

Will Interest Rates Be Going Higher?

By Weiss Research, Inc.

I've had plenty to talk about in recent weeks — underperforming REITs ... the ongoing problems in housing ... risky commercial real estate financing ... private equity firms gone wild ... overseas profit opportunities. These are truly interesting times in many markets.

But there's been one thing I *haven't* talked about — interest rates. The reason? They haven't been going anywhere. You ever see one of those EKG machine readouts? That's what the chart of 10-year Treasury Note yields has looked like since last August.

However, we may finally ... finally ... be getting the interest rate breakout I've been looking for. And the direction of that breakout is *HIGHER!*

This has obvious implications for interest-rate-sensitive sectors like residential and commercial real estate. It could also affect the broader market, too. So today I want to tell you ...

Why the Snoozefest in Bonds May Be Coming to an End

When professional traders want to speculate on U.S. interest rates, they primarily use bond futures. And for several months, 30-year Treasury, or "long bond," futures prices have been fluctuating in a range — roughly between 109 16/32 and 115.

Remember, bond prices and yields (meaning, interest rates) move in opposite directions. But when bond prices go nowhere, interest rates remain stable. For example, the yield on 10-year Treasuries has vacillated between 4.43% and 4.90% for about nine months.

The primary reason for the lack of action in bonds? The economy has been trapped in what I call "Stagflation Lite."

See, *inflation* remains above the Federal Reserve Board's preferred range. Typically, that would drive *bond prices lower* and *interest rates higher*.

However, economic growth has been weakening — the economy expanded just 1.3% in the first quarter, the smallest gain in four years. *Economic weakness* typically drives *bond prices higher* and *interest rates lower*.

Bottom line: We've seen a big battle with a lot of bloodshed ... but no real progress on either side. Thus, bond prices and interest rates have been stuck in neutral.

That may finally be changing, though. I see four reasons why:

1. China diversification fears — When it comes to currency reserves, China is the 800-pound gorilla. Its reserves topped \$1.2 trillion in March, up 37% from a year ago. That

accounts for 23% of the world's reserves, far ahead of the next largest player (Japan at 17%).

China's money pool is swelling because the country is running massive surpluses with its trading partners. In the past, it was content to just let the vast majority of that money sit in low-yielding U.S. Treasury bonds and other debt instruments. At last count, it had more than \$420 billion of them.

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Fact #1. For many investors, the total amount at risk in their stock portfolio is similar to — or even larger than — the amount at risk in all their other assets combined.

Fact #2. Stock market declines that damage your portfolio are more frequent occurrences than storms or disasters that damage your home.

Fact #3. The dollar damages could be significantly greater!

Now, China is now looking to diversify its reserves into other investments. It's setting up a reserve-management business that will take those funds and invest them in all kinds of instruments — foreign stocks, Chinese firms, and more. We just learned, for example, that China is giving \$3 billion to private equity firm Blackstone Group.

If China stops buying so many Treasuries, who's going to step up to the plate? That's a question bondholders can't answer, so they're turning into nervous sellers.

2. *Inflation concerns are winning out* — It was easy for bond traders to ignore high inflation readings a few months ago when the economy was falling apart, housing was crashing, stocks were tanking, and oil and gas prices were slumping.

But a few recent economic readings (initial jobless claims, industrial production, etc.) have leveled out. And while the news on housing isn't getting better, it isn't getting much worse, either. Plus, the global stock markets are rallying sharply.

As a result, fixed-income investors are finally focusing on the elephant in the room: Inflation. The fact of the matter is that import prices, producer prices, and overall consumer prices are all still rising at a decent clip. The so-called "core" Consumer Price Index isn't rising as quickly as it was a few months ago, true. But it remains well above the Fed's comfort zone.

3. *Foreign interest rates keep on climbing* — I've said it before and I'll say it again: While our central bank has wussed out in the anti-inflation fight, foreign central banks have not.

The European Central Bank is raising rates. The Reserve Bank of New Zealand is raising rates. Central banks in India and China are raising rates. And so is the Bank of England (BOE). In fact, policymakers at the BOE even considered raising rates by half a percentage point at their most recent meeting, rather than the customary one-quarter of a percentage point.

Until recently, those foreign rate hikes mostly impacted the U.S. dollar — driving its value down. Now, those rate hikes are starting to push up U.S. interest rates, too.

4. The technical pattern doesn't look good — Some investors consider "technical analysis" a bunch of mumbo jumbo. But I think reading the charts can be a great way to get a feel for what the big-money investors are doing. It can give you a "tip off" that a major new trend is unfolding.

Right now, things aren't looking so hot for bonds. Take a look at this chart and you'll see prices peaked in early December. They made one lower high in late February, then a second lower high in early May. All that's left is what I call "last ditch" support in the low 109 area. If that gives way, bonds could fall off a cliff.

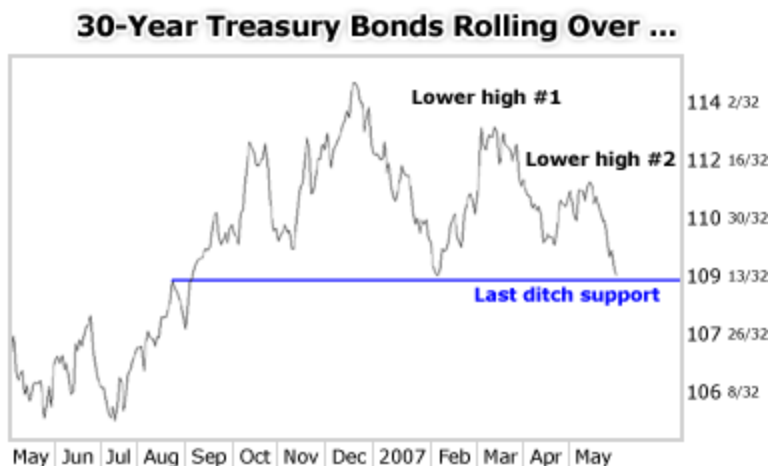
What You Can Do To Protect Yourself ...

A flood of easy money, fueled by low interest rates, has helped grease the market's wheels for some time now. It's why you've seen so many leveraged buyouts, corporate takeovers, surging valuations, and rocketing stocks.

But if the bonds do break down, and interest rates punch through the top end of their recent range, that could throw a real wrench in the works for *vulnerable sectors, such as housing and commercial real estate*.

Also, when rates are rising, short-term instruments hold their value much better than long-term bonds. Treasuries with shorter-term maturities also allow you to continually reinvest your money at higher and higher rates.

So continue to *keep your fixed-income money in short-term instruments*. That includes three-month or six-month Treasury bills, Treasury-only money funds, or exchange-traded funds that hold Treasuries with maturities of two years or less.



Lastly, *now might be a good time to pocket some of the big gains you may have racked up* during this sharp market rally. At the very least, consider tightening some stop losses. Because if bonds do break down, we could be in for some fireworks!

Money and Markets (MaM) is published by Weiss Research, Inc. and written by Martin D. Weiss along with Sean Brodrick, Larry Edelson, Michael Larson, Nilus Mattive, and Tony Sagami.

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