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Feeding Frenzy in Treasuries

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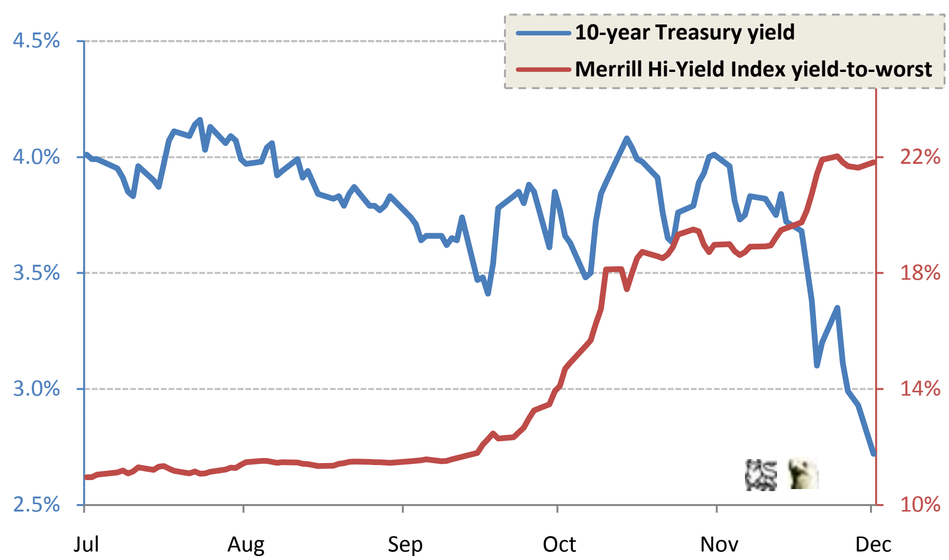
Safe haven or mo-mo trade, at this point it offers little potential upside and much risk.

Update to strategic view
US BONDS: With a yield of 2.7% on the 10-year, the upside is extremely limited at this point, while the downside is considerable. Buyers are riding a bullish momentum wave, underpinned by the notion that a severe recession and declining commodity prices mean that inflation risk is a nonfactor. Once the economy and financial markets stabilize, it will become clear that significantly higher inflation will be a legacy of this period, and the momentum trade in bonds will abruptly reverse.
[see Investment Strategy Dashboard]

The rally that has now taken the 10-year Treasury to its lowest yields in more than 50 years is the flip side of the extreme risk abhorrence that has put equities at historic levels of undervaluation, and left riskier assets such as high-yield debt with risk premiums pricing for a re-run of the Great Depression (see "It's a Recession -- Not the End of the World" November 21, 2008). The degree of downside risk versus upside potential between government debt and risk-based assets has to be as gaping as any ever recorded. Indeed, the notion that Treasuries have reached "bubble" territory is gaining even among some analysts who have been regarded as long-running bond bulls.



The buying frenzy that has pulled the benchmark 10-year yield down from 4% in late October to 2.7% today has been supported by a decidedly bond-friendly news flow. The reality of a rapidly weakening economy has

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becoming increasingly obvious. The weakness has contributed to an intense reversal of commodity prices, which not long ago were in a run-up that had traits of a bubble of its own, particularly in oil prices. This price action has led to a flattening out of the official statistical price indexes, and an idea now gaining traction has it that the concern is no longer about rising inflation but potential deflation (see "Deflation Takes Center Stage" November 19, 2008). Amid all this, continuing financial market volatility is drawing funds to the Treasury arena as a safe haven, concomitant with the liquidation that is pounding the value of riskier assets.

The Fed is also playing a significant role. Its announcement last week that it was initiating a program to purchase up to $600 billion in mortgage assets from the GSEs spurred Treasury buying by institutions which needed to replace the duration that the Fed would be removing from the market. Then yesterday, Fed chairman Ben Bernanke sparked a wave of fresh demand with his remarks suggesting the Fed could soon be a big buyer of Treasuries.

Bernanke's comments were curious. Reprising his notorious "helicopter drop" speech of November 2002, Bernanke observed that the Fed has other tools at its disposal to provide liquidity even as its nominal rate target approaches zero. "The Fed could purchase longer-term Treasury or agency securities on the open market in substantial quantities," he said yesterday. "This approach might influence the yields on these securities, thus helping to spur aggregate demand." He then noted that the announcement of the GSE program last week was met with a fall in mortgage rates, which he called "encouraging." But it seems odd that Bernanke would be touting the Treasury purchases as a means to reduce yields and thereby encourage growth of "aggregate demand." Even prior to this latest rally, Treasuries were already running at historically low yields. They're not the problem. The problem is that spreads relative to Treasuries are at or near all-time highs in virtually every other asset class. It's difficult to see how, in this environment, taking action to attempt to reduce yields on the Treasury curve is going to do much good. And why talk about it, when last week's action was so clearly aimed to dropping yields in other fixed income markets?

Our takeaway is that the real significance of Bernanke's speech yesterday was that he is essentially confirming that the Fed is shifting its focus from interest rate targeting to quantitative easing. Given that the size of the Fed's balance sheet has more than doubled in the last two months, this was already evident to us (see "1% and So What?" October 29, 2008). But by publicly looking past the point where the Fed would otherwise be constrained by the rate target, and introducing the live possibility that the Fed will soon be engaging in outright monetization through purchases of "substantial quantities" of Treasuries, he is bringing the focus on quantitative easing to a new level.

This is likely to be an extremely slippery slope for America's creditors. Yes, as a short-run first-order effect, the Fed purchases will provide support to bond prices. In the current environment, the rush to cash driven by asset liquidation in riskier financial markets is masking the liquidity excess engendered by the Fed. At some point, though, riskier markets will stabilize, and the reality of the Fed's extraordinarily easy posture will reemerge. In his remarks yesterday, Bernanke acknowledged the inflationary potential of the Fed's balance sheet expansion, suggesting that "to avoid inflation in the long run…the Fed's balance sheet will eventually have to be brought back to a more sustainable level." The FOMC, he claimed, "will ensure that that is done in a timely way." But historical experience does not provide much comfort in that regard. More likely than not, the Fed will be hesitant coming out of this period of heightened stress to take sufficient action soon enough to restore monetary equilibrium and forestall a significant resurgence of inflation. This is a lesson that may have to be learned the hard way by those who have rushed to capture the bounteous gains that have recently been on offer in the Treasury market.

BOTTOM LINE: With a yield of 2.7% on the 10-year, the upside is extremely limited at this point, while the downside is considerable. Buyers are riding a bullish momentum wave, underpinned by the notion that a severe recession and declining commodity prices mean that inflation risk is a nonfactor. Once the economy and financial markets stabilize. it will become clear that significantly higher inflation will be a legacy of this period, and the momentum trade in bonds will abruptly reverse.