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ECONOMIC TALKING POINTS

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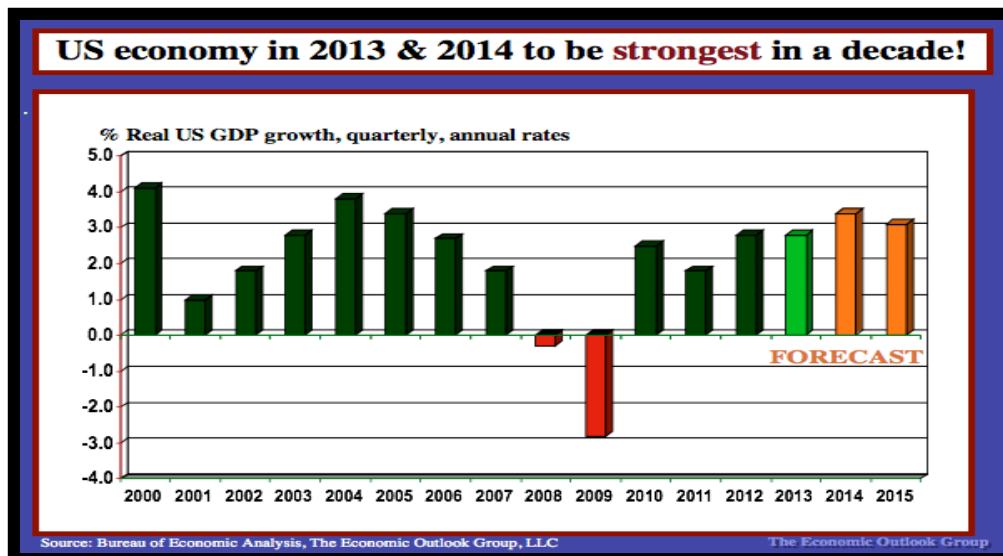
Can You Have Low Treasury Yields AND A Stronger Economy?

Among the most common questions I get visiting clients is this: If the economy is truly gaining more steam and if so many economists are revising their GDP forecasts higher, then why hasn't the Treasury bond market responded accordingly, with prices declining and yields rising? Why aren't these securities behaving as they have in past business cycles?

This head scratching is perfectly understandable when looked at from an historical perspective. But a closer study of the current dynamics in the bond market will show their behavior to be perfectly rational, and I'll explain why in a moment.

Let's first look at the premise behind the question.

The U.S. economy has clearly turned the corner and is on course now to show the best back-to-back growth (2013 – 2014) in a decade.



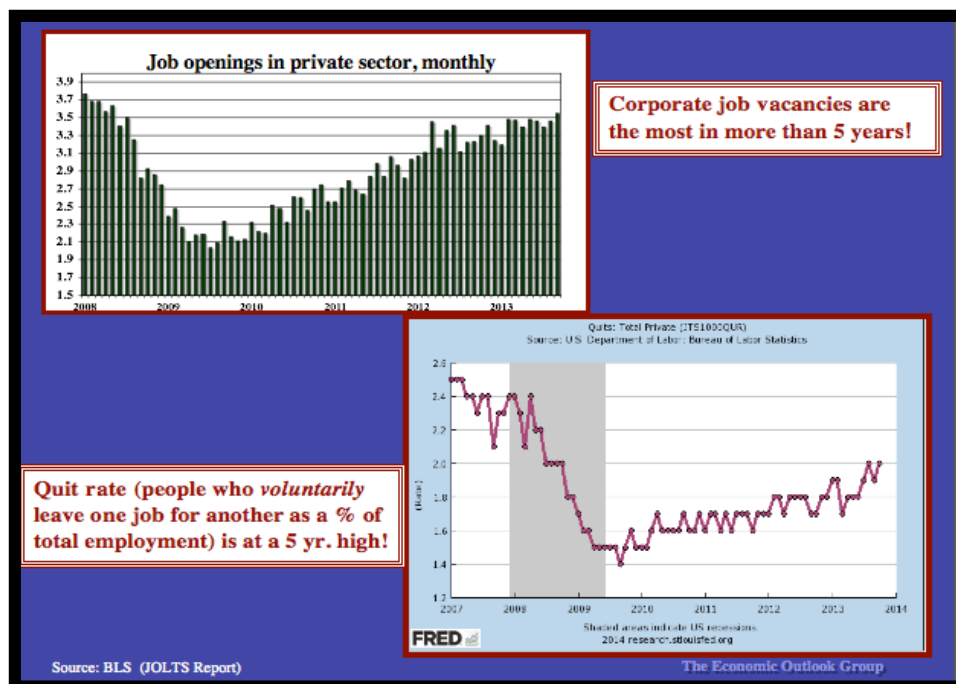
For example, consumers have ramped up spending. Retail sales in the last quarter was the strongest in three years. Remember, this shopping took place when much of the country experienced one of the coldest temperatures and biggest snowfall in years.

Housing, too, continues to show progress. Mortgage applications surged last week to both refinance older debt and purchase new homes. Even the builders, who are on the front lines of this industry, remain confident about future sales. The National Association of Home Builders said optimism among their members in January stood near 8-year highs. The government reported last week that total new residential construction and permits jumped last year by the most since 2007! Our forecast calls for single-family housing starts to rise to 805,000 this year (up 30% from 2013), with total starts climbing to 1.15 million (a 25% increase).

Other important sectors of the economy have made impressive gains. One especially noteworthy report by the Federal Reserve last week was on industrial production. Not only did it rise by 0.3% in December--- the fifth monthly increase in a row --- but total output is now at an all-time high!

I haven't yet mentioned the real blow out news. Flying under the radar screen last week was perhaps the most telling statistic of all — the latest number on job openings that need to be filled. The *Job Openings and Labor Turnover Survey* (JOLTS) showed that employers (both government and private sector) had more than 4 million job vacancies during November, the largest in more than five years!

Moreover, that same report noted the number of workers who voluntarily quit one job to find another leaped to 2.43 million that month, the most since September 2008. Fed policymakers closely watch this data point because it sheds light on how comfortable people are leaving one job for another in the current economic climate.



These are not the kind of reports one expects to see in a feeble economy. If anything they portray the opposite. Households and business leaders are showing more conviction that this expansion is real, sustainable and even picking up even speed. (Indeed, the plethora of strong economic data has utterly undermined the integrity of the poor payroll numbers first reported for December. Unfortunately, Americans were so stunned by that initial report, it momentarily staggered consumer confidence in the University of Michigan's survey for early January.)

So here's the question: If the economy is actually getting stronger, then why haven't we seen a more meaningful increase in the 10-yr treasury yield?

First of all, make no mistake, that yield will edge higher as the year progresses. With faster economic growth comes a growing demand for credit. At the same time, as consumption and capital investments pick up, inflation will bottom out. In fact, we got fresh evidence that firms are beginning to regain some pricing power. The BLS reported that December's CPI rose by 0.3%, the most in six months, and that US industries were now operating at 79.2% of capacity, the highest since 2008.

You can be certain yields are going to be higher in the coming months. **The big difference this time is the pace of that increase.** Our forecast calls for the 10-yr. benchmark to stay within a 3% to 4% range this year, even if real GDP growth approaches 3.5%.

To be sure, this is still significantly below the 10 yr. yield's average of 6.60% seen the last 50 years. We estimate the probability the 10 yr. note will climb anywhere near that level this year is a miniscule 15%! (The singular event that could kick yields toward 6% is if banks rush to convert a significant portion of their \$2 trillion in excess reserves into credit, a process that would cause the money supply and velocity to surge, and allow inflation to take off. Investors would then understandably bail out of treasuries for fear the Federal Reserve has fallen way behind the inflation curve. **But again, we do not see this as a realistic scenario this year or next.**)

What will keep the 10-yr yield from rising much beyond 4% this year?

There are multiple factors that should limit its rise

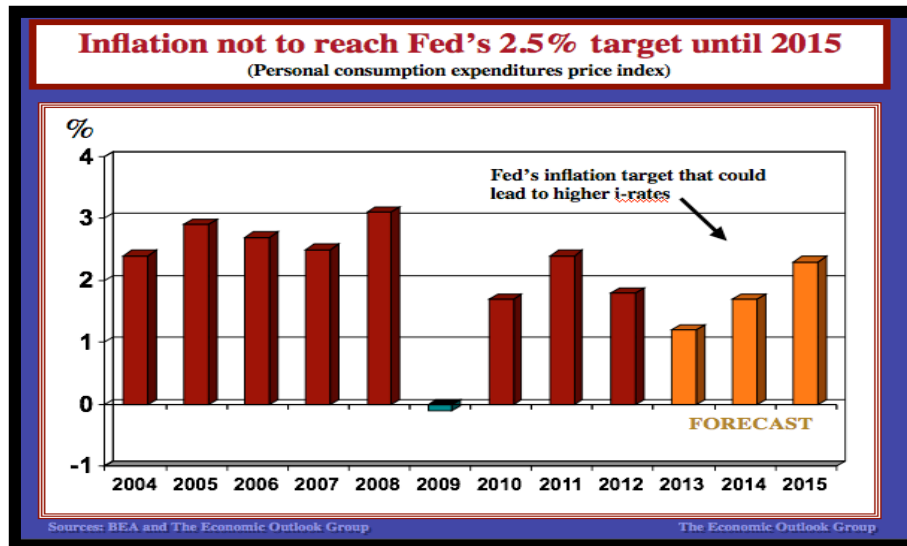
1. **There is no sense the economy is overheating.** The latest Federal Reserve Beige Book noted that "almost half the Districts reported that prices were stable; most other Districts noted small increases in prices."

Indeed, there is still a concern expressed by key central bankers and IMF officials about the risk of deflation in the developed economies, including the U.S. Here at home, consumer goods inflation, excluding food and energy, remain negative in year-over-year terms. Last year, the CPI increased 1.5%, the smallest calendar year gain in three years.

Nor are there any pressures building in the US inflation pipeline. The PPI for intermediate and crude goods prices are well behaved, with the former showing no change over the year, and the latter actually falling 2.2%.

With both commodity prices and nominal wages barely increasing, the risk of a break out of inflation is very low and explains why investors are not demanding much of an inflation premium to own fixed incomes. Even at a current low yield of 2.8% on the benchmark note, investors are still earning a real return.

So, while inflation may be close to bottoming out, our forecast calls for it to remain within the 1.5% to 2.5% range this year.



2. **Demand for Treasuries is actually on the rise.** Financial firms around the world, from traditional lenders to swaps and other derivative traders, are under pressure to shore up their defenses against potential losses in the future. Indeed, the message from Dodd Frank, the Federal Reserve, Basel III, and the European Central Bank is a firm one: better beef up your capital position so you have enough safe liquid assets even under the most strenuous economic conditions.

And what constitutes among the highest quality asset? Treasuries!

In addition, foreign central banks are hungering for more US government debt. The latest Treasury International Capital (TIC) report showed that both China and Japan just boosted their holdings of US sovereign paper to a record high. China added another \$12.2 billion in November, lifting its total ownership of US debt to \$1.317 trillion. This was the third straight monthly increase. Japan bought about the same (\$12 billion), to bring its holdings to \$1.186 trillion.

MAJOR FOREIGN HOLDERS OF TREASURY SECURITIES (in billions of dollars) HOLDINGS 1/ AT END OF PERIOD											
Country	Nov 2013	Oct 2013	Sep 2013	Aug 2013	Jul 2013	Jun 2013	May 2013	Apr 2013	Mar 2013	Feb 2013	Jan 2013
China, Mainland	1316.7	1304.5	1293.8	1268.1	1279.3	1275.8	1297.3	1290.7	1270.3	1251.9	1214.2
Japan	1186.4	1174.4	1178.1	1149.1	1135.4	1083.3	1103.7	1112.7	1114.3	1105.5	1103.9
Carib Bnkg Ctrs 4/	290.9	291.9	300.9	301.9	286.6	286.3	281.3	285.0	286.9	284.2	274.1
Brazil	246.9	246.7	249.2	252.9	256.4	253.7	255.2	253.1	257.9	256.5	254.1
Oil Exporters 3/	236.2	236.8	245.7	246.5	257.7	256.9	264.5	271.7	265.1	256.8	261.6
Belgium	200.6	180.3	172.5	166.8	167.7	176.2	175.2	185.5	188.4	187.3	185.6
Taiwan	183.7	184.5	185.9	183.6	185.8	186.1	188.8	185.7	188.9	190.0	192.7
Switzerland	176.6	174.3	177.2	181.2	178.2	180.3	182.6	185.8	183.6	186.9	190.0
United Kingdom 2/	161.5	158.5	158.3	159.2	157.0	162.6	155.8	160.2	159.1	138.6	139.4
Hong Kong	141.7	137.3	126.5	126.5	120.0	124.2	136.4	141.2	146.6	144.7	142.9
Russia	139.9	149.9	140.5	136.0	131.6	138.0	143.4	149.4	153.0	164.9	164.4

Source: US Treasury Department

Yet another important buyer of bonds are managers in the \$16 trillion US pension fund market. They have been rotating out of equities and into bonds at the fastest pace since 2008, according to the Fed's latest Flow of Funds report. Why do so now? Equities did look attractive when the Federal Reserve drove short term rates down toward zero and long term yields to record lows through QE. But with the Fed now scaling back its stimulus, pension managers sold \$135 billion of equities on an annual basis in the third quarter, and bought \$117 billion (annualized) of mostly long-dated debt securities in the three months ending in September. (The Fed will publish year-end numbers March 6th.)

So, once again, we see investors continue to view US treasuries as a safe haven. I suspect that sentiment got stronger now that President Obama signed into law last week a bi-partisan budget deal that puts off the risk of another government shutdown for at least two years.

3. More investors are coming around to the view that the sharp rise in excess reserves is not the same thing as printing money! A jump in excess reserves in itself does not create inflation. The Federal Reserve injected these reserves to offset the weakness in bank lending to the private sector.

The *real danger* to bond holders exists *only* if the Federal Reserve has failed to sop up those excess reserves *before* the economy shows signs of overheating. The very fact investors show a willingness to still hold on to treasuries reflects a level of confidence that the Fed will succeed in withdrawing those reserves at the proper time and pace. And credit for this higher level confidence in the Fed should be attributed to the unprecedented degree of transparency and communication introduced by Ben Bernanke during his tenure as chairman. It is a practice we expect to see continue under Janet Yellen's leadership.

4. The growth in the supply of US treasuries will be less than expected this year. Stronger economic growth in 2014 will increase tax revenues by an amount greater than initially estimated. We expect the US budget deficit this fiscal year will come in below the CBO's estimate of \$560 billion (and be closer to \$510 billion). That means there will be fewer issuances of treasury debt at a time when global demand for these securities remains quite firm, even as the Fed proceeds to gradually scale back its purchases.

5. Another factor that will bolster demand for US treasuries are the many questions that linger about the economies of Europe and China. The ECB, for example, has said repeatedly that while the worst of the debt crisis may be over for the single currency system, the central bank will continue to be very accommodative on monetary policy. Mario Draghi has not backed away an inch from expressing concerns about the weak recovery, record high unemployment and the danger of deflation in the Eurozone.

Investors therefore cannot help but notice the glaring divergence in economic activity between Europe and the US. They see the US in a much stronger position with a growing economy, shrinking twin deficits and an appreciating currency. Who would want to rush out of the US under such circumstances?

Finally, there is one other issue looming that has affected the psychology of bondholders. It is China and its massive debt. While Chinese leaders are scrambling to prevent any wide scale default by state-owned firms and private borrowers, the risk of a debt crisis erupting in the world's second largest economy and the potential global fallout is worrisome enough. It is a threat that cannot be easily dismissed, since it is so difficult to get trustworthy numbers on the scale of that debt burden. Thus again, one can understand why investors find comfort in the safety of US treasuries.

Bottom line:

We do not expect to see 10 yr treasury yields remain below 3% much longer. With growth now shifting into faster gear, we should see inflation begin its slow advance and that will set the stage for market interest rates to creep higher. This is the way the economy is supposed to work. We want to see a normalization of rates. Having said that, there is little chance the benchmark 10 yr. yield will climb much beyond 4% this year for reasons outlined above. Our forecast calls for the treasury note to yield 3.5% by mid-year and 4% in the final quarter. These are levels still consistent with GDP growth close to 3.5% in 2014.

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