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MACROCOSM

Bond Blowback

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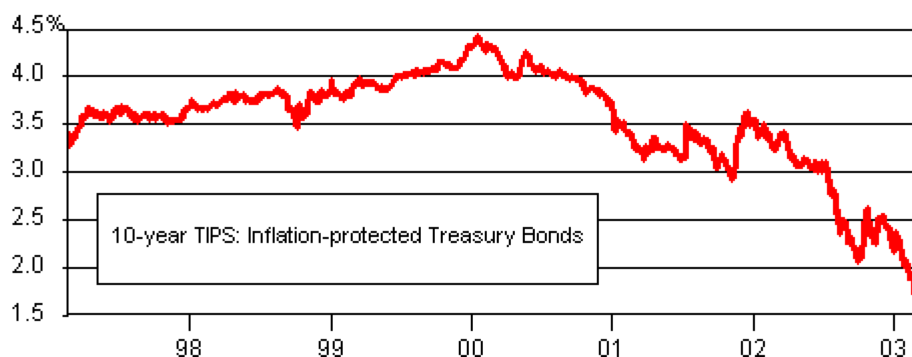
Iraq risk has been kind to Treasuries -- but what happens after that risk is resolved?

The geopolitical uncertainties that have dogged stocks since the early weeks of the year have been a boon for Treasuries, with the 10-year note rallying by some 50 basis points to below 3.7% -- within striking distance of last October's 40-year low of 3.57%. With the next few weeks unlikely to bring a great easing of current risk factors, yields on debt bearing the US government's full-faith-and-credit guarantee could well make new lows. But the forces we see setting up a compelling upside opportunity in equity markets once the **Iraq** uncertainty is resolved also figure to deal a significant blow to Treasuries. A market climate better able to absorb the hefty risk premium in equity assets would leave Treasuries highly exposed at these rich levels. In the coming bond market blowback, we expect to see the bulk of the past year's rally reversed, with the 10-year settling into a range around 5% by the time the dust clears.

The extent to which unusual and potentially unsustainable forces have driven Treasuries in this period can be gleaned from the behavior of the inflation-indexed counterparts to the nominal bonds. While not a perfect indicator, inflation-indexed Treasuries (TIPS) -- which strip out the inflation expectations and risk components of the nominal yield -- provide a rough and ready proxy for real returns available in US markets. From their introduction six years ago through 2001, the 10-year TIPS yield averaged 3.75%, which is right in line with long-run estimates of the real yield on nominal bonds. Since the end of 2001, however, TIPS yields have averaged 2.75% and, in the past six months, 2.23%. Just one month ago the TIPS yield fell below 2% for the first time and, at yesterday's close, the yield was at an all-time low of 1.58%.



That puts the spread between nominal Treasuries and TIPS at just above 200 basis points, up about 20 bps in the past two months. In some quarters, that outperformance by TIPS is seen as an early warning that significantly higher inflation is on the way. We don't agree. The inflation adjustment on TIPS is pegged to the CPI, which is estimated to incorporate a bias overstating changes in the price level by up to 1% per year. And that overstatement figures to be exacerbated over the next few months by the surge in crude oil prices, which implies a change in *relative* prices, not a higher price level. But up to a point, the widening of the TIPS spread is consistent with other signs that the Fed has adopted an accommodative, anti-deflationary stance, which we regard as a positive factor. Any concern about incipient inflationary influences has been substantially relieved in the past month by gold

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settling into a range around $350, after briefly spiking into the $380s, and by the dollar's stabilization on global forex markets.

For holders of nominal Treasuries that have ridden this great wave, the more significant issue raised by TIPS at this point is not their possible inflation implications but the likely short-lived compression of the real yield. We seriously doubt that a yield below 2% represents an expected real return in the true sense of the term. By and large, the TIPS yield has simply mirrored the ratcheting lower of nominal yields, which in this most recent period has been mostly a response to intense uncertainty. Abstracting out a CPI assumption, the TIPS/nominal Treasuries trade acts much like an arbitrage. The important point, though, is that while the CPI expectation has shown significant short-run volatility, on net the spread is now back in the range it held for several months starting a little less than a year ago, a period during which nominal yields ranged from 5 to 5.4%. In other words, an argument for the staying power of nominal Treasury yields at current levels might be easier to make were they primarily a reflection of a significant further decline in long-run inflation expectations. The market, however, remains unwilling to sustain a 10-year bet on CPI running much below 2%. That also suggests that once the fog of war is lifted and the market is again able to capitalize rising future income streams, the real return component of the bond yield is likely to revert to a level much closer to its historical averages.

But even as war risk continues to impose a damper on broad market activity, we continue to detect factors that point in an encouraging direction regarding underlying economic conditions. The highly growth-sensitive high-yield debt market, so ravaged the past two years by the deflation-induced collapse of profitability and revenue growth, continues to make impressive strides. Our High-yield Bond Model Position opened in early January is now up 3.61% on a cash basis, and 138.6% on a notional futures basis. TM