

“That’s a Bit Steep”

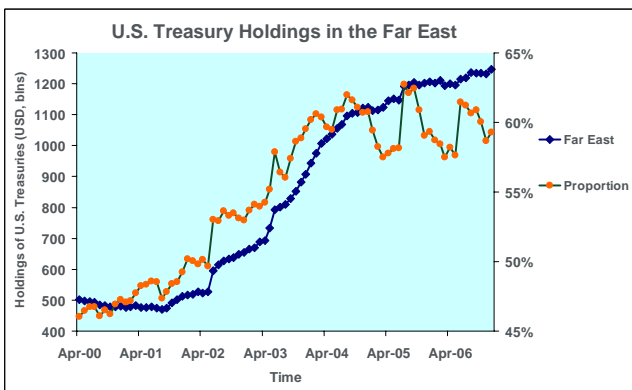
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Newton Global Fixed Income Strategy

Maintaining a low duration in the U.S. – looking for signs of yield curve steepening

A lot has been written about the credit markets, and specifically bank lending. The relationship between the U.S., the vast reserves that control the bond markets (and the U.S. dollar), and the budget deficit in recent years have also been in the headlines. Thus far, we haven’t seen a piece that puts it all together and proposes a way out of the situation and explains the potential results. A thought experiment is necessary and is an opportunity to think the whole situation through.

It’s fairly obvious that the U.S. has become chronically dependent upon other people’s money. They rely on the recycling back of earned dollars to keep the whole pyramid scheme going. The Chinese and the Japanese have been the main benefactors because it is in their interests to keep the U.S. consuming their cheap goods. However, it is also true that the rate at which they are doing this is being carefully controlled (see first graph). A collection of all the investors from the Far East shows that they collectively hold about U.S.\$1.2trn of government debt (which accounts for 59% of all foreign holdings). This keeps interest rates and bond yields low and allows for a managed depreciation of the U.S. dollar over time. Furthermore, it is also noticeable that the rate of acceleration has tailed off somewhat from the heady days between 2001 and 2004.



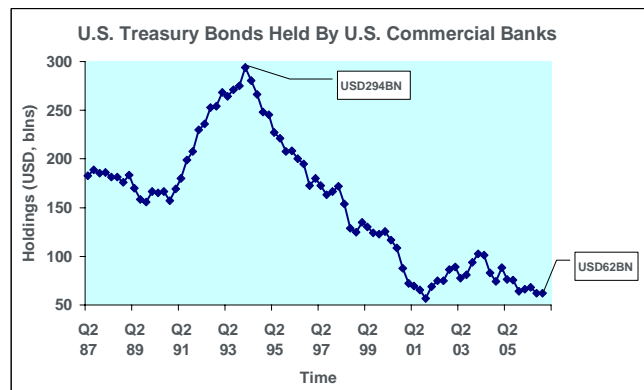
Data source: Bloomberg

At the same time, the U.S. banking system has by and large deserted the U.S. treasury market in favour of lending to the real estate markets. We only have to look at the rapid decline in the holdings of U.S. treasuries by U.S. commercial banks to see the truth of this. From a peak of over U.S.\$290bn dollars in the early 1990’s, today, they hold only U.S.\$62bn of their own debt. The reason is simple; it’s more profitable to lend money at high rates to home buyers than it is to lend to their own government. The last time the banks bought U.S. treasuries in any amount the then head of the U.S. Federal Reserve, Alan Greenspan, manufactured a yield curve so steep that they could put money in the markets and make +3.50% for very little work and at the same time be guaranteed by the government. This situation allowed the banks to put themselves back onto a sound footing so that they were in a position to start lending again, and get themselves out of the last real estate collapse.

If it is true that we are witnessing the gradual withdrawal of capital by lending nations from the U.S., then the U.S. Treasury must have its eye on alternative sources of funding.

If the world won’t lend it to them then they will have to fund it from within. Certainly, there appears to be little political appetite for the current administration to rein back on spending; the commitment to the ‘War on Terror’ is set to last a generation and nobody seems willing to dish out the harsh medicine of either cutting expenditure (or/and raising taxes) that is needed to restore prudent balance in an unbalanced economy. Certainly, it’s not the sort of thing you base a Presidential election campaign on.

To make the transition from external to internal funding, the head of the U.S. Federal Reserve, Ben Benanke, may have to perform the same trick as his predecessor. By manufacturing a steep yield curve, he would be able to staunch the flow of money from unruly lending in the real estate markets, and tempt the banks into buying U.S. Treasuries. At the same time it will require a change of behaviour away from funding using short-dated bonds, and back into issuing the long-dated debt so desperately craved by the liability matching pension funds.



Data source: Datastream

Notice here that we do not make a judgement of the absolute level of yields; the short-term rates could be lower but it is the steepness of the yield curve that will be important for the maths to work. However, when you consider the difference between money market rates and long-dated government debt is **negative** 0.5% there could be a long way to go before the banks are tempted back to the market.

Evidently this won’t stop the U.S. dollar from declining. In fact, the lack of external demand may even hasten the process of decline (and don’t forget it is a process not an event that happens one day).

So going forwards we should be looking for the following things:

- Continuing evidence of global reserves deserting the U.S.
- A change in the funding pattern in the U.S.
- A rise in the U.S. Treasury holdings of commercial banks within the U.S.

There are of course other ways through which problems can emerge. Yet if we can spot a behavioural change of the sort envisaged above, then our long-cherished idea that long-dated yields will be held down by a combination of lack of supply and excess demand will come under threat. In which case, we will have to change tack as well.

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