



Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Treasuries: Too Late to Buy, But Too Early to Sell

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David Gitlitz

The Fed's going to hold the whole curve down for quite a while... but then, look out.

The 10-year Treasury, today yielding 2.3% -- up marginally from lows under 2.1% last month but down sharply from around 4% in late October -- certainly doesn't look like a buy. But neither is there likely to be a good short-selling opportunity in the near to medium term. A good part of the trip to below 3% can be explained by the flight to safety that was manifest in the worst of the risk abhorrence in late fall. But that extreme risk abhorrence has faded, as seen in the 400 bp rally in high-yield debt since mid-December, while Treasuries have remained rangebound. We think we've probably seen the low in yields, and that yields will eventually come undone, potentially in a major way -- but likely not before we see a significant change in outlook for Fed policy, the 800-pound gorilla in the room for the bond market.

Update to strategic view

US BONDS: The Treasury market is significantly overvalued by any standard, but that doesn't mean it's due for a near-term reversal. As long as the Fed maintains its hyper-accommodative posture, bonds are unlikely to come unglued from their current range.

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Probably the best way to think about the bond market outlook is to conceive of it as a two-stage process. The first stage, which we're in currently, is dominated by the Fed's exceptionally accommodative policy posture. One of the Fed's primary objectives in bringing the funds rate down to near-zero is to anchor the entire yield curve at extremely low levels. Thus do we now have the 10-year yielding 2.3%, with the long bond under 3%.

For the Fed, this serves a dual purpose. For one thing, it believes that keeping yields this low will be stimulative, at least softening the blow of the economic downturn. Perhaps even more important, though, by keeping cash rates at such low levels, and even longer-term bond yields at exceptional lows, the Fed is fostering a scenario in which it makes a lot of sense for investors to take on more risk to acquire yield. In this way the Fed is helping foster a recovery in the functionality of the credit market and spurring the return of some degree of risk-bearing. The recovery of spread product should continue for the foreseeable future.

There have been a number of reports recently, including one influential one in *Barron's* last week, suggesting Treasuries are now in bubble territory, implying that they must be due for a fall, and soon. But while it's true that by any objective standard Treasuries are strikingly overvalued, it doesn't necessarily follow that they're poised for a sharp reversal in the near-term.

<http://www.trendmacro.com>
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

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The Fed's role here is critical. If anchoring the funds rate at near-zero proves to be insufficient to keep the yield curve in check, the Fed can become a direct purchaser of long-term Treasuries, which it has already stated it is considering. The long-term consequence of such purchases would be inflationary, but that likely wouldn't have implications for the yield in the time frame (say 6-12 months) that the Fed would be seeking to keep yields under wraps. In his [speech](#) this week at the London School of Economics, Fed chair Ben Bernanke suggested that in deciding whether to proceed with such purchases the Fed will "focus on their potential to improve conditions in private credit markets, such as mortgage markets." If Treasury yields begin to rise, that likely would have negative implications for the mortgage market, which would support Fed Treasury purchases under this rationale.

The second stage of the process likely will unfold at some point in the next 9 to 12 months. That's when, either because the economy has entered a convincing recovery and/or inflation begins to move significantly higher, speculation will begin about the Fed moving to reverse its extremely easy stance. At that point, Treasuries will be subject to extreme downside risk. We are convinced that the present Fed regime, which has seen its balance sheet grow from less than \$900 billion to more than \$2 trillion since last September, will end up having significant inflationary consequences, in which case the downside will be even worse than if the market only has to price for the removal of Fed accommodation. Looking somewhat longer term, a bear market in Treasuries seems very likely one way or another. Long term yields reaching significantly above 6% are not outside the realm of possibility.

Bernanke's speech this week included a discussion about the Fed's "exit strategy," in which he attempted to offer assurances that when the time comes the Fed will reverse the explosive growth of its balance sheet expeditiously enough to avoid a significant inflationary outcome. But while he noted that a substantial portion of the Fed's liquidity injections are in short-term transactions, and will simply roll off if they are not extended, he acknowledged that the Fed will also hold significant quantities of long-term assets, including the \$600 billion in mortgage securities that it is committed to purchase over the next two quarters. "We would not anticipate disposing of more than a small portion of these assets in the near term," Bernanke said, "which will slow the rate at which our balance sheet can shrink."

Finally, Bernanke offered perhaps the best reason to remain skeptical about the central bank's agility in shutting down the liquidity spigot, essentially pleading with the market to "trust us." Because the unwinding of the various programs "effectively constitutes a tightening of policy," he said, "the principal factor determining the timing and pace of that process will be the Fed's assessment of the condition of credit markets and prospects for the economy." In other words, it will be entirely dependent on the judgment of Fed policymakers, the inevitable consequence of a discretionary monetary regime. As we have noted previously, experience does not inspire great confidence in the efficacy of that judgment. Especially since, while this evolves, the Fed will necessarily be flying even more by the seat of its pants than usual. By Bernanke's own admission, the present policy regime "is not easily summarized by a single number, such as the quantity of excess reserves or the size of the monetary base... an important communications challenge."

For non-Treasury debt, the key question is whether or not this process is accompanied by a significant resurgence of inflation. If it is, the damage to non-Treasury debt could be significantly less severe. The biggest factor in the poor performance of non-Treasury debt has been rising default risk. Since rising inflation would mean the debt can be repaid with cheaper dollars, the real burden of the debt would be reduced, relieving default risk. Spreads could continue to contract under this scenario. If, on the other hand, the Fed shifts its policy stance away from

ease in a non-inflationary environment, the downside to non-Treasury debt would probably be just as severe as it is for Treasuries.

BOTTOM LINE: The Treasury market is significantly overvalued by any standard, but that doesn't mean it's due for a near-term reversal. As long as the Fed maintains its hyper-accommodative posture, bonds are unlikely to come unglued from their current range. Somewhat further out, there will be a reckoning for this period of extraordinary monetary largesse, when the piper likely will be paid in the form of significantly higher inflation and sharply tighter monetary policy, exposing Treasuries to great downside risk. ▶