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Treasury markets ‘complacent’ over Fed rate strategy

Robin Wigglesworth

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Fed chair Janet Yellen has promised that any interest rate rises will be gradual

The Federal Reserve is preparing to lift interest rates later this year, but many bond investors predict that chairwoman Janet Yellen will confront a puzzle that stumped one of her most famous predecessors.

In 2005 Fed chairman Alan Greenspan — then known for his gnomic but omniscient air — highlighted how the 10-year Treasury yield had shrugged off hefty increases in the US central bank’s benchmark interest rate, and called it a “conundrum”.

It looks like Ms Yellen could face a conundrum of her own. Although longer-term interest rates have jumped in recent months, the difference between shorter and longer-dated maturities remains low in light of the looming hikes, and the Fed’s desire to also see longer- term rates rise.

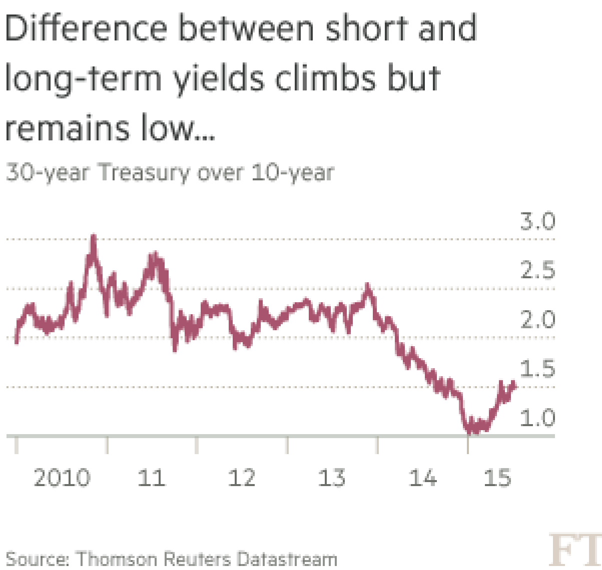
The “spread” of the 30-year Treasury yield over the five-year yield has climbed from a low of just 102 basis points at the start of the year to 149bps, but that is still well below the 250 bps points touched at the end of 2013. Treasury forwards also indicate that investors are betting on the difference between short and longer-dated yields narrowing again in the coming years.

Ms Yellen herself does not appear to expect a replay of the conundrum that befuddled her predecessor. In a recent speech she warned that the “term premium” — the extra interest investors demand for lending over longer maturities — has come down dramatically, but expressed more concern that it could rocket higher once the Fed starts raising rates. Indeed, her comments contributed to the spread widening.

Yet some indicate she might be too sanguine. In a 2012 paper, Daniel Thornton at the St Louis Fed’s research division, noted that link between the Fed fund rate and the 10-year Treasury yield had actually begun to disconnect as early as the late 1980s.

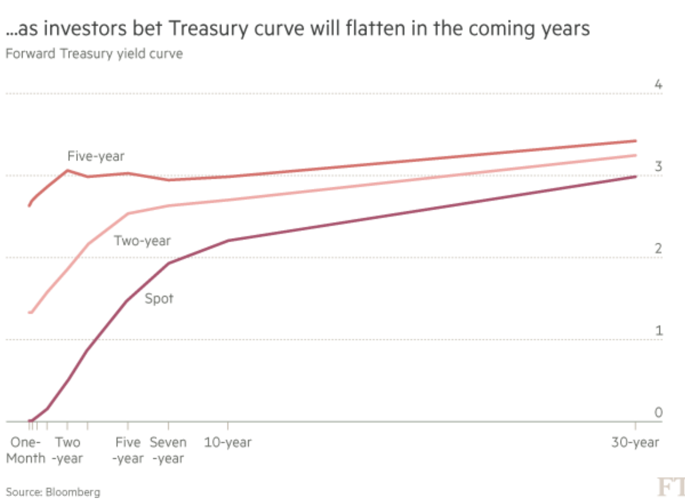
"The major implication of this research is that the Fed's interest rate policy may be much less effective than previously thought," he concluded.

For investors this is entirely unsurprising. They point out that while the US central bank can lift its Fed funds target, longer-term interest rates are mostly determined by longer-term factors, such as the economic outlook, inflation forecasts, demographics or global savings.



David Kelly, chief global strategist at JPMorgan Asset Management, estimates that for every 1 percentage point change in the Fed funds rate — the main central bank interest rate target — longer-term interest rates on US Treasuries have over the past two decades risen by just 22 basis points on average.

Analysts at Bank of America Merrill Lynch notes that the prevailing view among their clients is that the looming rate cycle "once again would show little increase in long term interest rates". Indeed, some investors believe that longer-term Treasury yields could actually fall as the Fed tightens monetary policy, as that would signal that the central bank's officials are serious about controlling inflation, which hurts bond returns.



That would mean that the "yield curve" of US interest rates will flatten as longer-term yields stay steady or fall to near short term rates — or even invert. "I think it will be very difficult to engineer a steepening of the curve," says Pascal Blanqué, chief investment officer at Amundi, the French asset manager.

Nonetheless, investors should be wary of being too confident that the Fed is powerless in preventing another conundrum. If longer-term Treasury bonds blow raspberries at any interest rate increases, it could encourage the central bank to tighten monetary policy less gently than currently planned.

“If the Fed tightens and the long end actually comes down significantly, then it would embolden the Fed,” says Eric Stein of Eaton Vance.

Moreover, the US central bank still sits on a $4tn portfolio of Treasuries, agency debt and mortgage-backed bonds acquired in its quantitative easing programme, a potentially potent tool to control monetary policy.

While the current assumption is that the Fed will carefully deflate its holdings through a gradual end to reinvesting coupons and repayments, if the Treasury market proves as stubbornly unwilling to climb as it was in the noughties — reprising the “Greenspan conundrum” — then officials could sanction the sales of some of these assets.

“Before, Greenspan could say he didn’t have the tools to send the long end up, but now they have $4tn of bonds they could sell to engineer a steeper curve,” Mr Kelly points out.
Some investors therefore fear that markets are still far too sanguine about the impact of Fed interest rate increases, and do not see a redux of the flattening yield curve that baffled Mr Greenspan.

“There is far too much complacency in markets,” Gibson Smith, chief investment officer for fixed income at Janus, warned a mutual fund conference last week. “We’ve seen a lot of people lulled into believing that interest rates will be low for longer, or even for ever . . . I think we will see steepening across the curve.”