The Treasury Bubble is Bursting

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Sincerely,

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The long bond repurchases are complete, and there is not much cash left for agencies and mortgage backed purchase programs.

We know when things don't look right. In early 2000, it was the Internet bubble. Anyone thinking rationally could see, earnings versus prices of Internet stocks did not add up. More recently, we could all see the free credit environment leading up to 2007. When the baristas at Starbucks are getting hundreds of thousands of dollars in loans with no money down, something has to be wrong. Anyone paying attention saw the opportunity to reap significant rewards from these two simple observations. Now, there is a third opportunity.

This bubble may be the biggest one of them all. The Treasury bubble is about to burst.

By now, most investors are wondering why the demand for US treasury bonds seems so high. The US dollar is declining, interest rates on US treasuries are extremely low, and other investments have been doing far better. Government officials and the Fed Chief have proclaimed an end to the recession, and that adds to the confusion.

If the recession is over, why are so many investors scrambling to buy U.S. Treasury bonds that pay nothing. The US government would like you to believe that demand comes from foreign nations. However, that is not entirely true. In fact, there has actually been an Exodus of foreign funds from the United States in 2009. Still, demand appears robust, but it could not just come out a thin air, or could it?

It just might. The US treasury began buying agency debt in January of 2009. It began buying long term government bonds in March. And it has been buying mortgage backed securities since 2008. This was all done in an effort to stabilize the credit markets and keep interest rates low. At least, that was one of the reasons.

Another might be the government's interest in satisfying its own debt obligations and propping up the dollar so it remains a world currency. With careful observation, this second reason begins to make more sense. In fact, a review of the current accounts that foreign central banks hold in the United States makes the treasury bubble much more clear.

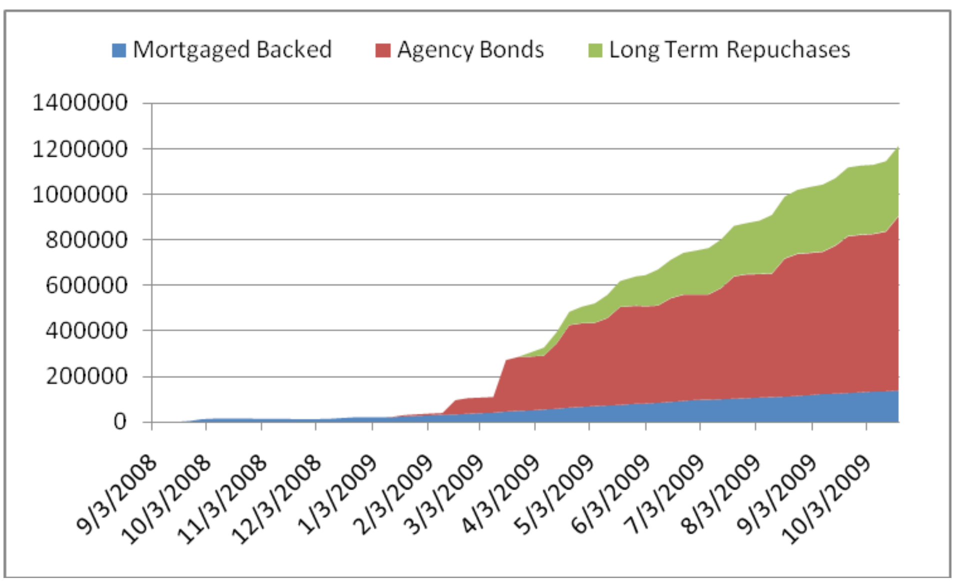
Foreign central banks owned a tremendous amount of agency bonds. In March, the US government committed to buying hundreds of Bllions of dollars in US agency bonds. In total, the US government committed $1.2 trillion to this combined effort. The goal sounds great on paper, but the method of operation produces a shell game, and falsifies demand for US treasuries. This is where the opportunity comes from.

Foreign central banks do have a vested interest in keeping the dollar from collapsing.

Therefore, they are willing participants in this bubble-process. Because they have a stake, they will do what it takes to support the dollar, but they are not willing to commit much more money to the effort. So, the U.S. Treasury came up with a plan.

This is how it works. The US government has been printing money to buy agency bonds from the current accounts of foreign central banks. It deposits the cash into those accounts. Then, the central banks buy U.S. Treasury bonds with those proceeds. In essence, the U.S. Treasury has been printing money to buy its own bonds. This has created the bubble in the U.S. Treasury Market that exists today.

Some investors might argue that this could last for ever, because we could print money forever. However, the treasury has already set a spending limit. The question is, how close are they? In the chart below you will see that the treasury has already spent $1.2 trillion on this combined effort. The chart below includes mortgage backed securities, agency purchases, and long term government bond repurchases. The illustration speaks for itself.



*Vertical Axis in millions of US Dollars

The US government has almost spent all of the monies allocated to this program. Soon, it will not be able to play this shell game anymore. Once that happens, the demand for treasury bonds will change considerably, and the bid-cover ratios will change (decline). Once the US treasury stops giving foreign current accounts the money to buy U.S. Treasury bonds in the open market, the demand for US treasury bonds will decline significantly.

From there, Treasury bond prices will decline.

In the early part of this decade, shorting Internet stocks was one of the most rational investments an objective investor could ever have made. At the end of the credit bubble, shorting financial stocks was an easy way to make money. Now, as the treasury bubble begins to wind down, the easy money will be made from shorting treasury bonds.

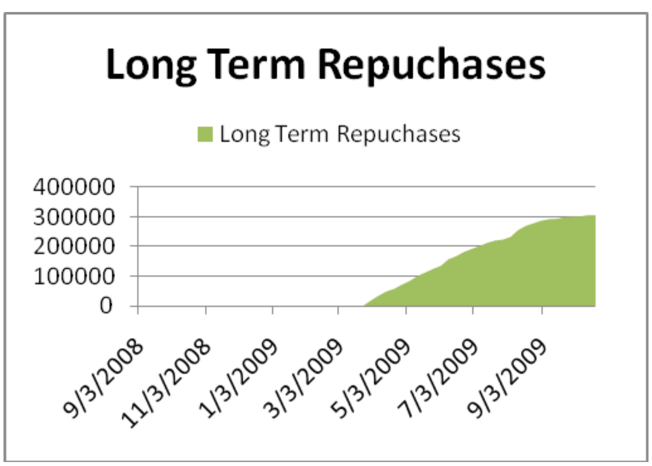
I am recommending TBT and PST for this. These are ETFs that will increase it Treasury Bonds decline. In addition, I expect higher levels of inflation to accompany the increases in interest rates, and I believe gold is an excellent hedge. In fact, but this is left for another discussion, I believe the US government wants inflation to come. GLD can be used for this.

Now, let's take a closer look at the probabilities.

First, the US began aggressively buying agencies in March, 2009. US Treasuries had already begun to decline from their December '08 and January '09 highs, and that lasted until June. This tells me, there was a lag before the foreign accounts began to participate.

TBT is a short based on the long-term bond. Therefore, we can be more specific. First, read this March 19, 2009 Washington Post article, and pay attention to the part about buying long term bonds. Specifically, the sentence that says: "The newest intervention includes a plan for the Fed to buy up to $300 billion of long-term U.S. Treasury bonds over the next six months." Then take a look at the excerpt below. This chart separates the Long Term Bond Repurchases from the Agency and Mortgage backed purchases in the chart above. It shows us that The Treasury has reached $300 Billion.

Washington Post Article: http://www.washingtonpost.com/wp-dyn/content/article/2009/03/18/AR2009031802283.html



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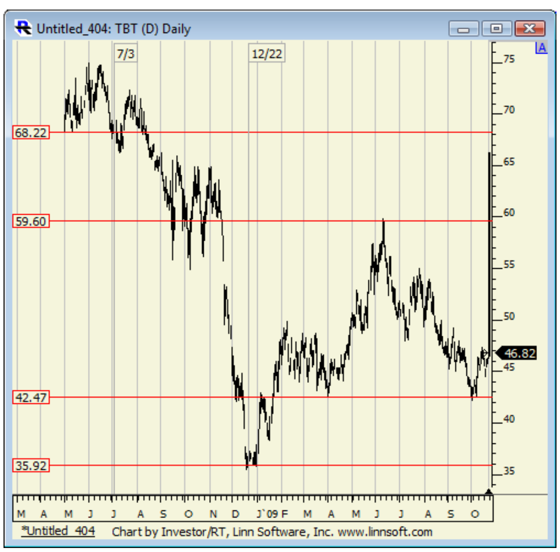
The first purchase was 3.19.09, but the first aggressive purchase did not come until May, and then continued from there. This pushed Treasury prices up, and yields down. This made it cheaper for the Government to borrow, satisfy its revolving debt obligations, and bring the net cost of its debt lower. It is the Government's way of refinancing. The last purchase was on 10.21.09. This article was published on 10.26.09. The shell game on the long end may already be over.

However, I estimate the remaining asset pool to still be approximately $200-$300 Billion. This money is projected to be allocated to Agencies and Mortgage Backed securities, not to the long bond. My estimate provides room for sway and accounting irregularities that could increase the pool. I am being realistic here, not generous. They have more money, but not very much.

I would appreciate a historical table of 'bid to cover ratios' to make this case more concrete, but there are plenty of tools to work with already. If anyone has such a table, please send it to info@stocktradersdaily.com. I would appreciate it greatly.

My primary recommendation for this concern, aimed directly at taking advantage of this Treasury Bubble, is TBT. There are a few things important to understand. First, in July of 2008, when the Target Fed Funds Rate was 2%, TBT was near $70. The Target rate is now 0-0.25%. When the knee – jerk reaction hit In December - January, TBT fell to $36. I first recommended it there. It moved as high as $60 afterwards.



Now, with the entire $1.2 Trillion pool almost exhausted, the long term pool completely exhausted, and the risk of inflation so clearly on the horizon, I believe the time has come again for TBT to be considered. I find support between $42 - $43. I do not think $60 is a limit on the upside though.

Although the charts clearly show $60 as an initial target, I believe TBT can easily push through, and make new highs. This assumes that Interest Rates start to edge up, as the demand for Treasuries subsides.

Ultimately, the open Market will determine fair value for US Treasury bonds, after the shell game has ended. I expect the Market to demand much higher yields, and I expect Treasury Bonds to fall accordingly. On the long end, that should start to happen immediately.

My analysis tells me to expect this to begin to happen within the next 30 days. That makes this recommendation ahead of the curve and timely.

Current Estimates: Target price = near $80. Timeframe = 6 – 12 months. Market conditions in the future will determine sell signals. Timeframe and price targets today will change as conditions change.

Good Trading.

Thomas H. Kee Jr. President and CEO

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