From: Arthur McKee <art@mckeeinvestments.com>
Subject: **US Bonds, Bernanke Raises Rates 02/18/2010**
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Event 1:
Yesterday, the Treasury Department said that foreign demand for US Treasury securities (US govn't debt) fell by the largest amount on record in December with China reducing its holdings by $34 billion. They also reported that total foreign holdings of US Treasury securities (US government bonds) fell by $53 billion in December, surpassing the previous record fall of $44.5 billion in April 2009.

Japan, now the "heavy weight title holder" for US debt, also decreased their holdings but did not out-run China.

Event 2:
Ben Bernanke raised the Discount Rate from 0.5% to 0.75%. This is the rate that the Fed charges to banks when banks borrow money directly from the Fed "Discount Window". The Federal Funds target rate remains at 0% to 0.25%, which is the rate that banks charge each other for loans.

This signals to the markets that interest rates will start to increase, albeit slowly. Bernanke moved just the Discount Rate, and left the Fed Funds rate the same, which is something like dipping a toe into the water to check the temperature. It sends a signal that the Fed wants to move rates higher, but keeps the "market" assured that it will happen slowly.

Potential Conclusion:
The government is in a tight spot. Other countries are less willing to lend money to the US government at almost 0% interest rate. Therefore, to attract more lenders, our government will have to offer higher interest rates (and get our deficit under control). However, the government is hesitant to do so because the unemployment rate is still higher than they would like. Raising rates generally slows down the economy and the current budget proposals call for even greater deficit spending. This is a difficult road to navigate and I bet that John Maynard Keynes didn't see this one coming. (John Maynard Keynes is considered the "father" of "Keynesian Economics" which says that the government should conduct deficit spending when the economy slows down.)

These two events are connected. I believe that our government is worried that their source of cheap money is coming to an end. I wouldn't lend to our government for 0%, so why would I expect other countries to do so?

NOTE: I believe that China and most other foreign governments are going to slowly, steadily, and quietly reduce their holdings of US debt and consequently, US dollars. The Treasury report provides further evidence of this. If this trend continues, the value of the US dollar will fall relative to other currencies and that will lead to inflation because most of the "stuff" we buy is imported. It will also make our exports more attractive, which is the silver lining. However, because we import so much relative to our exports, the falling value of the dollar will really hurt for a while. This is one reason we diversify our holdings to include international investments.

Best Regards,

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