Two Warning Signs For Treasuries

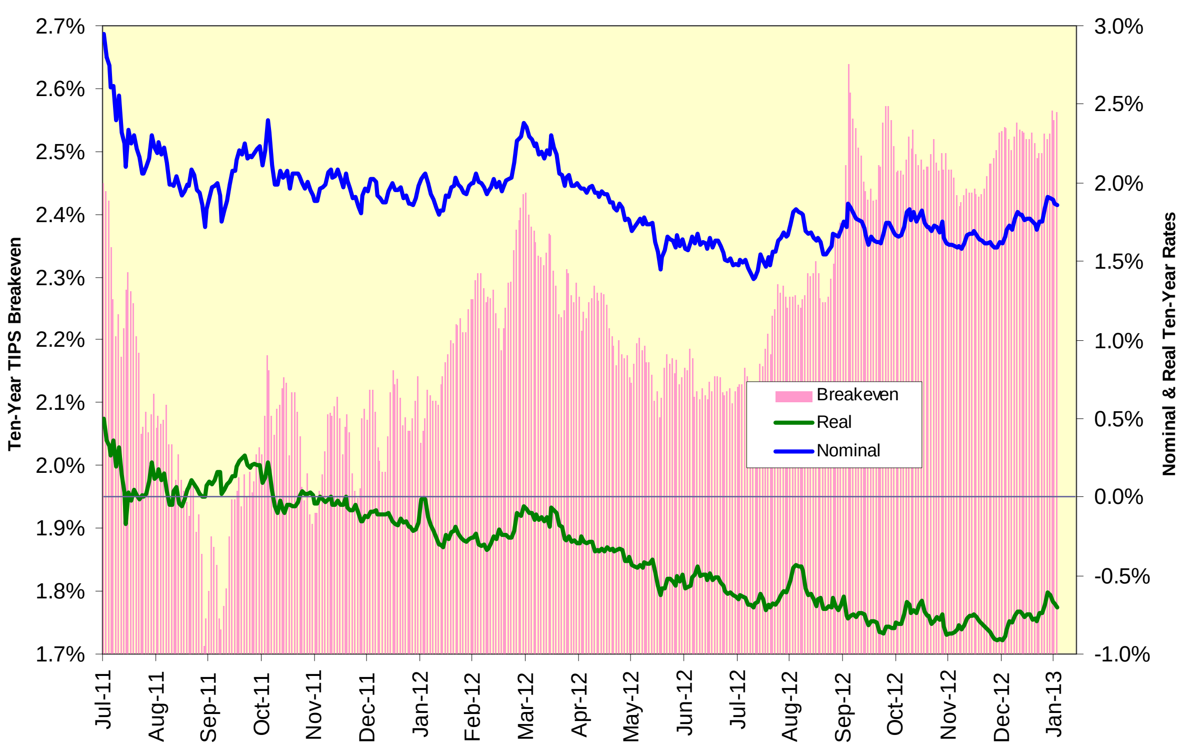
You can't fool all of the people all of the time, but let's face it, it is fun to try every now and then. Take the recent fiscal cliff negotiations where we were trained to regard a massive tax increase unaccompanied by even the pretense of spending cuts as a victory because no one, and I do mean no one, wanted to risk a repeat of September-October 2008. To paraphrase the late Jacqueline Susann, once was most certainly enough when it comes to having that trapdoor open beneath you.

In the meantime, the Treasury has been financing the national debt by having you pay them for the privilege of lending them money. Yes, the wonderful folks now conjuring up visions of $1 trillion platinum coins to address the debt ceiling get you to pay them. Had the word "shmendrik" not been invented as a character name in an 1877 Yiddish Theatre production it could have been invented to describe today's bond investors.

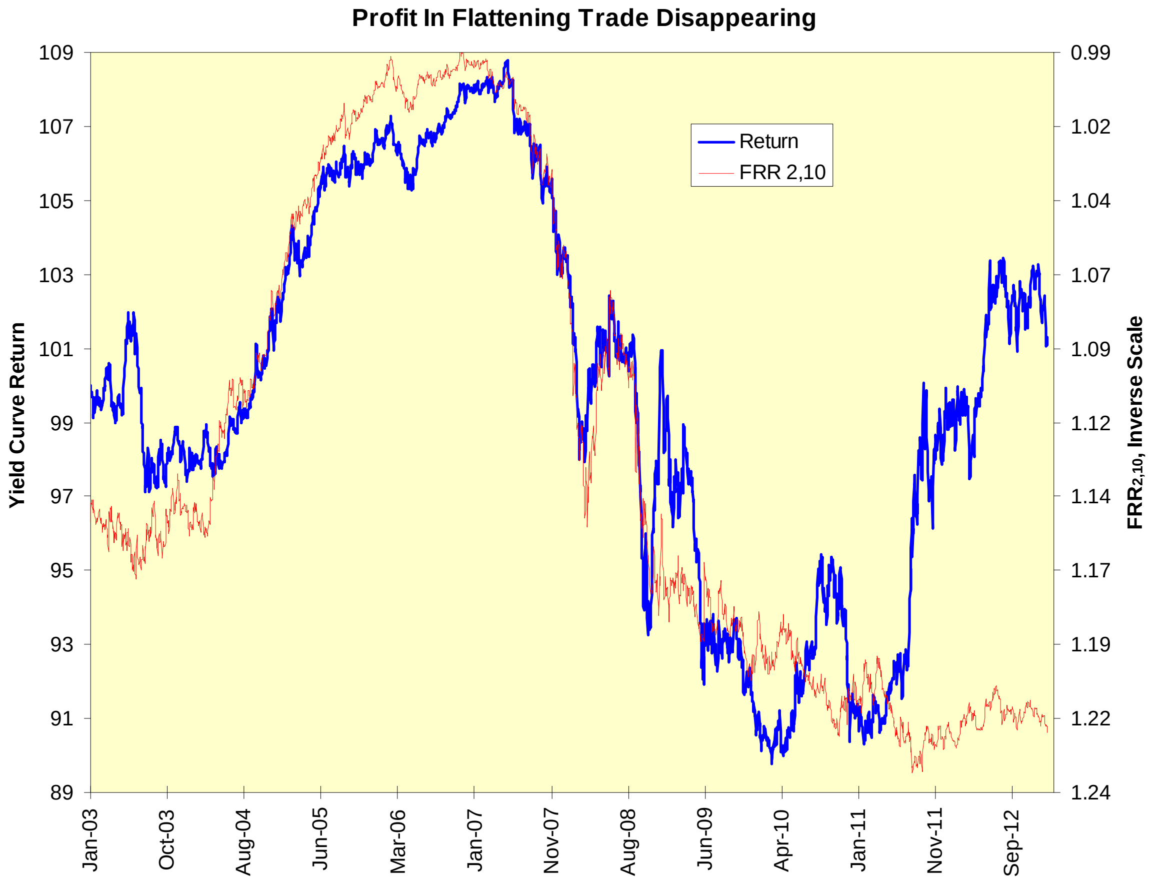
Two Bounds

Now that we have blown past two Operation Twists and at least three quantitative easings, even FOMC members are becoming a little queasy about adding buyer of first resort in Treasuries to their role as lender of last resort in market crises. Their efforts have been responsible for pushing real ten-year Treasury rates into negative territory over the last year. However, those negative real rates have hit resistance as no one else but them is buying right now. As a result, nominal yields are rising, real yields are becoming less negative and inflation breakevens are rising.

Resistance To Negative Real Rates Growing



A second bound is the declining rate of return on a yield curve flattener consisting of borrowing the two-year Treasury and lending the ten-year Treasury in a duration-neutral ratio. That trade was a huge winner between February 2011 and July 2012, but it has been fizzling ever since. If the borrowers of free money are unwilling to lend it back to Uncle Sam for a higher nominal yield, then you will see higher nominal yields as a result.



Please note in the chart above how the yield curve between two and ten years is starting to steepen. This is measured by the forward rate ratio between two and ten years, the rate at which we can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself.

If short-term interest rates are kept near 0% and long-term lenders demand higher yields, the end result will be a much steeper yield curve. That will force all borrowers, the U.S. Treasury included, to start shortening the maturity of their debt and to accept the greater rollover risk of doing so. At the extreme case of this you wind up with overnight repo financing, the rollover risk that brought Bear Stearns and Lehman Brothers down back in 2008. If the Treasury tries to keep debt service costs down by moving in this direction we will have another unholy mess on our hands.

Wait until they see what I charge them for my $1 trillion coin; I will even throw the Cracker Jack box it came in as part of the deal.