



November 2012

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Long-Term Treasury Bond Fundamentals Remain Strong

Talk about a “bursting bond bubble” is on the rise again, with no more merit than previously. It became louder in March as the 10-year yield spiked to 2.39%, it faded to murmurs during the full-percentage-point dive in yields that followed, and now the noise level is increasing again on the tail of the latest bond sell-off (chart 1). Nevertheless, the major long-term trend is still downward, and it will reassert itself in the months (or maybe even weeks) ahead.

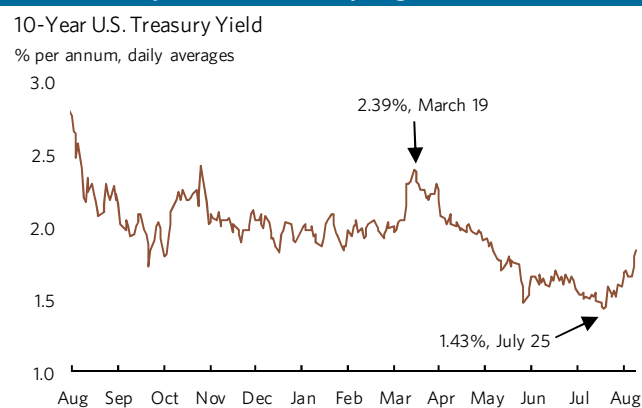
There is no change in the outlook for yields over the next year or the next few years. As most recently stated in the July Levy Forecast: “Treasury bond yields are still on a secular decline, and the 10-year yield will break 1% during the next recession.”

Ups and downs in Treasury yields such as have occurred so far in 2012 are both unsurprising and—in a world where sudden crisis flare-ups or policy statements can have sweeping market effects—unusually difficult to predict. Arguably, yields got ahead of their secular decline in June and July amid euro area political disunity in the face of swelling perceptions of bank problems and deteriorating government bond markets. On June 1, we wrote:

Now that the yield on the 10-year Treasury note has fallen to 1.5%, the level we have been forecasting for 2012, is it time to sell? Given the volatility of events and markets, we have no strong opinions on the short-term outlook for bond yields, and we would not argue with short-term trading decisions to sell based on technical or other reasons. However, do not view this yield plunge as a fluke, but rather as a move along an erratic but decisively downward long-term trend in yields that has not yet reached its ultimate bottom and as part of a global cyclical economic weakening that may or may not culminate in a global recession.

The bond market initially turned down following ECB President Draghi’s pledge to intervene as necessary in troubled sovereign bond markets, a statement that muted the crisis at least for the

U.S. Treasury Yields Back to Spring 2012 Levels CHART 1



time being. Investor relief in a market that had gone a long way without a sizable correction undoubtedly played a key role in the steep yield rise. Yields also gained support from some firmer (albeit still tepid and decidedly mixed) U.S. data, which may have eased investor fears of a U.S. recession.

However, the fundamentals still point to more strength for bonds. Worries about European financial stability will continue to ebb and flow with events; most eurozone government debt will remain tainted in the eyes of investors seeking risk-free assets. The global scarcity of safe assets will continue to intensify over time. Moreover, the economic outlook has not improved either at home or abroad:

1. Our Friday, August 17 bulletin noted the continued erosion of the European economy through the first half with the risk of a faster decline in the second half.
2. The U.S. “improvement,” as evidenced by some moderately better employment and retail sales data for July, is largely attributable to getting past the negative seasonal influences in the spring data—the flip side of the weather and other distortions we wrote about so much during the winter. As we noted on several occasions during the

spring, the economy was weakening but the weakening was undoubtedly exaggerated by these unquantifiable effects. Thus, while the economy may not be as weak as it seemed a couple of months ago, it would be a mistake to believe it is improving. On the contrary, profits fell in the second quarter and are probably falling again in the third.

3. The emerging market economies show increasing signs of weakening with little in the way of new visible fiscal policy measures. We emphasize the word visible; policy actions in many emerging market countries are not always transparent, at least not without a long delay. One positive: Brazil has announced a new infrastructure plan, but the program will probably not have a large impact for at least a year.

Altogether, the world is precarious and decelerating.

Meanwhile, the U.S. disinflationary secular trend is likely to be reinforced, rather than countered, by cyclical forces in the next six months. While spikes in food, energy, or other commodity prices could cause some brief headline CPI acceleration, such price moves in an economy in which workers have little bargaining power tend to depress margins and prices for other products, ultimately leading to more economic weakness and a reduction in inflation.

We view the rise in yields as an opportunity to take further long positions. We have no opinion on whether yields will move any higher in the near term, but such moves are unsustainable in the present environment.



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