

## Commentary

### Understanding the Short Treasury ETF

Yesterday, Proshares ([www.proshares.com](http://www.proshares.com)) introduced the first ETF (Exchange Traded Funds) that is designed to rise in price when Treasury bond prices fall. In effect, you are now shorting the Treasury bond market without having to be on margin, or open up a Futures account. They introduced 2 different maturity options as well. You can short the 7-10 year Treasury bond or the 20+ year Treasury market. The ETF will shadow the Lehman Brothers 7-10 year Treasury Index as well as the Lehman Brothers 20+ year index. Both ETFs will be listed on the American Stock exchange. The trading symbol for the 7-10 year ETF is "PST" and the trading symbol for the 20+ year ETF is "TBT".

These ETFs are "enhanced" or "ultra" EFTs as well. What is enhanced? It simply means that this index seeks 200% of the inverse of the daily performance of the underlying index... In plain terms the index is 2 times short. It is designed to deliver twice the inverse of the daily performance of the index. If the index declines 1% in a day, the ETF will increase by 2%.

Why do we want to short the Treasury market right now? We think there are several reasons. First, buying Treasury securities right here just does not make economic sense. The inflation rate is hovering around 4%. With Treasuries yielding about 3.85%, the buyer of Treasuries is losing to inflation right off the bat. And if these are purchased outside a retirement account, you will pay taxes on the interest as well. So a 3.85 percent yield is reduced by at least 25% by taxes leaving you with a 2.88% after return. Add to this equation the distinct possibility that inflation will rise over the next couple of years and you have a very unattractive investment at these yields.

Since the credit crisis, Treasury Bonds, in our minds were simply "crash insurance" and nothing more. They were being bought by money managers solely as a way to protect their portfolios in case the stock market crashed and lessen their exposure to equity and credit risk. Plus the fact that the Fed kept easing and lowering benchmark rates, helped enhance their attractiveness. So as the risk of a market crash have subsided and

inflation figures are starting to rise, treasuries are looking very unattractive and money managers are not only questioning why they are holding them, but are now seriously looking to sell them. This is what we call an asset allocation trade, where managers sell out in force of one asset and replace it with another. This seems to be the play today.

Another major reason we are looking to short the Treasury market is because of data we just compiled about the 10 year return of Treasuries vs. stocks. The conclusion is important and is at the core of our conclusions. Over the last 10 years, Treasuries have vastly OUTPERFORMED stocks. This will be shocking to most, especially 401k participants who usually have all of their money invested in stocks vs. bonds. But the facts are in.

The average annualized return for the S&P 500 during the 10 years ended March 2008 was 3.5%. Not only is this well below the average annualized return of 11.08% for ten year periods, but it is below the 7.54% annualized return of Treasury bonds over the same period.

**THE LAST TIME SUCH A PERFORMANCE GAP OCCURRED IN FAVOR OF TREASURY BONDS WAS APRIL 1941.**

Is this irrational exuberance within the bond market? We think so. We think for reasons stated above, the Treasury market will become the next financial market bubble. Just the economics of bond yields today make it very hard for fixed income doing well in the future. This past 10 year performance has been an aberration of the historic trend and normal returns should return to stocks and bonds in the future. That means stocks should outperform bonds by a good margin over the next 10 years, and given the huge spread between stocks and bonds over the last 10 years, this out performance could be near the top of the scale. Vice versa, we believe bond performance could be dismal over the next 10 years hence our interest in shorting that specific market.

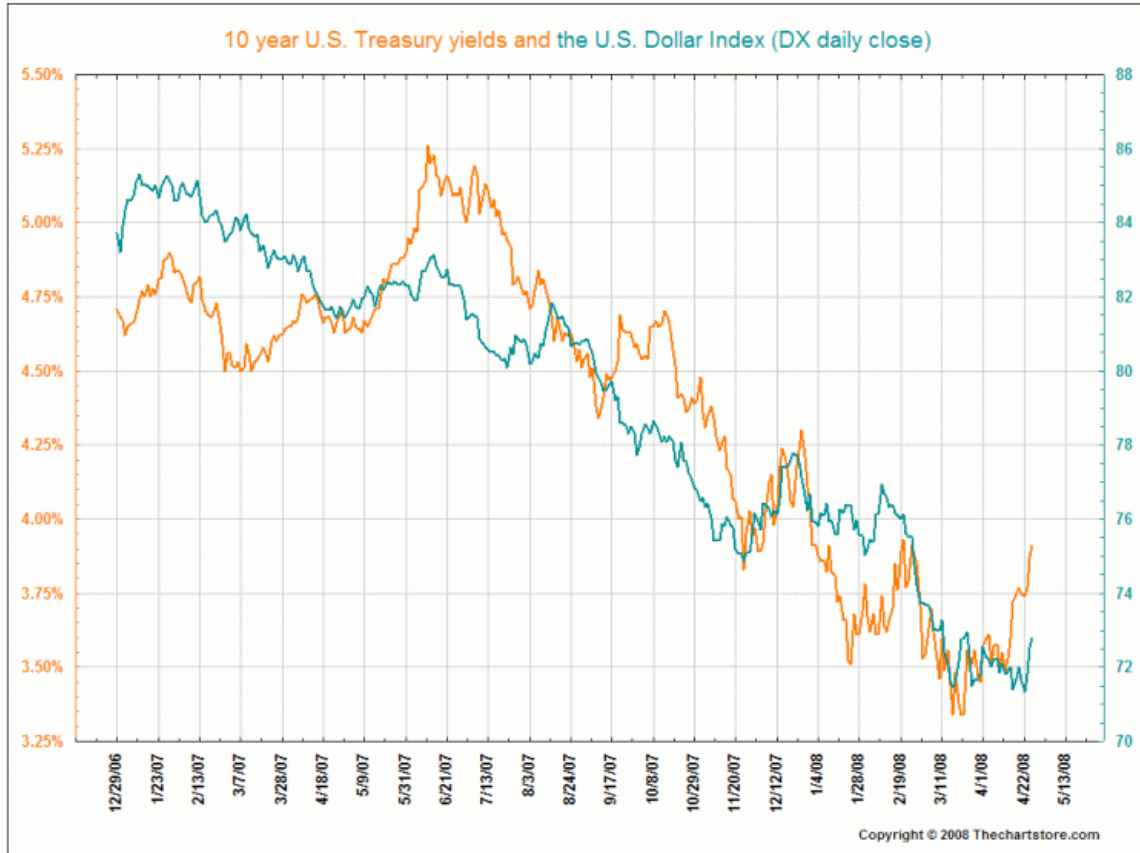


The above long term monthly chart shows interest rates on the 10 year Treasury bond dating back to 1994, and as is evident, we are near the historic lows of 2003. The major down trend line lies up around the 4.75% level. This trend line has been in place for the entire contract life of the 10 year bond so it is considered a very major technical area of resistance.

If we look even farther back to 1950, rates back then were right where they are today. Some may argue that yields can drop even further looking at this long term chart. We would argue that notion just based on inflation and the value of the dollar. Today's yields are at the same level that they were in 1954, 1956, 1957 and 1961. Eisenhower and JFK were in the White House. Our parents and grandparents were earning the

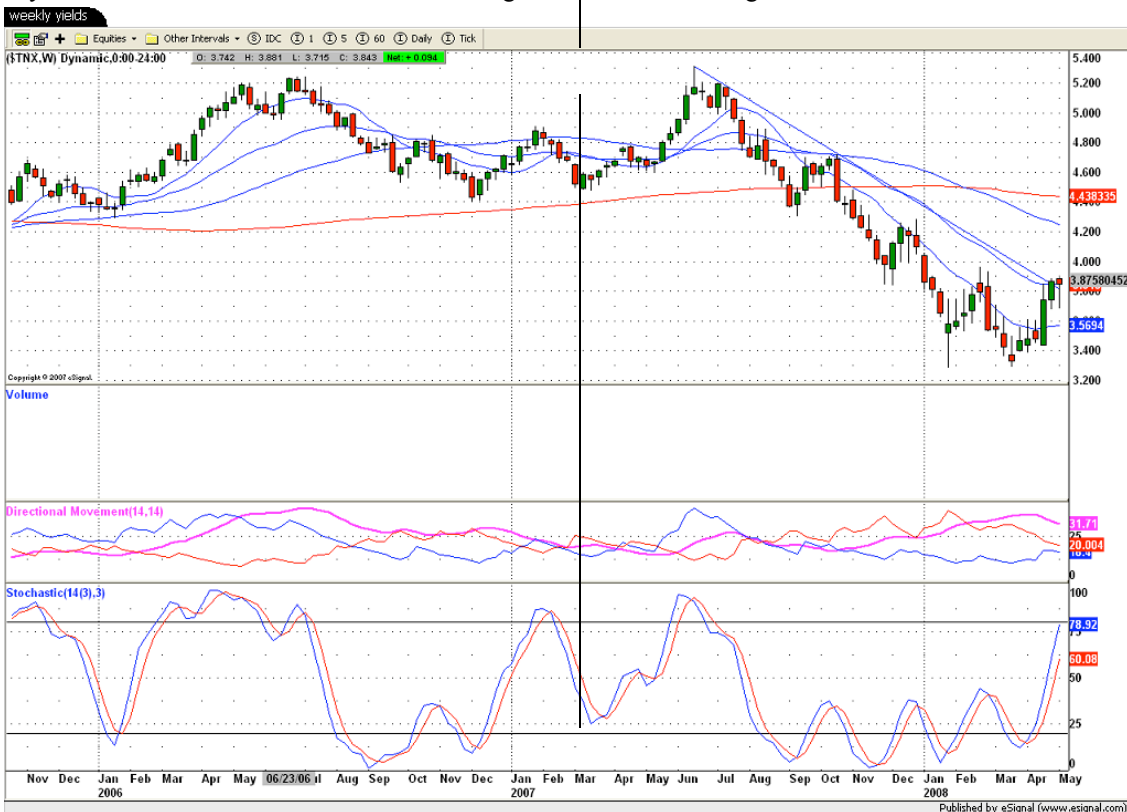
same amount of interest on their savings and investments that their children and grandchildren are earning today. But the cost of things like cars and homes and food are up in some cases 50 times what they were back then. So to think that interest rates can still go lower is to think that we will be returning to a deflationary economic period equivalent to the Great Depression and beyond. We do not think that is going to happen.

We also think the dollar is destined to rise. If you look at the following chart, you can see how interrelated 10 year bond yields and the value of the dollar have been. If you think the dollar has bottomed and will rise from here, then you must also believe that interest will go higher as well.



Our conclusion is that bond yields are at a crossroads. If we look shorter term at a weekly bond chart, you can see that we are right near the down trend channel line and any move above this trend line will mean higher

yields. We still need to see 2 closes above this line to put on a position but we are with the Proshares ETF we now have the tool available to us to take advantage of these rising rates.



A close this week above that downtrend line would constitute buying the PST as it would be the second weekly close above the downtrend line. We would be inclined to do this.

### **CONCLUSION:**

We believe there is an asset reallocation away from debt and into equities just beginning to take hold. We believe that it makes sense to short the Treasury bond market by using the ETF, symbol PST, that shorts the

Lehman 7-10 year Treasury Index. We also feel that the historic out performance of Treasuries over equities that has taken place over the last 10 years will reverse shortly. We believe that eventually a short bond, long equity position will be a very profitable one. We continue to believe that using foreign ETFs vs. US indexes will enhance that return even further. The first step available to us is to start this asset reallocation by shorting the bonds and buying the PST.

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