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Interpreting Low Treasury Interest Rates

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The yield on the 2-year Treasury has not reached new secular lows today, presumably because of renewed fears that the US economy was moving closer to a double-dip recession. While it is doubtful that the US economic activity will fall sufficiently to push us back into recession, the Treasury market clearly signals that the risk has risen materially.

An alternative view is that low yield levels across the entire yield curve indicates that the US is moving closer to a deflationary cycle. In this scenario, it would be expected that long-term yields would fall at a sharper rate than shorter term interest rates.

If Treasury yields were representative of investor's collective views that the US was indeed heading back to a double dip economic contraction, then it would be expected that other markets would also be corroborating.

For example, the last time that long-term Treasury yields were as low as today, the spread between high-yield bonds and Treasury yields was an eye popping 1,458 basis points. The current spread is about half of that, at 722 basis points. The spread between investment grade corporate and Treasury yields was around 530 basis points in April of 2009 versus 250 basis points currently.

When looking at spread relationships in the bond market, there seems to be little evidence that the economy is poised to enter into another recession.

Stocks are showing a similar pattern. The S&P 500 closed at 855.16 in April 28, 2009 and is currently trading around 1043. The Russell Small Cap Index was at 472.84 and is currently around 641. Broadly speaking, since April 28th 2009, the S&P 500 gained 22% and the Russell Small Cap Index gained 36%.

If deflation was the greater risk, then we would expect long-term yields to have fallen relative to short-term yields, which is also not the case. In fact, the yield curve has actually steepened across the entire coupon curve between April 28, 2009 and today. The sharpest decline in yield has been the 3-year note with a decline of 40 basis points. The yield on the 10-year note dropped slightly by 5 basis points and the 30-year bond posted a drop of only 1 basis point.

If the economy was unambiguously marching toward another recession, then credit spreads would be expected to be substantially wider and stocks equally as low. Neither of these conditions are currently priced into private sector asset classes.

It is our view that investors should sell all government related debt at current overvalued levels and seek to re-deploy proceeds into corporate notes and bonds, equities and gold. All three of these asset classes should be expected to provide more price protection than the excessively priced Treasury notes and bonds.