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# No, Mr. Bond, I Expect You to Die

Friday, May 22, 2009

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**China's not dumping. It's Treasuries gearing up for "Black Wednesday" with the Fed.**

| **Update to strategic view** |
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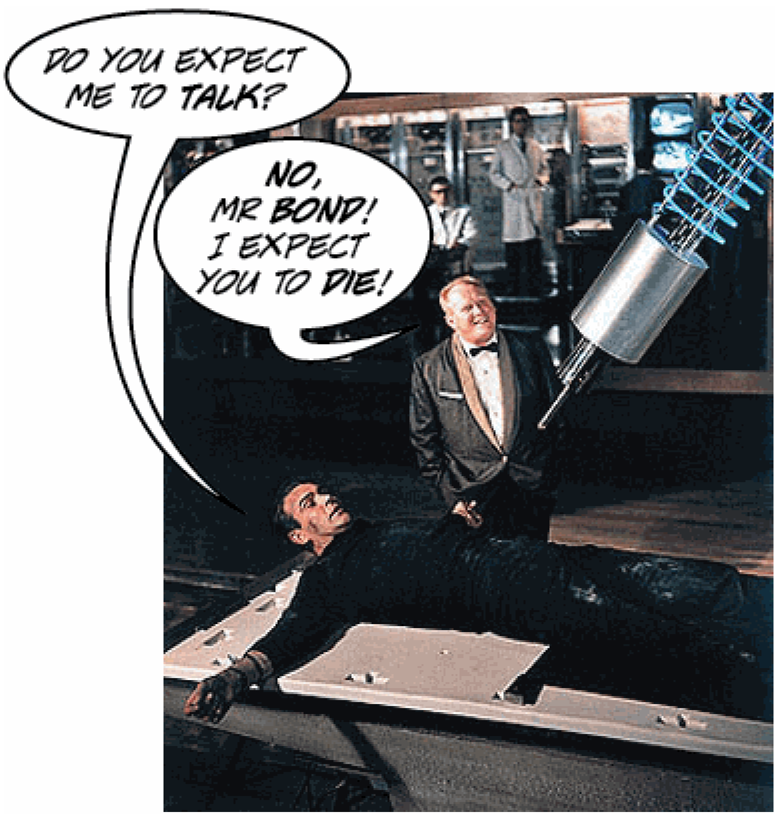
| **US BONDS:** Rumors notwithstanding, we doubt that yesterday's shock in Treasuries is a sign that China is dumping its holdings. It is another scrimmage in the dangerous game being played out between the market -- which requires yields to rise -- and the Fed -- which wishes they wouldn't. The market will win, as it did against the Bank of England in 1992. But the Fed will defer that day as long as possible, so this will take months to develop -- which will make timing very tricky for shorting long-term Treasuries. But the longer it is deferred, the more damaging will be the ultimate rupture. |
| [see Investment Strategy Dashboard] |

The Treasury bond market yesterday was hit by another foreshock of what will someday be an outright earthquake. For now sharply rising yields at the long end of the curve are doing just what we expected, "testing the Fed's implicit promise to intervene to suppress them" (see "The Fed, Blinded by the Obvious" April 30, 2009). There are many good fundamental reasons why yields *ought* to rise. But at some unknown point, the Fed *will* intervene to cap them, when they rise to a level that is deemed to imperil the nascent economic recovery and the stabilization of the housing market. The Fed's meddling won't change the fundamentals, and indeed will perversely make them even more powerful, as we will detail in a moment. So at some further point, the Fed will have to bow to the inevitable and get out of the way -- much as the Bank of England did on "Black Wednesday" in September 1992, when irresistible market forces made it impossible

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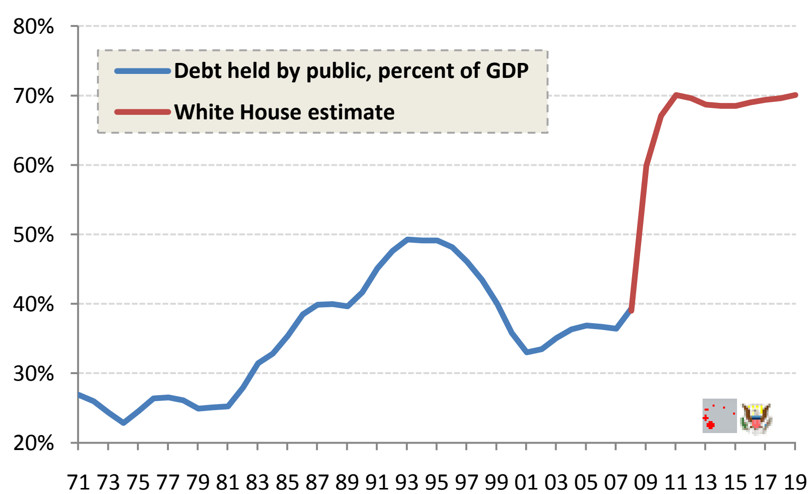
to support the fixed Sterling exchange rate, and compelled the UK's sudden withdrawal from the European Monetary System. Yields then will have to be far higher than they are today, and that will indeed be an earthquake. We can only hope that it is deferred long enough for the economy to have recovered sufficiently to withstand the shock of it.

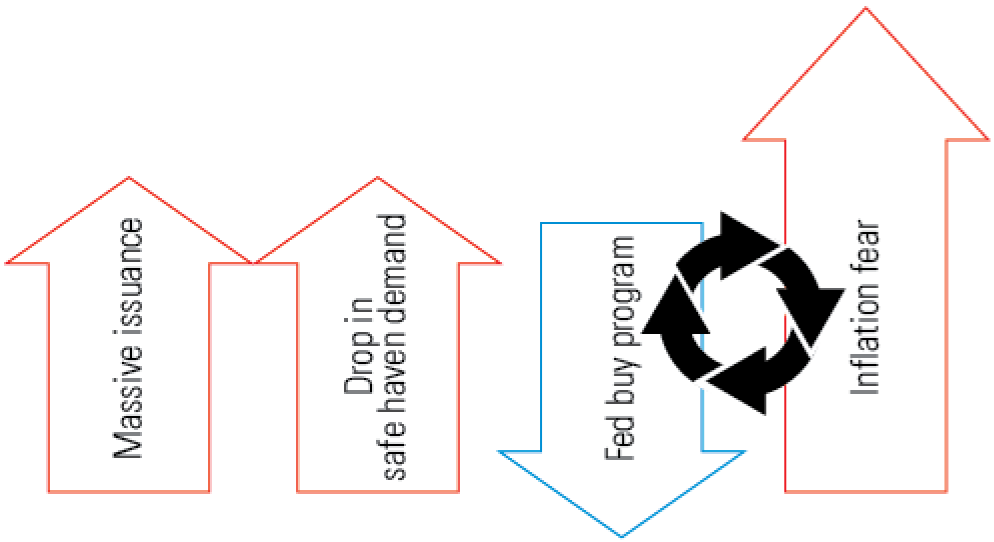
The first tremor was two weeks ago, on the occasion of a difficult Treasury auction (see "Stress Test for T-Bonds" May 8, 2009). Yesterday's further rumbling, taking the 10-year yield to new highs not seen since last November, was catalyzed by rumors that a foreign central bank was dumping bonds into the New York Fed's weekly auction, conducted as part of the Fed's $300 billion buy program announced two months ago (see "Ben Boldly Goes" March 19, 2009). With markets already rattled pre-opening by Standard and Poor's announcement that it was putting UK sovereign debt on watch for possible downgrade, these rumors resonated with the popular Armageddon scenario in which China's central bank would dump its massive holdings of Treasuries and agencies, crushing the bond market, raising US interest rates sky-high and fomenting a global run on the dollar.


We have no idea whether China's or any other nation's central bank was indeed selling yesterday. If one of them were, it wouldn't be especially surprising to see at least some unwinding after the very rapid acceleration of Treasury purchases last year during the flight to quality triggered by the global credit crisis. China's buying in the second half of last year was especially intense, far more than offsetting its selling of agency MBS. At that, according to the Treasury's latest TIC data as of March 31, buying by China's and other nations' central banks remains quite substantial, growing over the last three months at a 20%-plus annual rate. Further, we see no rational economic reason why China or any other holder of Treasuries would wish to dump them in a way that disrupts the market and diminishes the value of their remaining holdings. Neither would there be any rational economic reason to damage the forex value of the dollar, especially for China or any other nation concerned with maintaining its export competitiveness. Indeed, we've seen evidence recently that some emerging economies are deliberately supporting the dollar for just such mercantilist purposes (see "Constructive Currency Signals" May 18, 2009).

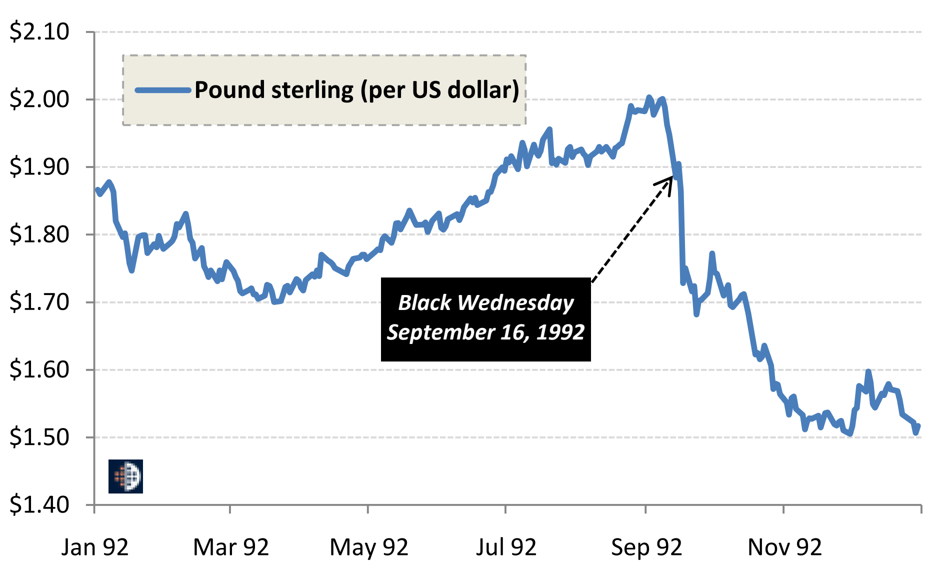



All that said, we think a very negative scenario will eventually play out in Treasuries, probably without any central bank dumping at all. For one thing, today's low yields are utterly inconsistent with the massive borrowing schedule to which the

Treasury is now committed for many years, as the result of TARP and various "stimulus" measures, and then for what we have no doubt will be a secular ramp-up in government spending during the Obama administration (see "Wolf in the Fold" May 18, 2009). Already federal expenditures are set to rise to more than 28% of Gross Domestic Product, from 22% last year. Treasury debt held by the public is set to rise to more than 70% of GDP, from less than 40% last year. And that's based on extremely optimistic expectations for GDP growth. Today's anomalously low yields have been made possible by the flight to quality during the global credit crisis, and in that sense have served as an automatic stabilizer for the US economy. The problem now is that, even though it is great news that the credit crisis seems to be easing, that ends the flight to quality and acts to withdraw the automatic stabilizer -- perhaps sooner than would be ideal to nurture along our nascent recovery.




This is where the Fed comes in, and where a vicious cycle gets set in motion. Massive issuance and the drop in safe haven demand will drive yields higher, and the Fed will try to counter that with its existing $300 billion buy program -- and, we feel sure, more such programs in the future. This is outright monetization of debt, and in the context of a recovering economy, it is sure to be inflationary (note that gold made new recovery highs above $950 in yesterday's bond scare). The problem is that inflation itself is another factor that will contribute to higher yields, as investors demand higher nominal compensation to offset the loss of real purchasing power in the future. The more Treasuries the Fed buys to keep yields low, the more inflation is packed into the pipeline -- and the higher yields will need to rise.




It is a perfect example of "reflexivity," the principle of the self-reinforcing interaction of markets and the real economy posited by George Soros, the principle actor in 1992's "Black Wednesday." And we have no doubt it will end the same way. Treasury yields will be much higher than they are today -- they *have* to be, to reflect, increasing supply, diminishing safe haven demand, and rising inflation. In the short term, the Fed will surely intervene to slow down the inevitable rise in yields, to give the economy more time to recover. Ultimately, the price of delay will be higher inflation -- and, as a result, higher yields -- than we would have had otherwise. Let's hope we at least get an economic recovery out of it first. We'll need one -- to withstand those yields, and to withstand that inflation.

**BOTTOM LINE:** Rumors notwithstanding, we doubt that yesterday's shock in Treasuries is a sign that China is dumping its holdings. It is another scrimmage in the dangerous game being played out between the market -- which requires yields to rise -- and the Fed -- which wishes they wouldn't. The market will win, as it did against the Bank of England in 1992. But the Fed will defer that day as long as possible, so this will take months to develop -- which will make timing very tricky for shorting long-term Treasuries. The longer it is deferred, the more damaging will be the ultimate rupture.