

November, 2006

I completed an interview with Futures Magazine yesterday, for their January 2007 issue.

The questions they posed are below, along with my answers.

Their January issue is usually a rate and economy forecast for the upcoming year.

You may see some information on Dec06 and Nov06 in my answers.

When I was writing my answers for the interview I didn't know what issue they were going to be in. Although the information for Dec and Nov06 won't be included in the article, I thought they'd be pertinent for you, so I left them in.

Thank you

Jim Goulding, GHCO, Chicago Treas-Arb

FM: What is Jim's overall view on where interest rates are headed in 2007?

Inflation will determine the level of interest rates, in 2007.

I'm looking for inflation to move lower through April, then slowly move higher into August.

By the end of the year it will have moved lower again.

Therefore, there's two questions to answer, what will the fed do? And where can we expect the 10y to trade?

I'm looking for the fed to cut rates twice next year.

At the July meeting, .25 bp, and again at the August meeting by .25.

That'll be it.

As far as the 10y: I'll look for Core CPI YoY inflation to move down to 2.2 percent by April. That should be the low for the year as far as core CPI YoY inflation goes. I don't see us moving higher than 2.8 YoY core CPI.

That dictates a range for the 10s of: 4.10 to 4.80

Credit my boss Earl Spencer, the head of Treas arb with that equation.

The predictions are mine, the equation is his.

FM: What will be the major factors affecting this?

For the long end of the market, it's always going to be inflation data. CPI, PPI, etc.

For the short end, it'll be the FOMC.

Then, of course we have everyone's opinion in between the economic releases and the FOMC meetings.

That must be measured day to day by reading newsletters, every morning.

FM: With the 10-year note recently trading near its lows for the year, what insight might he give traders for trading this in the coming months?

From mid Nov 2006 to mid Dec 2006 we'll look for a range in the 10s of 4.62 - 4.45.

I don't think the 10s trading 80 bp through the Fed Funds rate is unreasonable.

I don't see volatility picking up until June 2007. Dec 2006 volatility should be a bit less volatile than Nov 2006 volatility.

That should give traders confidence to increase their trading size. I'm a big proponent of picking up trading size when volatility is moving lower. As long as you have strict money management parameters in place, this shouldn't be a problem.

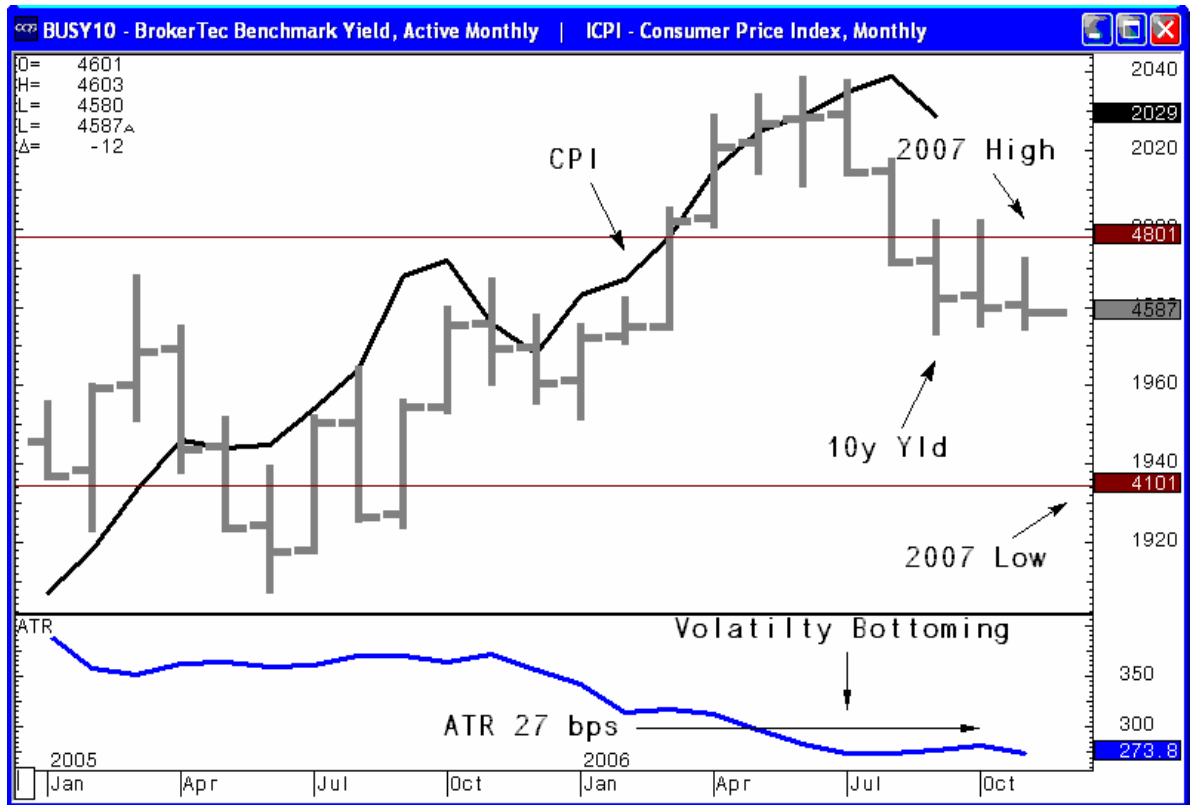
Many traders either try and skate until the end of the year, or they bet too large trying to make up for a poor year.

My experience coaching traders tells me to meet somewhere in the middle. No skating, no trading in the past.

I'd keep my eye on the swaps market also. The spreads have been tightening extremely quickly in recent weeks.

That should put a bid in the 10s.

Finally, look for the last two weeks in Dec to go out with a fizzle. Low volume and low volatility.



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FM: If he can discuss technical's, I am happy to hear his technical view on where interest rates are headed.

Besides what I've touched on above, I'd say a trader must step back and look at the big picture to understand what kind of era are we trading in.

1) We're repeating invention cycles.

As the computer, internet, cell phone, and broadband push from 50 % US household penetration (2000/01) towards 90 % (2008/09), in some regards we are repeating the 1920s automobile cycle.

Auto's hit 50% household penetration in 1920/21. We saw a shakeout of that market that was eerily similar to the tech shakeout in 2000/01.

[See my Research Note *The 1920-21 Crash and The 2001 Crash, A Comparison*]

2) However, there's something very different about the era we're trading in now compared to the 1920s, that is, we are becoming a post industrial society. This means we've exported the most volatile sector of business, manufacturing. [See Gavekal.com, *A Brave New World*]

Yes, we still have volatility left in us, here in America, but not until we see a financial crisis.

That should take place in 2010/11. Until then, interest rates will remain steady as she goes, with .25 increases and decreases. Bernanke doesn't want to rock the boat...yet.

FM: If he can discuss the overall economy, I would like to know what he sees as the biggest potential drag for the economy next year, for example the housing market (?) and what might be the biggest potential positive for the economy?

The housing market must be divided into two categories.

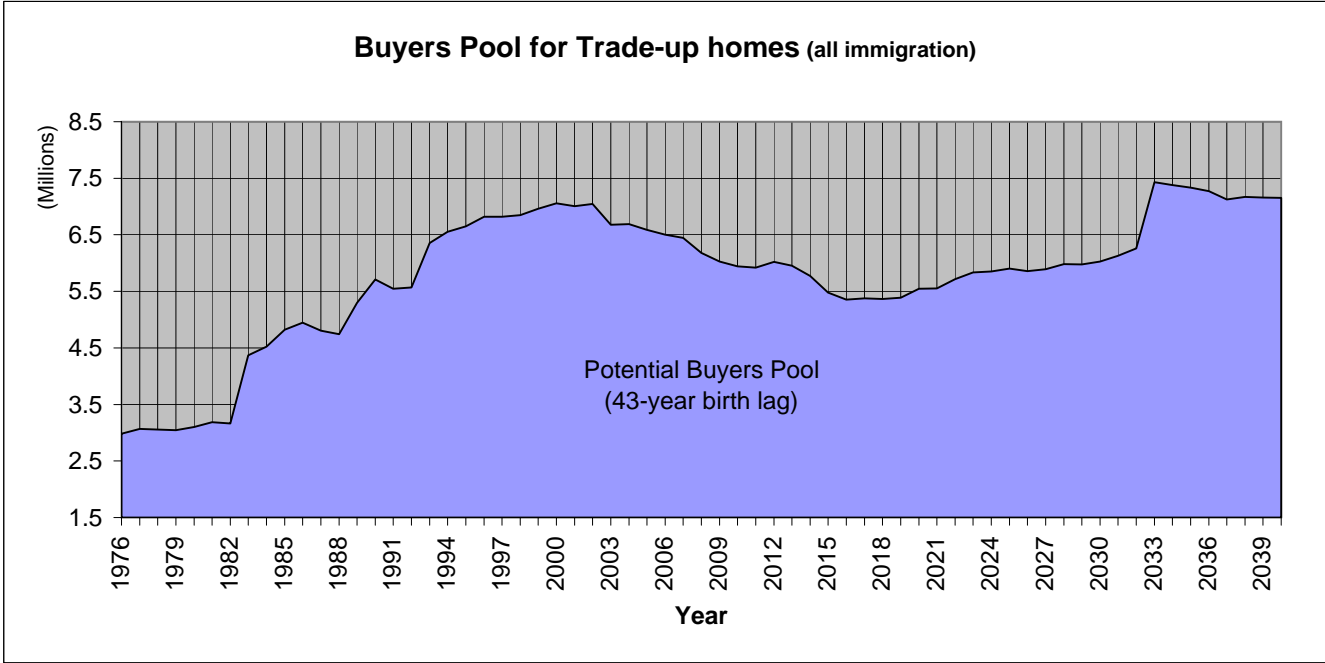
1) Houses under 750k (start-up homes) and houses over 750k (trade-up homes).

2) There's plenty of buyers to purchase start-ups all the way until 2016.

Those homes aren't an issue. [see my Research Note *Housing*].

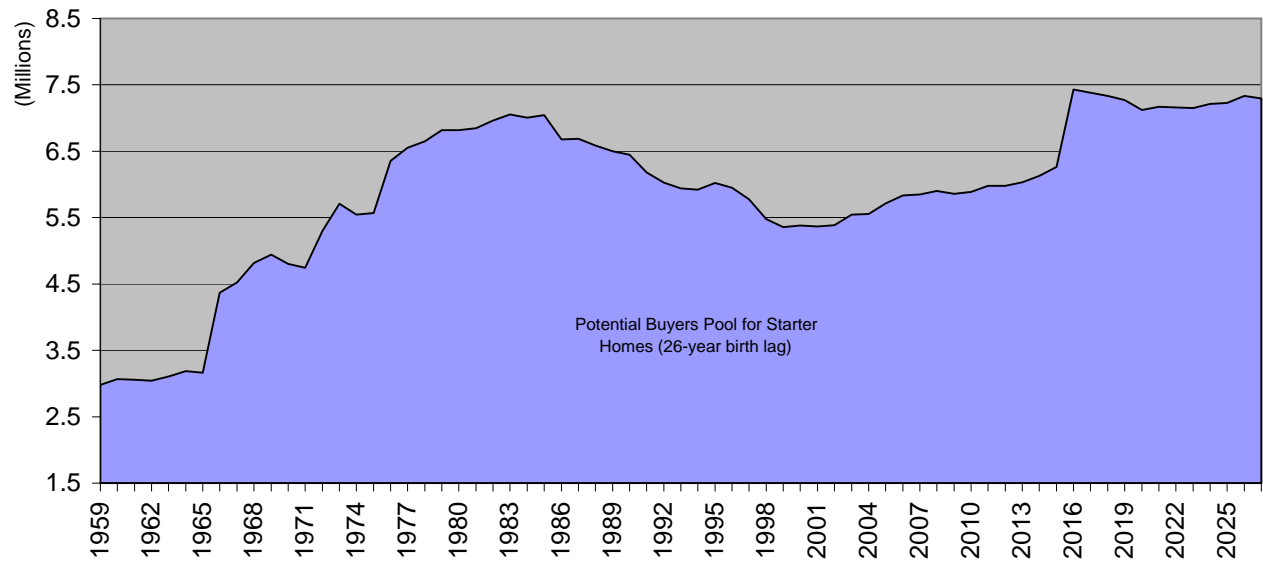
However, the trade up homes peaked in January, 2003. It takes about three years for a market like that to cool. I was looking for a slow down in that market by Jan 2006 and that's exactly what we got.

That market has peaked and will not turn up until 2033.



However, as the chart below shows, there are plenty of buyers ready to buy start-ups.

Potential Buyers Pool for Starter Homes (all immigration)



■ Potential Buyers Pool for Starter Homes

The biggest potential positive for the economy lies in several areas.

- 1) Geo-political tensions appear to be subsiding.

Although I'm sure we will receive some shock-and-awe news throughout 2007,

I'm confident the market is becoming less reactive to these types of stories.

- 2) Another area I see as being very positive is the stock market.

I've been a bull since May 2004 when I put out a buy signal for the DJIA. It was trading at 10k.

So far we're doing well with that. I'm still very bullish and see the down heading up about 22% in 2007.

The question I'm asked when giving this kind of projection is, *What is it based on?*

What I've come to learn is, we live in a time that if stocks go up, they're suddenly *way too high* and if

they go down, *the big crash is coming*. I can't win, so I don't release what I base my

predictions on. I'll say this though, we're going a lot higher between now and 2010.

The crash will come, but not until then. When it does happen, no one will believe it's happening.

[see my Research Note *Dow 35,000*]

- 3) The other item I see as great for the economy is continued deflation in consumer basics, like, clothing, shoes, and electronics etc, (although that's not a basic need!)

This deflationary aspect will continue to offset the areas that are hurting consumers, like health care, housing, and schools.

All in all, we should see Core YoY inflation move to about 2.2 % next year on the low side and 2.9 on the high side.

FM: And any overall outlook he might be able to offer on the 2007 economy.

We can discuss consumer spending, energy prices, etc.

Energy prices are very difficult to predict because of geo-political tensions. There's probably about a \$25-30 bbl premium in Oil at the moment. With China's increase in oil usage, as an emerging manufacturing economy, oil is probably fairly priced in the mid 30s.

The rest of the premium is strictly middle-east tensions along with Nigerian problems. This market is impossible to predict. It's a wild-card.

I don't foresee consumer spending as an issue in 2007.

They'll probably tighten their belts in the first quarter of the year which will give the elusion of an ever-slowng economy.

That'll force the Fed to move by mid year. But look for the consumer to pick-up their spending habits in Q2.

and throughout the second half of 2007

I'm looking for an average GDP growth of 3.5 % when all is said and done, in 2007. However, like I said, that number will be erratic throughout the year. With the GDP being the lowest in Q1, say, 1.7 % but then picking up substantially the rest of the year.

Volatility should bottom into June. The markets will get more volatile from that point on, well into December.

I'm looking for a very busy November and December in 2007.

Further Reading

Research Note: *The 1920-21 Crash and The 2001 Crash, A Comparison*

Research Note: Housing

Research Note: Dow 35,000

Web Sites

Harry S. Dent (HSDENT.com)

Gavekal.com, A Brave New World

www.jamesgoulding.com