



“Prospect of Shortage Drives U.S. T-bill Yields Down”

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It's a funny world we live in. Rising commodity prices have many Americans worried about inflation. Soaring gold and silver prices reflect—and, in the circular psychology of the market, also create—fear that the U.S. dollar is about to collapse. The Fed, while it has ruled out an official “QE3” for now, continues to maintain one of the laxest monetary policy regimes in history. And to cap it all off, the infighting between Congress and the White House has led to Treasury Secretary Tim Geithner openly using the dreaded “D” word—default—saying that it would have catastrophic consequences on the financial markets and the economy.

Citing the ballooning national debt and annual budget deficits that refuse to shrink down to normal size, credit rating agency Standard & Poor's already reduced its outlook on the United States—raising the very real possibility that the country will lose its AAA credit rating.

One might think that with this volatile combination of risks, Treasury yields would be rising. After all, investors should want to be compensated for lending to a U.S. government that looks like an increasingly bad credit risk. This is what led legendary bond fund manager Bill Gross, the founder of PIMCO and the largest money manager in the world, to completely liquidate the U.S. government bond investments of his flagship fund, the PIMCO Total Return Fund.

Yet a funny thing happened. Treasury yields have been steadily falling since February and are now at roughly the same levels of a year ago.

It's fair to ask: What gives?

The *Financial Times* article referenced above suggests that a short-term shortage is to blame. The Treasury announced that it would be borrowing less money due to higher than expected tax receipts and spending cuts.

While this explains the supply of Treasuries, it most certainly does not explain the demand. Why, exactly, are investors continuing to buy Treasuries with yields as low as they are?

One simple answer is that the demand for Treasuries is higher than usual due to lack of alternatives in the fixed income world. With issuance of new non-Treasury debt falling, investors have the unappealing choice of U.S. Treasuries or climbing up the risk scale to something like municipals or high-yield junk bonds. At least in the case of Treasuries, investors can be certain they will be paid back, even if it is potentially in depreciated dollars.

But perhaps a better explanation is that for all the inflammatory rhetoric, the bond vigilantes simply aren't that concerned about inflation risk right now. At a time when Americans are paying off the excesses of the past and the aging of the Baby Boomers is sapping consumer demand, a period of prolonged disinflation or deflation—like that experienced by Japan—would seem more likely.

Interestingly, 98% of “Big Money” investors were neutral or bearish on Treasuries as of last month’s survey. Only 2% were bullish.

The market has a funny way of doing precisely what no one expects it to. Don’t be at all surprised if Treasury prices stay high for a lot longer than most investors—even the great ones like Bill Gross—think.

Sincerely,

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