

CONCLUSION

A key United States interest rate benchmark, the 10 year Treasury note, probably established a major bottom around 1.40 percent in late July 2012.

The Federal Reserve Board's fixing of the Federal Funds rate at exceptionally low levels admittedly restrains ascents in US government yields. Its benevolent promise and determination to maintain the Funds rate almost flat on the ground until at least mid-2015 encourages faith that government yields generally will remain depressed. Also, heightened flight to quality fears and nervous leaps in recessionary worries may push the 10 year UST challenge back toward or even slightly beneath its July low. The Eurozone crisis, for example, has not disappeared. America's 2013 federal "fiscal cliff" looms large on the horizon.

However, all else equal, a flood of money printing tends to increase inflation and thus interest rates. And all else equal, cracking or crumbling creditworthiness for a borrower- whether an individual, corporation, or government- tends to boost the interest rate charged that borrower. America nowadays confronts another round of Federal Reserve money printing and has made little headway in resolving its awesome fiscal problems.

The Federal Reserve's long rumored (fervently hoped for) and recently decreed (9/13/12) third cascade of money printing, QE3, probably will be massive, perhaps over one trillion dollars. Over time, this deluge will help to boost US government (and other) interest rates.

Moreover, given a generous desire to avoid the fiscal cliff and a downturn, Congress probably will continue its huge deficit spending spree. Not only has America become habituated to deficit spending, debt (including personal debt), and assorted forms of entitlement. How many people volunteer nowadays to pay sufficiently more taxes to solve- or at least significantly reduce- near term (as well as long run) national fiscal troubles? For a debtor nation such as America, running substantial budget deficits alongside elevated (and thus expanding) government debt as a percentage of nominal GDP raises the risk of a severe fiscal trial. The arrival of this crisis probably will occur relatively soon rather than at some vague date many years down the road. In any event, this visit will tend to raise US government rates. The US may be an economic fortress, but that does not guarantee that its creditworthiness will be unquestioned or unchallenged. Witness Europe in recent years; also recollect the debt sagas of many emerging marketplaces.

THE MONEY PRINTING TRAIN

During the worldwide economic disaster that emerged in 2007, the Fed artistically has tried to spark and sustain economic growth, create (sell) economic confidence, and buy time for politicians to engage in fiscal mending. So not only has America's central bank, in its unimpeded interpretation of its legislative mandate, established its personal definition of "stable prices" (inflation around two percent). This clairvoyant in recent weeks decided that an appropriate unemployment level is probably around six percent. Thus alongside its ongoing longstanding manipulation of interest rates, in order to help fix the economy and sustain recovery (repair household balance sheets, boost stock and housing prices) and reduce unemployment, it recently embraced an extravagant third round of money printing.

As there has been modest American GDP growth for around three years, for the Fed to engage in this third QE adventure, it probably is more worried about overall economic conditions than it confesses publicly. The Fed may not believe it can abolish recession once and for all, but its crusade for growth and quest to boost inflation from present levels probably will propel government rates higher from recent lows.

Anyway, even though the Fed Funds rate was very low, how did the US Treasury 10 year note respond after its QE1 and QE2 experiences?

After QE1 set sail, the 10 year climbed from 2.04pc on 12/18/08 and 2.47pc on 3/18/09. It eventually reached four percent. It hit 4.00pc on 6/11/09, 3.91pc 12/31/09, and 4.01pc on 4/5/10. QE1 ended March 2010.

After the advent of the QE2 money printing experiment, the UST rose from 2.33pc (10/8/10) to 3.77pc (2/9/11; final plateau 3.61pc on 4/8/11). The Fed quit QE2 in June 2011.

The 10 year UST yield rose about 195 basis points during QE1 and 145 basis points in QE2.

Money printing (including its cessation) obviously is not the only economic variable influencing government and other interest rate yields. Yet given the experience of QE1 and QE2, some rate increase during the QE3 money printing escapade looks probable. Keep in mind that QE3 is open-ended in time and thus in printing press quantity.

The Fed's Operation Twist (selling or redeeming short term Treasury securities and buying long term ones) will persist at least until end 2012. Given previous QE history and the sizable potential money printing, the continuation of Operation Twist probably will subdue but not eliminate the QE3 lift of longer term interest rates.

In the UST 10 year yield context and the likelihood of higher rates due to QE, remember that other major central banks currently engage in money printing and (or) other easy money policies. Look at recent European Central Bank, United Kingdom, and Bank of Japan actions. China apparently will embark upon another infrastructure spending venture.

QUALITY GOODS

In social circles, viewpoints regarding the respectability of social luminaries and institutions can change, sometimes rapidly. In economic arenas, opinions regarding the merit of individuals, institutions, and instruments likewise can alter- perhaps significantly. High quality does not necessarily or always remain high.

All else equal, very low real returns, and especially negative ones, make owning debt instruments- even UST- less desirable. A nation's deteriorating creditworthiness also generally makes its government bonds less attractive to purchase and own.

The Fed intends to keep Federal Funds and thus other rates low for nearly three more years, out to mid-2015. Given its vaunted "price stability" goal, "inflation over the medium term" with a "2 percent objective", why rush to buy and hold onto UST at current yields if one has faith the Fed

will persist in its policies? Already, an extended stretch of the government yield curve (note the two year at .25pc, five year at .65pc, seven year at just over 1.10pc) offers negative returns relative to current weathervane inflation measures. How attractive is the 10 year yield around 1.75 percent?

Suppose the trusty Fed continues to boost inflation and achieves sustained triumph in its battle to have stable prices/inflation of two percent. It also may elect to tolerate inflation rates over two pc for a while “just to be very sure” its policies are working, right? Anyway, do current UST 10 year yields under two percent (or even rates at 2.50pc) look appealing over the long run?

Suppose noble rescue efforts by the Fed, the ECB, and their allies somehow manage to subdue flight to quality fears somewhat. Then how alluring are current UST yields if inflation is at least two percent?

The Fed’s policy of aiding debtors and borrowers (at the relative expense of creditors and lenders) probably has limits. Suppose rising inflation alongside the Fed’s government yield repression further reduces real returns from UST (and many other debt instruments). What if the broad real trade-weighted US dollar also begins to depreciate? What happens to the dollar if the yield repression remains steadfast after an initial round of dollar decline?

The global marketplace eagerly awaits genuine fiscal discipline from Congress. At end August 2012, US federal debt was just over \$16.0 trillion, with about \$11.3tr held by the public (\$4.7tr are intragovernmental holdings; US Treasury, Bureau of the Public Debt).

The US dollar of course is the key international reserve currency and the Treasury marketplace a critical domain in which to place funds. At end July 2012, foreign UST holdings were just over \$5.3 trillion; official holdings were about \$3.9tr, with private owners around \$1.5tr (Treasury TIC report, 9/18/12). Foreigners therefore grasp a big share of America’s outstanding public (federal) debt. But how happy will foreign holders (and potential buyers) of UST be if returns remain low or even negative? Will they cut their net acquisition rate, or even become net sellers? What if the dollar depreciates significantly over the next few months? What if the US makes limited or no progress on the national fiscal front? Net selling, and even reduced net buying, especially if deficits remain lofty, will tend to raise UST rates.

The International Monetary Fund estimates government (federal, state, and local combined) fiscal situations for various nations. The US picture warns of problems. As a percentage of nominal GDP, the overall fiscal balance for the United States was -9.6pc (a deficit) in 2011, with the forecast -8.2pc in 2012 and a still-high 6.8pc for 2013. What about America’s general government gross debt? The 2011 level is 102.8pc of nominal GDP, with 2012 at 106.7pc and 2013 rising to 110.7pc. (“Fiscal Monitor Update”, Table 1, 7/16/12).

Suppose the debt problems of major states such as California or Illinois worsen. Especially if the US government ultimately rides to the rescue of key states, could this help to propel UST rates higher?

LANGUAGE LOOPHOLES AND RISING RATES

The Fed, acting as a prescient interest rate guardian proclaims that it: “currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015.”

Even if the Fed does not intend to change this formal policy guideline for a long time, its declaration is not inflexible. “Currently” (and “likely”) warns that it could, however reluctantly, change course. Suppose the US and worldwide economic recovery became powerful and continued surging alongside a notable sustained pickup in inflation to at least two percent. Or, suppose the broad real-trade weighted dollar fell sharply from current levels (and especially if it tumbled beneath July 2011’s record low around 80.6). Or, what if the federal fiscal crisis worsened, accompanied by declining foreign (or domestic) net buying or even net selling of UST?

In any event, even in the absence of a dramatic change in the economic horizon, Fed language of “exceptionally low” probably offers a loophole that permits somewhat higher Federal Fund rates than now prevail. Given the Fed’s repeated pronouncements on this topic, “exceptionally low” may imply only the 25 basis points or less level. Indeed, the Fed Funds rate has resided beneath .25pc since December 2008 (Federal Reserve H.15 data, monthly average, rounded to .05).

However, this interpretation of exceptionally low is not absolutely certain. First, the Fed wording does not specifically provide a numerical requirement.

In addition, as the booming Goldilocks Era faded, the central bank sentinel began slashing the Fed Funds rate when it was far above current levels. It was 5.25 percent in July 2007 and 4.75pc in October 2007 at the time of the major peak in US equities. So relative to such Federal Funds heights, a small climb to .50 percent or even one percent appears rather modest. And the Fed Funds rate still arguably would look exceptionally low. After all, there has been some economic recovery from the recessionary depths of the worldwide economic crisis. From July 2003 through June 2004, the Fed Funds level was around one percent. In historical context, that one percent also looks exceptionally (extraordinarily) low. Is there really much difference between one percent and current levels?

The H.15 data extends back to July 1954. The average monthly Fed Funds rate from then through August 2012 is just over 5.25 percent. Only rarely has the rate been under one percent. In 1954, there were a few months with Fed Funds under one percent, with .80pc the low. In May through July 1958, the rate also was under one pc, with .63pc the valley.

Suppose higher than desirable inflation grabs marketplace attention. What may the Fed say in order to calm fears (and to sustain belief that its policies remain praiseworthy)? Watch for Fed wordplay about “needing to wait for more evidence” or comments that the higher prices generally result from “temporary (or unusual) factors”. It probably will stress that inflation expectations remain “well-anchored”, and that “over the medium term” inflation does not appear troubling. Thus the Fed will keep its very accommodative policies as long as possible, thus increasing the chances of higher interest rates.

IN THE YIELD COLUMN

What are key levels for the US Treasury 10 year note? Start at the low end and walk higher.

** Around one percent. Although US rates are low, the history of other nations indicates they could slip further, maybe even to around one percent or less. German 10 year government rates were 1.13pc on 6/1/12. What about Japan? Japanese 10 year government yields have been under

one percent. The JGB now yields around 80 basis points. Recall 10/7/10's .83pc, .44pc on 6/11/03, and the 72pc bottom on 10/2/98.

Sustained US central bank and political effort to avoid deflation (create inflation) makes the very low rates experienced by Japan unlikely. However, a global financial panic could drive rates lower, particularly as many believe there currently is a relative shortage of high-quality (really safe) assets.

In any case, watch 10 year government trends in the US, Germany, and Japan, for they have tended to move in the same direction around the same time in recent years.

** 1.30 to 1.60pc. The intraday low for the UST was 1.38pc on 7/25/12. Its all-time high 30 years ago was 15.84pc (9/30/81); ten percent of this is about 1.60pc.

** Two percent. Half of the four percent peaks in recent years is 2.00pc. Also, 2.04pc was the crucial 12/18/08 trough. In addition, for the current QE3 period, adding about half of QE2's 145bp increase to the July 2012 UST trough makes the 10 year just over two percent (1.38 plus .70 is 2.08pc).

** Around 2.35 to 2.50pc. 2.33pc was the 10/8/11 bottom. 2.47pc on 3/18/09 was an important low within QE1's rising rate environment. Remember the fall-offs from 2.42pc on 10/28/11 and 2.40pc on 3/20/12.

Again recall the UST yield climbs of about 195bp in QE1 and 145bp in QE2. Since QE2's yield increase was less than QE1's, and given the Fed's brave effort to crush the Federal Funds level and its devoted continuation of Operation Twist, assume QE3 manages a UST yield lift of only one hundred basis points versus the late July 2012 depth around 1.40pc. That makes the UST resistance around 2.40pc.

What's the bottom line for the near term for UST 10 year rates? Although yields will rise, they may be stuck in a 1.30 to 2.50 percent range for some time. If (when) more than temporary modest inflation emerges or a US fiscal crisis erupts (and one or both of these scenarios are probable), rates will march above the top of that range.

** Three to 3.30pc. Historians recall the very important 3.07 percent 6/16/03 bottom. During 2008-09, the UST reached various key turning points around the 3.00-3.30pc range. The initial stage of QE1 rate rises carried up to 3.05pc 2/9/09; this support level held at 3.10pc on 10/2/09. The break under 3.00-3.30pc during the acceleration of the worldwide financial crisis was very significant. Note the initial low of 3.14pc on 3/16/11 as well as the breakdown level high after the ending of QE2 in June 2011. The 7/1/11 top was 3.22pc.

** 3.75pc (2/9/11 high 3.77pc) to four pc (recall the yield peaks of 4.00pc on 6/11/09, 3.91pc 12/31/09, and 4.01pc on 4/5/10). Then look up to about 4.30pc. See the 4.29pc level on 12/26/07 and 6/13/08's 4.27pc.

** Five to 5.25pc: Though these yield summits may seem to belong to ancient times, recall the Goldilocks Era 5.32pc high on 6/13/07 and 6/28/06's elevation at 5.25pc. Wasn't growth marvelous and unemployment sufficiently low?

** Don't forget the 6.82pc peak on 1/21/00. Also, central bank gurus and other marketplace guides have warned (think of the Eurozone crisis) of the "unsustainable" dangers of seven percent or higher yields when budget deficits are large alongside a high level of indebtedness.

Federal Reserve control (influence) over Fed Funds of course greatly affects the yield curve, particularly at the shorter end. Many players avidly study the two year versus the 10 year UST. Interest rate watchers know yield curve slope can become negative (10 year less two year levels of -51 basis point lows on 4/7/00 and -19bp on 11/27/06 during the glorious Goldilocks Era). However, this negative slope between the 10 year and the two year becomes quite difficult to produce when the Fed Funds rate is on the floor. The slope has been positive (10 year yield higher than two year) for the past few years.

Though the yield curve's shape of course can vary, higher short term rates will tend to prod longer duration ones upward. Suppose one looks at recent years in the two year versus 10 year US government note spread. What are some important levels for the 10 year less two year relationship?

The Fed's unveiled Operation Twist on 9/21/11. Its continuation of Operation Twist through end 2012 (eventually selling or redeeming a total of \$667 billion in short term Treasury securities, buying long term ones) will tend to flatten the yield curve and mitigate yield boosts at the longer end of the curve. Even though this policy will not necessarily stop the widening of the 10 year versus two year spread or preclude at least some 10 year UST yield increases relative to the summer 2012 bottom, one should not overlook its influence.

During the Operation Twist effort since September 2011, note the 118 basis point low in the 10 year less two year UST spread on 7/24/12. Compare the timing of the UST 10 year bottom. Suppose the two year UST stays around .25pc. Then the 10 year finds support about 115 or 120 basis points higher, or around 1.40pc. The spread could become narrower, thus pressuring the 10 year (recall Japan's low 10 year JGB yields). Yet around that 120bp spread level is some other historical support. In the pre-Operation Twist environment, recall the 10 versus two year spread troughs of 117bp on 6/12/08 (it ran up to 262bp on 11/13/08) and 125bp on 12/26/08 (UST key bottom 12/18/08 at 2.04pc).

Highs in this 10 year/two year differential (and before Operation Twist) include 291 basis points (2/22/10), 289bp (2/4/11); and 274bp (8/13/03). Adding 290 basis points to a two year yield of .25pc gives 3.15pc. Suppose the Fed ceases Operation Twist.

More recently, and within the horizon of Operation Twist, 10year/two year highs were around two hundred basis points (209bp on 10/27/11 and 200bp on 3/19/12). So if the two year holds at .25pc, resistance for the 10 year UST is around 2.25pc. This is close to the 10 year's recent yield fall-off points of 2.42pc on 10/28/11 and 2.40pc on 3/20/12.

In addition, monitor US mortgage rates and corporate bond yields as well as credit spreads (including sovereign debt spreads around the world) for trends relevant to 10 year UST moves and levels.

During QE1 and QE2, rising UST 10 year yields roughly have been associated with a rally in US stock yardsticks such as the S+P 500; falling UST rates after the close of money printing episodes generally have been associated with weaker equities. Will this pattern continue during and after QE3? Such relationships do not have to last forever. What would break them?

Suppose that during QE3 the broad real trade-weighted dollar fell sharply, breaking beneath its prior record bottom. What if interest rates rose significantly, whether due to inflationary pressure, a fiscal crisis, or both? What happens to US equities if during QE3 the dollar dives substantially alongside at least a modest move upward in UST yields?

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