

April 26, 2011

# Treasury Bond Squeeze

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Treasury bond yields have been falling while equities are hitting new post-2008 highs, an unusual divergence. We think the explanation is stronger second half economic growth (which helps equities) but anticipation of a debt-limit-related cut-off in the supply of Treasuries (which pushes yields down temporarily.) We expect Treasury bond yields to jump back up after the debt ceiling increase, reconciling the equity and bond markets. (See Whipsaw in Bond Yields on April 18.)

## 10 Year U.S. Treasury Yields (last obs. April 26, 2011)

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Source: Federal Reserve Board; Encima Global

Speaker Boehner said today that the House might not vote on the debt limit increase prior to the July 4 Congressional recess. We think it will, but an extended fight over the debt limit implies a multi-week cutoff in the supply of Treasuries.

- Over time, most bond buyers can find near substitutes for Treasuries, so a cut-off of supply shouldn't have a lasting impact on yields or spreads. However, in the short-term, some buyers have inelastic demand and may bid Treasury prices up, yields down.
- The Fed itself may be a determined buyer of Treasuries during the May and June completion of QE2. Even after QE2, the Fed probably intends to reinvest roughly \$40 billion per month in Treasuries to offset principal repayments from its MBS holdings in order to keep its balance sheet stable at \$2.9 trillion after June.
- **An important issue for bond yields in tomorrow's FOMC statement and Chairman Bernanke's press conference is whether the Fed will announce flexibility in the timing or choice of instruments for its bond purchases during the debt limit battle.** (The Fed went forward with MBS purchases in late 2008 and Treasury purchases in late 2010 in spite of unfavorable pricing when markets had bought ahead of the Fed.)

After the first quarter letdown in GDP growth, we expect better economic news. Small businesses have been hiring. Corporate profits are strong. There's pent-up demand for business investment. Foreign growth is holding up. We think this will push stock prices higher and bond yields higher as the year progresses (see Tall Wall of Worry; Good Second Half Outlook on April 15.)

- As expected, however, Treasury bond yields are falling for now, with the 10-year yield back down to 3.3% and the 30-year Treasury at 4.39%, almost as low as the 4.37% low during Japan's nuclear meltdown.

### 30 Year U.S. Treasury Yields (last obs. April 26, 2011)

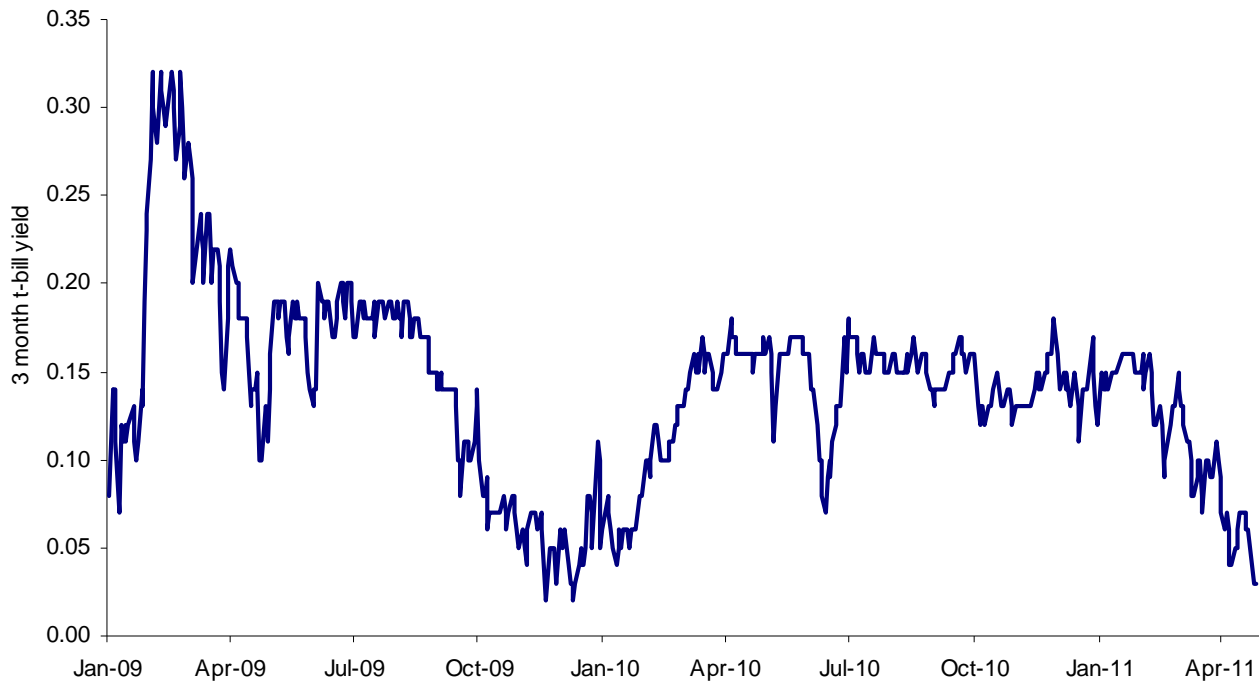


Source: Federal Reserve Board; Encima Global

- In addition to the debt ceiling problem, technical factors are pushing down the interest rates at the front end of the yield curve, putting downward pressure along the curve. In recent weeks, regulators have expanded the portion of bank assets that are subject to capital requirements. This has disrupted the repo market (see Record Gold on April 5) and contributed to a decline in the effective Fed funds rate (at 0.1% annual interest today) and the three-month Treasury yield (which is even lower than the Fed funds rate.)

### 3 Month U.S. Treasury Bill Yields (last obs. April 26, 2011)

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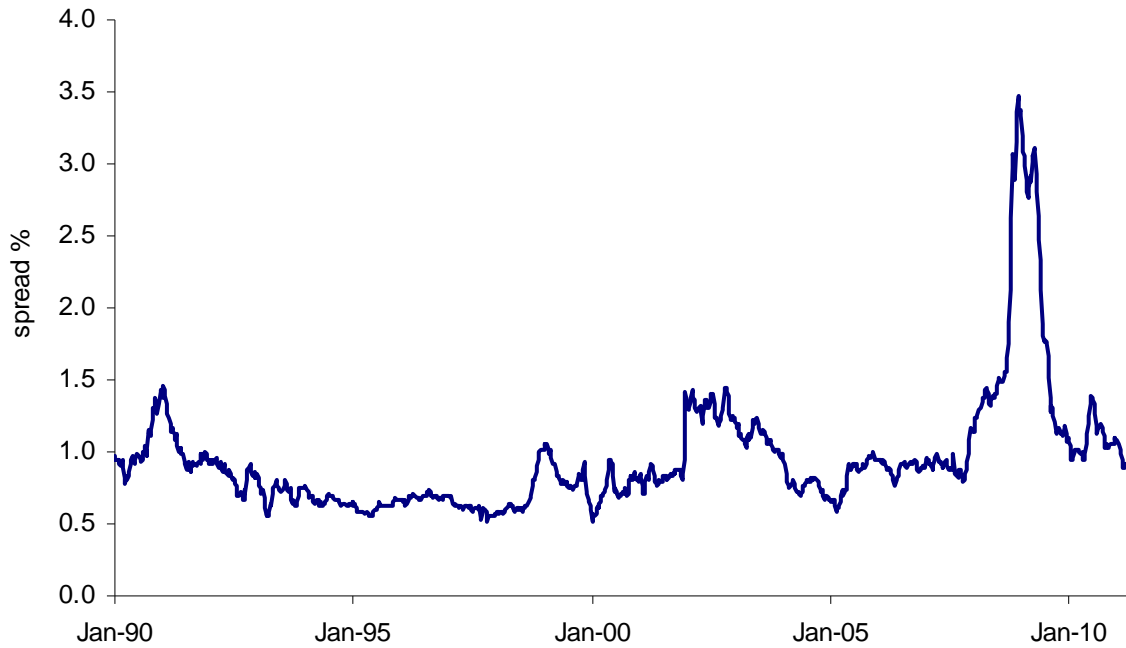


Source: Federal Reserve Board; Encima Global

- An alternate interpretation of the decline in Treasury bond yields is that bond markets are more risk averse than equity markets, perhaps sensing a slowdown in growth. However, the spread between Baa and Aaa bonds, a good indicator of growth and risk, moved to new lows today, which is consistent with equity market gain. **Our reading is that Treasury yields are falling due to the debt limit fight and technical factors and will resume their uptrend once the debt limit is increased.**

## Baa – Aaa spread (last obs. April 26, 2011)

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Source: Federal Reserve Board; Encima Global

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