Bonds Of The Baskervilles

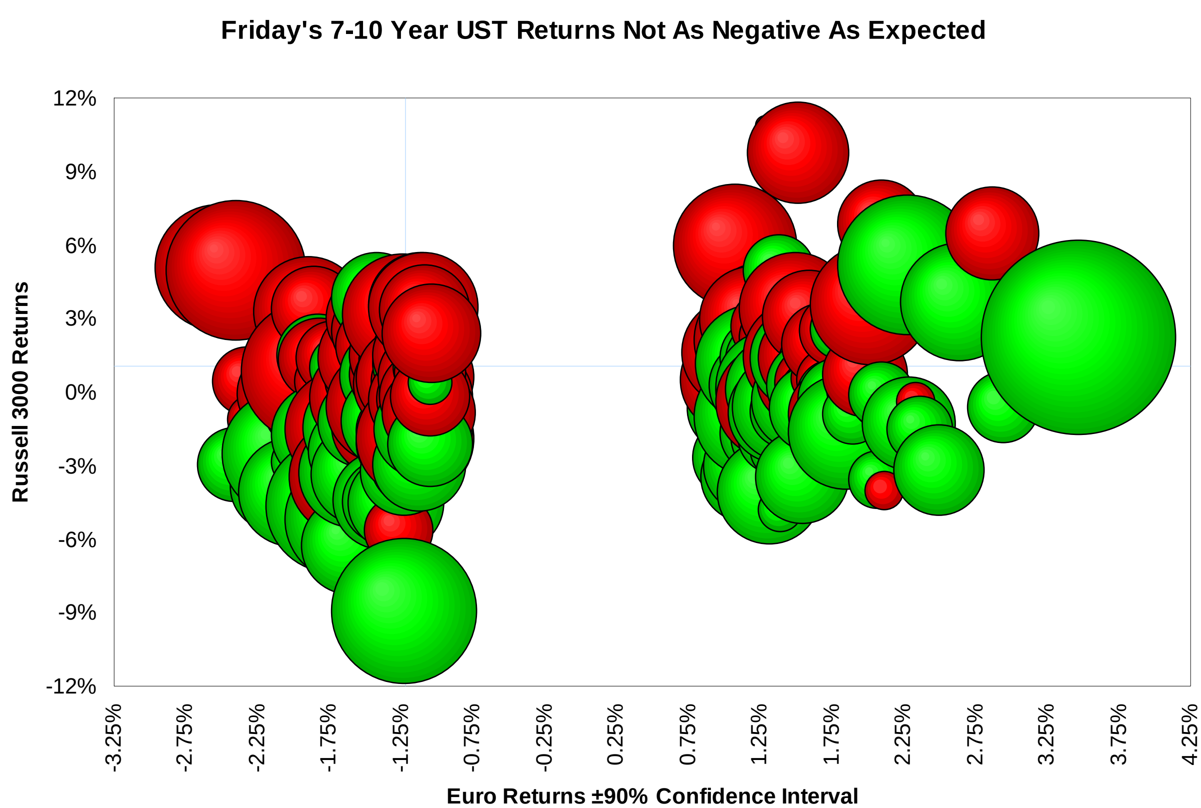
You always get greater information from a market that refuses to move as expected. Take the long end of the Treasury yield curve after last Friday's employment situation report. You might have thought the economy gaining 33,000 or so jobs more than expected out of a base of 139.4 million would have produced the usual ululation and donning of sackcloth and ashes in the bond market, but no. Like the famous hound, it did not bark; no (fooling) Sherlock.

Market Environment
The total return on an index of 7-10 year Treasuries declined all of 0.092% on Friday, a move well within the parameters of statistical noise as the daily standard deviation of returns for this index since the advent of the euro in January 1999 has been 0.42%.

The euro, however, had a significant drop; the carry trade from borrowing the dollar and lending the euro fell 1.216% against its standard deviation of 0.632%. This places the daily return on the euro outside of a ±90% confidence band. The total return on the Russell 3000 index was 1.081%.

These moves were attributable to expectations U.S. short-term interest rates would start to increase in 2015 and economic growth in the U.S. would be sufficient to maintain or even increase earnings and to protect stocks' relative valuation advantage to corporate bonds.

Given this environment and the moves in both the euro and in U.S. equities, what should the return on 7-10 year Treasuries have been? First, let's isolate daily returns on the EUR outside of a ±90% confidence interval and the daily returns on the Russell 3000 index on those same days. Treasury returns on those days are depicted with green bubbles for positive returns and red bubbles for negative returns; the diameters of the bubbles correspond to the absolute magnitude of the return. Friday's euro and stock returns are marked with a bombsight. The expected return on 7-10 year UST was -0.14%, much lower than the observed -0.092%.



Implications
The 7-10 year UST market is pricing in three conclusions. First, the continued rise in the dollar against a very wide range of currencies should continue to induce carry trade inflows. Second, even if the Federal Reserve does in fact move to tighten credit in 2015, the first effect will be to flatten the yield curve via higher short-term rates. Finally, the employment data simply do not justify any fears of broadly higher employment costs and the notion an additional 33,000 jobs will lead to a greater than expected surge in private-sector credit demands is unsubstantiated.

The long-term downtrend in ten-year Treasury yields that began 33 years ago last week remains intact. These yields have persisted in failing at a series of lower highs over this period and current yields are almost 90 basis points below this long-term loglinear downtrend line. A bull market in bonds combined with steady if unspectacular growth in the U.S. economy and carry trades into U.S. financial assets should be quite supportive of stocks. Of course, we can conjure many scenarios where external events and shocks could upset this outlook, but for now it remains the way to bet.