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Return of the Long Bond

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The 30-year gives bond investors a new way to mis-play the inverted yield curve.

The Treasury showed a notably inapt sense of timing in discontinuing **30-year bond** issuance in late 2001 on the eve of a prolonged run of historically low long-term rates. It now seems to be closing the circle, bringing back the bond with a **coupon** very much at the low end of any range that can be rationally conceived going forward. To be sure, for **pension funds**, **insurance companies** and other institutions with long-dated **liabilities**, the long-sought return of the market's **highest duration debt instrument** with **zero default risk** is highly welcome. For these institutions, the more complete match of their liabilities with long-dated **assets** could free up marginal **risk-bearing capacity**, helping to support future **growth**.

But after weeks of anticipation, and despite the generally celebratory tone of today's press coverage, yesterday's **auction** met with what market players considered only a mixed response. The $14 billion issue went off with a 4.5% coupon, the lowest ever for a 30-year sale, but fully 65% of it went to **indirect bidders** -- probably predominantly major domestic **buy-and-hold institutions**. With just a 2.05 **bid-to-cover ratio**, **demand** was considerably less than white-hot. There was a sense in the market that the issue was too richly priced, and the heavy participation of indirect bidders in the auction was seen limiting the upside in the **secondary market**.

The new **long bond** now enters a frenetic **fixed income** arena with a host of speculative and contrary fundamental forces at work. Those convinced that the **long end** still presents upside potential, or at least limited downside, are putting their faith in the message of the **inverted yield curve**. The supposition is that while **the Fed** is still moving **short rates** higher for now, the braking effects of **higher rates** will force them to reverse course and **cut rates** in the not-too-distant future. Indeed, the curve inversion can be seen as an early bet on the likelihood of lower short rates. The only reason to hold **higher-risk** longer-term debt with a yield lower than **low-risk** short-term paper is the perceived opportunity to capitalize when rates drop.

We continue to believe, however, that this line of thinking embodies several fallacies. For one, historically, this apparent opportunity has not paid off on average. The 12-month **total return** of long-term Treasuries has been *lower than average* following periods of yield curve inversion. Moreover, looking forward, while the Fed has raised rates by 350 basis points since mid-2004, there is a dearth of empirical support for the notion that the strength of the **expansion** is being put at risk. In **real terms**, the **nominal fed funds target rate** of 4.5% -- about 2.3% relative to **core inflation** -- remains at the low end of long-run norms. Historically, Fed **rate-hiking cycles** have not entered the economic **danger zone** before **real rates** get into a range around 4%. At this point, we view it as unlikely that the Fed will be pushing rates high enough to approach that level. In addition to the contemporaneous macroeconomic readings on the health of the **labor market**, **consumption** and **investment** -- which give no evidence of approaching weakness -- more sensitive **market-based indicators** continue to paint a bright economic outlook. **High-risk**

credit spreads, for example, remain below 350 basis points, indicating a level of **risk tolerance** that has always been consistent with robust levels of sustained growth. If an impending **slowdown** were on the horizon, default risk would be pushing these spreads higher, as happened in early 2000 in the first indication that the late-1990s boom was coming undone.

The continued narrow credit spreads are also a sign that Fed policy remains **accommodative**, and in fact can be seen as one manifestation of the central bank's still-generous **liquidity posture**. As the most sensitive indicator of **supply-demand balance** in the market for **dollar liquidity**, we were pleased to see the price of **gold** this week back off by some $25 from its 25-year highs around $575 last week. As also indicated by recent movement in **the interest rate futures complex**, the market appears finally to be showing some degree of confidence in the Fed getting it right, remaining in its current mode until **monetary equilibrium** is reached. It's also true, however, that movements in gold this week were highly **volatile**, suggesting that while on the margin confidence in the currency may be rising, it remains subject to considerable risk.

For long-term bonds, however, the message can hardly be considered a positive one. Even with gold coming off its highs, at these levels relative to its long term average, currently around $340, a significant bump higher in core inflation almost assuredly lies ahead. To varying degrees, other market-price indicators -- including broader **commodity indexes** and the **dollar's foreign exchange value** -- all tell a similar story of a decline in **real dollar purchasing power**. Inevitably such a sustained period of real dollar weakness feeds through the **price system**, invariably resulting in a period of higher inflation, an eventuality for which bonds remain woefully mispriced. Moreover, once the Fed gets wind of the fact that core inflation is moving higher than it currently anticipates, short-term rates are sure to remain **higher longer** than the bond bulls' calculations currently allow.

Bottom line: This week's 30-year bond auction came against the backdrop of considerable market ferment. In certain quarters, the yield curve inversion is taking on a life of its own, persuading those who want to believe it that the inversion must augur approaching economic weakness, ultimately requiring a Fed response and thereby validating the inversion. We rebut that notion, seeing no sign of economic weakness on the horizon, while continuing to view the market as systematically underestimating the impending inflation reality, which also implies the Fed keeping rates higher longer than currently anticipated. TM