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Shorting US Treasuries could be a mistake

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Should traders and investors short the US Treasury market? The bearish case is straightforward.

The budget deficit assures massive supply of government debt for years. Foreigners are having second thoughts about financing the deficit, highlighted by recent reports that China was selling some of its Treasuries. The crisis in Greece and elsewhere emphasises the risks of buying bonds from heavily indebted countries. Finally, the expansion of the Fed balance sheet through a variety of lending and asset purchase programmes threatens both the central bank's credibility and its inflation performance. Higher inflation would surely push long term yields much higher. Indeed, a month ago a prominent author and hedge fund manager suggested that "every single human being" should be short Treasuries.

Maybe so. Certainly over the long run the US must rediscover fiscal prudence and reduce its deficits or face a costly rise in borrowing costs. However over the medium term – say the next several quarters, a reasonable investment horizon – there are reasons to expect the Treasury market to hold its own, and perhaps even surprise with lower yields.

The deficit is high at about $1,500bn, roughly 11 per cent of GDP, similar to 2009. That 2010 deficit forecast has been fairly consistent for a year now. In other words, current prices – and the steep yield curve – reflect this level of supply. With the economy stabilising, receipts should also stabilise soon. In any case, the link between the absolute size of deficits and yields is inconclusive. Japan has run huge deficits for 20 years yet with the lowest yields worldwide.

But Japan finances itself from internal savings, while the US relies on foreigners. Aren't those foreigners getting edgy? Last month the Treasury reported its monthly tally of Treasury holders. While foreigners as a group were adding to their Treasury holdings, the Chinese were apparent sellers. Was this the canary in the coal mine? China's holdings reportedly declined from $800bn at the peak to $755bn at year end. This story received significant attention but, barely noticed, were subsequent revisions to that data series. These revisions showed that foreigners, in aggregate, were even larger buyers in 2009 than initially reported. Most notably, China's holdings were revised higher – significantly – with the latest estimate being that it holds $894bn rather than the earlier estimate of $755bn.

Additionally, the US private sector is now deleveraging. Households and businesses are now paying down debt according to the Fed's flow of funds data. Savings are rising. In short, the government is not competing with – or "crowding out" – other

borrowers in what is a bigger pool of domestic savings while foreigners, as noted, are not showing signs of decreased demand.

But what about "sovereign risk" worries? Global markets are interrelated and money is constantly seeking the best risk-adjusted rates of return. At times of stress, investors seek perceived havens. Right now the focus is very much on the European periphery. The dollar has risen 10 per cent since November, in part due to the structural flaws now being exposed (though long-known) in the euro area. The Treasury market has treaded water in recent months, responding more to signs of US recovery, albeit weak. Should the crisis expand beyond Greece, the Treasury market is more likely to become the recipient of investment capital as investors factor in a broader period of stress in Europe.

Won't the Fed's balance sheet expansion and "quantitative easing" policies generate inflation and thereby degrade the Treasury's debt? The recovery, while moving in the right direction, is weak by historical standards and the ongoing deleveraging process acts as an ongoing headwind on both growth and inflation. Slack in the economy is high and inflationary pressures are likely to stay low.

Remember the Bank of Japan pushed rates to zero, launched quantitative easing and assorted programmes to jump start lending – all while the government ran substantial budget deficits – and still Japan remained mired in deflation. Indeed the yield on 10-year JGBs fell to an ultimate low of 49 basis points (0.49 per cent) in spring 2003. Perhaps more money was lost shorting JGBs in the 1990s than any other single trade.

This is not to say the US need not address its fiscal problem in the long run. Failure to do so will ultimately lead to higher yields. But for investors, the imperative is to define one's time horizon. Over the next several quarters, evidence of stabilising deficits, ongoing foreign demand for Treasuries, stresses in Europe that push capital flows to the US, and the lack of inflationary signs suggest yields might surprise to the downside. In that environment aggressive short positions have the wrong risk/reward profile.

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