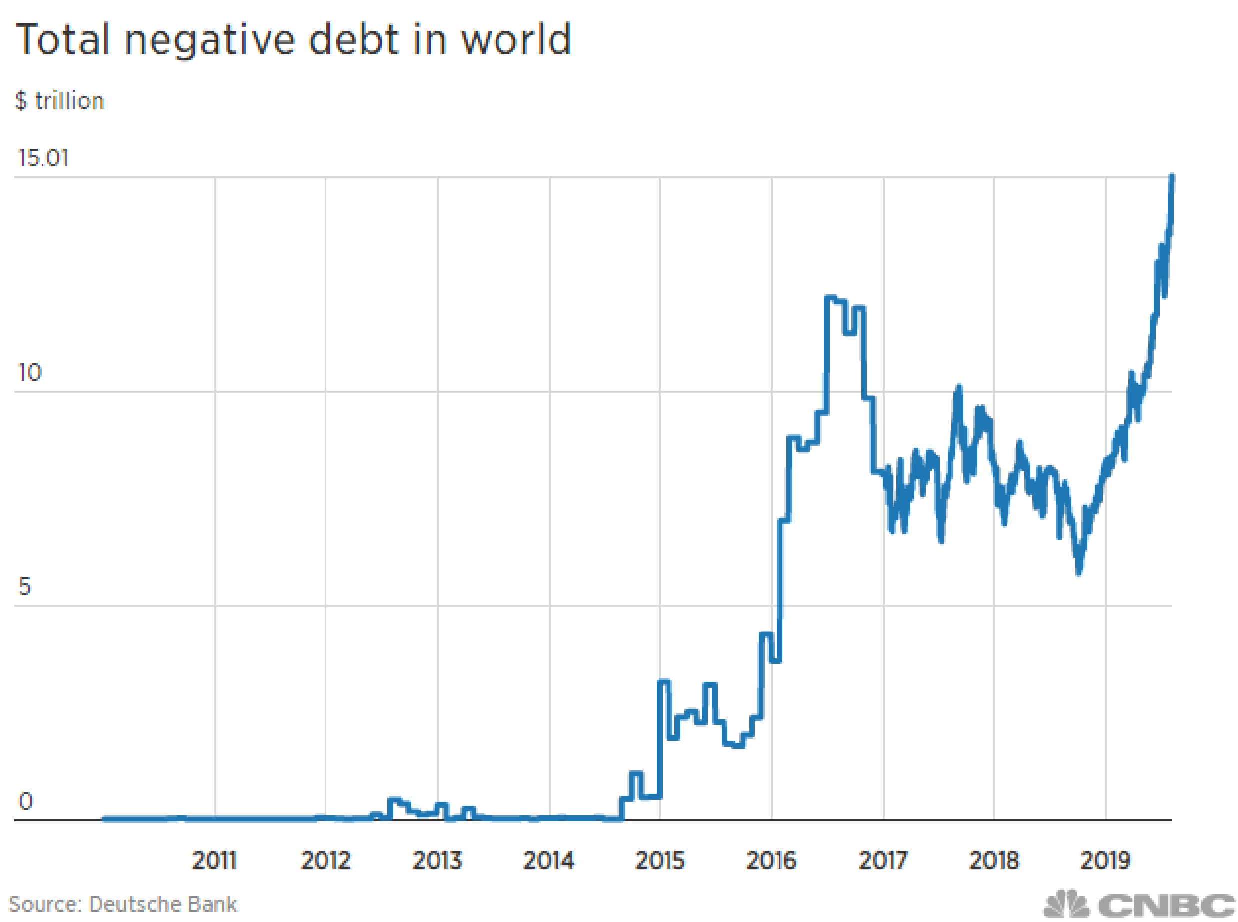
US Yields – Lower For Longer

Date: 14-Sep-19

Can interest rates be negative?

If you had asked any mainstream economist that question a decade ago, the answer would have been no. He might even have looked at you as if you needed to have your head examined for asking such a question, which goes contrary to all his theories.

If you had asked an Austrian economist the same question, he would have first examined it in the context of the *time preference theory* of interest rates, and answered no. While he would have been flummoxed by the rise in negative yielding debt worldwide, he would be quick to understand that the bonds are the same *physical goods*, but transported through time, they become different *economic goods*. My point being that the Austrian framework is more robust for analysing the world we live in, and is the framework I have used to come to the conclusion that *being long US treasuries is one of the best trades in this environment, in terms of risk reward.*



Forget conventional wisdom for a minute. Look just at the chart, without any pre-conceptions as to what it represents. That's an exponential move; a *tell* that this is a bull market.

Why is someone buying negative yielding bonds? Which country/company has this *exorbitant privilege* of a negative cost of capital? All valid questions to be addressed.

A quick point to note – yields being negative doesn't imply the bonds are *issued* that way. The yield is imputed from the bond price. Although, the trend of debt being issued at negative interest rates is catching up. Danske Bank of Denmark offers to pay interest to homebuyers to take out mortgages. There's a catch of course, they are not giving away money for nothing. Likewise with those buying negative yielding bonds, they are not really paying €100 in order to be paid back €99, as financial journalists portray it. They are in it for turning a profit, not out of some altruistic motive of funding bankrupt European governments to provide free healthcare for illegal immigrants.

Percentage of countries with yields less than US Treasuries, across maturities (Sample size: 71)

	Overall	Ex. Africa and Middle East	Ex. Africa, ME & APAC	G7
1 Year	54%	62%	71%	100%
2 Year	57%	68%	74%	100%
3 Year	55%	63%	73%	100%
5 Year	55%	64%	71%	100%
7 Year	56%	69%	81%	100%
10 Year	52%	61%	68%	100%
20 Year	60%	69%	81%	100%
30 Year	70%	75%	87%	100%
Average	**57%**	**66%**	**76%**	**100%**

Country Composition

Africa	8
Americas	8
APAC	17
Middle East	5
Europe	33

No. of countries with negative yields

1 Year Debt	12
2 Year	14
3 Year	16
5 Year	16
7 Year	10
10 Year	11

20 Year	4
30 Year	1

Speaking of Europe, isn't it interesting that the biggest concentration of negative yields is with European countries? In 2013, the economic situation was so dire that the government mandated banks to steal their depositors money in order to stay alive. Fast forward to today, and Cypriot 10-year bonds have a yield of 0.535%. Their 3-year rate is actually negative!

1 Mo	2 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
1.99	1.98	1.96	1.92	1.88	1.79	1.76	1.75	1.83	1.9	2.17	2.37

Table: US Treasury Yields

European nations from Latvia to Lithuania, Bulgaria to Belgium, countries the average American would be hard pressed to even find on the map, seem to enjoy better interest rates than Uncle Sam. No wonder Donald Trump is pissed. For a man who built his business empire on the smart use of debt, it is obvious that there is room to get a better deal for Uncle Sam.

He started off with a tweet on the Fed…

Donald J. Trump @realDonaldTrump · Sep 11

The Federal Reserve should get our interest rates down to ZERO, or less, and we should then start to refinance our debt. INTEREST COST COULD BE BROUGHT WAY DOWN, while at the same time substantially lengthening the term. We have the great currency, power, and balance sheet.....

7.5K 14K 58K

Donald J. Trump
@realDonaldTrump

Follow

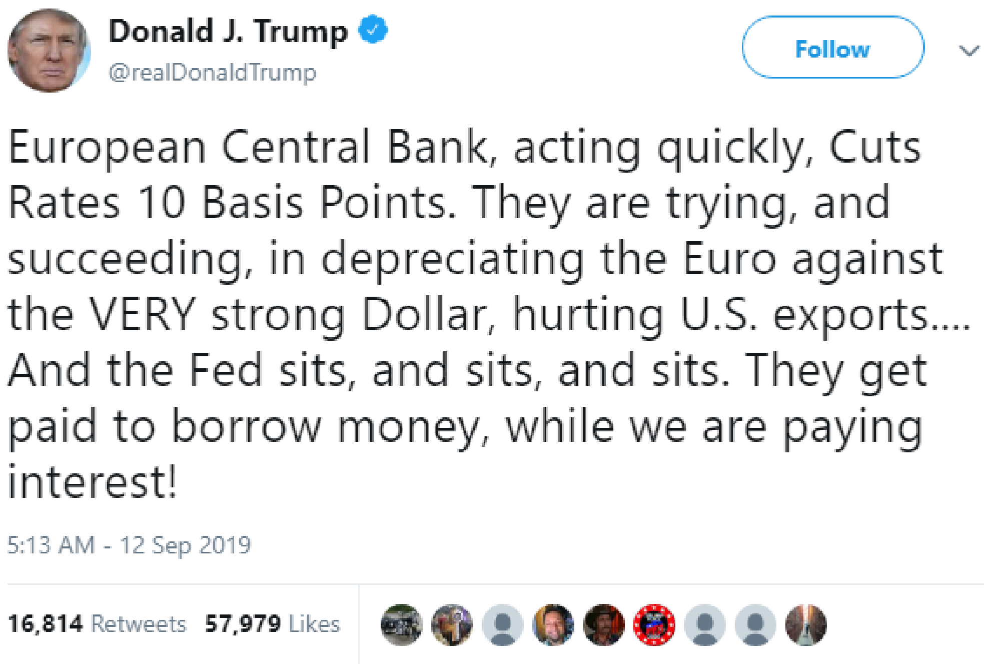
....The USA should always be paying the the lowest rate. No Inflation! It is only the naïveté of Jay Powell and the Federal Reserve that doesn't allow us to do what other countries are already doing. A once in a lifetime opportunity that we are missing because of "Boneheads."

3:42 AM - 11 Sep 2019

10,385 Retweets **44,948** Likes

4.9K 10K 45K

…and then mounted the pressure when the ECB cut rates to negative 50 basis points (-0.5%) and announced more QE to start in November.



The Fed meets next week. They cut only 25 bps in July. What are the odds that the next rate cut will be 50 bps, maybe even with a hint of QE to come?

I don't know what the Fed would do, and I would certainly not take a gamble with unknown odds. What's interesting is the market's reaction to the Trump tweets and the ECB action.

There was a massive sell-off in TLT, an ETF which holds Treasury bonds maturing 20 years and above. TLT lost 5.11% over the week; on Friday alone the ETF fell 2.14%.

There were similar losses across ETFs owning Treasuries with different maturities.

The move makes absolutely no sense. Does the market expect the Fed to hike rates next week? Is the US a worse credit risk than France? Financial theory holds that yields reflect the risk-free rate plus a risk premium. The risk-free rate typically used in such calculations is the Treasury yield, which according to conventional financial wisdom is the safest asset. But as you can see in the table above, almost all countries seem to have lower credit risk than the US, an absurd inference which can only mean that there's a missing piece.

Before we get to that, let's first analyse why someone would buy negative yielding bonds.

If you're a European life insurance company or a pension fund, by mandate you need to own bonds regardless of yield. That's one source of demand. If you're an institution with over €100 billion in assets under management, where would you park your cash? If you leave it on deposit at a European bank, not only does the bank charge negative interest rate on deposits, you're also taking on counterparty risk – the risk that the bank blows up and you get Cyprused. As the ECB made clear with the Cyprus bail-in, and by letting Italian banks fail to further emphasize their stance, if you have capital in a bank under their regulatory ambit, they don't have your back.

However, if you happened to buy sovereign bonds of any of the EU member nations using the common currency, they do have your back. The ECB doesn't care if the bonds have a negative yield. Like Pac-Man gobbling up dots, they will buy anything and everything that meets their QE criteria. Thanks to the ECB, you're safer in keeping your capital in Italian government bonds than in an Italian bank. Institutions responded to this incentive and bought negative yielding bonds. Hedge funds front ran the ECB and bought some too. US based asset managers operating from the wrong analytical framework didn't understand the dynamics. Bill Gross, the supposed bond king, called German bunds "the short of a lifetime". 10-year Bunds were then yielding positive 0.94% and now yield a negative 0.446%. Anyone who had put the trade on with even 10x leverage would have been wiped out by now. (Excel doesn't allow calculation of bond prices for negative yields, and I don't want to spend time figuring that out since it's rather beside the point. A 10-year zero coupon going from a 0.94% yield at issuance to 0% would gain 9.4% in price, so in all probability shorting German bunds would have been the disaster of a lifetime).

Taking stock of everything covered so far:

- Negative interest rates are a reality, and there's a very logical reason for it
- US yields are ridiculously high as compared to Europe and Japan
- Trump blames the Fed for the high rates

Logically, based on the above analysis, US Treasuries are a bargain as compared to the negative yielding debt. But then this poses a deeper puzzle: why haven't investors bid up Treasuries and turned yields negative in the US? The Japanese were the first to introduce NIRP, the Europeans followed, yet the US hasn't.

The reason: The Fed. They are not 'behind the curve' as is fashionable to say. The roots go back deeper.

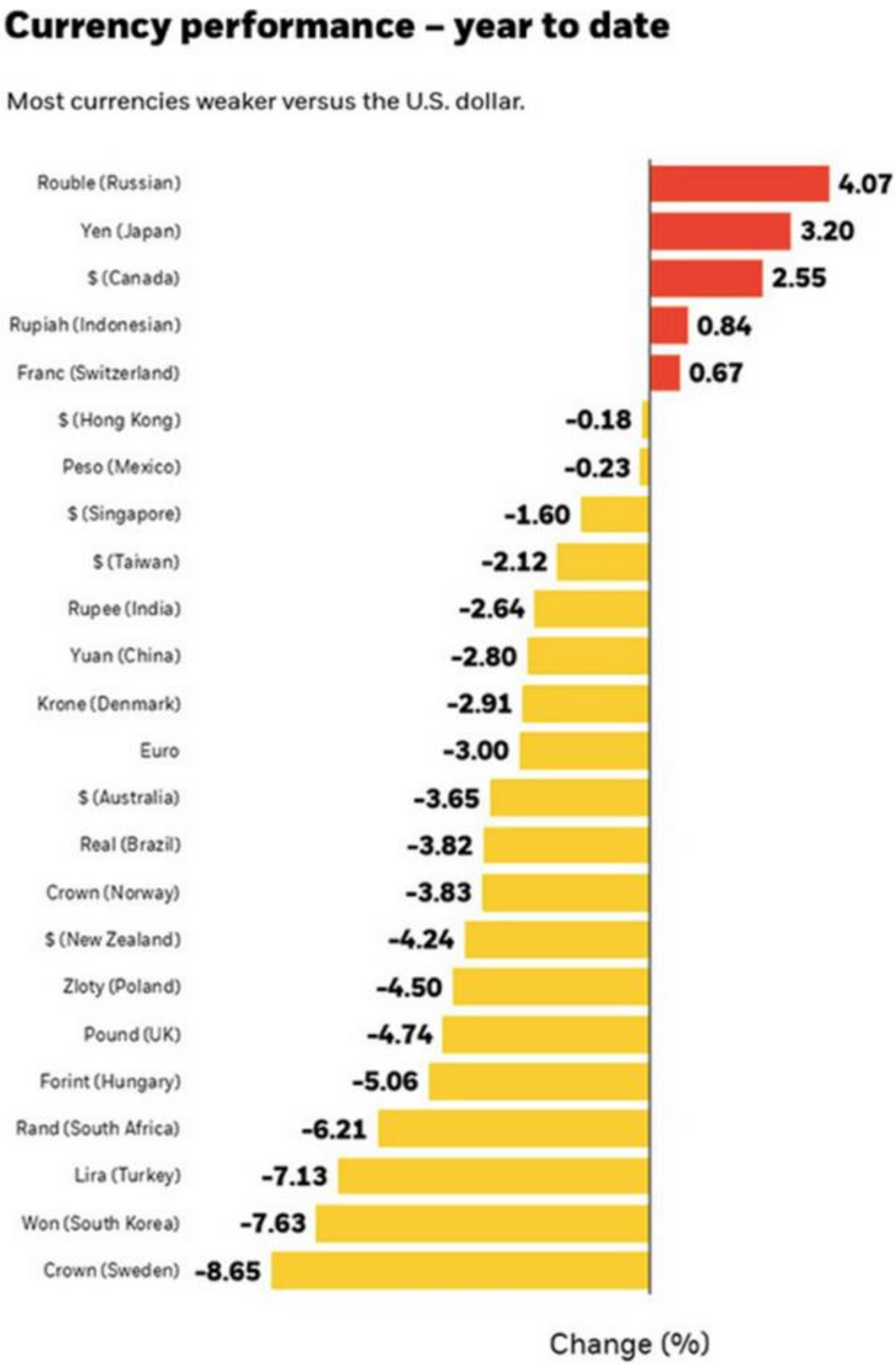
In 2008, the dollar became the carry currency when the Fed introduced QE. Japan had been doing it for decades, but QE didn't pick up until the Fed started it. The other central banks followed. What ensued was a weak dollar fuelled commodity boom, with central banks worldwide cranking up the printing press in order to keep their currency from appreciating too much against the dollar. Capital went into every emerging market growth story. Dairy company in Vietnam? Here, take my money. Top private bank in India? Here, I'll pay you 5 times the amount of bank capital you have loaned out. Bonds issued by the Chinese government in their own currency? Call them "dim-sum" bonds and market them to fund managers who love their Chinese takeout. If you were a company with international operations, you borrowed in dollars – it was much cheaper than borrowing in your home currency, and we all know the dollar is collapsing.

The Fed ignited bubbles not just across the world, but also at home. QE1 was followed by QE2, followed by QE3, followed by QE4. The Fed started taking a lot of flak for the continued QE. Being academics, they seek peer adulation, and eventually the pressure got to Janet Yellen, who discontinued it and decided to turn around and please her peers by doing the opposite: raising rates. Ever so gradually, so as to prevent a hard landing and being blamed for causing a crisis, as she had observed happening to Alan Greenspan.

With the Fed's printing press on cool down mode, and US interest rates starting to go up, the carry trades started to unwind. Capital started leaving risky international markets for the relative safety of the US. The commodity boom ended, foreign investors left, and suddenly commodity producing emerging market central bankers were trying to save their currencies from plunging versus the dollar. International companies which had issued dollar denominated debt were scrambling to acquire dollars in the offshore (Eurodollar) dollar market.

The Fed kept hiking rates, making the US an even more attractive place for capital. Foreign investors flooded in, seeking both safety and the high returns offered by US equities. However, the Fed's rate hikes, and market expectations of more to come, kept a floor on interest rates, which is why Treasuries had a positive yield even as German bunds slipped into negative territory.

As the unwinding of the carry trades continue, most currencies will continue depreciating against the US dollar. Governments will eventually respond with capital controls, import restrictions, a sudden devaluation to take the pressure off, or other measures that may be well intentioned but bound to precipitate an economic crisis. Investors who have studied history will see the signs and start heading for the exit, resulting in even larger capital in-flows into the dollar.



The dollar will run up, the liquidity will buoy stocks higher, and high (not to mention positive) yields on debt denominated in an appreciating currency will push up demand for Treasuries. There's even a chance of more QE. Would Powell want to be known as the man who brought the US into recession?

Trump will be sure to scapegoat him, as his tweets make clear. QE or no QE, **the rate cutting cycle has begun, which in itself is enough of a catalyst for a bond rally.**

The US has the highest yields, in a currency that is considered a safehaven at a time of crisis, and which is functioning as one in 2019 if you happened to live in any of the countries with massive down moves versus the dollar. How long will it take for the narrative to change, to reflect what I have argued above? To me, it looks obvious that we are entering an era of lower interest rates and a stronger dollar. In this environment, Treasuries are an absolute bargain.

With the yield curve inverted, short-term rates have a lot more room to fall. The way bond pricing works, the further out you go along the yield curve, the bigger the gains when interest rates fall. The reverse is true as well; rising interest rates will hurt longer-term bonds more.

Below is a list of ETFs offering exposure to Treasuries of different maturities:

Ticker	**Name**
SHV	iShares Short Treasury Bond ETF
SHY	iShares 1-3 Year Treasury Bond ETF
IEI	iShares 3-7 Year Treasury Bond ETF
IEF	iShares 7-10 Year Treasury Bond ETF
TLH	iShares 10-20 Year Treasury Bond ETF
TLT	iShares 20+ Year Treasury Bond ETF

As always, do your own due diligence.

Disclaimer: I may/may not hold positions in the ETFs mentioned above.

Kashyap Sriram