Economic Update

Broadleaf Partners, LLC

Mortgage Rates, A Treasury Bubble and Oil's Comeuppance

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Thirty year mortgage rates have tumbled almost a percent to about 5.5% in the week since the Fed and Treasury department started making purchases of mortgage bonds in the open market. It looks like this most recent approach to stimulus seems to be working given the positive market response. Apparently refinancing applications have doubled in the last week, which should ultimately help free up some cash in consumers' monthly budgets.

Until these recent moves, mortgage rates had remained stubbornly high. While this is bullish for the markets longer term, it will also be interesting to see how many mortgage holders will qualify for refinancing. You would think it would be in most banks' interests to help improve their customers' liquidity profiles, but with many incomes and housing values now lower than where many mortgages were originated, it will be interesting to watch how the game plays out. I will be curious to know how many people will fail to qualify for new mortgages in the very homes in which they live today.

Long term treasury rates have plunged to the mid two percent level on the ten year as investors have continued to seek safety at all costs. While 2.6% may not seem like much of a bargain, in hindsight it has certainly beaten the pants off the forty percent decline in the stock market. The long bond has gained nearly thirty percent this year in price alone and most of this was in the month of November.

Many folks are starting to point out that there may be a bubble in treasuries. The P/E ratio on the thirty year bond - the reciprocal of its yield - is nearly 37x! Stocks - many trading at 10x - now look like a relative bargain. Usually, the faster the growth, the higher the multiple. With the government growing so fast, some multiple expansion in government bonds could be warranted. If you take that route, however, you also need to guess at the sustainability of such higher growth over time.

I am pretty sure the treasury bubble will pop at some point, but as with many asset bubbles, it could persist for a period of time. One thing is for sure, however. Once people start to feel better about the economy, the move down in treasury prices will be every bit as quick and severe as the comeuppance in oil prices has been from $150 to $44. As we have said before, in coveting treasuries at all costs, investors are once again being greedy and - once again - are oblivious to that greed.

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Speaking of oil's decline, all I can say is wow. I guessed prices would come down over the summer, but I was thinking $75 might be a decent resting point. We are down another 6% today to $44. I remember filling my tank with gas during the winter of 1991 in Pittsburgh for $1.54 per gallon, levels I am seeing at some gas stations today. Just like the stock market, fifteen years of gains in oil prices have gone up in smoke nearly overnight.

Some debate whether or not oil was in a bubble this summer or if it has just come back down temporarily because of the global recession. An argument here may seem silly to some, but for longer term investors it could prove an important distinction. When a bubble bursts, it typically takes years if not decades for the asset to return to its prior levels.

To me, bubbles are not marked by the existence of high P/E ratios, but by too much money chasing the same thing. We had that in high-priced tech stocks and low-priced housing stocks. We saw it in private equity a couple of summers ago and commodities and emerging markets more recently. I agree that the demand for oil and other commodities from China seemed insatiable a few months ago, but I wonder if the same phenomenon did not also exist for networking routers and high rise condos earlier in the decade.

To what extent was the run up in commodities driven by the availability of easy credit for anyone who wanted to speculate on price? When the economy recovers - which it will - will these same sources of liquidity exist to drive prices yet higher once again? I must admit I am somewhat doubtful. At the same time, energy stocks did not follow oil prices' parabolic path, so maybe that is a counterpoint to consider.

Understanding and discerning the difference in the issue may not matter in the short to intermediate term, but it will no doubt be a decision we will have to confront and ponder more seriously at some point in the not too distant future. In the meantime, I would sell what everyone is buying and buy what everyone is selling.

Stocks good, treasuries bad.

Kindest Regards,

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