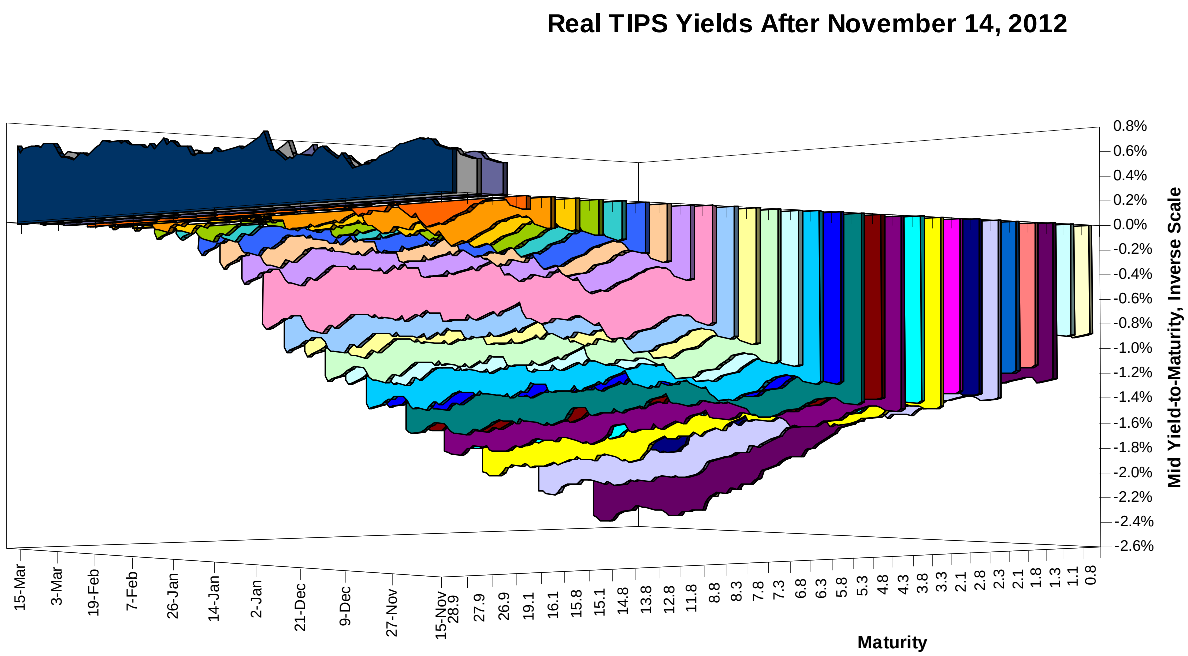
There Is Plenty Of Risk Aversion

The inaugural episode of *Saturday Night Live* included a [mock commercial] for a three-bladed razor with the tagline, "The Triple-Trac. Because you'll believe anything." That commercial is notable for its star, then-comedian and current U.S. Senator, Al Franken, and because it might have paved the way for today's four- and five-bladed razors. It might have paved the way for the official justifications for QE4 or whatever number we are on at present.

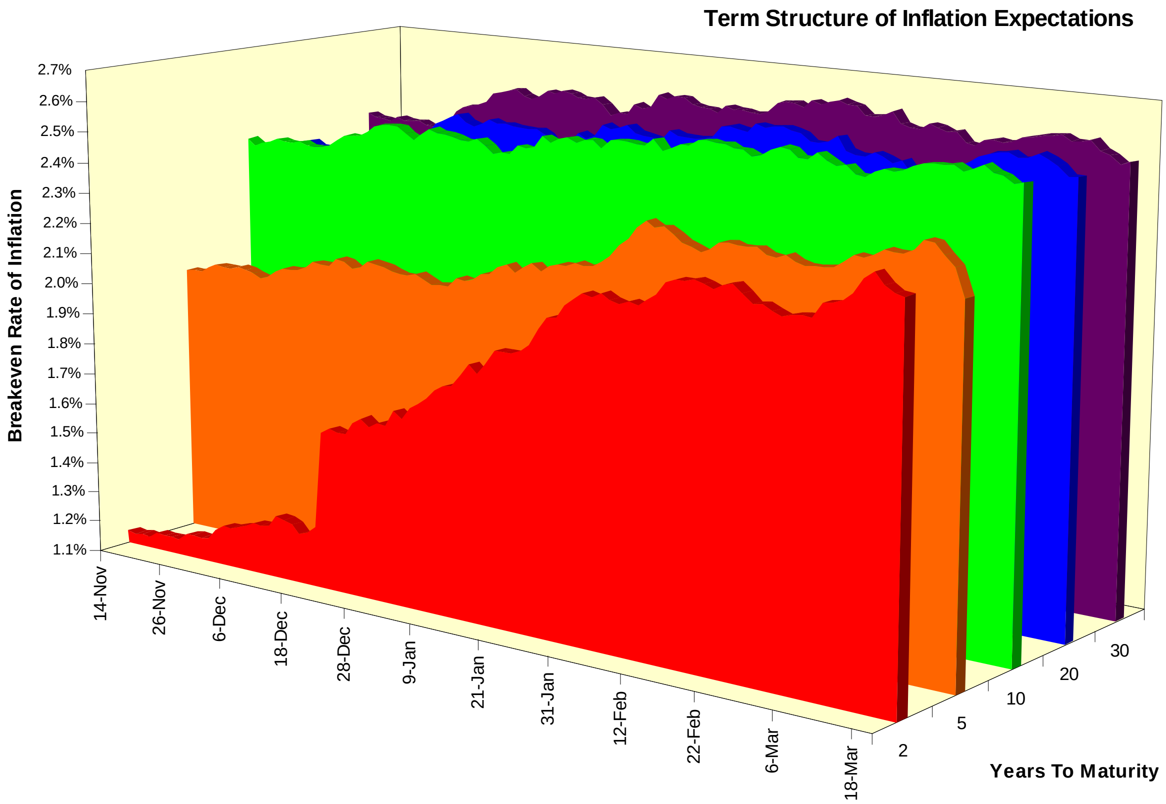
Let's be blunt: Why in heaven's name would the Federal Reserve end its campaign when it is allowing the Treasury to borrow at increasingly negative real rates and Congress and the Administration to dither endlessly in their kabuki fiscal crises?

The chart below depicts the real yield on a bond-by-bond basis for current TIPS. Two things should stand out, how many of these yields are negative and how so many of these yields have made new lows during the month of March. To be specific, every issue maturing up to and included the 1.375% TIPS due July 15, 2020 has a negative yield that hit its low this month.



Investors' willingness to accept negative real yields is a classic insurance trade of accepting a fixed loss in hopes of avoiding a larger potential loss in the future. The greater the loss, the more risk-averse the market is. Here we are in a month where a host of U.S. market averages including the Dow Jones Industrial and Transportation Averages and the small-capitalization Russell 2000 index all have made all-time highs in nominal terms and yet a large group of bond investors are diving under the bed in fear of losses. I should add all of these new lows in real yields were made prior to the latest fashionable worry, Cyprus, and the pronouncements of an amazing number of instant experts thereon.

As nominal short-term interest rates cannot fall significantly from the levels where they have been pinned for more than four years, the decline in real rates produced by this wave of risk-aversion has had the strange effect of raising short-term breakeven rates of inflation far more rapidly than long-term breakeven rates. This is hardly an implied and path-dependent forecast of a spurt higher in inflation over the next two years followed by a glide to 2.7% inflation forever; no, it is simply an artifact of subtracting negative real rates from a suppressed nominal rate. It also makes short-term TIPS breakevens somewhat less than useless as an economic indicator.



Newton Was Right

Newton's Third Law noting every action has an equal and opposite reaction is playing out amongst investors. One group is risk-seeking and is seizing on excess liquidity to get while the getting is good. Another group is wailing like some annoying Greek Chorus about how all of us surely will be slapped upside the head when the getting ceases to be good.

So long as the pool of risk-averse investors is making its presence felt and is willing to pay to lend money to the Treasury, the pool of risk-seeking investors will benefit. When these negative real rates disappear, they party will be over.

Ben Bernanke and company know this. This is why they come up with "you'll believe anything" explanations about unemployment, inflation and other claptrap with the full and complete knowledge money-printing will not influence these measures except by accident. It will, however, enable speculators and governments.