SPREADING IT AROUND- SOME US 10 YEAR TREASURY RELATIONSHIPS
© Leo Haviland, 646-295-8385 January 24, 2012

"The Dude abides. I don't know about you, but I take comfort in that. It's good knowin' he's out there. The Dude. Takin' 'er easy for all of us sinners." From the Coen Brothers' film "The Big Lebowski"

CONCLUSION

Relationships of assorted debt instruments to the widely-watched United States Treasury 10 year note offer insight on the American economy's health. They also offer some guidance regarding stock marketplace signposts such as the S+P 500. Several years of easy money policies and massive deficit spending by the United States and its allies indeed have helped to inflame and propel an American recovery and stock marketplace rally. Because the S+P 500 at around 1300 is nearly double its March 2009 abyss, has the economic crisis that emerged in 2007 almost disappeared, and is a new golden age of prosperity eagerly beckoning? Probably not. These interest rate comparisons confirm that only a fair economic recovery has emerged during the ongoing worldwide economic crisis. These yield relationships also suggest that the S+P 500 faces very strong resistance at its 2011 highs (around 1345/1371), as well as around its May 2008 final top at 1440.

The Federal Reserve's abiding battle and repeated sweet promises to keep government interest rates resting comfortably near the floor aim to inspire not merely consumer spending and business investment, but also incremental buying in stocks. If, for example, a government two year note pays next-to-nothing in interest, where should we put our money? Stock dividend yields may appear alluring (especially if viewers decide equity prices will not slump much if at all). The fervent search for acceptable returns by many marketplace players sometimes sweeps into other arenas such as corporate notes and bonds, real estate, and alternative "investments" such as commodities. Marketplace voyeurs should ask whether the current quests for "yield" bears at least a passing resemblance to the later scenes of 2006-07 during the gorgeous Goldilocks Era.

SHAPELY CURVES: US TREASURY 10 YEAR LESS TWO YEAR YIELDS

The 10 year less 2 year US Treasury spread made a key low around 125 basis points (positively sloped curve, daily close basis, Bloomberg data) on 12/26/08. The S+P 500 reached its major bottom a few months afterwards, on 3/6/09 at 667. Economic recovery ensued.

Highs in this relationship since then were around 290 basis points on 2/22/10 (291bp) and 2/4/11 (289bp). These yield differential peaks occurred not long before significant tops in the S+P 500: 4/26/10 at 1220 and 2/18/11 at 1344 (followed by the 5/2/11 one at 1371). Because the faithful and vigilant Federal Reserve has pinned short term rates near zero, most of the widening and narrowing of this differential derives from movements in the 10 year note. The spread made a subsequent high around 7/1/11 at 271bp and then narrowed (the curve flattened some); compare the timing of the S+P 500's highs on 7/7/11 at 1357 and 7/21/11 at 1347 and subsequent talk about slower economic growth.

After hitting a low around 152bp on 9/22/11 (S+P 500 low 10/4/11 at 1075), the 10 versus 2 year spread traveled to 209 basis points on 10/27/11. At the end of last week, it was almost 180bp (10

year 2.02 percent, two year merely .24pc). Although the S+P 500 fell from 1293 on 10/27/11 to 1159 on 11/25/11, it advanced to around 1315 by the end of last week.

Lows in the spread have occurred at or around the Federal Reserve's initiation of looser (or otherwise flexibly creative) policy. Recall not only the first round of quantitative easing (and the boost in the monetary base) alongside the 12/26/08 low (and remember the preceding low at 117bp on 6/12/08). The Fed began to unveil QE2 in late August 2010. The yield curve relationship made a low at 196bp on 8/26/10; the S+P 500 reached a crucial low at 1040 on 8/27/10, just above 7/1/10's 1011. The second round of money printing ceased at end June 2011. However, devoted Fed sheriffs remained ready, willing, and able to accommodate. Recall the announcement of Operation Twist on 9/21/11. From October 2011 through June 2012, the Fed will sell $400 billion of shorter term US Treasuries, purchasing the same amount of longer term notes and bonds.

In addition to the 270/300bp resistance, monitor around 195/210bp. Regarding this second range, the spread attained an interim peak at 208bp on 3/6/08, a few months before the S+P 500's final high on 5/19/08 at 1440 before the financial crisis accelerated in late 2008. Also, around 208bp is the 50 percent retracement of a move from 125bp to 291bp. Support is about 115/125bp and 150bp.

So from December 2008 to the present, a guideline for this spread appears. The wider the 10/2 spread is (more positive the yield curve slope), the more economic strength (or more faith in it, anyway) and the higher the S+P 500. The tighter the spread becomes, the weaker the economy (or less belief in the recovery continuing or being strong). Stock marketplace weakness intertwines with this spread narrowing.

The spread's now being midway between support and resistance suggests a sluggish economic situation. The Federal Reserve essentially has promised to maintain rock-bottom short term interest rates into mid-2013, and the US economy has revealed signs of strength in recent months. However, many forecasters are reducing their US (and European and worldwide) 2012 GDP growth estimates. On the other hand, the Fed probably will ease anew if the economy weakens (or if it fears it will soon do so). With short rates already in the basement, that policy probably will focus on lowering rates at the long end of the curve. Will there be a QE3? Thus this spread probably will inhabit a 115/125/150bp to 270/300bp range for the near term.

****

However, beware of generalizations regarding this yield curve spread (or any other spread). Suppose inflation becomes substantial, forcing the Fed to boost short rates. Also note the run-up in differentials from 6/12/08's 117bp to 11/13/08's 262bp as the stock marketplace withered and as financial turmoil blossomed. Besides, although the 10/2 yield curve became more positively sloped during the final stage of the Goldilocks Era and as the S+P 500 joyously danced to its 10/11/07 major high at 1576, the initial warning of the weaker economy arrived much earlier. It came via a negatively sloped yield curve, not one with a substantial positive slope. Note the 11/27/06 negative 19bp spread (two year yield over 10 year one; see too 2/23/06 at -16bp). In addition, not long after the major highs in stocks in 2000 (S+P 500 3/24/00 at 1553, Dow Jones Industrials 1/14/00 at 11910, the yield curve reached a negative slope of -51bp. It then advanced to a positive slope of 274bp on 8/13/03, quite some time after related equity troughs (final S+P 500 low 3/12/03 at 789, initial low 10/10/02 at 769).

RISK ON, RISK OFF: 10 YEAR US CORPORATE NOTES VERSUS TREASURIES

Suppose relatively high quality debt instruments such as US Treasuries offer very depressed nominal yields, or even provide negative returns relative to inflation indicators such as consumer prices. Then lower quality interest rate playgrounds that wear the prized investment label often may appear more attractive than usual to many fortune hunters. The generic 10 year US corporate industrial note of around B+ grade (Bloomberg data) is one benchmark to put on the runway against the 10 year US government note. This yield spread relationship often has swung substantially since the worldwide economic crisis erupted. The differential provides guidance on or confirms US economic and S+P 500 trends. This corporate yield recently exceeded the comparable Treasury by around 475/480 basis points. Although players disagree regarding what represents a "high", "low", or "average" spread level or important marketplace turning point, let's examine some history.

During the Goldilocks Era, this 10 year spread made its final low on 6/14/07 at 222 basis points, about four months before the S+P 500's major pinnacle at 1576 on 10/11/07. The crisis worsened and stretched around the world over the next year and a half or so. With US Treasuries representing a safe haven whereas corporate note and bond prices fell out of bed, the differential between 10 year corporates versus Treasuries skyrocketed to over one thousand basis points. It peaked on 1/5/09 at 1288 basis points, with a final high of 1189bp on 3/9/09, around when the S+P 500 reached its 3/6/09 basement at 667 and during the darkest days of the recession. Its 6/23/10 spread peak at 558bp preceded the 7/1/10 S+P 500 low at 1011 by only a few days (and was close in time to the QE2-inspired 8/27/10 bottom at 1040). The 10/6/11 corporate/government spread top at 592bp was almost the same day as the S+P 500's 10/4/11 low at 1075.

What about lows in the spread in the past couple of years? Key spread lows have occurred rather near in time to S+P 500 highs and amid recovery optimism. Note the 394bp of 4/27/10; compare the S+P 500 4/26/10 top at 1220. More recently, survey the 362bp (2/22/11)/396bp (7/28/11) range relative to the 2011 equity tops of 2/18/11 (S+P 500 at 1344), 5/2/11 (1371), 7/7/11 (1357), and 7/21/11 (S+P 500 at 1347).

Thus recent history suggests a guideline for the "current situation". When this corporate versus government spread reaches a fairly narrow (low) level, it is associated with a relatively bullish stock marketplace trend and (at least among much of Wall Street and the financial media) widespread economic optimism. A very wide spread is linked to economic weakness and a bearish S+P 500 period.

What does the 2000 peak in the S+P 500/Dow Jones Industrials say in this context? The final low in this 10 year spread low was close in time to this equity pinnacle, at 312bp on 1/3/00 (initial low 7/20/99 at 307bp). Another final peak in the spread, around 616bp on 10/11/02, occurred almost exactly when the S+P 500 touched its 10/10/02 low at 769. Also remember the following interim top at 553bp on 6/13/03 and the S+P 500's 3/12/03 final low.

****

However, history is not destiny. The pre-crisis low at 208 basis points on 3/10/05 was long before the breakout of the financial crisis and the breakdown in equities (though this March 2005 level was close to the 6/14/07 spread low). The 10/11/02 summit at 616 was matched by an earlier one on 10/9/01 at this elevation (and neared one at 566bp on 12/11/00). And even within some apparent general trend, one should be cautious regarding spread interpretation. The rather wide level of 637bp on 4/1/08 was rather close in time to the S+P 500's 5/19/08 final high. The 10/2

year UST yield curve relationship does not necessarily move in the same fashion or change trend at the same time as this corporate/UST spread. Yet compare the timing of the UST 10/2 year spread top on 3/6/08 at 208bp with that April 2008 one at 637bp in the corporate/UST relationship. Some perspectives instead may connect the corporate/UST spread's lower low on 6/20/08 at 472bp to May 2008's S+P 500 height (recall the 6/12/08 UST yield curve spread bottom at 117bp). However, if one selects the later and lower corporate/UST relationship of 6/20/08 as "fitting" the May 2008 equity peak, then arguably it is inconsistent to link the 10/2 yield curve's earlier 3/6/08 high at 208bp (instead of its 6/12/08 low) to this May 2008 S+P 500 peak.

****

Anyway, for the near term, key support for this 10 year corporate/UST spread is around 360/400 basis points. Major resistance hovers at around 590/620/645bp (637bp is the 4/1/08 top; half the 1288 plateau is 644bp).

Since the first quarter 2009 spread peaks tower over current levels around 475bp, the US economy is much stronger now than 1Q09. Bulls also can point to its staying under recent highs at 558bp (6/23/10) and 592bp (10/6/11) as signs of economic robustness. However, the current corporate/UST differential not only is well above the June 2007 low of around 222 basis points. It also remains above its 2010-11 lows of about 360/400bp.

FURTHER ASTRAY? MUNICIPALS, MORTGAGES, AND GERMAN GOVERNMENTS

The worldwide economy has improved substantially relative to late 2008/early 2009. However, the 10 versus 2 year US Treasury yield curve spread and the 10 year corporate/UST differential are not the only interest rate relationships indicating that the worldwide economic crisis is continuing and will likely do so for quite some time. Suppose we quickly survey yield spreads between the 10 year US Treasury note and municipal, mortgage, and German sovereign debt.

****

Compare the 10 year UST with an index for municipal general obligation BBB rated securities (Bloomberg data). From 1997 to the onset of the financial crisis in mid-2007, the UST yield usually exceeded that of municipals. The notable sustained exception was alongside the equity downturn (the 2002-03 stage), in which UST yields tumbled to their 3/10/03 low about 80 basis points under munis. Recall the stock marketplace low of March 2003. UST yields then climbed above those of the comparable municipal, reached their peak premium of 80 basis points over munis on 6/12/07 (recall the 6/14/07 bottom at 222bp in the 10 year corporate less UST spread), a few months before the October 2007 major peak in the S+P 500.

UST 10 year yields then collapsed relative to munis as the financial crisis proceeded, reaching around 419 basis points under munis on 3/18/09. Recall not only the related bottom in equities, but also the stratospheric first quarter 2009 highs in the corporate/UST spread and the 12/26/08 low of 125bp in the UST 10 versus 2 year relationship.

The muni/UST spread always has remained negative (UST yields under municipal ones) since the March 2009 low. This suggests that the American recovery is relatively weak. Admittedly, there has been progress, but a negative 76 basis point spread high since then (3/26/10, not long before the April 2010 S+P 500 high) is well below the 80bp UST yield premium of June 2007. And at roughly negative 160bp recently, the spread is even beneath the later lower highs around -115bp (see 12/14/10 and 6/30/11) as well as the March 2003 low of -80bp. Support for the spread is

around -200/-240bp (negative 199bp low 7/10/09, -220bp low 9/22/11; half the -419bp major low is about -410, -241bp the 10/22/08 low before the final 2008 crash).

****

United States thirty year home mortgage rate yields (from Bloomberg, citing bankrate.com) have fallen under four percent. The 10 year UST note yields have been about 200 basis points under these mortgage rates lately. Yet homeowners (and the Federal Reserve and politicians) still await a significant rally in American real estate prices. Surely the Fed and its allies, actively abiding, would love a housing price rally to occur alongside one in the stock marketplace! Will the Fed's unyielding determination to maintain low interest rates alongside other measures such as Operation Twist help cure real estate troubles?

Certainly the current spread of 30 year mortgages over the 10 year note is far distant from the 327 basis points peak of 12/16/08). However, they also are clearly above the blissful tight spreads of the Goldilocks Era. Recall the level just under 100bp in early 2007 (UST 97bp under, 1/17/07) and about 90bp in first quarter 2005 (3/22/05). Current levels are also below the rally levels of 121bp (3/24/10; recall the later high in the S+P 500) to 128bp (2/8/11; recall the S+P 500's initial peak in February 2011). The current spread yield differential is not far from the lows when the Fed announced its lax money printing festival (8/26/10 low at 202bp) and Operation Twist (9/22/11 at 228bp). In regard to the 200/230 support range for the spread, remember some previous crucial lows prior to the current economic crisis. See 10/15/98's 227bp mortgage premium to the UST 10year, as well as the 216bp one on 8/25/00 and 215bp of 9/30/02 (not long before the October 2002 stock marketplace low).

****

The European sovereign debt and banking nightmare inspires diligent attention to interest rate spread relationships involving that continent's countries. The 10 year note is a popular benchmark. Given Germany's relatively strong fiscal position, many players compare its 10 year government yields with that of other European nations. German sovereign debt, like the US Treasury marketplace, has represented a "flight to quality" refuge during the economic disaster of the past few years.

What does a quick scan of the relationship between the 10 year German and US government notes reveal? On 10/25/05, the UST yield was 122 basis points over the German one. At the dawn of the economic debacle, the UST yield final peak was around 39bp over (7/31/07). UST 10 year yields eventually plummeted beneath German ones as the economic crisis developed and gathered steam, reaching their low of 90bp under on 12/30/08. During the prior major equity price downturn, UST yields likewise retreated under German ones. From a premium of UST 169bp over on 6/11/99, they headed down. UST yields fell to 73bp under on 10/9/02 (S+P 500 low 10/10/02; final spread low associated with the S+P 500 bottoms is the UST 43bp under of 6/24/03).

The high in this spread (UST premium) since the 2008 low was 4/5/10's 90 basis points, not long before the 4/26/10 S+P 500 top at 1220. From its early 2011 high just over 50bp (52bp on 1/5/11), it has edged downward; it was 33bp over on 7/27/11. The UST flipped to a 34bp discount versus the German bund on 11/29/11 (the UST also was 12bp under on 6/8/11 and 8/9/11).

Last week, the 10 year UST yield was about 10bp over the German note. Current levels (and recent lows) are well above the low of 2002 and 2008, reflecting progress in mending the financial system and promoting economic recovery. However, present differentials remain quite a bit below the April 2010 and January 2011 highs (UST yields over), as well as those generally

prevailing from the October 2005 summit through around end July 2007. Thus this US-German government spread likewise indicates that the US (and worldwide) economic recovery remains rather fragile.