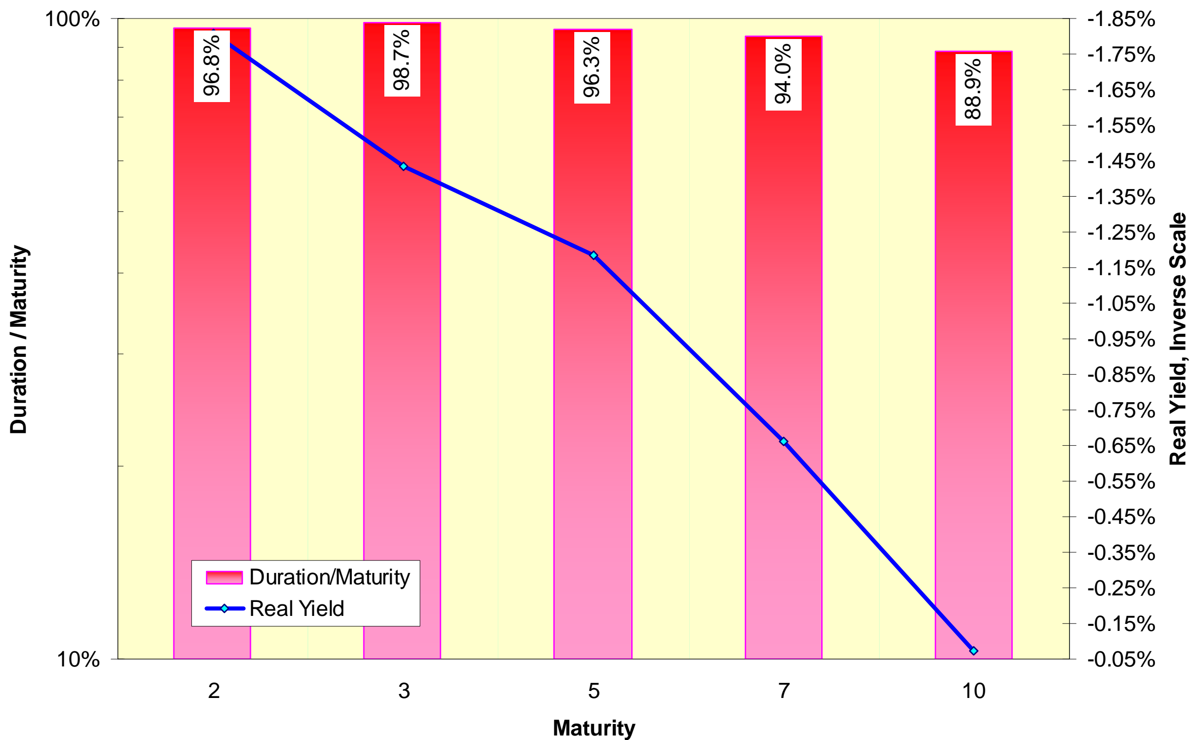
The Long-Term Downtrend In Interest Rates Could Continue

The Short-Term Looks Bumpy, Though

In August 2011's Treasuries Approaching Zero-Coupon Status I lamented the bond market's lack of value, something I have been harping on since, including last week's Treasuries Shedding Their Insurance Premium Component. Does this mean I am a rip-snorting, step-out-of-my-way-while-I-sell bond bear? Hardly; I think what we are going through is a short-term or secondary selloff in the Treasury market within the context of what still has to be classified as a long-term bull market in bonds.

Does this mean I cannot make up my mind? Hardly; it is called a path-dependent forecast, one where you really have to call your shot both lower and then higher (in price terms).

First, let's review just how devoid of value the Treasury market has been of late. The duration, or interest rate risk, of a standard or "bullet" bond cannot exceed its maturity; the duration/maturity ratio of a zero-coupon bond is 100% by definition. This snapshot of the Treasury market from last week shows how far above 90% we are for everything shorter than ten years in maturity.

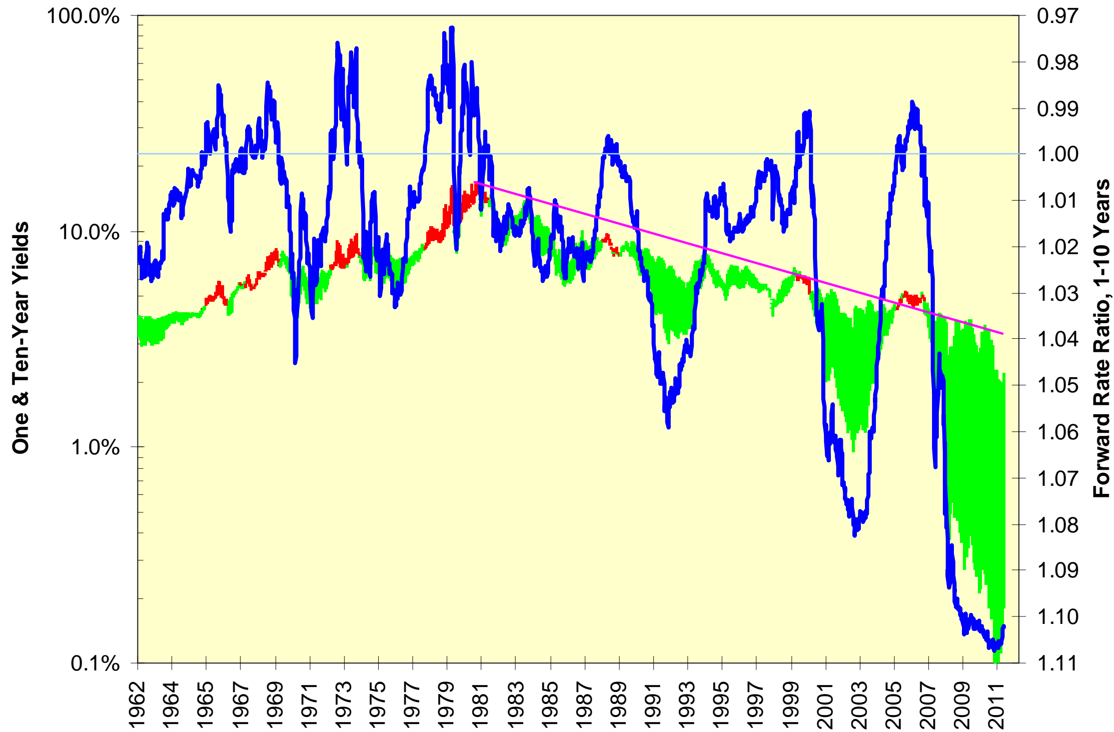


Second, the real yields extracted from the TIPS market and plotted inversely are negative. Now maybe I am more old-fashioned than I think, but why would anyone who did not have their own printing press line up to buy something with a negative return and nothing but pure interest rate risk unless they were buying insurance with both fists?

Conclusion: We need to sell off to restore value.

Long-Term

However, once we sell off, the likelihood is we will fail from a lower high in ten-year yields. I have plotted the one- and ten-year Treasuries and the forward rate ratio between them going back to 1962 and superimposed a trendline on the ten-year yield since its September 1981 high. This line on a logarithmic scale tells us in no uncertain terms we have been failing from exponentially lower highs since the first year of the Reagan administration. In addition, each dose of monetary stimulus has driven one-year rates lower and the $FRR_{1,10}$ steeper since Alan Greenspan asked the question, "What's this button do?"



The reasons behind these successive failures are simple: All sectors of the economy become more leveraged as rates fall; this means they are increasingly sensitive to any upturn in yields. Once rates rise, some sector such as housing or automobiles or municipalities or technology deleverages in a process academic economists refer to as "puking."

We came very close to hitting 0% for the one-year in 2011. Why we cannot drive toward that limit with the ten-year in the next cycle is beyond me.

Politicians vote for it before they vote against it. You can go short Treasuries (TBT) before you go long again (TLT).