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OBSERVATIONS ON THE MARKET

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The music just keeps playing. Will there be enough chairs when it stops? Liquidity became a hot topic during the global recession of 2008, because there was a point when there wasn't any. As markets began to freeze up, prices went into free-fall. In January of 2008, rates for a conventional 30 year mortgage where at 5.75%. However, if you wanted to borrow over $425,000, the rate was over 8%. That is what happens when there is no 'liquidity'. Today, we seem to have the opposite problem, there is too much of it.

In the letter to shareholders for JPMorgan Chase (the large bank), Jamie Dimon discusses the hazards of liquidity and why we should worry about it. The Treasury market, which has about $12.5 trillion of Treasury bonds currently, is much larger than it was in 2007 when there were only $4.4 trillion in Treasury bonds. However, the average size of dealer inventory for the 10-year Treasury is about $125 million. It was $500 million in 2007. The market is three times larger, and dealers are carrying three times less. You might say who cares, $125 million or $12 trillion, how does that affect me? On October 15th of last year, Treasury yields moved from a high of 2.17% in the morning to a low of 1.87%, and then back up to close the day at 2.09%. This is supposed to be the most liquid market in the world and should not be moving that much. This means that mortgage rates could have moved by .4% during the day depending on which bank you were talking to. In the corporate bond market it gets worse. The market has grown by about 50%, however, inventories of corporate bonds have declined by 75%.

This is happening at the same time that Mexico has issued a 100-year bond that has a yield of 4.2%. Germany now only pays .079% for bonds that mature in ten years. If you have $10,000,000 in Germany, your income is $7,900 per year. In Switzerland $10,000,000 entitles you to pay them $14,000 per year. Ten year rates are negative. What seemed impossible just a few years ago is now happening thanks to the Federal Reserve and the European Central Bank (ECB). When you are buying more than the market is selling, yields go down. The ECB is expected to keep this up into 2016. Our market seems to no longer really care that short-term rates may move up, because the Fed has indicated that rate hikes will be few and far between. This may even make our 10-year Treasury bonds look attractive at 1.92%.

If you have $10,000,000 in the US, our government bonds will generate $192,000 per year income. That implies that our bonds are cheap and should be bought. Then when you consider that the dollar has been increasing in value against most of the world's currencies, they are really cheap compared to European bonds. That creates a real dilemma. There is a scenario where investing in Treasuries may make sense, but long-term value is nowhere to be found. When prices are artificially manipulated, they eventually return to where the market thinks they should be, and that is the potential problem.

Because of the new financial regulations that have been put into place restricting what large banks can invest in, it is potentially creating a new problem. In the past they were the ones that provided liquidity to the market place. They would hold inventories of bonds to trade, but no one has replaced them as they have been forced to leave the market. This does not mean that the markets will crash eminently. The global central banks have almost guaranteed that liquidity will not be an issue for at least a few more years. They are hoping that the market will fill in the liquidity void in time, but new regulations almost guarantee that it can't. This is what worries the CEO of JPMorgan Chase. His bank survived the 2008 crises better than any other major bank with maybe one exception, so he is worth listening to. The former CEO of Citigroup, Chuck Prince, stated in 2007: "As long as the music is playing, you've got to get up and dance." He is no longer the CEO of Citigroup.