Economic Analysis

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The new “D” word: duration!

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The home stretch in the Treasury bull market

What a great time it has been to have been long the Treasury market as we head into the home stretch of this massive bull market. And to think that the asset class most despised and the most under-owned in pension fund, household, commercial bank and mutual fund portfolios is the one generating the greatest returns. The 10-year note yield is now firmly below the 3% threshold and this next leg down in yield will undoubtedly represent the classic mania-turn-to-bubble phase that quite plausibly sees an overshoot to or even through the April 1954 lows of 2.3% (doesn’t a bubble need to see a new “price peak”?). This phase is when the general investing public becomes enamored with the Treasury market, as was the case with tech stocks in 2000 and real estate in 2006.

Overvalued condition in Treasuries likely to persist

We have been long-standing bond bulls, and have stuck with the call through thick and thin. However, investors should understand that while we maintain a constructive posture, Treasuries have moved into overvalued territory, though this overvalued condition is likely to persist as the Fed, households and institutional investors emerge as large-scale buyers, even as foreign central banks pull back.

Greater risk-reward in high-quality spread product

Just to recap, the total return generated by the Treasury market was +5.1% in November, making this the best month since 1981 when the yield on the 10-year note was 15%. Imagine that a coupon one-fifth that much can generate similar returns when the capital gain is factored in, even at microscopic interest rate levels (convexity!). The Treasury market managed to return more in just one month than the US equity market has managed to muster over the past decade! But looking ahead, there now seems to be greater risk-reward in high-quality spread product, especially since the Fed is becoming a direct buyer. So, asset-backed bonds, muni bonds, bank bonds (now guaranteed by the government), GSE debt, Baa corporates, etc would seem to make sense, allowing for the fact that there still may be liquidity problems to consider over the near term.

Measures taken last week were epic

The Fed is now embarking on the road towards “quantitative easing”, now that the funds rate is about to be cut to or close to 0%. The measures taken last week were epic:

- The Fed created the Term Asset-Backed Securities Loan Facility (TALF) which will lend up to $200bn to holders of AAA-rated ABS.
- The Fed will also buy up to $100bn in GSE debt.
- The Fed will also buy up to $500bn in GSE-backed MBS.

Refer to important disclosures on page 10.
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Fed’s balance sheet to expand further in coming months

All of this, of course, followed the recent announcement by the Fed that would establish a facility to purchase commercial paper outright. The Fed’s balance sheet is going to expand further in coming months, and, in our view, this promises to be bullish for longer-term Treasuries and high-quality spread product.

Aggressive Fed measures will only cushion the blow

The intent here is to bring down private sector interest rates, and so far it has worked for conforming mortgage rates. But many other interest rates remain in orbit, including high yield at nearly 22%, Baa corporates stubbornly above 9%, car loan rates remain stuck near 6%, with HELOC rates near 5-1/2% too (note that they have not come down), and credit card rates on average are stuck above 12%. Our private sector interest rate proxy remains firmly above 8%. To be sure, the Fed’s move to more forcefully backstop the mortgage market and other consumer loan markets will help, at the margin, to trim interest payments for debtors upon rollover. It is debatable as to whether these actions are going to induce banks to lend, or if households are going to boost their credit demand either, at least over the intermediate term. The Fed is getting more aggressive, but we think the measures will only serve to cushion the blow because private sector balance sheets are still extremely stretched after years of excessive leverage.

The question is: what are the Fed’s next steps?

We may find out more on 16 December. Remember, the Fed has changed this to a *two-day* meeting from a one-day meeting, which could be very important. In our view, this could be a very big day for the markets, as the Fed might end up announcing something dramatic. But how much further can the Fed go to try to stimulate the economy? Make no mistake, the Fed now sees the possibility of a deflationary backdrop emerging as being non-trivial, and is likely to take some very aggressive actions. Go back and read the last set of FOMC minutes from the October meeting and you will see recurring commentary surrounding the widening output gap and the problems that may represent.

But what is left in the policy toolbox?

For an answer to that, we went back to a series of speeches that Ben Bernanke gave back in 2002 and 2003 when we had a deflation “scare”. That was a “scare”. *This* is the real deal. Back in 2002-03, the recession was behind us, and 5% real growth lay ahead, the credit cycle was turning parabolic and real estate was inflating at a rapid rate. Commodity prices were starting to bubble as well.

Let’s hear what Bernanke had to say in the past

The following is a speech Bernanke gave on 23 July 2003. It is titled “An Unwelcome Fall In Inflation?”

“Where is inflation likely to go over the foreseeable future … inflation in the intermediate term is affected primarily by four factors:

Economic slack. If aggregate demand is below potential output, implying a positive output gap, the rate of increase in labor compensation and other input costs should slow, firms should be less able to pass price increases, and thus inflation should slow.

Inflation expectations. All else being equal, higher expected rates of inflation will intensify pressure for increases in wages and other costs and thus raise actual inflation. The objectives and performance of monetary policymakers over the long run are key determinants of these expectations.

Supply shocks, such as changes in energy prices, food prices, or import prices. Some supply shocks, such as shocks to import prices other than those of food and energy, affect core inflation directly. Shocks to the prices of energy or food may affect core inflation if they become embodied in inflation expectations or if they boost core prices indirectly by raising the costs of inputs in the production of non-energy, non-food goods and services.

Inflation persistence. Many economists have argued that inflation tends to be persistent, or “sticky,” perhaps for institutional reasons related to the process of wage determination, supply contracts, and the like. Hence, current trends in inflation can be expected to persist.

You may have noted that I did not include money growth in this list of inflation determinants. Ultimately, inflation is a monetary phenomenon, as suggested by Milton Friedman’s famous dictum. However, no contradiction exists, as the expectational Phillips curve is fully consistent with inflation’s being determined by monetary forces in the long run. This point, originally made by Friedman himself, has been demonstrated in many textbooks and so I will not discuss it further here. I only note that, as an empirical matter, instabilities in money demand, financial innovation, and many special factors affecting the monetary aggregates make them relatively poor predictors of inflation at medium-term horizons. For this reason, the role of the money supply remains implicit in this discussion.”

We truly love that last line since everyone seems to think that merely boosting the money supply is enough to kick-start inflation; in addition, we have money velocity, which hinges on credit creation, to consider.

“The form that this continued ease will take depends on developing conditions. Keeping the federal funds rate target at or near its current level for an extended period may be sufficient. Alternatively, as Chairman Greenspan testified last week, we could certainly cut the rate from where it is now. In my view, though recognizing that such an action imposes costs on savers and some financial institutions, we should be willing to cut the funds rate to zero, should that prove necessary to provide the required support to the economy.”

Bernanke advocates keeping policy rates near the floor

So here, Bernanke advocates announcing to the public that policy rates will be kept near the floor for an extended period of time. We can expect to see something like this at the next post-meeting press statement, or the ones thereafter. Also note that he recognizes the cost this imposes on savers and money market funds too.

"Should the funds rate approach zero, the question will arise again about so-called nontraditional monetary policy measures … Without going into great detail, I see the first stages of a "nontraditional" campaign as focused on lowering longer-term interest rates. The two principal components of that campaign would be a commitment by the FOMC to keep short-term yields at a very low level for an extended period (I'll say more about this in a moment) together with a set of concrete measures to give weight to that commitment. Such measures might include, among others, increased purchases of longer-term government bonds by the Fed, an announced program of oversupplying bank reserves, term lending through the discount window at very low rates, and the issuance of options to borrow from the Fed at low rates. I am sure that the FOMC will release more specific information if and when the need for such approaches appears to be closer on the horizon."

This has a certain Japanese ring to it

Who was to know that the "release" of the information would take another five years? But keep in mind that Bernanke has already unveiled several of these measures, in terms of the discount window and excess bank reserves. But "increased purchase of longer-term government bonds by the Fed" has a certain Japanese ring to it and still leaves us moderately bullish on fixed-income, as a result.

More aggressive actions the central bank can take

Speaking of Japan, Bernanke also delivered a speech on 31 May 2003, titled "Some Thoughts on Monetary Policy in Japan". This was a seminal event, and if Bernanke practices what he preaches in this sermon, there are clearly more aggressive actions the central can take:

"Without denying the many difficulties inherent in making monetary policy in the current environment in Japan, I believe that not all the possible methods for easing monetary policy in Japan have been fully exploited. One possible approach to ending deflation in Japan would be greater cooperation, for a limited time, between the monetary and the fiscal authorities. Specifically, the Bank of Japan should consider increasing still further its purchases of government debt, preferably in explicit conjunction with a program of tax cuts or other fiscal stimulus."

Printing money to fund the deficit

This sounds like a template for what we are going to see unfold here: a huge fiscal stimulus, but instead of the Treasury financing it by selling bonds to the public, it will be the Fed that finances the plan by buying the Treasuries and expanding its balance sheet (ie, printing money to fund the deficit).

"One option would be for the Bank to use its increased ability to bear risk to undertake new policy actions that would entail accepting other types of risk onto its balance sheet. Today I will argue for a different approach and suggest that the Bank of Japan cooperate temporarily with the government to create an environment of combined monetary and fiscal ease to end deflation and help restart economic growth in Japan. To do this, the BoJ might have to scrap rules that it has set for itself–for example, its informal rule that the quantity of long-term government bonds on its balance sheet must be kept below the outstanding balance of banknotes issued."

More advocacy to buy long-term bonds to stimulate growth

"Demand on the part of both consumers and potential purchasers of new capital equipment in Japan remains quite depressed, and resources are not being fully utilized. Normally, the central bank would respond to such a situation by lowering the short-term nominal interest rate, but that rate is now effectively zero. Other strategies for the central bank acting alone exist, including buying alternative assets to try to lower term or liquidity premiums and attempting to influence expectations of future inflation through announcements or commitments to expand the monetary base."

How far will the Fed wade into the risk pool?

Here, Bernanke supports the central bank purchase of risky assets to help compress credit spreads. But how far the Fed would wade into the risk pool (equities? sub-investment grade credit?) remains to be seen.

"The Bank of Japan has taken some steps in these directions but has generally been reluctant to go as far as it might, in part because of the difficulty in determining the quantitative impact of such actions and in part because of the Bank's view that problems in the banking system have "jammed" the usual channels of monetary policy transmission. Ironically, this obvious reluctance on the part of the BoJ to sail into uncharted waters may have had the effect of muting the psychological impact of the nonstandard actions it has taken".

Now is the time to be very proactive

Wow. Bernanke lecturing the BoJ for its early refusal "to sail into uncharted waters" is substantial. The delay in implementing non-traditional tactics risks dampening the effects once these policies are introduced. This could be why Bernanke has called for a two-day meeting in December. Something really big may be in the works. Now is the time to be very proactive.

"My thesis here is that cooperation between the monetary and fiscal authorities in Japan could help solve the problems that each policymaker faces on its own. Consider for example a tax cut for households and businesses that is explicitly coupled with incremental BOJ purchases of government debt–so that the tax cut is in effect financed by money creation. Moreover, assume that the Bank of Japan has made a commitment, by announcing a price-level target, to reflate the economy, so that much or all of the increase in the money stock is viewed as permanent."

Bernanke advocates fiscal plan financed by printing money

Once again, Bernanke advocates a fiscal plan that is financed by the Fed printing money. If it is good enough for Japan, you have to believe he thinks it is good for the USA.

"Under this plan, the BoJ's balance sheet is protected by the bond conversion program, and the government's concerns about its outstanding stock of debt are mitigated because increases in its debt are purchased by the BOJ rather than sold to the private sector. Moreover, consumers and businesses should be willing to spend rather than save the bulk of their tax cut: *They have extra cash on hand, but–because the BOJ purchased government debt in the amount of the tax cut–no current or future debt service burden has been created to imply increased future taxes. Essentially, monetary and fiscal policies together have increased the nominal wealth of the household sector, which will increase nominal spending and hence prices.* The health of the banking sector is irrelevant to this means of transmitting the expansionary effect of monetary policy, addressing the concern of BOJ officials about "broken" channels of monetary transmission."

Fed is the lender of last resort for the government

Once again, Bernanke makes a strong case for the Fed to become the lender of last resort for the government: there is no "Ricardian equivalence" where people save the tax cut because they are concerned that the run-up in the deficit is going to lead to higher taxes in the future.

"Isn't it irresponsible to recommend a tax cut, given the poor state of Japanese public finances? To the contrary, from a fiscal perspective, the policy would almost certainly be stabilizing, in the sense of reducing the debt-to-GDP ratio. The BoJ's purchases would leave the nominal quantity of debt in the hands of the public unchanged, while nominal GDP would rise owing to increased nominal spending. Indeed, nothing would help reduce Japan's fiscal woes more than healthy growth in nominal GDP and hence in tax revenues.

Potential roles for monetary-fiscal cooperation are not limited to BoJ support of tax cuts. BoJ purchases of government debt could also support spending programs, to facilitate industrial restructuring, for example. The BoJ's purchases would mitigate the effect of the new spending on the burden of debt and future interest payments perceived by households, which should reduce the offset from decreased consumption. More generally, by replacing interest-bearing debt with money, BoJ purchases of government debt lower current deficits and interest burdens and thus the public's expectations of future tax obligations. Of course, one can never get something for nothing; from a public finance perspective, increased monetization of government debt simply amounts to replacing other forms of taxes with an inflation tax.

But, in the context of deflation-ridden Japan, generating a little bit of positive inflation (and the associated increase in nominal spending) would help achieve the goals of promoting economic recovery and putting idle resources back to work, which in turn would boost tax revenue and improve the government's fiscal position … Under the current circumstances, greater cooperation for a time between the Bank of Japan and the fiscal authorities is in no way inconsistent with the independence of the central bank, any more than cooperation between two independent nations in pursuit of a common objective is inconsistent with the principle of national sovereignty."

Bernanke likely will back a huge fiscal stimulus plan

We can assume from this that Ben Bernanke is going to fully back a huge fiscal stimulus plan – "industrial restructuring" sounds a lot like the infrastructure renewal plan that the Obama team is talking about. And again, this is financed ostensibly by the Fed, and the "monetization" will lead to "positive inflation," which is exactly what Mr. Bernanke was advocating back in 2003 for Japan. That said, if i is good enough for them, we would have to assume that it must be the same for us.

How to deal with deflation when rates fall to zero

Bernanke also gave a speech back on 21 November 21, 2002, "Deflation: Making Sure It Doesn't Happen Here", where he laid out the framework for how to deal with a deflationary backdrop once the overnight rate falls to zero. A very strong case here for fixed-income, high-quality non-government debt and, especially, duration:

“As I will discuss, a central bank, either alone or in cooperation with other parts of the government, retains considerable power to expand aggregate demand and economic activity even when its accustomed policy rate is at zero. In the remainder of my talk, I will first discuss measures for preventing deflation–the preferable option if feasible. I will then turn to policy measures that the Fed and other government authorities can take if prevention efforts fail and deflation appears to be gaining a foothold in the economy … As I have mentioned, some observers have concluded that when the central bank’s policy rate falls to zero–its practical minimum–monetary policy loses its ability to further stimulate aggregate demand and the economy. At a broad conceptual level and in my view, in practice as well, this conclusion is clearly mistaken.”

Bernanke does not believe his policy options are limited

The Fed is about to take the funds rate down to or near 0%, and,has already tiptoed into non-conventional terrain. Moreover, policymakers are voicing concerns over deflation, and no matter how remote the odds may be, they are certainly not trivial. Bernanke in no way, shape or form believes that his policy options are limited, even with the funds rate at the floor.

“To stimulate aggregate spending when short-term interest rates have reached zero, the Fed must expand the scale of its asset purchases or, possibly, expand the menu of assets that it buys. Alternatively, the Fed could find other ways of injecting money into the system–for example, by making low-interest-rate loans to banks or cooperating with the fiscal authorities … One relatively straightforward extension of current procedures would be to try to stimulate spending by lowering rates further out along the Treasury term structure–that is, rates on government bonds of longer maturities.”

Fed may buy long-term government bonds

The Fed may be about to expand its balance sheet and buy long-term government bonds. Given the sharp rally in the Treasury market in recent weeks, some may have already taken positions.

“There are at least two ways of bringing down longer-term rates, which are complementary and could be employed separately or in combination. One approach, similar to an action taken in the past couple of years by the Bank of Japan, would be for the Fed to commit to holding the overnight rate at zero for some specified period. Because long-term interest rates represent averages of current and expected future short-term rates, plus a term premium, a commitment to keep short-term rates at zero for some time–if it were credible–would induce a decline in longer-term rates. A more direct method, which I personally prefer, would be for the Fed to begin announcing explicit ceilings for yields on longer-maturity Treasury debt …

…Yet another option would be for the Fed to use its existing authority to operate in the markets for agency debt (for example, mortgage-backed securities issued by Ginnie Mae … a second policy option, complementary to operating in the markets for Treasury and agency debt, would be for the Fed to offer fixed-term loans to banks at low or zero interest, with a wide range of private assets (including, among others, corporate bonds, commercial paper, bank loans, and mortgages) deemed eligible as collateral … pursued aggressively, such a program could significantly reduce liquidity and term premiums on the assets used as collateral. Reductions in these premiums would lower the cost of capital both to banks and the non-bank private sector, over and above the beneficial effect already conferred by lower interest rates on government securities.

Each of the policy options I have discussed so far involves the Fed's acting on its own. In practice, the effectiveness of anti-deflation policy could be significantly enhanced by cooperation between the monetary and fiscal authorities. A broad-based tax cut, for example, accommodated by a program of open-market purchases to alleviate any tendency for interest rates to increase, would almost certainly be an effective stimulant to consumption and hence to prices. Even if households decided not to increase consumption but instead re-balanced their portfolios by using their extra cash to acquire real and financial assets, the resulting increase in asset values would lower the cost of capital and improve the balance sheet positions of potential borrowers."

Fed and Treasury have unveiled no fewer than 20 programs

Since late last year, we have seen the Fed and the Treasury unveil no fewer than 20 different programs to stem the credit collapse and housing turndown.

Fed will be the captive market for new debt issuance

The amount of taxpayer money risked to backstop the entire financial sector is now estimated to be in excess of $4tn. The Fed has expanded its balance sheet from $800bn to well over $2tn. The funds rate has been sliced 425bp 1%. There has already been one round of tax stimulus costing $130bn and a spending package is in the offing that will probably be as large as $700bn. Fiscal policy is set to become more aggressive, as is monetary policy, but the Fed is going to have to be more "non-traditional", seeing as there is no more room to ease via short-term interest rates. Ben Bernanke's past musings suggest that he will be working with fiscal policymakers by being the captive market for the new debt issuance. He is also taking early steps toward quantitative easings by buying commercial paper, GSE debt, GSE-backed MBS and AAA-rated asset-backed securities.

The bottom line for investors

Investors should operate under the assumption that the Fed is going to embark on a new course of balance sheet expansion to mitigate the downside risks to the macro outlook and fight the looming deflation battle, in our view. Either way, this is bullish for long bonds because (1) to be successful, the Fed is going to have to emerge as a very larger buyer of Treasuries, and (2), if the Fed is not successful, deflation will move from a forecast to a reality and long-term rates will likely approach Japanese levels.

But it also stands to reason that the Fed's aim is not just to bring the overall term structure of interest rates down to encourage risk-taking and help trim debt-servicing costs. Its aim is also to create an environment where credit spreads can narrow to more comfortable levels. So, in addition to 10-year T-notes and 30-year bonds, other high-quality fixed-income securities offering a decent spread over government bonds look very attractive in this policy environment.

Fed futures contracts priced for the Fed to start hiking rates next year

These are also a nice buying opportunity, in our view, because it is unlikely the Fed will be hiking in advance of a peak in the unemployment rate, which the October FOMC minutes told us would most likely not occur until the first half of 2010.

0% short-term rates are bullish for gold

As an aside, 0% short-term rates are very bullish for gold, as there is a convincing inverse relationship between policy rates and bullion. After all, the opportunity cost of holding gold is the coupon at the short end of the yield curve.

Defensive and dividend plays screened best

As we have said in he past, these periods of negative nominal GDP growth have tended to see the equity market quite skittish, with the sectors that screened best being the defensive and/or dividend plays (ie, utilities, consumer staples, health care and telecom services).

The dollar is currently the one-eyed man in the land of the blind

It would be tempting to be dollar-bearish, but the reality is that most countries are under similar duress and in the process of easing fiscal and monetary policies significantly. In fact, M2 growth in regions like the UK (+12.8% YoY), Germany (+12.5%), France (+9.9% and Italy (+8.6%) are all running faster than the USA (+7.4%, as of October). In the land of the blind, the one-eyed man is king, and the dollar is currently the one-eyed man.

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