

Treasuries Not Set Up For Big Slide

Pavlov's dogs have nothing on investors when it comes to closing the barn door after the horses have escaped. If you need more proof, just look at the instinctive reaction to every upwards move in any market and how it gets classified as a bubble. While I used to classify a bubble as a pattern of self-reinforcing behavior, I now have to lean toward the definition floating around as an uptrend doubted by most and missed by many.

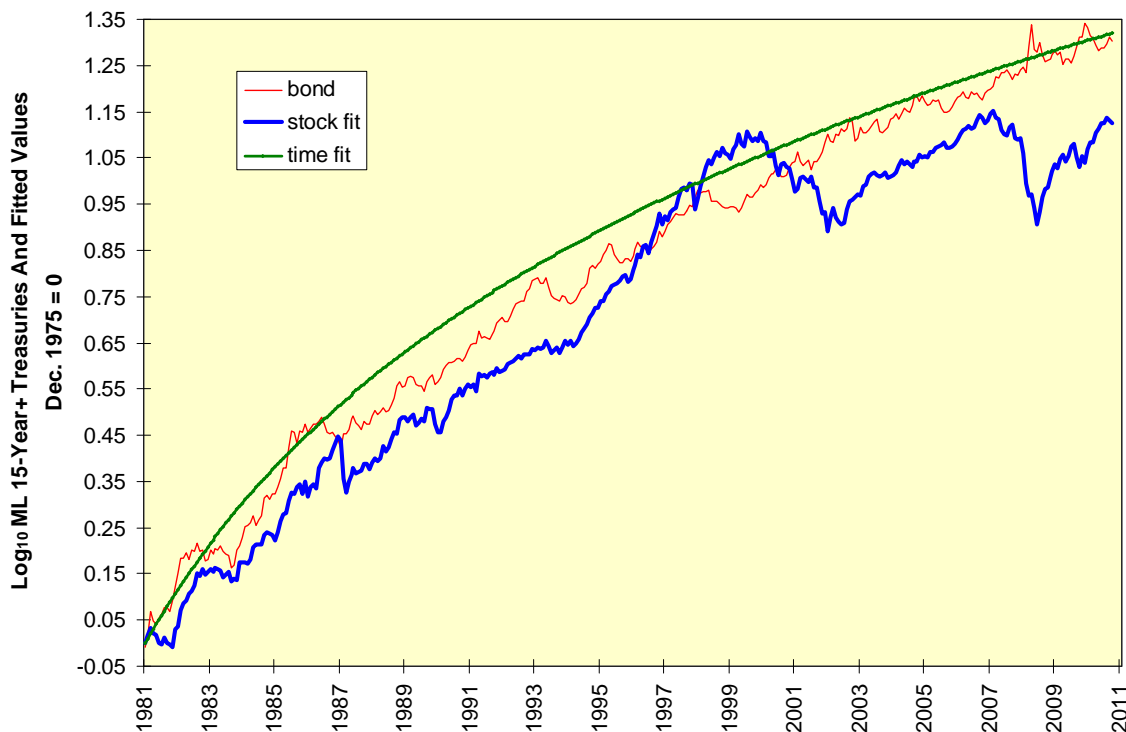
The bond market has been classified as a bubble by many who have a great deal of difficulty in conceiving of a three decade-long move whose top has a finite limit in a yield of 0%. Interestingly, many of these same doubters who fear the [duration risk](#) of mid-curve and long-term Treasuries are willing to accept the [credit risk](#) of high-yield and emerging market bonds.

Bonds For The Long Run

Let's take a look at the total return of the Merrill Lynch index of 15-year+ Treasuries and two very simple regression models thereof. I present these results on a logarithmic scale to convey the exponentially higher price of a bond as its yield to maturity approaches zero. Each basis point lower in yield has a greater effect on price.

The two fitted series are this bond series against time and against the MSCI total return series for U.S. equities. The fitted value for time confirms the simple endurance of the bull market in bonds extant since September 1981; the fitted value against the stock series is intended as an antidote to those who believe bond prices only fall when stock prices fall. Nothing could be further from the truth; the elasticity here is 0.80.

Actual & Modeled Values For 15-Year+ Treasuries

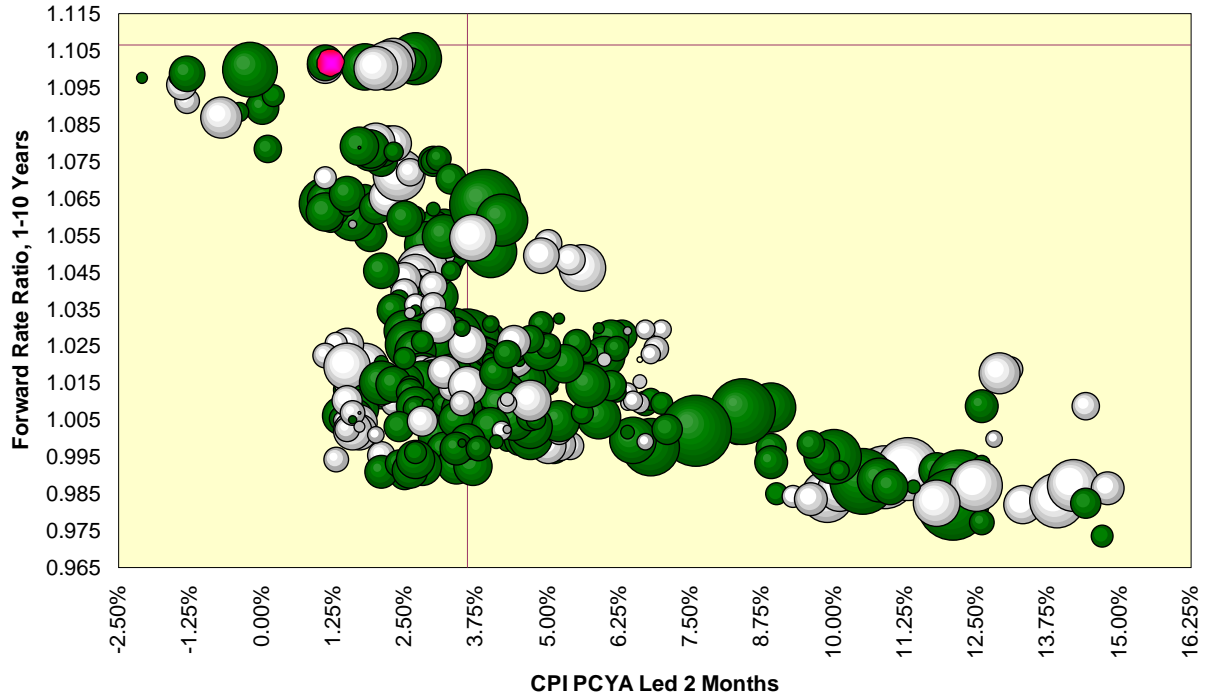


Inflation And The Yield Curve

Now let's look at prospective returns, three months ahead, for bonds as a function of the yield curve and lagged inflation. The yield curve involved is the forward rate ratio between one and ten years ($FRR_{1,10}$) for Treasuries; this is the rate at which we can lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is.

Positive prospective returns are depicted in green; negative in white, with the diameter of the bubble corresponding to the magnitude of the return. The current environment is marked with a bombsight and the last datum used is highlighted in magenta.

Three Month-Ahead 15-Year+ UST Returns As Function Of CPI & Yield Curve



Please note we are in a zone with no direct observations. However, there are only a few white bubbles nearby; most prospective negative returns occur in an environment of much higher inflation or a much flatter yield curve. Here we are near record steepness on the yield curve and inflation that has yet to take off to the upside.

The conclusion is simple, therefore: It is unlikely we will emerge from the present environment with a major bond selloff unless, of course, the ongoing budget kabuki in Washington convinces everyone to sell their bonds and...do what with the money?