

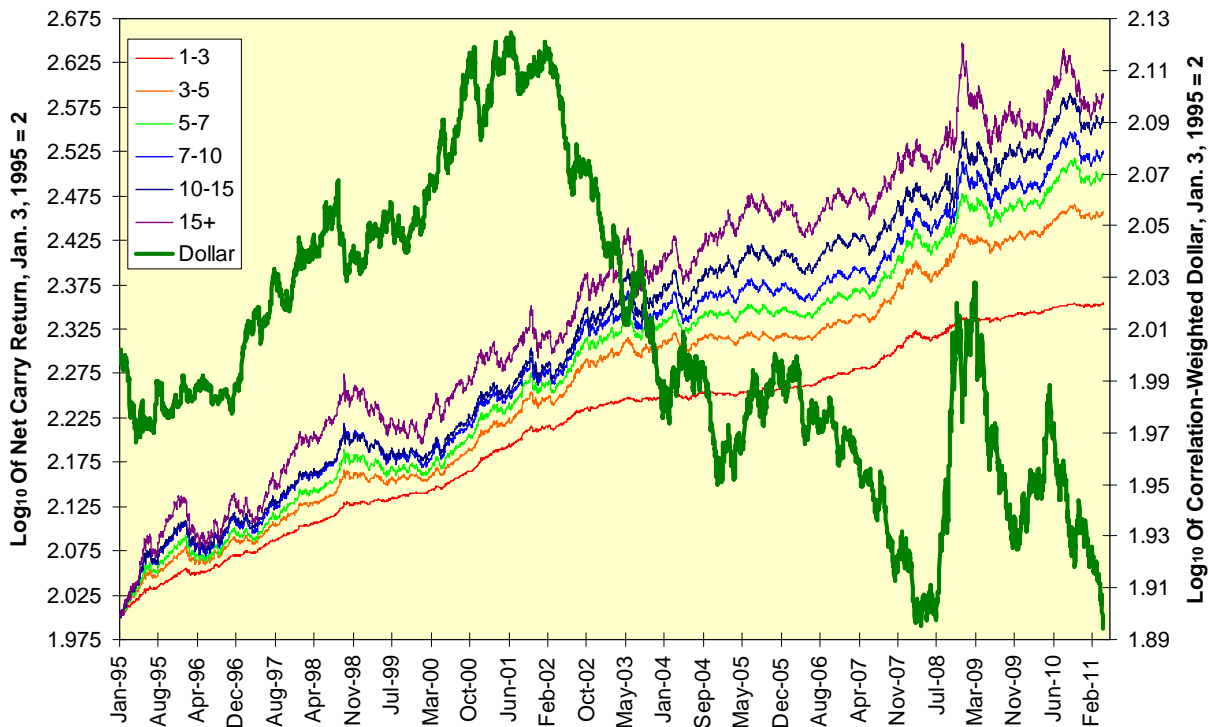
The Dollar Will Not Sink Treasuries

It might be hard for younger investors to imagine, but there was a time when any hint of dollar weakness was enough to prompt a selloff in Treasuries. Yes, those were the old days when people not named “Ben” or “Hu Jin-Tao” actually bought bonds.

The thinking then was foreign buyers of U.S. debt, principally Japan as they were the country everyone admired, would freak out over the declining value of their Treasury holdings and dump their bonds. Upon our heads. Unceremoniously. The only salvation, it was presumed, would be for the U.S. to raise short-term interest rates to preserve some exchange value of the greenback.

Now let’s fast-forward, which was then done on a VHS cassette player and is now done on your iWhatever (Can you trade iShares on an iPad while watching YouTube? Yes, you can!). The U.S. dollar is burning while Ben fiddles and is about to make a new all-time low on the major indices. However, the net carry returns on Treasuries by maturity class remain strong. Net carry return is the total return on the bond index less the short-term financing costs, if those still exist.

Net Treasury Carry Returns And The Dollar

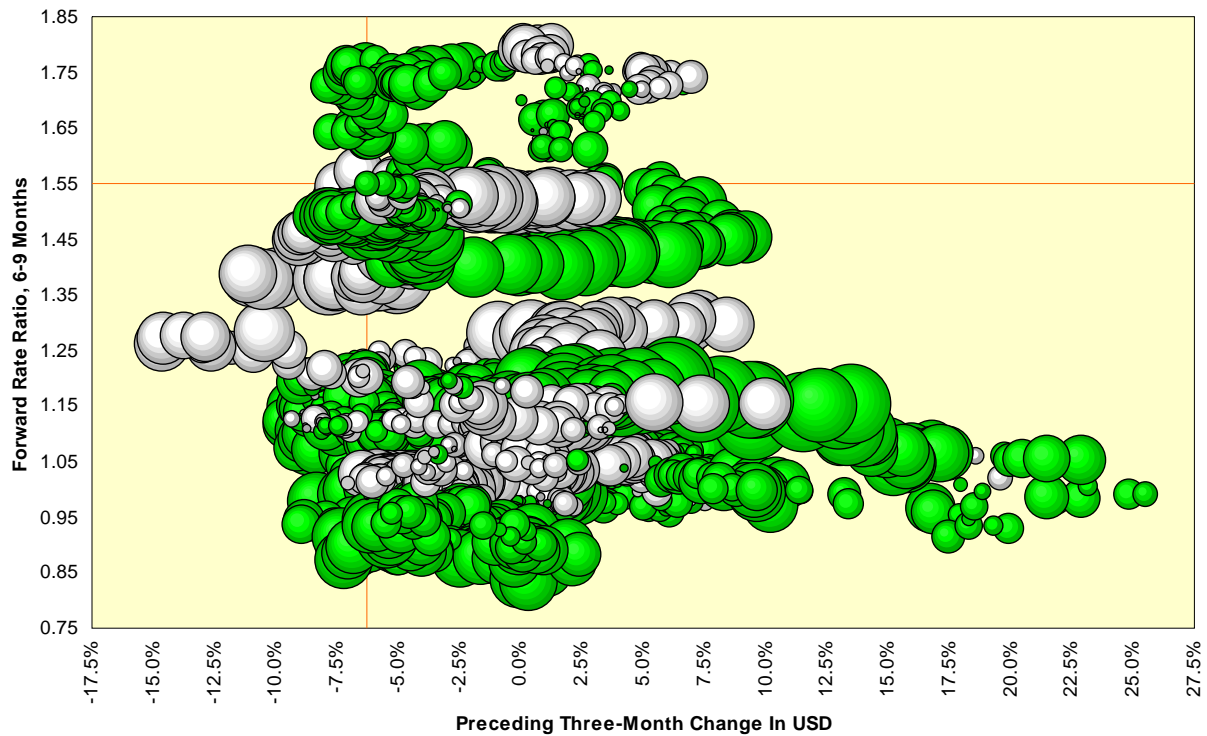


I should note for the record this has played out as I used to preach at the time: Not only would foreign investors not drive down the value of their existing holdings, they would need to finance us as a customer and a lower dollar would raise the prospective returns on new Treasury purchases.

Where Now?

I do have to admit, however, I would get pretty sick and tired of financing someone whose house was increasingly out of order, and there may come a time when our creditors will, too. It should not happen within the next three months, however. If we map the three month-ahead net carry returns for 7-10 year Treasuries against the preceding three months' change in the USD and the shape of the money-market yield curve between six and nine months, we see we are in an indeterminate zone, a mix of positive green and negative white bubbles. The current environment is marked with an orange bombsight.

Three-Month Ahead Returns On 7-10 Year Carry



What would push UST returns lower? One such region lies just to the southwest of where we are now, which would be a flatter yield curve and a weaker dollar. This would be possible if the Federal Reserve gets pushed to the wall by a collapsing dollar and starts tightening credit. Possible, yes; likely, no. A second zone of negative returns lies straight to the east; this would be a stronger dollar rising on the basis of prospectively higher short-term interest rates or on higher asset returns. Once again, the markets would have to believe this Federal Reserve even remembers how to tighten credit.

The largest belt of positive prospective returns occurs just south of where we are today; it involves a modest flattening of the yield curve and is indifferent to the dollar. This is where I think we will go and this is why I do not believe the weaker dollar will spook the Treasury market.