Long-Term Treasuries Caught The Haven Bid

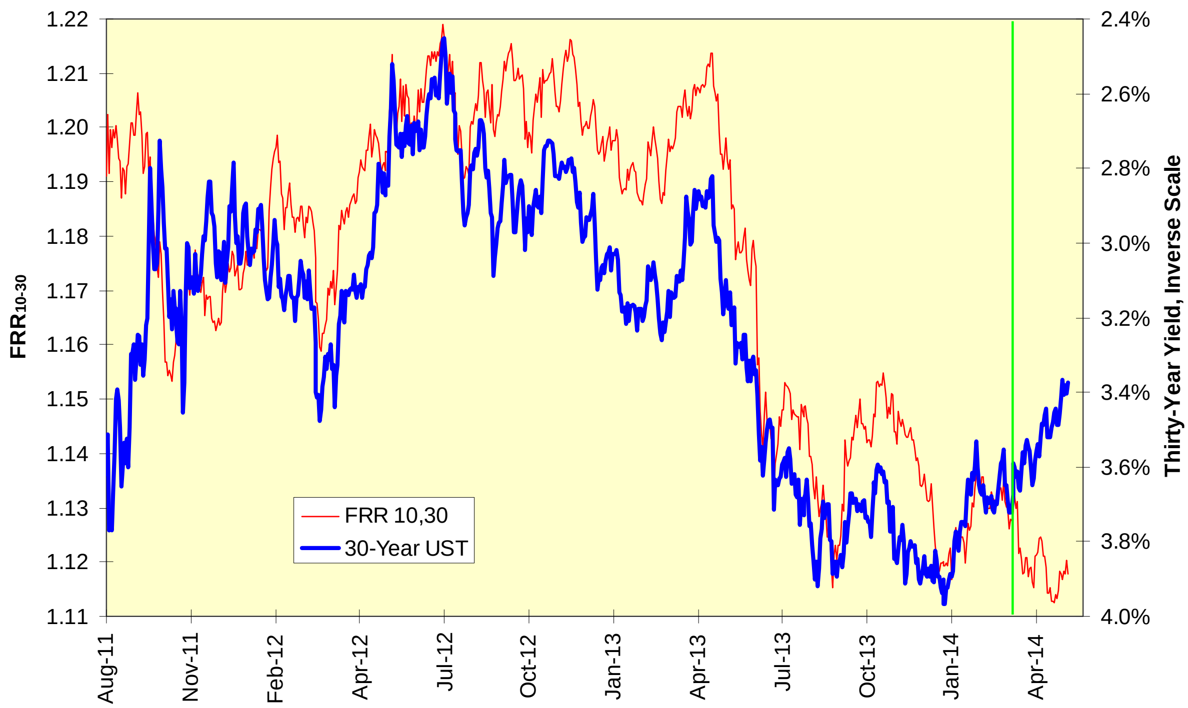
I love head-scratchers, the economics problem kind and not the kind you can order on Amazon.com (AMZN), home of the 0.55% profit margin. I have had the opportunity to explain in recent years why the Japanese yen could rise when they were printing enough of them to pave the Pacific Ocean or why the euro was worth anything during the height of their sovereign debt crisis period in 2010-2011. We can add long-term Treasury bonds to this list; who was lined up to buy the things last December after 10-year+ Treasuries lost 12.54%?

Flatter My Yield Curve To Thee

That selloff was accompanied from May 2 – December 24, 2013 by a bearish flattening of the yield curve as measured by the forward rate ratio between ten and thirty years ($FRR_{10,30}$). This is the rate at which we can lock in borrowing for twenty years starting ten years from now, divided by the thirty-year rate itself. The more this $FRR_{10,30}$ exceeds 1.00, the steeper the yield curve is. This bearish flattening had been quite the norm following the start of Operation Twist back in August 2011.

The Long End Of The Yield Curve In The Twist Era

The Bullish Flattening Was Anomalous



Given the strongly inverse relationship between the $FRR_{10,30}$ and thirty-year yields, the bullish steepening between December 24, 2013 and March 13, 2014 should have come as no surprise. However, what happened afterwards was unless you start accounting for haven bids. Thirty-year yields continued to fall but the $FRR_{10,30}$ flattened bullishly. This is an unmistakable sign of strong and risk-seeking behavior at the long end of the yield curve.

Who might be the usual suspects? Please recall March 13, 2014 came immediately after a large and otherwise mysterious drop in securities held in the Federal Reserve's custody holdings. As this came after the first phase of unpleasantness in the Ukrainian situation, speculation emerged quickly Russia was the seller so as to avoid a potential freezing of assets. Such speculation emerged one month later, albeit from me, Russia was a major seller of U.S. equities as well.

If Russian money flowed back into Treasuries or if flight capital from elsewhere flowed into Treasuries, it seemed to be going into the long end of the yield curve, the last refuge of positive real returns. Even now real rates are negative out to six years and ten-year real rates are a paltry 0.40%. You might as well grab for the 1.11% real-rate brass ring at the thirty-year horizon.

I think this trade is coming to an end for those of you looking to buy the long end of the yield curve, either directly with bonds or through an ETF such as the SPDR Barclays Long Term Treasury ETF (TLO). The $FRR_{10,30}$ bottomed on April 24, 2014 and unless ten-year Treasuries can break resistance at 2.55%, the next steepening of the yield curve will be a bearish one. The world is a scary place, but it does not have an infinite supply of profit-indifferent flight capital.

Industry Group Impact

If you are wondering how this little tale affected various industry groups, the answer is not much. I compared the returns for 144 industry groups from December to March and tested to see which ones changed at a 90% confidence level afterwards. Only eight did, and there was no real pattern involved. Twenty-five groups remained unchanged at the same 90% confidence level. Restated, the stock market shrugged as the long end of the Treasury market rallied.