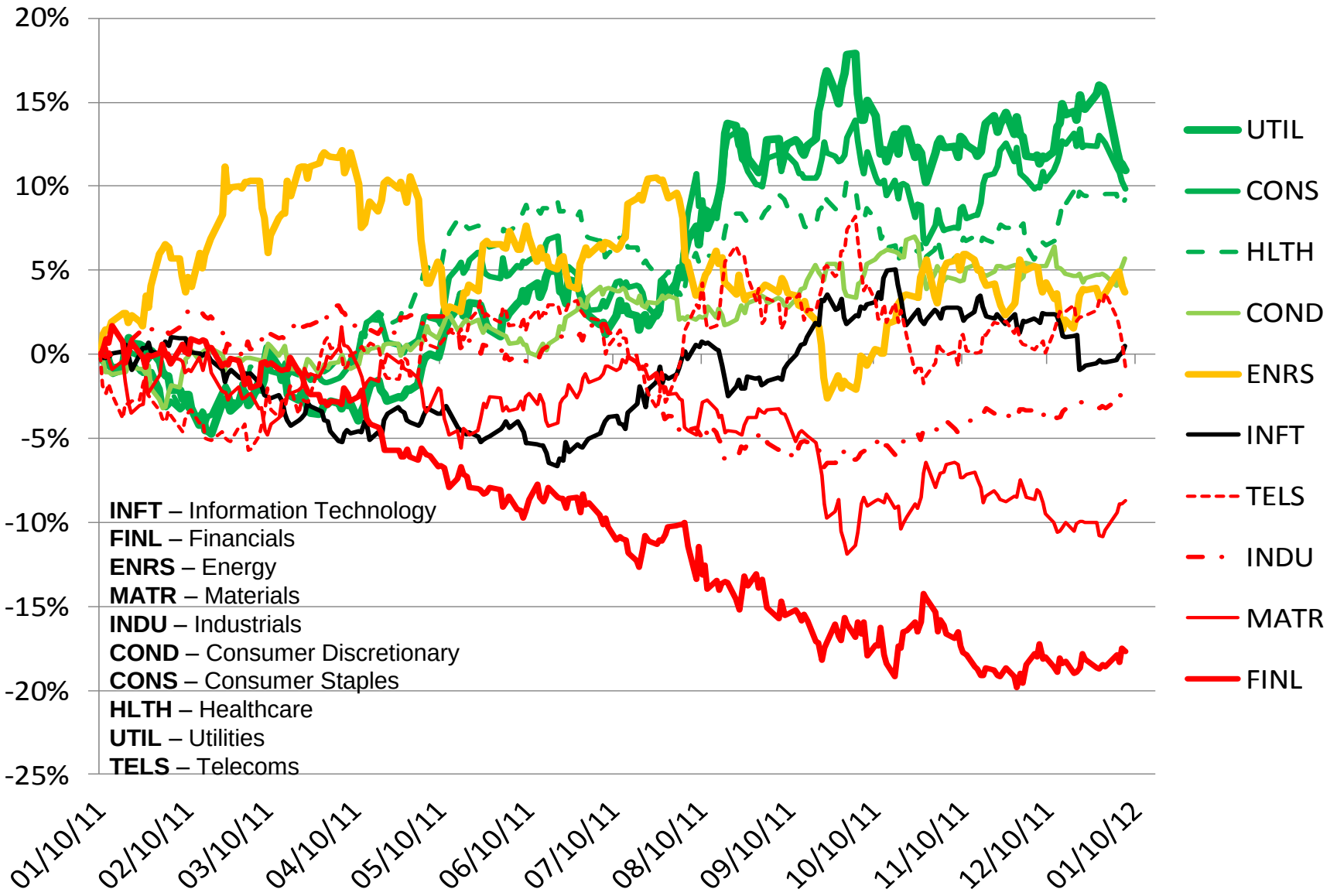
Subdued disposable income growth, housing woes, and broad deleveraging remain clear risks.

Chart 13: S&P Consumer Discretionary/Consumer Staples Sector, and Private Employment Growth (Ratio, Dec 2007 = 100, and Thous.)




*Sources: Bloomberg and Decision Economics, Inc*

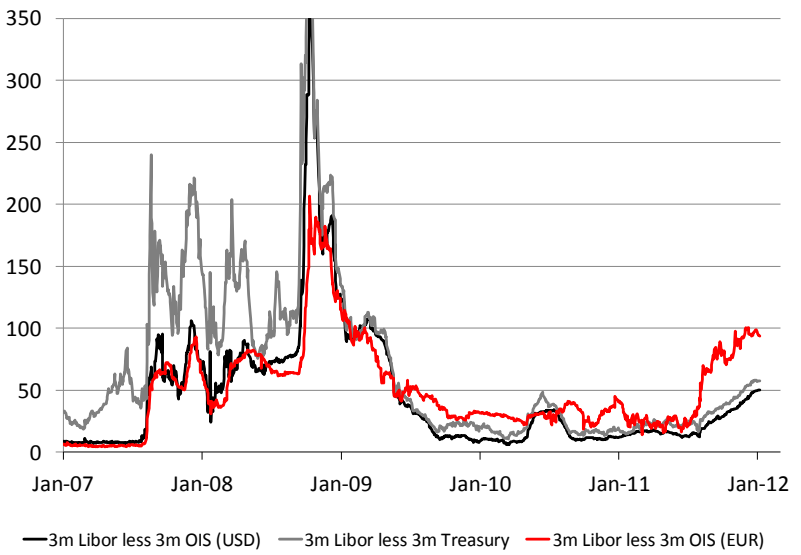
**Chart 14:** Clear outperformance for more-defensive sectors in YTD terms, less clear trend in recent months.




*Source: Bloomberg and Decision Economics*

# Decision Economics: *Liquidity, Money Market*

Chart 15: USD and EUR Libor-OIS, TED Spread (bps)




Financial stress remains elevated.

Central banks are committed to providing liquidity in an attempt to ward off a liquidity crunch.

Chart 16: Elevated Financial Stress, Another

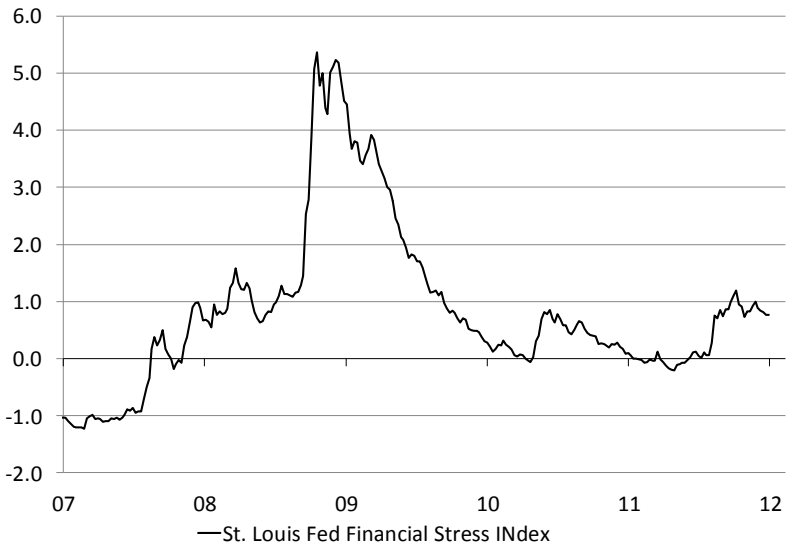
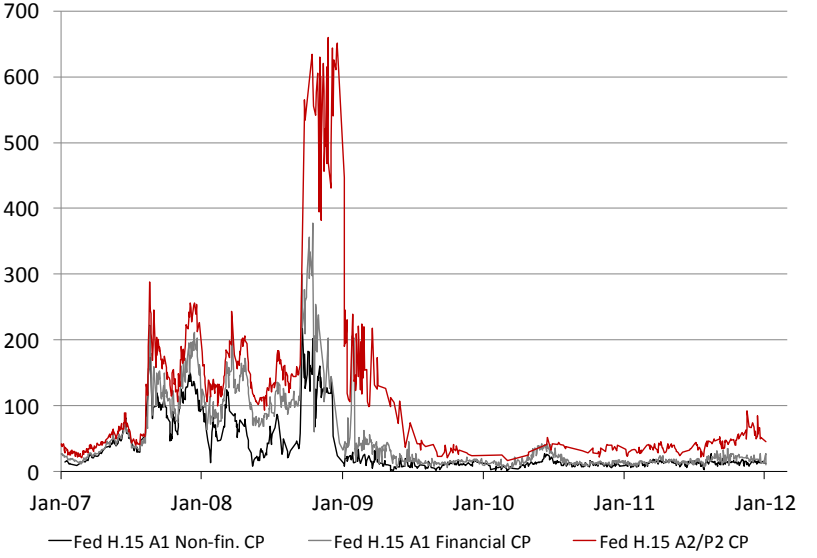


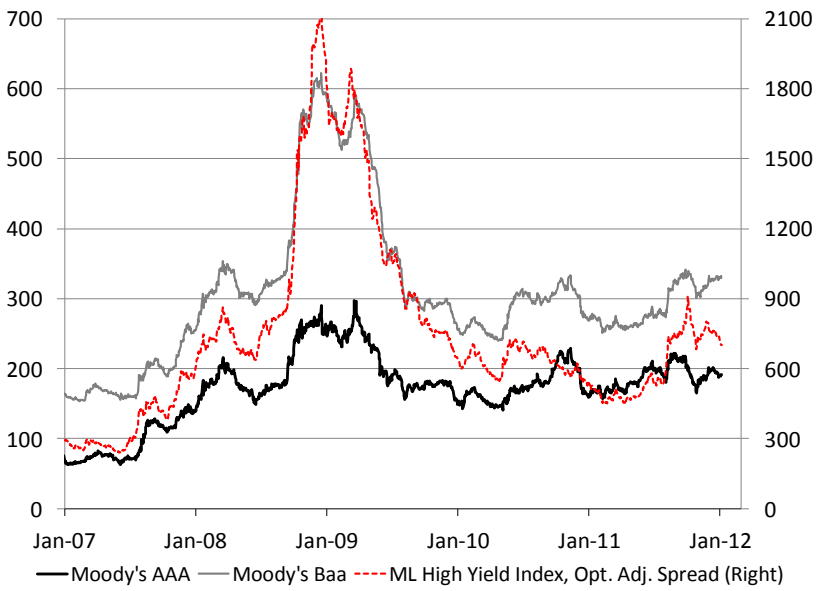

Chart 17: 90D Commercial Paper Spread to Treasury Bill (bps)




*Sources: Bloomberg, St Louis Fed., and Decision Economics, Inc*

# Decision Economics: *Credit Conditions, Quality Spreads*

Chart 18: Corporate Spreads to 10yr Treasury (bps)




Corporate quality spreads to Treasuries have come off recent highs, but remain wide.

The HY spread remains at early-2008 levels. Pricing in slow growth or recession-like period ahead.

Financials under pressure in Europe, tied to sovereign troubles.

Chart 19: Markit N. America CDX Indices

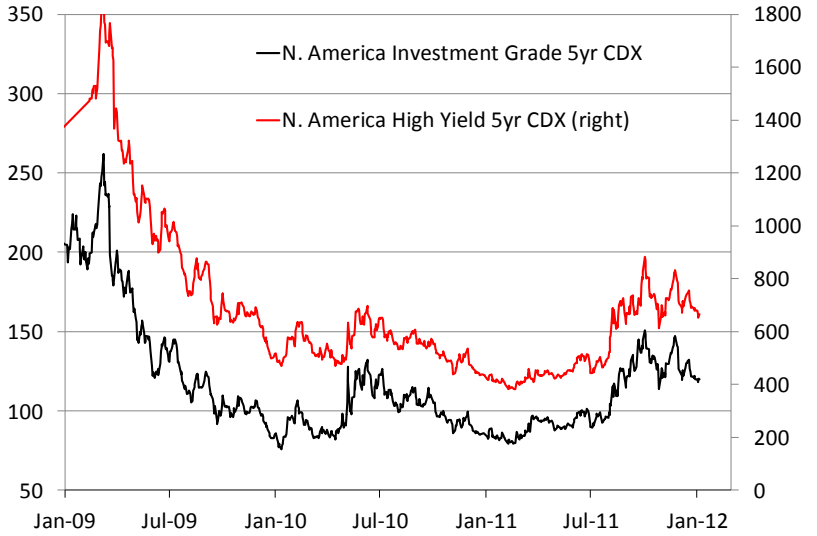
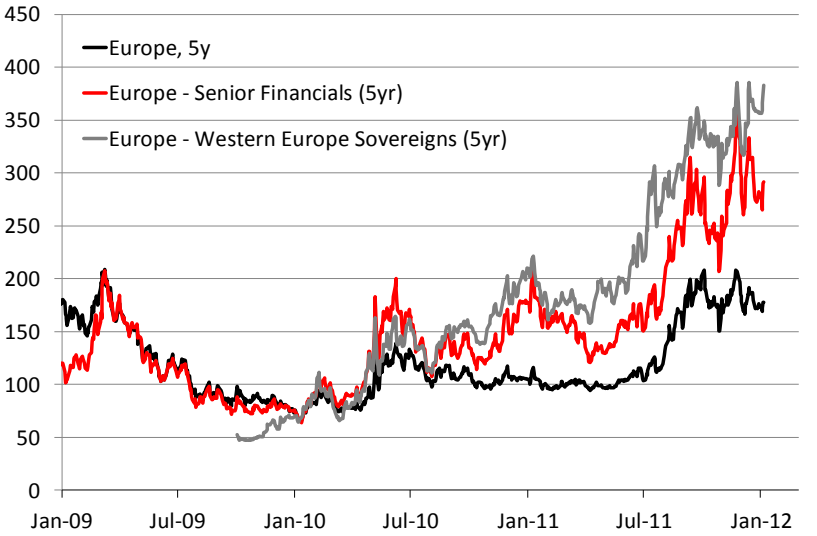



Chart 20: Markit Europe CDX Indices




*Sources: Bloomberg, Moody's, Merrill Lynch, and Decision Economics, Inc*

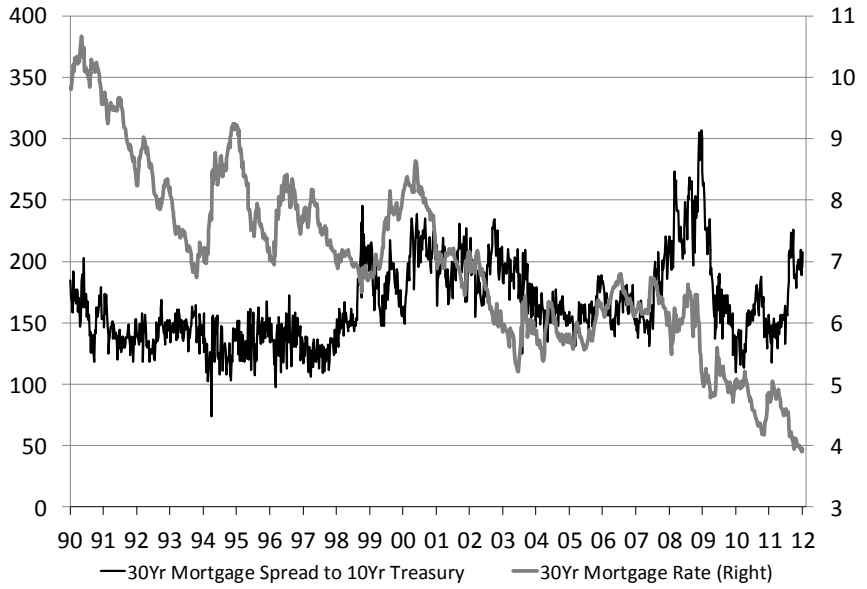
# Decision Economics: *Munis, Mortgages*

Chart 21: AAA Municipal Bonds, Ratio to Treasuries




Municipal bonds typically trade at a lower yield than Treasuries due to tax advantages. There are opportunities to be had, but fiscal concerns have upended "normal" relationships.

Chart 22: 30Yr Mortgage, Spread to Treasury, and Level

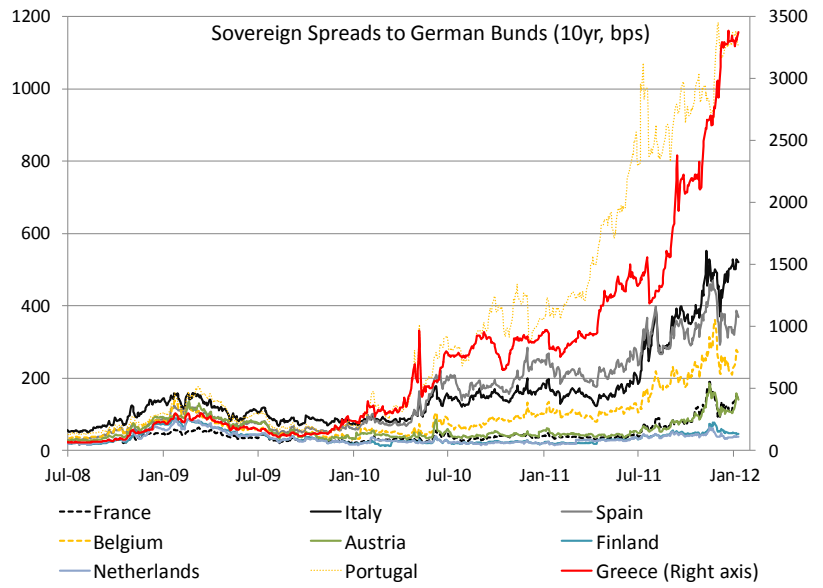



Mortgage rates lowest on record. Even so, will wide spreads have the Fed buying?

*Sources: Bloomberg and Decision Economics, Inc*

# Decision Economics: *Global Sovereign Spreads*

Chart 23: 10yr Spread to German Bund, Weekly (bps)




Europe struggles to contain debt crisis. Resolution another matter entirely.

Signs of a move to fiscal integration in Europe could ease near-term worries, but problems may simply shift to a later date. Severe recession may find electorates less willing to cooperate.

Chart 24: G7 - 2yr Yield Spreads to US Treasury, Weekly (bps)

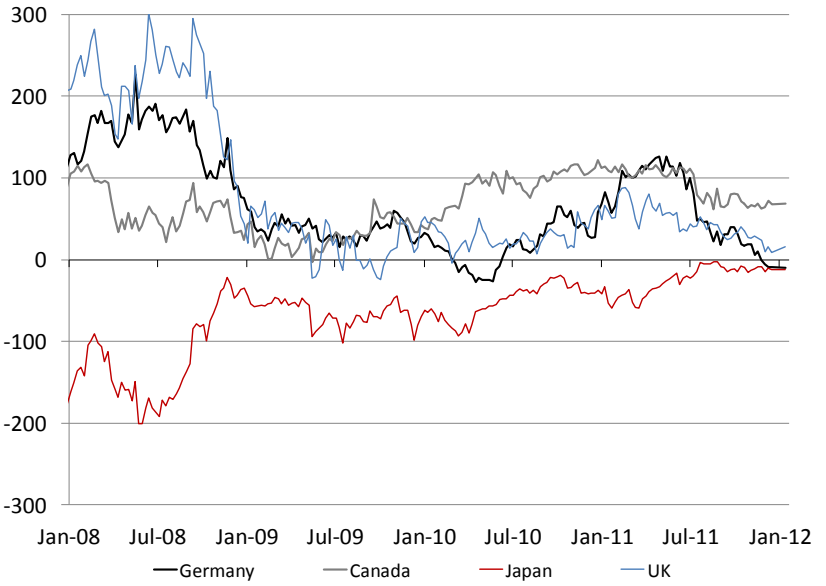
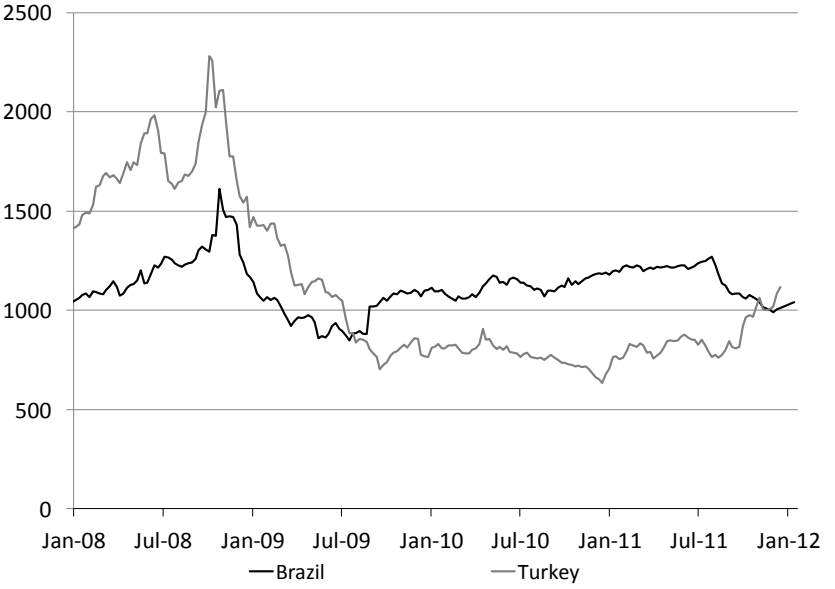


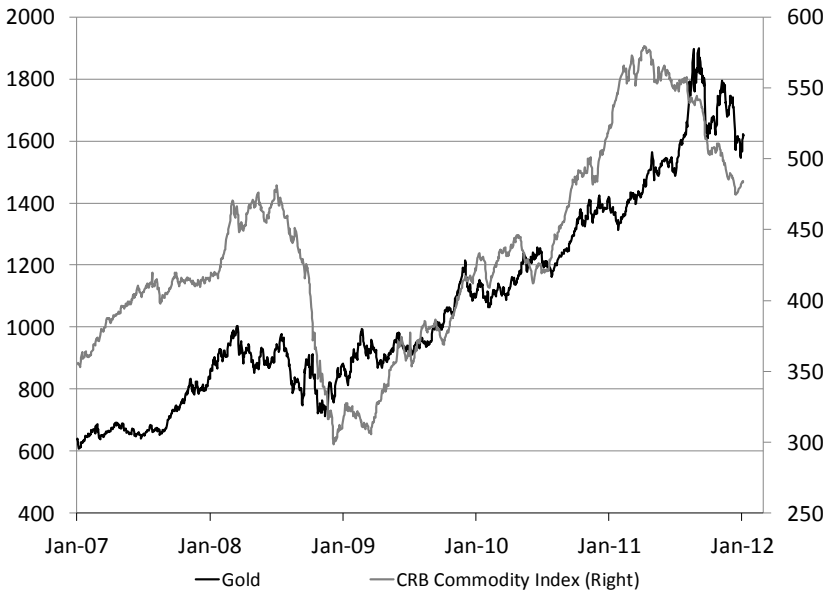

Chart 25: Emerging Mkts - 2yr Spreads to US Treasury (bps)




*Sources: Bloomberg and Decision Economics, Inc*

# Decision Economics: *Commodities, Gold, the Dollar*

Chart 26: CRB Commodity Index, Gold Price




Broad commodity indices slip further. Gold resumes climb.

Dollar rises a bit off lows.

Gas prices down, helping wallets.

Chart 27: Real Trade-Weighted Broad Dollar Index (1973=100)

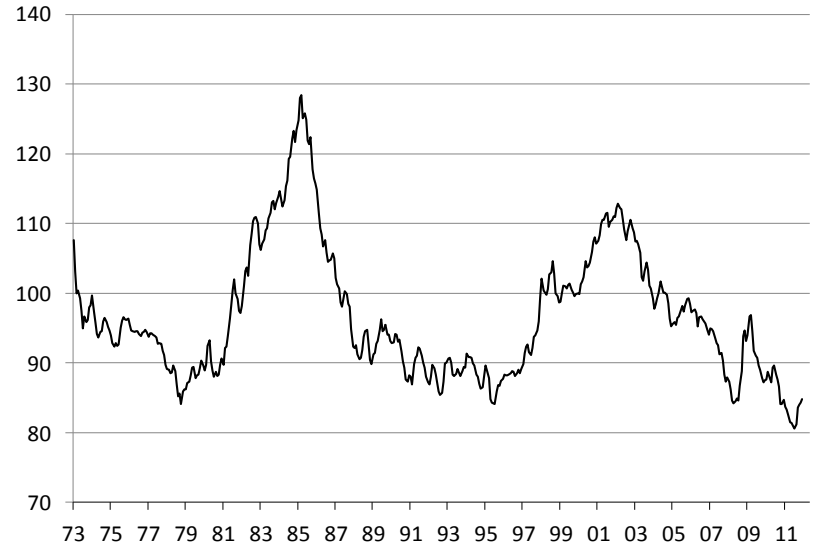
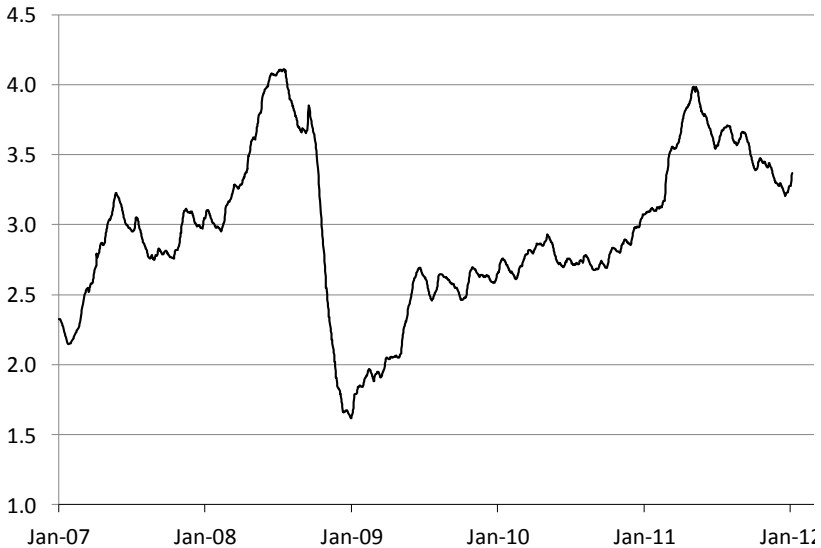


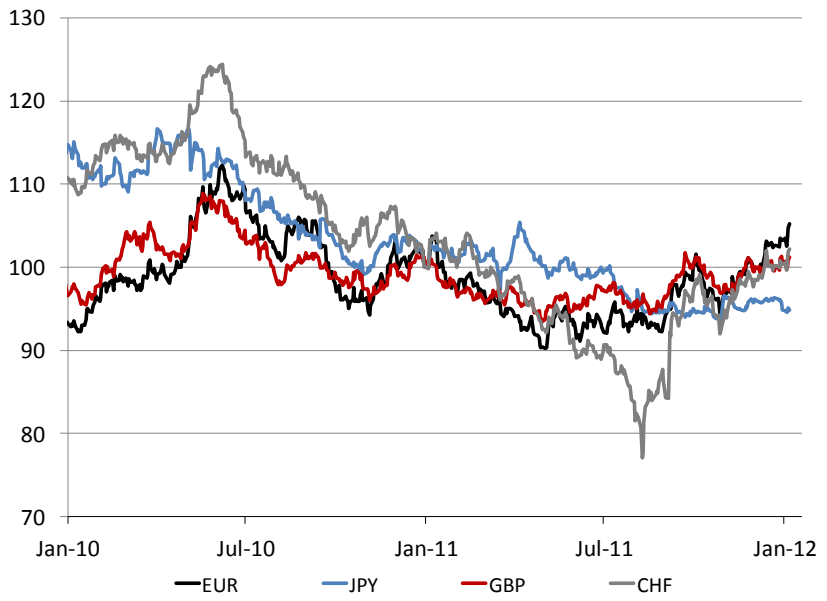

Chart 28: Average Regular Unleaded Gasoline Price ($/Gal.)




*Sources: Bloomberg, FRB, and Decision Economics, Inc*

# Decision Economics: *Currencies Versus the US Dollar*

Chart 29: Dollar Performance (Dec 2010 = 100)




Basket of fiscally-sounder, some "commodity-currencies," and gold better store of value than the USD over the long term.

But, USD still holds "crisis currency" status, evident in clear outperformance since mid-year 2011.

Chart 30: Dollar Performance (Dec 2010 = 100)

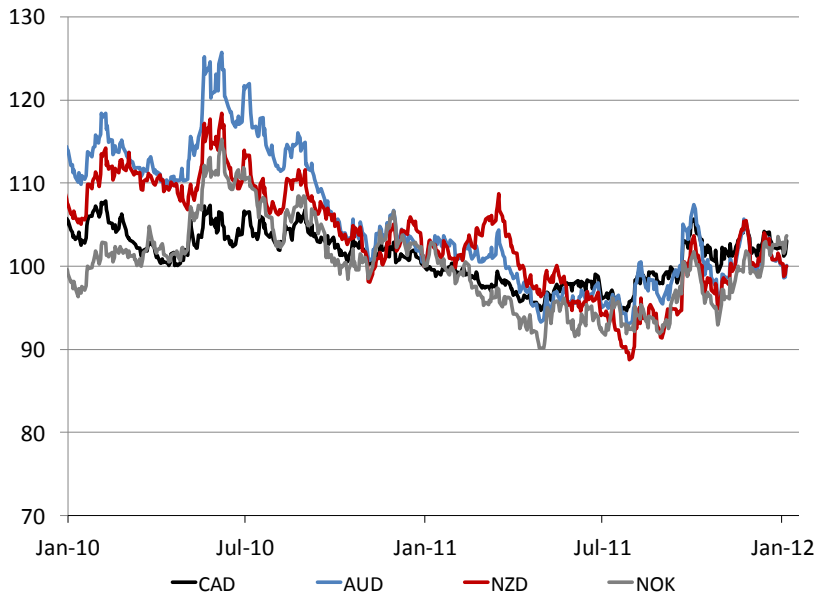
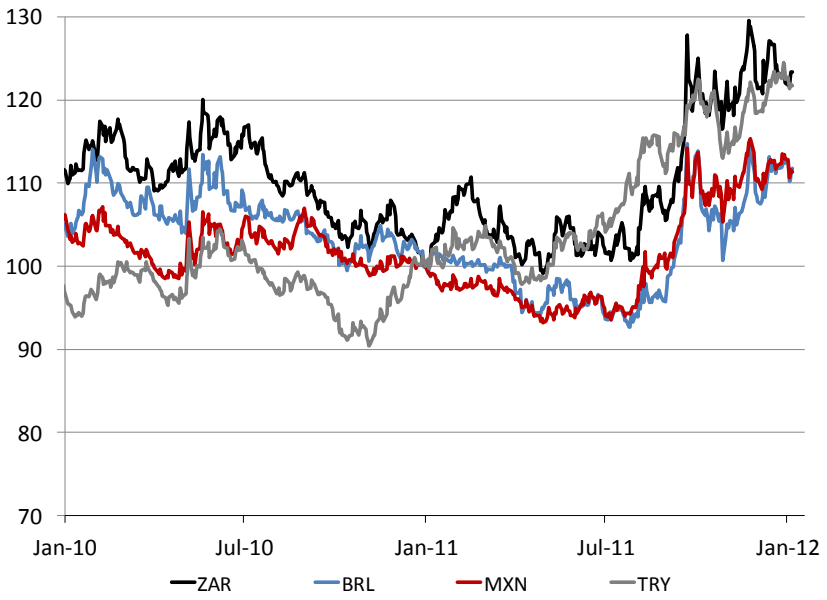



Chart 31: Dollar Performance Against Emerging Market Currencies (Dec 2010 = 100)




*Sources: Bloomberg and Decision Economics, Inc*