FED UP: OTHER EXIT STRATEGIES

(c) Leo Haviland, 646-295-8385 June 10, 2013

"What's the beef, boys? So I'm trading. Everybody here is trading. So maybe I trade a little sharper. That make me a collaborator?" asks Sergeant Sefton, an American prisoner of war during World War Two in Stalag 17, a German camp. From the film "Stalag 17" (Billy Wilder, director). Sefton eventually escapes.

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STRATEGIC ESCAPES

The Federal Reserve Board proclaimed in June 2011 a framework of principles for an exit strategy from its extraordinary and highly accommodative monetary policy. Are their exit principles in the process of changing a little bit, and might they do so relatively soon? It seems so.

The Fed is not the only financial visionary with an exit strategy. Participants in debt, stock, currency, commodity, real estate, and other marketplaces also possess exit (and entrance) schemes and tactics. The marketplace views, plans, and actions of many of these participants probably are influenced substantially by the Federal Reserve's exit strategy talk and maneuvers. Why not review actual and potential signs of exit actions in the United States Treasury marketplace?

FED GATEKEEPING: EXIT PRINCIPLES, REVISITED

"The funny thing is- on the outside, I was an honest man, straight as an arrow. I had to come to prison to be a crook", says Andy Dufresne in the movie, "The Shawshank Redemption" (Frank Darabont, director)

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The Federal Reserve Board's highly accommodative plans include interest rate repression and massive money printing. These and related tools aim to spark and sustain economic recovery, restore consumer net worth (balance sheets), assist debtors/borrowers (though at the relative expense of creditors/lenders), and boost United States stock and real estate prices. The Fed has not stood alone on the financial ramparts; the mighty European Central Bank and central banks in Japan, China, the United Kingdom, and elsewhere have in various liberal fashions embraced easy money policies. As in the song made famous by Elvis Presley, "Everybody in the whole cell block was dancin' to the Jailhouse Rock."

The Fed sentinel's longstanding policy of maintaining the Federal Funds rate at a rock bottom range of zero to .25 percent generally has encouraged yield declines- or helped to bar significant yield increases- in US Treasury securities and many related debt instruments. Acting in light of its personal interpretation of its legislative mandate, the guardian Fed has employed several massive rounds of note and bond purchasing (quantitative easing). In its recent gathering (5/1/13), the FOMC restated its plans to continue monthly purchases of $40 billion in agency mortgage-backed securities and $45bb in longer term UST. Alongside its Fed Funds program, its debt buying/money printing spectacular (despite its significant inflationary potential) thereby fights to promote growth while keeping a lid on UST rates. Many wonder when the Fed's current ravenous consumption of mortgage-backed and UST securities will slow or stop.

Will the Fed alter its policy significantly soon? The revered marketplace guide, Federal Reserve Board Chairman Ben Bernanke, stresses to eager audiences: "Consumer price inflation has been low." Moreover, he declares: "Over the next few years, inflation appears likely to run at or below the 2 percent rate that the Federal Open Market Committee (FOMC) judges to be most consistent with the Federal Reserve's statutory mandate to foster maximum employment and stable prices." (Statement before the U.S. Congress Joint Economic Committee, 5/22/13).

However, this general emphasizes that the Fed's monitoring of the financial system is "ongoing" (Speech, "Monitoring the Financial System", 5/10/13). The S+P 500 attained an all-time high recently, on 5/22/13 at 1687, an elevation more than 2.5 times its March 2009 trough at 667. As has been the case for the UST yield curve, yields for many low quality debt instruments have plummeted in recent years. Might such events in stocks and interest rates inspire a Fed policy change, or at least a reformulation of existing views, even though its inflation and unemployment targets have not yet been achieved? After all, this always alert warden assures marketplace inmates: "In light of the current low interest rate environment, we are watching particularly closely for instances of 'reaching for yield' and other forms of excessive risk taking, which may affect asset prices and their relationships with fundamentals." (Speech, 5/10/13). In addition, he underlined to Congress that the Fed (as it noted in its recent meeting), "is prepared to increase or reduce the pace of its asset purchases" to ensure an appropriate stance of monetary policy". So at some point, might there be "a recalibration of the pace of its purchases"? (5/22/13).

Consequently, many marketplace watchers (especially those who want US stock prices to stay buoyant and who hope UST and other rates will remain depressed) fear that the Fed in the relatively near future may choose to reduce or cease its debt purchases.

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The Minutes of the Fed's June 2011 meeting introduced exit strategy principles. These guidelines bolstered marketplace hopes that the vigilant Fed would not be caught asleep at the wheel or out to lunch, that the benevolent Fed indeed would know how and when it could retreat gracefully from one or more of its glorious easy money programs. The Fed Minutes for 4/30-5/1/13 emphasized that the Fed in June 2011 proposed "broad [exit strategy] principles along with some details about the timing and sequence of specific steps". This enables the Fed, no doubt inspired to be the Houdini of financial marketplaces, "to clarify how it intended to normalize the stance and conduct of monetary policy when doing so eventually became appropriate".

Now dig into the fine print of the FOMC Minutes of the 4/30-5/1/13 rendezvous. The Fed, though it believes "The broad principles adopted almost two years ago appeared generally still valid", murmured about explaining or revising those principles at some future time (pp9-10). The President of the New York Fed, William Dudley, also commented that "we may need to update our thinking" in regard to the June 2011 exit principles "to bring them up to date with developments since then, and ensure they do not unnecessarily constrain our ability to conduct monetary policy in the most effective way today". ("Lessons at the Zero Bound", 5/21/13).

How should one interpret these recent murky Fed remarks regarding its exit strategy? Read them alongside the Bernanke comments about monitoring and reaching for yield, which he uttered in the implicit context of elevated stocks (S+P 500) prices and quite low interest rate yields (particularly in lower grade corporate and emerging marketplace sovereign debt). These hint that the Fed may be more flexible in altering its currently expressed accommodative policies than many believe. The Fed probably does not want to bind itself to acting only around when its much-heralded inflation and unemployment goals have been or apparently soon will be achieved. So even if the Fed does not slow its mortgage-backed or UST purchases in its June 2013 or other

near term meetings, it might slash or stop them "relatively soon" (or strongly threaten that they will do so) if and when it fears something akin to "irrational exuberance" has emerged in key securities marketplaces (such as US stocks or junk bonds).

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The Fed congregates 6/18-19/13, 7/30-31/13, and 9/17-18/13.

FED UP: A FOCUS ON US TREASURY SECURITIES

"You made me cry when you said goodbye…
Ain't that a shame…you're the one to blame." Cheap Trick's song, "Ain't That a Shame"

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The wide assortment of trading viewpoints and actions reflects the great variety of marketplace perspectives and the diverse selection between and weighting of marketplace variables. Captivating Federal Reserve rhetoric and related accommodative monetary policies do not necessarily keep all, most, or even any given marketplace participant in chains. However, in important interest rate, stock, foreign exchange, and commodity battlefields, numerous marketplace warriors may flee their positions (or march into new ones) "because of" potential, highly anticipated, or definite Fed statements and action.

Thus exit strategies are not restricted to the Fed. Traders (investors, speculators, commercials, hedgers) may get fed up too and run for it.

Inflation fears or Fed tightening might induce a widespread exodus from ownership of US debt instruments by wary, weary, or money-losing holders. Also, trends and levels in the United States Treasury marketplace intertwine with those in other interest rate fields in the US and overseas. What if corporate junk bond yields steadily mount higher? What if government rates in Germany and Japan jump up a lot?

The UST in varying ways links up with US equities (picture the S+P 500 benchmark) as well as with foreign stock marketplaces. Many US dollar and other currency watchers pay close attention to the travels of the US 10 year note and other government bond instruments. Since interest rates are not in solitary confinement, totally separated from stocks and currencies, perhaps levels or trends in the S+P 500 or the US dollar might inspire efforts by many to escape from UST holdings. Commodities "in general" are not divorced from other financial territories, including UST.

In any event, suppose observers for the moment focus primarily on the UST landscape. What signs probably warn that (for whatever reason, including a potential change in Fed policy) there is a noteworthy (substantial) exit underway from long positions in the UST?

EXIT SIGNS

In the film "The Great Escape" (John Sturges, director), Ramsey, an Allied POW in a WW2 German prison camp, declares: "Colonel Von Luger, it is the sworn duty of all officers to try to escape."

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Fundamental perspectives and methods vary. So do technical ones. So do reasons for entering and exiting securities and other marketplaces. People tell and justify various and competing stories regarding a given marketplace and relationships between marketplaces. Anyway, suppose one spotlights the UST 10 year note, a major debt signpost. What can the upward flight in its yield signal? In that marketplace over the given time horizon there has been either net selling, reduced net buying, or an insistence on higher yields to encourage buying. Of course the supply of UST and related securities also is a key factor. So although a conspicuous yield boost trend by itself does not categorically show that there has been "net selling" (involving a significant exit by existing owners), it may reflect this. At any rate, notable yield ascents can alert observers of a growing reluctance by existing holders to stay in place (or to add to their positions) or the increasing unwillingness of potential buyers to join the ownership gang. Especially at low levels of real return/yield, unhappy debt owners may elect to depart from their positions rather quickly.

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For the UST 10 year for the near term, certain yield trends and levels stand out:

**The UST established a major bottom at 1.38 percent on 7/25/12. Recall such distant heights as 5.32pc on 6/13/07 and 6.82pc on 1/21/00, as well as the ancient summit (over thirty years ago) on 9/30/81 at 15.84pc.

**Watch around 1.90pc to 2.00pc. Sustaining a move above 1.89pc, the 9/14/12 high as the Fed announced QE3, is noteworthy; half the 3.77pc top on 2/9/11 equals that level. The 12/18/08 bottom was 2.04pc. The UST established several ceilings around four percent from October 2008 through April 2010 (10/5/08 at 4.10pc, 6/11/09 at 4.00pc, 4/5/10 at 4.01pc); half of four pc is 2.00pc. A 50pc rally from the 7/25/12 low is 2.07pc. A successful (permanent) escape by the UST 10 year above the 2.14/2.07pc gap of 4/5-4/9/12 would be a long run bearish sign. The high yield since 7/25/12 is 5/29/13's 2.32pc.

**The next important wall ahead is about 2.35pc to 2.50pc. First, note the 10/28/11 high at 2.42pc and the 3/20/12 plateau at 2.40pc. Recall the trough at 2.33pc on 10/8/10. Finally, remember the interim low at 2.47pc on 3/18/09, reached not long after the major bottom in the S+P 500 (3/6/09 at 667). In that 2009 stock rally stage context, keep in mind the popular chant back then that "rising UST rates means increasing S+P 500 (and economic recovery). However, to what extent (if at all) in the current and future environment do rising UST rates continue to portend higher US equity prices and a robust American recovery?

**If the UST breaks out above this, watch 2.66pc (half the 6/13/07 major high at 5.32pc) to 2.76pc (double the 7/25/12 major bottom). After that, significant resistance looms at about 3.05pc/3.30pc (6/16/03 bottom 3.07pc, 2/9/09 top 3.05pc, 7/1/11 high 3.22pc; lows at 3.28pc on 1/23/08 and 3/17/08, 3.24pc on 9/16/08, 3.10pc on 10/2/09, and 3.14pc on 3/16/11).

**3.75pc (2/9/11 peak 3.77pc) and 4.00pc/4.30pc.

Keep an eye on the UST 10 year less two year note spread. The Fed's terrific effort to restrain Fed Funds near the zero floor tends to have especially strong success in repressing yields at the short end of the government yield curve. Hence the two year note has been pinned down. However, this vigorous Fed quest thereby also influences and to some extent limits the ability of the UST 10 year yield to scramble higher. However, this 10/2 year spread established a floor on 7/24/12 at about 117 basis points (settlement basis). See the essay, "Throwing Curves: the Friendly Fed's Yield Curve Game" (3/5/13). Its recent high was around 188bp (5/28/13), which it is testing now.

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Those on the alert for bulls to exit (bears to enter) the UST corral should monitor German and Japanese sovereign debt marketplace yields. During the worldwide economic crisis era which began in mid-2007, many often have deemed these domains, like America's UST marketplace, a safe haven. Their rates have edged up recently. Note the lows in the German 10 year government note at 1.13pc on 7/23/12 (and 6/1/12) and 1.15pc on 5/2/13. The yield in the Japanese 10 year JGB has climbed from its 4/5/13 depth at around .33pc Also remember debt yields and trends for European "periphery" and emerging marketplace nations.

The Fed can trap UST yields at low levels more readily than it can US (and other) corporate marketplace ones. Thus those corporate yields- whether in junk bonds, mortgage-backed securities, or elsewhere- may keep running higher even though the Fed blocks the UST's efforts to do so for a while. After a long and arduous hunt for sufficient yield and good returns, why not take the money and run before rates spike higher? A sustained significant increase in corporate yields (and in real estate rates) can hint that similar pressures for higher rates exist in the UST territory. See the recent Financial Times article "Mortgage investors in the line of fire" (6/8-9/13, p14).

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The Federal Reserve clearly has put itself in a corner regarding its widely trumpeted intent to generate around two percent inflation. What should UST yields be (on both the long and the short end of the yield curve) if inflation creeps up to two percent or more?

Moreover, buried in the Fed Minutes ("Summary of Economic Projections of the Meeting of March 19-20, 2013", p3), one discovers the view (the array) of FOMC participants regarding their current opinion as to the target year end Federal Funds rate. Admittedly the 2013-15 Federal Fund range remains suppressed both in nominal terms and in relation to current and expected inflation, with 2015 around merely one percent. However, the "longer run" (post 2015) target for Federal Funds rate at year end is around four percent. Assume that is the "longer run" central bank target (expectation) and a flat or positive yield curve and at least two percent inflation. Then how alluring is ownership of long-dated UST notes (such as the 10 year) or bonds (such as those with 20 or 30 years until maturity)? By the way, the 30 year UST made a major bottom at 2.44pc on 7/26/12, with its subsequent high a still-modest 3.37pc (which is now being attacked).

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Of course US dollar, S+P 500, and commodity trends entangle with and help to explain exits from (and entrances into) UST (and other interest rate) playgrounds. How much convergence and divergence has there been and will there be between falling (and rising) UST yields and past and future S+P 500 patterns? If UST rates keep rising higher and higher (suppose they exceed the high achieved in the past few weeks), will the S+P 500 inevitably continue to move up and up? Other questions loom. If the Fed keeps repressing UST yields, what will the jury decide for the US dollar (either on a broad, real trade-weighted basis, or in individual crosses against the Euro FX, Japanese Yen, Chinese renminbi, and so forth).

Yet for now, and although interest rate perspectives can and often do interrelate with viewpoints and variables allegedly "outside" the debt field, suppose we confine the current overview to the debt vista. Other information (including marketplace conversations) from the interest rate territory can unveil wide-ranging exits from (and ventures into) debt fields and other marketplaces. Such statistics and talk often can confirm suggestions made by yield fluctuations, trends, and levels.

Some study interest rate fund data. What if any fund flights have occurred lately? The Financial Times (6/8-9/13, p11) reports that according to EFPR Global, “Investors have pulled a record $12.5bn out of global funds in the past week”, with selling across all major bond fund classes, including $6 billion from junk bond funds and $1 billion from emerging marketplace hoards. US fund represented two-thirds of the outflow.

Past and upcoming federal US deficit totals and trends influence the total of UST outstanding and readily available for purchase (“free supply”). So does the extent of the Federal Reserve Board hunger for UST. However, overseas institutions, including both central banks and the private sector, own a massive amount of UST. Thus foreign behavior in the UST context is extremely relevant to UST yield trends.

The United States Treasury reports on a monthly basis net foreign purchases of UST notes and bonds. Though the government releases these on a lagged basis, they offer insight into overseas actions.

What does a snapshot of recent history regarding net foreign UST trading reveal? First, even though these players generally have been net buyers of UST, they are not imprisoned in that marketplace. For example, they were net sellers of about $17.5 billion in notes and bonds in September 2012.

Even if foreigners are not net sellers, their rate of net buying may decrease even if federal deficits remain rather lofty. Average net buying in calendar 2009 was about $44.9bb per month, with that in 2010 $58.6bb per month. Net foreign purchases of UST notes and bonds in calendar 2011 slipped to $36.0bb per month, with calendar 2012’s just over $33.8bb. However, for the seven months from September 2012 through March 2013 (the most recent month available), the net monthly acquisition has plummeted to about $13.2bb; February 2013’s displays meager net buying of $2.6bb, with March 2013 only $5.3bb.

Within the overall foreign sector in recent months, sometimes “other foreigners” (the private sector) were net sellers. They sold about $22.1bb in September 2012 and $23.1bb in January 2013. However, sometimes “foreign official institutions” were net sellers. Therefore one should not take the official fraternity’s substantial net buying for granted. They were net sellers of about $1.7bb in November 2012, about $6.7bb in February 2013, and about $16.8bb in March 2013.

Thus it apparently has become increasingly difficult (at least at low nominal yield levels) to captivate foreigners into buying UST notes and bonds (and T-bills too). The slowdown in overseas net buying of UST probably occurred after March 2013 as well. In this context, note the steady rise in rates since July 2012’s bottom (and the 1.55pc low on 11/16/12 and 1.56pc on 12/6/12). And after all, the US does have some inflation (now around 1.5 percent) and the first several years of the UST yield curve offers no (or very little) real return to foreigners or anyone else. The seven year note now yields around 1.60pc. Even the 10 year’s return is mediocre.

Look further into the overseas UST holdings field. Major foreign holders of US Treasury securities (bills, notes, and bonds) own a total of about $5.76 trillion of them at end March 2013. Foreign official holdings represent about 71.1pc of this; just over ninety pc of the overseas ownership is in notes and bonds. (US Treasury data, 5/15/13).

Who are the largest holders by far? Mainland China owns about $1.25 trillion, with Japan grasping about $1.11 trillion. The country data does not reveal a breakdown into official and private (general public) ownership totals.

However, Japan's private sector probably owns a substantial amount of UST. Japan's Ministry of Finance publishes weekly updates of international securities transactions (derived from reports from "designated major investors"). In each week of the three week span since 5/12/13 (through the week ending 6/1/13), Japanese residents have been net sellers of foreign bonds and notes (for a grand total of 30,976 hundred million Yen). It is not unreasonable to suppose that many of these are American debt instruments, with probably quite a few of them UST. Signs of an exit in UST by this key ownership group? So to what extent are other overseas private holders (or central banks) exiting from (or reducing their net buying of) UST? What about US institutions and individuals?

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