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Carrying On

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It's ironic -- the carry trade that makes Treasuries look great now is what will make them big losers.

Last week we talked about the Treasury market as the enabler of the move of the gold price above $1000 (see "Gold Above $1,000: What Took So Long?" September 16, 2009). In this report we'll look again at many of the same dynamics, but focus on what it means for long-term Treasury bonds, and for today's FOMC meeting.

At about 250 bp, the 2-10 yield curve has rarely been steeper, setting up a lucrative carry trade to capture the spread, which will remain in play as long at the short end is reliably anchored by the Fed's super-easy policy posture. In fact, by holding yields so low, the carry trade is fulfilling an important mission the Fed set for itself. Recall that it initiated its $300 billion Treasury purchase program last March on the assumption that it would keep yields in check and "help improve conditions in private credit markets." Instead, yields proceeded to bound sharply higher, briefly crossing 4% in June. The Fed now regards the Treasury buying program as a serious mistake that threatened a potentially devastating loss of market confidence by raising the specter of the monetization of government debt (see "The Fed's Bond Boo Boo" July 24, 2009). Through the carry trade, the Fed's objectives for the credit markets are being met even as it phases out the Treasury buy program.

Update to strategic view

US BONDS: The Fed's supplying a reliably low short-end deliberately sets up an attractive leveraged arbitrage in long-term Treasuries via the carry trade, which will keep yields low for the foreseeable future. Intended to inflate the "slack" economy out of recession, it bears the seeds of the future inflation outbreak that will ultimately send long-term yields far higher.
FED FUNDS: The Fed is reliving the 2003-2004 "considerable period" of low rates -- there will be no signal at today's FOMC that this policy is about to change anytime soon.

[see Investment Strategy Dashboard]

At the same time, with the carry trade helping sustain low Treasury yields, the Fed is not going to want to pull the plug on the trade anytime soon -- either by raising rates, or signaling that it will raise them anytime soon. Once the market forms expectations that short rates *will* rise, the short end of the curve will take a heavy hit, the carry trade will be unwound, and pressure on longer term yields will probably get intense.

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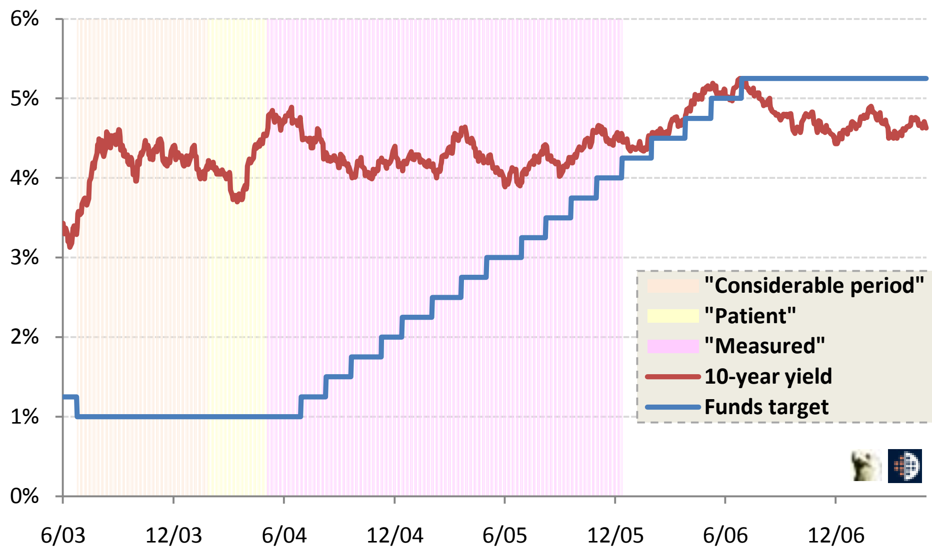
The Fed will want to be sure the economy is strong enough to withstand such a development before it seriously contemplates a shift out of hyper-accommodative mode. That's what it did in the previous ultra-easy policy cycle in 2003-2004. Just as now, the carry trade was an important factor keeping yields in check at that time, when the funds rate bottomed at 1% (see the chart below). The Fed took great care in managing the bond market's policy expectations during that episode, first asserting in June 2003 that policy would be kept accommodative for a "considerable period;" then, starting in January 2004, assuring that it would be "patient" in removing policy accommodation; and finally, starting in June 2004, promising that its accommodation would "be removed at a pace that is likely to be measured." In all this, the Fed was endeavoring to sustain low yields by facilitating the street's gradual exit from the carry trade without provoking undue trading losses.



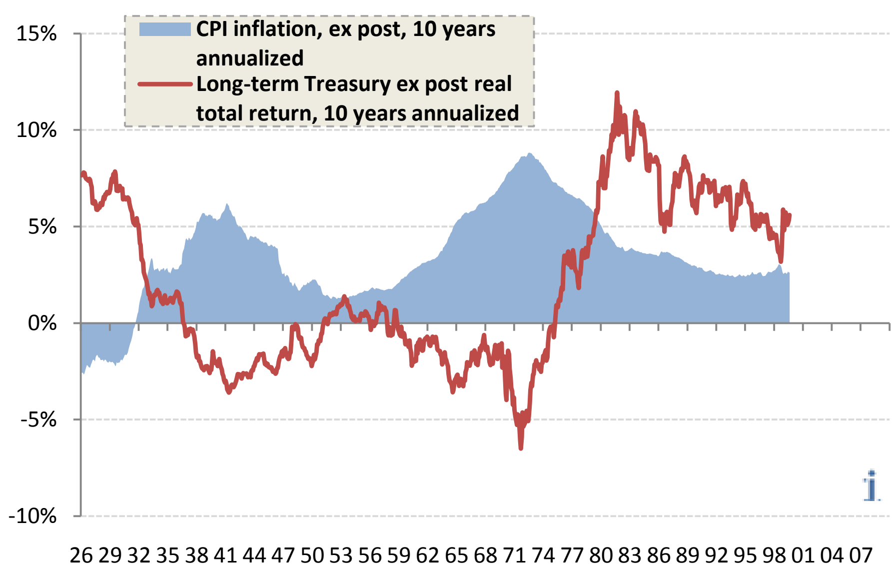
As this process reached its conclusion, the response of the bond market was characterized by Alan Greenspan in February 2005 as a "conundrum," because yields didn't jump higher as the Fed raised rates. But we don't see the bond market's reaction as all that mysterious. It makes perfect sense that the 10-year yield surged by more than 100 bp in spring 2004 -- topping out at nearly 4.90% -- anticipating initiation of a rate-hiking cycle as the Fed shifted from "considerable period" to "measured." But yields gave back most of that as soon as the market heard the Fed's promise of only "measured" rate hikes. So when Greenspan saw a "conundrum," he should have realized that it was of his own making -- his very gradual exit from the carry trade assured no blow-out for yields. Indeed, shortly after the "measured" language was removed in January 2006, yields promptly moved to new cycle highs. Also, at that point, inflation began to shift higher, from around 3% to around 4%, and the Fed policy communications became more hawkish. With the funds rate having nearly caught up with the bond yield, from there the bond yield tracked the funds rate higher, topping out at 5.25% at the same time the Fed ended its tightening cycle with the funds rate at 5.25%. Then yields fell again, as slower growth kindled expectations that the Fed would not only stay on hold but that its next move would be to cut rates.

Can it happen that way again, with the Fed managing market expectations to sustain the carry trade and keep yields from moving significantly higher even when it eventually exits from its extremely loose stance? That's what the Fed hopes, but we're highly skeptical. Yes, much like the "considerable period" language of 2003, the Fed is now promising an "exceptionally low levels of the federal funds rate for an extended period." For now, with the economy only hesitantly emerging from the worst recession since the Great Depression and inflation appearing at the moment as a non-factor, that's enough. But inflation moving significantly higher will inevitably be the major variable differentiating this episode from the previous one -- with vastly more monetary stimulus in play this time, not only from the zero funds rate but also from the unprecedented growth of the Fed's balance sheet.. In fact, an inflation breakout could well come before the Fed would prefer to act, so that by the time it moves to begin reversing course it would be unlikely to have the luxury of proceeding in the "measured" fashion that it did last time. And with gold yesterday reaching a new all-time closing high at $1013.8, it's clear that the market most sensitive to the Fed's liquidity posture is not expecting any signal from the FOMC today that it is even considering a shift. While we see reported market chatter that bonds look "extremely cheap" now, they're likely to get much "cheaper" before all is said and done.

Although the steep yield curve is currently presenting attractive fully financed arbitrage opportunities in Treasuries via the carry trade, it would be a considerable stretch to suggest the market is "extremely cheap" as a cash investment -- especially considering the inflation dynamics in play. Ironically, to the degree the desire to support the carry trade is a significant factor motivating the Fed to remain so easy, it is also a significant factor boosting the outlook for future inflation -- after all, the whole point of using the carry trade to keep the long end low is to help inflate the economy out of recession. Adjusted for the inflation risk being inflamed by the carry trade itself, bonds don't appear so cheap. It's true that the steepness of the curve reflects an inflation premium in the differential between short and long term maturities, and that's a matter of indifference to highly leveraged carry trades. But as a cash investment, at current yields, bonds would earn their historic expected real return of 2.4% only if inflation averages less than about 1.0%.Given what amounts to an ongoing mandate for the Fed to inflate, the chances that inflation will run no more than about 1% from here are virtually nil.

For now, with trailing one-year CPI inflation running at negative 1.4% -- that is, *deflation*, which creates the superficial optics of a very attractive *ex ante* real 10-year yield of about 4.8% -- the market is content to either overlook the risk or to accept the Fed's rationale that the "slack" in resource utilization, with what is likely to be a long stretch of high unemployment (see "On the July Jobs Report" September 4, 2009), will keep inflation under wraps, and allow the Fed to maintain its mega-easy stance for as far as the eye can see. San Francisco Fed president Janet Yellen, whose long-standing position on the far dovish end of the policymaking spectrum now appears to be running interference for the FOMC consensus, has suggested the funds rate could stay near zero for several years to combat what she sees as the danger of inflation drifting too low.

If, as we think is highly likely, this turns out to be a significant miscalculation of the inflation reality for bonds, it won't be the first time. In the two periods of great inflation in the US -- the reflation following the Great Depression, and the inflation of the late 1970s -- Treasuries persistently realized large negative *ex post* real returns, as inflation turned out to be sharply higher than the bond market was priced for *ex ante* (see the chart at left). In the case of the 1970s, when reality finally hit, coming with the appointment of Paul Volcker as the Fed chairman



committed to rooting out the entrenched inflationary psychology, it wasn't pretty. From mid-1979 through February 1980, the 10-year yield soared by nearly 500 bp. This was a searing experience for the Treasury market, which as a result kept real yields at elevated levels through the 1980s and 1990s as disinflation took root -- and the result was a decade of excessively positive *ex post* real returns. The bond market "vigilantes," committed to ruling out a repeat of the 1970s experience, were in the drivers' seat. While we don't yet formally forecast inflation bulging back to the double-digit levels of Volcker's day, we don't think it's impossible anymore -- given the extraordinary policy response to the events of the last year that, previously, would have been thought of as equally impossible. Without doubt, the base for an extended run of rising inflation is now being put in place, which will likely at some point precipitate an aggressive course of Fed tightening -- and for a long-term Treasury market that some dare to call "extremely cheap," that could bring back more than mere memories of the Volcker experience.

BOTTOM LINE: The Fed's supplying a reliably low short-end deliberately sets up an attractive leveraged arbitrage in long-term Treasuries via the carry trade, which will keep yields low for the foreseeable future. Intended to inflate the "slack" economy out of recession, it bears the seeds of the future inflation outbreak that will ultimately send long-term yields far higher. The Fed is reliving the 2003-2004 "considerable period" of low rates -- there will be no signal at today's FOMC that this policy is about to change anytime soon.