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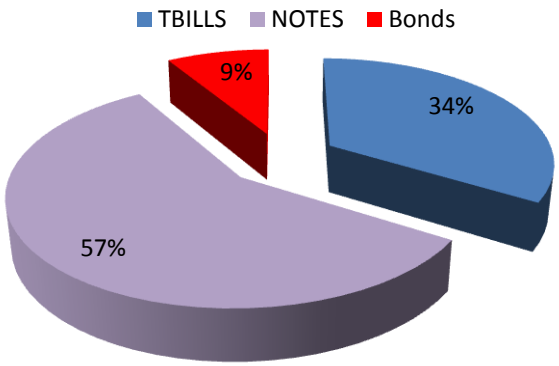
The Nutcracker and the Bond King

- **10-year bond yields have just experienced one of the sharpest 100-day percentage drops in over 50 years**
- **Interest rates are now below their closing level of the 666 March '09 low on the S&P 500**
- **Long-term rates have overshot their fundamental value**
- **The same technical market forces which drove the Greenspan "conundrum' are now at work in the bond market**
- **The stock of outstanding long dated Treasury Bonds is surprisingly small relative to other asset classes and pools of liquidity**
- **BRIC foreign exchange reserves dwarf the total stock of long dated Treasury Bonds**
- **The Fed holds its limit of 35% of the outstanding issue in several maturities**
- **Central bank policy-based buying of Treasuries diverges from the objective of investors and significantly distorts the bond market signal**
- **Interest rates could temporarily move to 2 percent on weak economic data, QE2, equity weakness, and sovereign debt worries**
- **The risk-reward of investing in the 10-year Treasury at current levels is extremely negative**

Chart 1 - Composition of US Treasury Market *



** US$7.3 TN Marketable Treasuries (x/ TIPS)*
Adjusted for securities maturing in different categories

The collapse in US Treasury yields has generated a spirited debate as to whether bonds are in a bubble. The more important question, in our opinion, is why long-term rates are approaching historical lows and what, if anything, are they signaling about the future?

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This is not the first time the behavior of interest rates has confused markets. In 2005, for example, then Fed Chairman Alan Greenspan found the price action of bonds perplexing and a "conundrum:"

This decline in long-term rates has occurred against the backdrop of generally firm U.S. economic growth, a continued boost to inflation from higher energy prices, and fiscal pressures associated with the fast approaching retirement of the baby-boom generation. The drop in long-term rates is especially surprising given the increase in the federal funds rate over the same period. Such a pattern is clearly without precedent in our recent experience.

In fact, Mr. Greenspan blamed, not his monetary policies, but rather, the impact that long-term rates had on the mortgage market, as the primary cause of the housing bubble and subsequent financial collapse:

… it was indeed lower interest rates that spawned the speculative euphoria. However, the interest rate that mattered was not the federal-funds rate, but the rate on long-term, fixed-rate mortgages.

Record Percentage Drop on Long-term Rates

The yield on the 10-year Treasury bond has fallen 150 bps from the April 5th year high of 4.01 percent. This represents a 36 percent decline in just a little over 100 trading days.

In the past fifty years, only during the height of the 2008-09 financial collapse has the 10-year rate experienced such a sharp percentage drop in such a short period. Tuesday's close is 30 bps below the closing rate on March 6, 2009, the 666 intraday low on the S&P500.

No doubt the market is reacting to soft economic data, including the Fed's paring of its growth forecast and its announcement that proceeds from maturing securities will be recycled back into the Treasury markets. But is such a large move to almost record low interest rates justified by long-term fundamentals?

We think not. The collapse in long-term rates is only partially explained by the deteriorating economic data. As with the Greenspan conundrum, technical forces are causing interest rates to "overshoot" their fundamental value.

Bond market sending a clear signal?

As the Economist recently wrote, ***"A lot has to go wrong to justify today's rock-bottom bond yields".*** We might add that ***a lot also has to go right*** to profit from investing (not trading!) in long-term Treasuries at today levels.

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Not only is the bond market banking on zero inflation, if not deflation, and protracted recessionary growth, it is also betting that investors have an almost infinite demand for the U.S. government debt. The market is unfazed that annual deficits are expected to average nearly $1 trillion for the next decade and has priced no risk premium for a potential deterioration in the U.S. government's debt servicing capacity. This is surprising given that the rating agencies have been vocal in their concerns about U.S. fiscal trends.

Furthermore, unlike Japan, which finances the bulk of its budget deficits internally, the U.S. is highly dependent on foreign savings for debt financing. Coupled with the U.S. economy's large negative net external asset position, it is highly unlikely the dollar will follow the same path as the yen, which has appreciated almost 70 percent since the bursting of Japan's real estate and financial bubble. The stronger currency is a major factor contributing to the deflationary forces in Japan's export-led economy.

Many very smart fund managers have been "carried out on stretchers" this year betting the market will internalize these risks But the soft economic data has trumped the other risks and is now fueling a powerful rally in "*Deflation Bonds*," driven, largely, by huge technical imbalances. The ***Bond Kings***, who have sided with the Fed and bet on technicals, have the best seat at the Opera and are surely enjoying the market's classic rendition of ***The Nutcracker***.

We will leave further discussion on the fundamentals for a later piece to briefly focus on the market forces behind the downward spike in rates.

Composition of the Treasury Market

First, to understand what is driving the price action, it is important to recognize the basic composition of the Treasury market. **Chart 1** illustrates that after excluding the US$576 BN stock of Treasury Inflation-Protected Securities (TIPS), the bulk of marketable Treasuries held by the public consists of notes, with maturities of two to ten years. Surprisingly, less than 10 percent of outstanding Treasuries mature after August 2020.

Relatively Small Size of the Long Dated Treasury Bonds

Second, the stock of outstanding long-dated coupon Treasury Bonds is inordinately small relative to other asset classes and sources of liquidity**. Chart 2** illustrates this point as the total cash and investments on the balance sheets of the 12 largest non-financial U.S. corporations is nearly equivalent to the outstanding stock of 9 to 11-year bonds.

Of course, this doesn't mean that the corporate sector is about to pile all their cash into bonds, but the data do provide a sense of how inelastic the supply of bonds can become during a ***dash for duration.***

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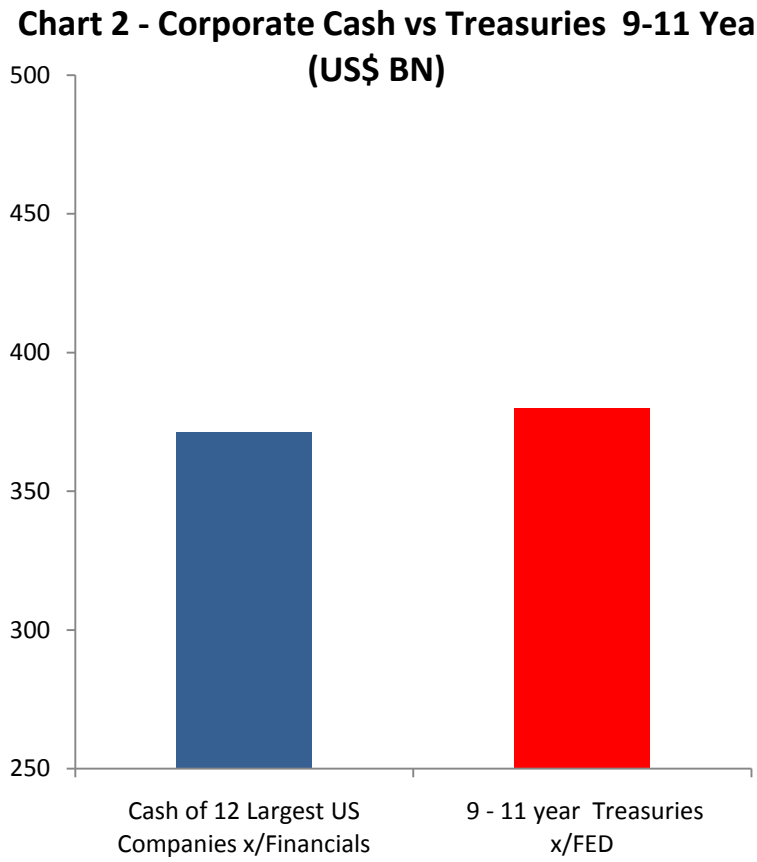

Chart 3 shows that the total face value of bonds, excluding those held by the Fed, is dwarfed by the foreign exchange reserves of the BRICs -- Brazil, Russia, China, and India. This liquidity/supply imbalance was also a huge factor in the Greenspan conundrum as global central banks recycled their dollars into an even smaller stock of bonds. One can only speculate on the maturity structure of their holdings, but it is good bet their propensity to move into longer maturities increases with the steepness of the yield curve.

The chart also illustrates the almost US$1.5 TN expansion of the Fed's balance sheet is more than the double the stock of bonds outstanding. Though the vast majority of the Fed's asset purchases were mortgage related, their net purchase of Treasury securities was significant, totaling almost $200 BN over the two-year period. Hypothetically, the Fed could have bought up the entire stock of long dated Treasuries twice over.

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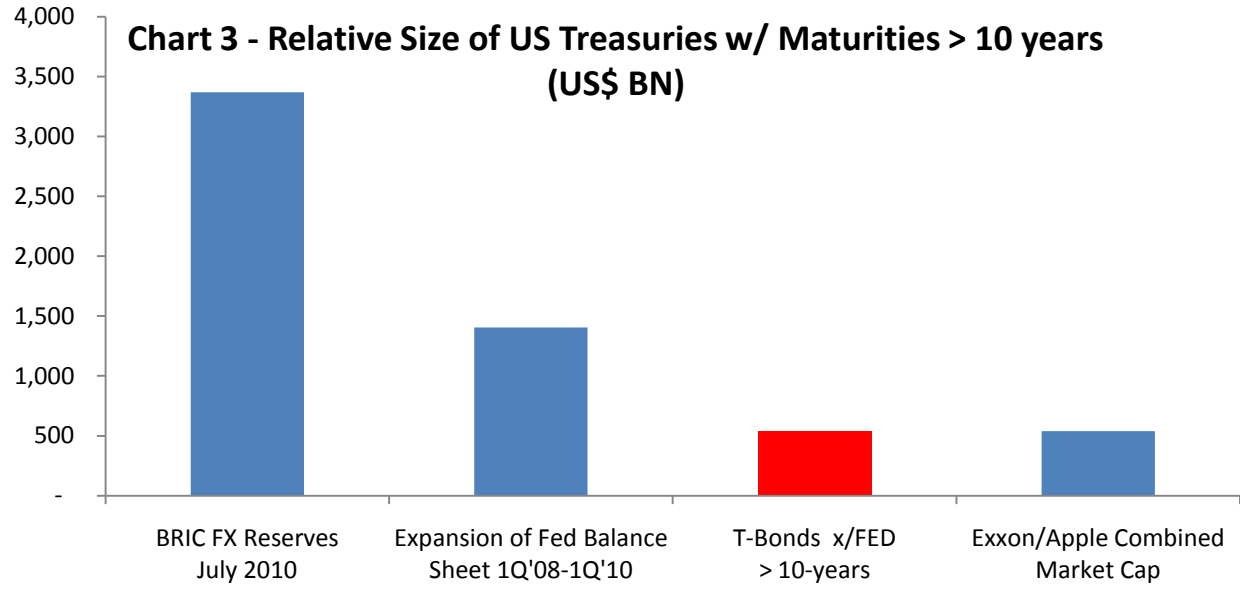

Fed Activity in the Market

As of July 30, the Fed's System Open Market Account (SOMA) held around 12.5 percent of the coupon Treasury curve maturing beyond one year with a position in 184 issues spread across different maturities. In 25 of these, it held its limit of 35% of the outstanding issue. **Chart 4** shows the annual maturity structure of fixed-coupon Treasuries along with the FED holdings in the SOMA.

With the Fed and other global central banks such large players in a relatively small market, demand easily swamps supply when markets seek duration and the safety of the U.S. Treasuries. Furthermore, the primary objective of a central bank buyer of Treasury bonds is mostly policy based and diverges from those of the investment community, which is motivated by profit. This, as Alan Greenspan observed in 2005, can significantly distort the signal from the bond market.

Summary and Outlook

The relatively small stock of Treasury bonds, coupled with Fed purchases and its zero interest rate policy, has distorted the U.S. long-term interest rate, which is one of, if not, the most important price in world. Consequently, the message from the bond market may not be a true signal of future economic, inflation, credit, and foreign exchange risks.

One danger of the lack of price discovery is the potential formation of a positive feed-back loop, where other markets fail to discount these distortions and act accordingly. One prominent economic strategist recently stated, "***We're in a depression. That is what the bond market is***

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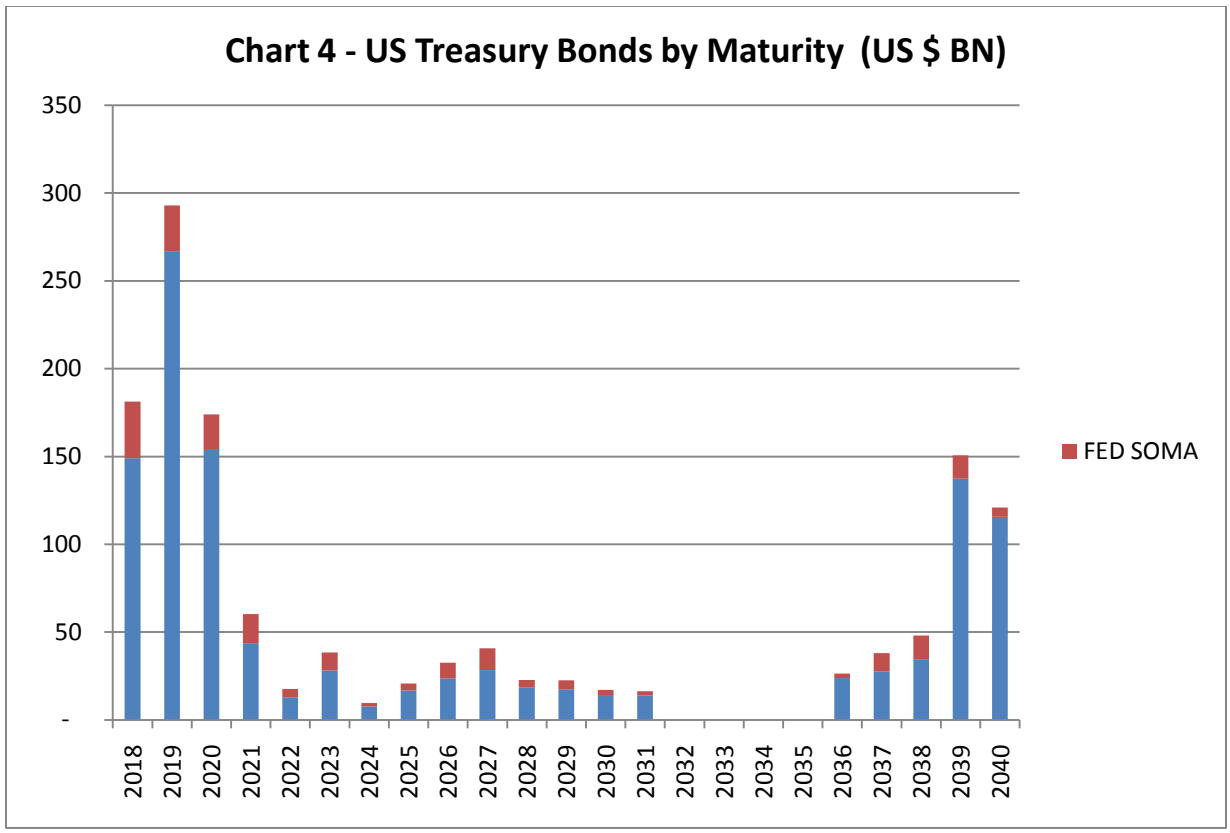
telling us." Only time will tell, but decision makers would be well advised to at least partially discount the signal coming from the bond market.



Deflation Bonds, QE2, and the Pancaking of the Yield Curve

The weak economic story has emboldened the bond bulls, who are riding an inelastic supply curve and expectations of QE2 and further pancaking of the yield curve by Fed. We think the 10-year rate has the potential to fall another 50 bps, to around 2.0 percent. Weaker economic data, the announcement of QE2, further pressure in the equity markets, and a new round of European sovereign worries are all potential catalysts for such a move. A short term correction and back-up of rates to 2.80 percent is likely and would provide a good risk-reward entry for traders.

A sustained move below 2 percent is a low probability, however, unless core CPI moves into deflation for several months. Rents will have to fall, which seems unlikely, and recent wage pressures in China threaten to reverse secular disinflationary pressures. "Biflation" is the most likely scenario, where inflation and deflation in the economy occur simultaneously – i.e., deflation in goods and services dependent on domestic credit, and inflation in goods or commodities traded in the global markets.

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Though the bond should remain relatively firm in the near term, the risk-reward for long-term investors is extremely negative. The U.S. government will issue several trillion dollars of new debt in the next decade and the temptation to increase its average maturity will be irresistible at a 2.50 percent 10-year interest rate. Current fears of Japanese-style deflation will fade, the Fed will change course, the supply/demand imbalance will reverse and long-term interest rates will spike higher.

Understanding the market forces driving Treasury bond rates is essential to formulating a profitable investment and trading strategy. The dustbin of history is filled with *Bond Market Vigilantes* who have not.

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