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MACROCOSM

Stress Test for T-Bonds

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How high will the 10-year yield go before Bernanke slaps it down?

Update to strategic view
US BONDS: Yesterday's T-bond sell-off suggests not only over-supply, but also recognition of economic recovery and inflation risks. It continues the testing process to probe for the level of yields at which the Fed will intervene with the announcement of more purchases, in an effort to keep yields from squelching nascent recovery.
[see Investment Strategy Dashboard]

A weak auction yesterday sent Treasuries into a tailspin, yields rising to their highest levels since late last year extended the process we described last week, "testing the Fed's implicit promise to intervene to suppress them" (see "The Fed, Blinded by the Obvious" April 30, 2009). We don't doubt that if the recession drags on, if yields were to rise to a level seen by the Fed as interfering with recovery, at some point the Fed will be compelled to act to prop up the bond market. The question is exactly under what conditions the Fed is prepared to intervene forcefully enough to prevent yields from ramping higher.

Yesterday's market downdraft came on the last leg of a $71 billion refunding, with $14 billion of 30-year bonds up for bid. Up to this point, the federal government's need to finance a record spending and borrowing spree has met with little resistance from the bond market. With global capital markets under strain, Treasury debt has been considered a safe haven, with investors eagerly snatching up the paper that was on offer. But with markets showing at least tentative signs of stabilizing, the safe haven bid appears to be waning. Some evidence of this is that yesterday, even as Treasury yields rose, yields on high yield bonds fell. So it's not that the market doesn't have an appetite for bonds -- it's just losing its appetite for US Treasury bonds.

The Fed has committed to acquiring a total of $300 billion in Treasury debt, of which it has so far bought more than $90 billion. In the FOMC statement last week, the Fed said it "will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets." Clearly, the Fed is keeping its options open for additional purchases of Treasuries if it deems it necessary.

But what is not known is the circumstance that would induce such action. Most likely, there is a yield level that the Fed would want to defend. Is it 3.5%? Higher? Lower? We can't know for certain. The volatility of yesterday's action, with the 10-year jumping nearly 19 basis points higher to close at 3.34%, also probably caught the Fed's attention. The Fed would be concerned

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that increasing volatility in Treasuries could spread through the credit markets, upsetting the restoration of some degree of calm that has been seen recently. If the Treasury market continues to unravel, it's likely the Fed will come in. But if it settles down and yields don't continue to ratchet higher, the Fed probably will not expand its Treasury purchases, at least not yet.

The recent uptrend in yields also appears to represent a nascent recognition of the inflation risks being stoked by the Fed's hyper-accommodative policy posture (see "Fed Says, Give Us Some Slack" May 6, 2009). For the most part, the investment community seems blind to those risks, maintaining that the sharp economic downturn and financial market turbulence meant that deflation was the bigger danger. However, today's *Wall Street Journal* acknowledges that the Treasury sell-off reflected some concern that "the Federal Reserve's efforts to revitalize the economy by increasing money supply may lead to a rise in inflation in the longer term." In the longer term, Fed purchases of Treasuries and other assets adds to those risks. But in the near- to medium term, those risks would likely be overcome simply by the demand factor created by the Fed's purchases.

The yield bounce of recent weeks -- the 10-year yield was still below 3% in the last week of April -- also amounts to some recognition that the worst-case economic scenario that had so captured the markets is unlikely to be realized. Recent data releases usually considered reliable as coincident indicators -- jobless claims and the ISM manufacturing index -- suggest that the economy has bottomed and may have entered at least a tentative strengthening phase. New claims for unemployment benefits seem to have peaked a month ago, and that has historically been an excellent indicator of recession troughs. Today's employment report showed a loss of more than half a million jobs last month. However, it was the best month since last October.

BOTTOM LINE: Yesterday's T-bond sell-off suggests not only over-supply, but also recognition of economic recovery and inflation risks. It continues the testing process to probe for the level of yields at which the Fed will intervene with the announcement of more purchases, in an effort to keep yields from squelching nascent recovery.