MARKETS

Up or down? Interest rate outlook could be either or both

BY PHILIP BURGERT

The fiscal cliff, political gridlock, European sovereign debt crisis and other global economic scenarios make it hard for traders and analysts to agree on what will happen in fixed income markets in the next six months.

Interest rates are going up, say some traders, fund managers and analysts. But others say they'll be going down. Just like the outlook for maintenance of the U.S. Federal Reserve's freezing of short-term interest rates through mid-2015, the yields and pricing of interest rate futures will be subject to many dynamic forces in the next few months.

The presidential and Congressional elections are now behind us, but with the U.S. fiscal cliff, Europe's sovereign debt problems and challenging economic conditions both domestically and around the world unresolved, volatility will be the watchword going forward.

- Washington gridlock
- European debt
- Global recovery

The dynamic forces are driving some traders and analysts to the view that the more than 30-year bull trend in fixed income may be over soon.

"Our current view on interest rates is bearish based on some recent improvement in our macroeconomic measures coupled with an overvalued U.S. Treasury market," says Joseph A. Baggett, founder, chief investment officer and portfolio manager for Dix Hills Partners.

Baggett says his company's research has concluded, and recent experience shows, that neither current non-traditional zero interest rate policies (ZIRP) nor quantitative easing (QE) guarantee a "straight, smooth path" to perpetually lower interest rates.

"Rather, we would argue that rates will fluctuate over time to reflect changes in market participants' expectations for the duration and magnitude of QE/ZIRP," Baggett says. These changes in expectations will be driven by evolving economic conditions in terms of both real growth and inflation, he adds.

Baggett notes that on a month-to-month basis throughout the Treasuries' bull trend, interest rates actually have risen 47% of the time from 1981 to the present (see "Ups & downs," right). "[You] need to be flexible and opportunistic when it comes to interest rate forecasting," he adds.

Baggett also notes that real rates are negative in Germany and the United Kingdom as well as in the United States

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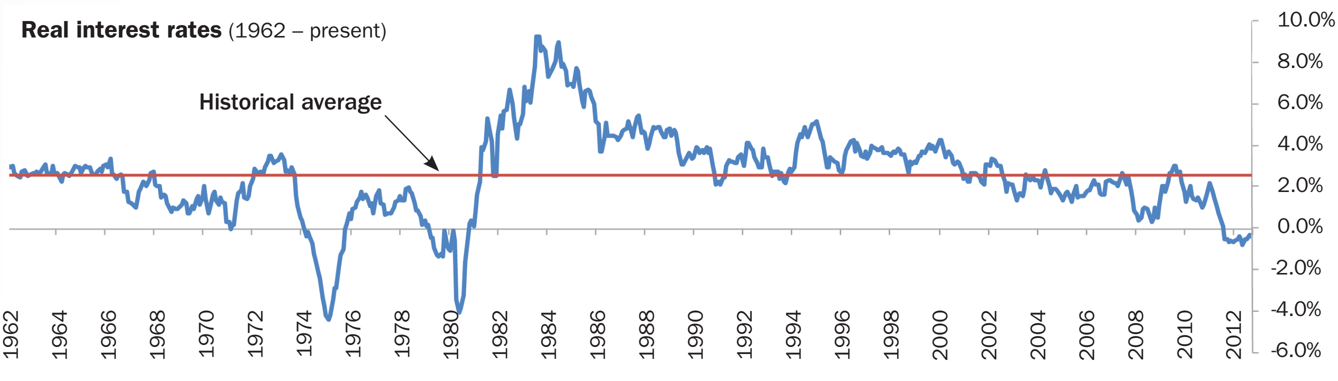
(see "Keeping it real," right). "As such, our bias is for higher rates in those sovereigns as well," he says. He adds that Dix Hills also currently is short Japanese government bonds, but the position size and investment conviction is much smaller.

Baggett says "headline risk" of the European sovereign debt crisis seems to be diminishing slowly as markets react less violently to each new twist and turn in the saga. A positive baseline scenario for the European crisis likely would lead to improved confidence for Europe's investors and consumers, he adds. "As such, a potentially rebounding Europe in 2013 might bolster — not undermine — U.S. economic prospects, Baggett says. "Further, we feel that recent U.S. economic improvements can be sustained by reduced political uncertainty through the conclusion of the November elections and some progress on the 'fiscal cliff.'"

Larry McDonald, senior director for credit, sales and trading at Newedge, says that an unusual phenomenon for

KEEPING IT REAL

Global real interest rates have fallen into negative territory.



Source: Dix Hills Partners

the last couple of years has been systemic risk, in that Europe has created a constant bid for Treasuries.

"U.S. Treasury yields have been suppressed by global systemic risk," he says. "Now the horrifying thing is if Europe just normalizes and we go back to a 2003 to 2006 type of world where there really was no systemic risk, then you are going to see a 100-150 basis point increase in Treasuries because you just don't have that flight to quality."

Recently, he noted Treasuries have not been rallying during stock market selloffs as they have in previous market corrections. "That is very, very, very unusual. This has not happened in the last two or three years. It either means that U.S. and global investors are relieved that the relaxation of systemic risk in Europe is starting to hurt the bid for Treasuries, or for the first time investors are starting to look at the fiscal cliff — not just the fiscal cliff but the deficit, the budget and Washington inaction — because Treasuries are not rallying the way they should be."

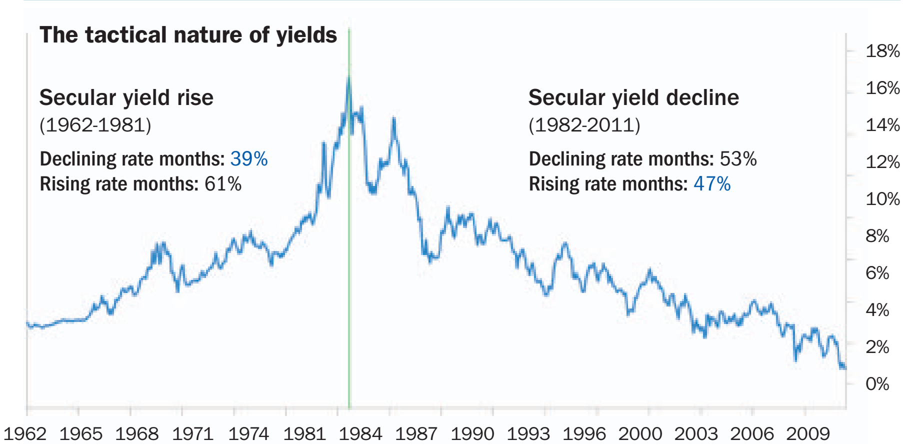
Risk on/risk off

McDonald says there still is one more big risk-off trade ahead for the bond markets (perhaps in late 2012/early 2013), but his index of 17 systemic risk indicators that have predicted past market turns remains calm.

"These indicators were going crazy before Lehman," he says, adding that they went crazy again in May shortly before the market drop, and last summer when a 20% drop was seen over 34 days. "Now those indicators are calm as can be. So there is definitely lower systemic risk. Banks are trusting each other more," he says.

UPS & DOWNS

Even during long-term trends in interest rates, yields move both ways a good portion of the time.



Source: Dix Hills Partners

McDonald expects the Federal Reserve to lose control over the longer end of the yield curve when Europe later normalizes. "The Fed is being assisted by Europe because they are able to do QE, which lowers rates. If they were doing QE with a normal Europe, they would have a tough time keeping rates low," he says.

McDonald says fear is why investors continue to buy U.S. Treasuries under 1.7%. "They are just terrified. Why else would you do it? When that goes away, the Fed has a much harder time controlling the yield curve."

Rick Pearson, Zurich-based portfolio manager for Signina Capital AG, says European bond markets "are very artificial" as a result of €80 billion ($102.4 billion) worth of core bond purchases by the Swiss National Bank after the central bank's sale of Swiss francs to suppress the currency. "I don't think France, for example, would be trading at these levels without the purchases the Swiss have made," he says.

But Robert I. Kessler, CEO of Kessler Investment Advisors, argues that interest rates are likely to continue declining and that the 30-year-plus bull market in Treasuries is still years from ending. Until then, the primary trend of U.S. Treasury interest rates will be lower, although there will be periods of rising yields, he says.

"Rates will continue to ratchet down," Kessler says. "The question is, how much further can you go?" Examples to look at, he says, include Japan, Switzerland, Northern Europe and Australia.

"Let's look at countries that really do have substantially lower rates than we have," he says. "Look at the bund, look at the gilt or look at Australian rates, which are the lowest we've seen perhaps ever. We're not the only ones; it's not like this is endemic to the United States. It's a global rate situation."

Kessler says he usually bases his interest rate outlook on the spread relationship to the overnight cost of money. He notes that the normal spread between the cost of money and, for example, the 10-year Treasury is 100 to 125 basis points, 1% to 1.25%.

Kessler sees the 1% rate as a possibility as well as a rate of 1.75% to 2.25% in the 30-year, noting that is where Japanese rates have gone. "The Japanese 10-year rate is 0.75% and the Japanese 30-year rate is 1.75," he says

He also notes that the Fed is telling investors that they are keeping rates at zero until either 2015-plus or until unemployment or inflation change significantly. It's theoretically indefinite, Kessler says. For Japan's 10-year JGB, he notes, the low was reached 13-plus years after the peak (see "JGB at bottom?" right). "This is five years for us," he says. "If you look at the low in the peak after the 30-year, the 10-year reaches a low almost 16 years after 1929."

As for 2013, Kessler says, "[Treasuries] probably will be making new lows. And that, by the way, only would be an indication that the economy continues to struggle."

He adds that those lower rates could hit in December if no deal is made on the fiscal cliff. Even while predicting lower rates, Kessler expects 10-year Treasuries to maintain a range of 1.25% to 2.25% over the next few months. In the long bond, he expects an upside of not much more than 3.25% in the next few months while they could go as low as 2.25%.

Kim Rupert, managing director for fixed income analysis with Action Economics, counters the forecast for lower interest rates by saying, "We are going to be in an upward trending range. In general, yields are going to be going higher, but it's going to be a very bumpy road. There are a lot of exogenous factors that are going to be hitting over the next couple of months."

Rupert says markets will continue to see a more risk-on/risk-off type of trade that could last from several weeks to a month or two before deciding on a direction.

She notes the Fed is not the only game in town when it comes to determining if interest rates will rise or stay low. "There are a number of factors that would cause investors to be sellers of Treasuries. At some point, those will overwhelm the Fed purchases," Rupert says (see "The old normal," above). "Right now we see yields climbing higher because there is a bit of inflation concern cropping up and again there are fears that maybe the Fed won't continue its buybacks. And there is some thinking that perhaps the economy is on the road to recovery."

Even if the Fed were to continue its open-ended QE3 through 2013, Rupert says there is a potential that yields could go higher if investors decide they don't like all the stimulus. "There is a negative side to the Fed's stimulus with inflationary concerns. If those are greater than Fed purchases then yields could be biased higher," she says.

Rupert adds that everyone realizes yields eventually must go higher. "Nobody wants to be the last one out," she says. "You're going to get hammered if you're the last guy because it's a very crowded trade right now in Treasuries. We see traders and investors taking some chips off the table every now and again."

If and when that trickle becomes a torrent is what bond traders must ask themselves. F

JGB AT BOTTOM?

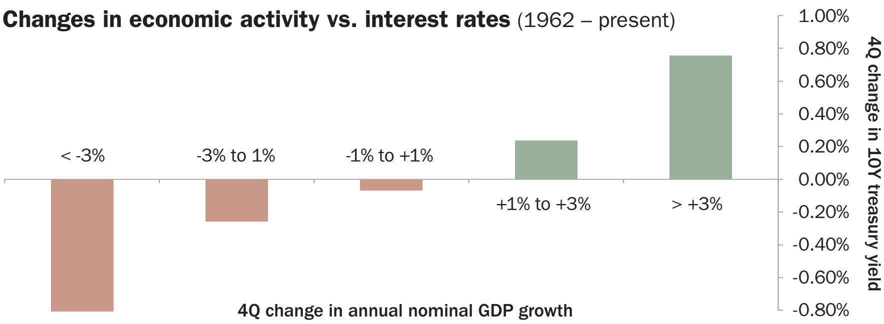
Japanese 10-year bonds have a long history of falling rates.

Source: LawrenceGMcDonald.com

THE OLD NORMAL

Typically, rates rise in a growing economy and drop with contraction. However, we are hoping for stronger growth with the Fed dedicated, via QE3, to keep even long-term rates down.

Changes in economic activity vs. interest rates (1962 – present)



Source: Federal Reserve, Bureau of Economic Analysis