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INTELLECTUAL AMMUNITION

A Considerable Seduction

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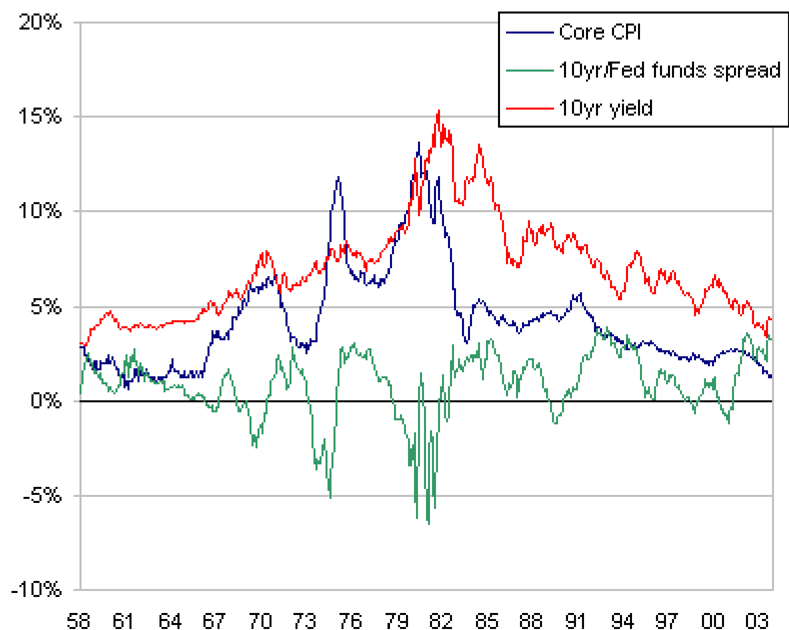
The Fed's campaign to lower long-term yields and increase inflation is a dangerous bait-and-switch.

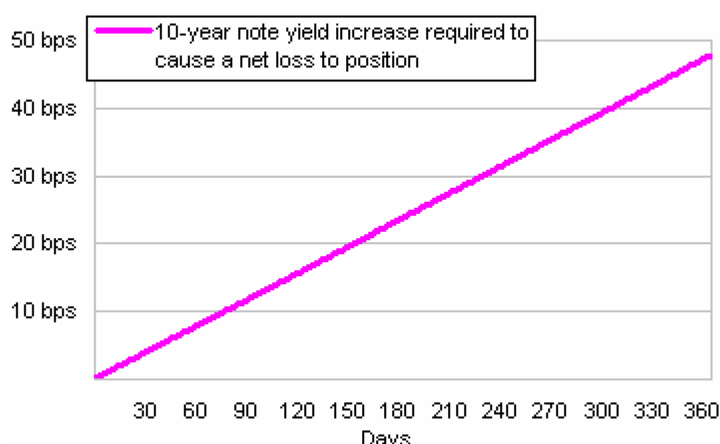
Ongoing assurances from **the Fed** that "policy accommodation can be maintained for a considerable period" form the core of a deliberate strategy to lower the level of long-term interest rates -- since the *overnight* rate that the Fed controls directly cannot be lowered much further, if at all (see note 1, below). Low long-term rates, in turn, are themselves the core of the Fed's deliberate strategy to not only quash deflation, but to raise the level of *inflation* -- so that the Fed may freely engage in macroeconomic fine-tuning without having to worry about the zero-bound in the overnight rate (see note 2, below, and "Desperately Seeking Inflation?" October 29, 2003). These objectives were laid out in black and white by **Fed Governor Ben Bernanke** in his remarks before the **National Economists Club** in November 2002, and the Fed has been following Bernanke's play-book ever since.



For investors and traders these Fed strategies amount to a dangerous seduction. The bait is the yield-curve -- investors are being lured into extending maturities to capture a near-record level of the spread between Fed funds and longer-term Treasury yields. Yet yields themselves are bouncing off this summer's levels at 35-year lows, not seen since the days when CPI inflation stayed reliably around 1%. When yields inevitably rise -- either because the Fed raises the overnight rate, or because they succeed is raising the inflation rate, or both -- then the resulting capital losses in Treasuries will almost certainly wipe out any short-term gains conferred by today's wide spreads. Anyone who was lured by the spread into buying long-term bonds at low yields will have gotten burned.

One way to concretize the dynamics of the Fed's seduction -- and the risk of getting burned -- is to look at the arithmetic of a deliberately simplistic version of the "carry trade," from the perspective of an arbitrageur. In this trade, you finance a position in the 10-year Treasury note at the overnight rate. Every day this trade can be held, and assuming that nothing changes, you earn a day's worth of the spread between the Fed funds rate of 1.00% and the 10-year yield of

4.18%. Your gains would accumulate day by day, and over an entire year you would earn 3.18%.



The risk in this position is that if Treasury yields rise, the value of the 10-year note would fall commensurately. The impact on the position's net profitability is a function of *when* that happens -- as illustrated in the chart at left. If it happens right after the position is first put on, even the smallest adverse move in yields would result in a capital loss that would overcome the accumulated daily gains from the spread. During the first 60 days, less than a 10 bps move would be enough. But if it happens sufficiently far in the future, then accumulated gains would more than compensate for the capital loss. By the time a year has passed, the position could withstand an almost 50 bps move. This is why the Fed keeps assuring investors that rates will stay low for "a considerable period" -- to instill confidence that this position can be held for a sufficiently long time to earn the spread gains necessary to cushion the inevitable capital loss.

Is a capital loss inevitable? To be sure, it is not impossible that yields will move *lower* -- and that the resultant capital *gain* in the T-note would make the position profitable beyond its accumulated spread gains. But we see this outcome as highly unlikely, other than within the limited scope of random short-term fluctuations. Remember: we're starting from close to 35-year low yields to begin with. And the whole purpose of this seduction, by the Fed's own admission, is to raise the level of inflation -- which, if successful, would drive today's low yields substantially higher. Already we see overwhelming evidence that inflationary forces have been irrevocably set in motion (see "The Inflation Chartbook" December 2, 2003). Yet they are hidden behind the smokescreen of the backward-looking government price statistics -- and so the seduction goes on.

Soon enough the smokescreen will dissipate, and long-term yields will be forced higher by rising inflationary expectations, Fed rate hikes or -- most likely -- both. As the chart above indicates, even small moves higher in yield are enough to burn investors who took the risk of holding long-term Treasuries in order to capture what seemed like an irresistibly wide spread. Indeed, the very anomalousness of the spread, though calculated to create a lure to the long end of the curve, should be perceived as sending a warning instead. Such anomalies are not sustainable. The smart bet is on their collapse, not their perpetuation.

And it doesn't matter whether one is a total-return macro investor who puts on the trade exactly as described here, or a bond fund manager who simply extends maturities. In the former case the losses will be explicit, and in the latter case they will be masked as opportunity costs. At the moment, of course, so far so good for both. With each passing day, the "carry" in today's wide spread is accruing against those who, as in our **Model Position short the 10-year Treasury**, are taking the other side of this trade. But in our view, it's just a matter of time now -- probably a short time -- until the "considerable period" seduction ends in tears. TM

NOTES

1. "So what then might the Fed do if its target interest rate, the overnight federal funds rate, fell to zero? One relatively straightforward extension of current procedures would be to try to stimulate spending by lowering rates further out along the Treasury term structure -- that is, rates on government bonds of longer maturities... One approach, similar to an action taken in the past couple of years by the Bank of Japan, would be for the Fed to commit to holding the overnight rate at zero for some specified period. Because long-term interest rates represent averages of current and expected future short-term rates, plus a term premium, a commitment to keep short-term rates at zero for some time -- if it were credible -- would induce a decline in longer-term rates."

From "Deflation: Making Sure 'It' Doesn't Happen Here"
Remarks by Governor Ben S. Bernanke before the National Economists Club, Washington, D.C., November 21, 2002

2. "First, the Fed should try to preserve a buffer zone for the inflation rate, that is, during normal times it should not try to push inflation down all the way to zero... Maintaining an inflation buffer zone reduces the risk that a large, unanticipated drop in aggregate demand will drive the economy far enough into deflationary territory to lower the nominal interest rate to zero."

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