

# CRISIS AT THE FED

By Adrian Douglas

The upcoming meeting of the FOMC on June 28-29, 2006 is an event that is like no other FOMC in the last 24 years. Make no mistake about it, the FED is in crisis. The crisis is best summed up by the following graph of the yield on the 10 year Treasury.



The interest rate on the 10 Year Treasuries has been in a well defined descending channel for 24 years. On June 23, 2006 the yield on the 10 Year closed at 5.23%. As indicated by the red arrow the yield has broken up and out of this 24 year trend channel. In 2000 the yield moved slightly above the upper resistance line but in 24 years there has NEVER been a confirmed break-out as has just occurred.

The implications of this are enormous. The 10 year Treasury rate drives the rates of the mortgage market. The ever decreasing cost of borrowing that has fuelled an unprecedented boom in house purchases and refinancing has commenced a reversal.

Let's zoom in and take a look at the last 3 years.



Within the 24 year down trend channel the yield on the ten year treasury has, over the last three years, been consolidating within a box formation. In the last 6 weeks the yield broke up and out of this box formation.

Bernanke is widely expected to raise interest rates by 0.25%; some market observers are predicting a surprise 0.5% rate hike. Any rate hike whatsoever is going to add fuel to this rate break-out rendering it irreversible.

The US economy is like a drug addict that is dependant on fixes of cheap credit. This has enabled the government and individuals alike to live beyond their means. A trend of higher rates will bring the economy to a grinding halt eventually leading to recession.

If Bernanke has a moment of hesitation and opts for a pause in rate increases the dollar is going to tumble which will in turn lesson the appetite of foreigners to hold US assets, particularly treasuries. The market will impose higher rates independent of what the FED wants.

Many analysts incorrectly state that rising rates strengthen the dollar and make gold go down. This is true in a stable and strong economy. The US economy is a pyramid standing on its point. It is stable while no one knocks it over! Trillions of dollars have been created over the last 24 years which have not had an

inflationary impact because they have been hoarded as the world's reserve currency, or been used to purchase treasuries, which was the principle driver of the declining rate trend. As these dollars are dishoarded the inflationary effects will be like a Tsunami. The resulting rise in interest rates will always be behind the curve. They will not be high enough to encourage net dollar buying; they will be high enough only to slow down the dollar dishoarding. A portion of the funds seeking refuge from the declining dollar will go into precious metals. It can be seen from the chart above that in the last great gold bull market the yield on the 10 Year went from 6% in 1971 to 15% in 1981. Rising rates do NOT prevent a gold bull market, on the contrary, they are entirely consistent with runaway inflation which is conducive to funds seeking out the only real money in the world...GOLD.

Next week Bernanke will Chair the most crucial FOMC meeting in the last quarter of a century. Unfortunately, destiny is already written; a twenty four year trend is broken. For the rate decision he might as well flip a coin, heads he **doesn't** win, tails he loses!

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