The Treasury Bull Market Is Over; Inflation Will Take Center Stage

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by: Economics Fanatic

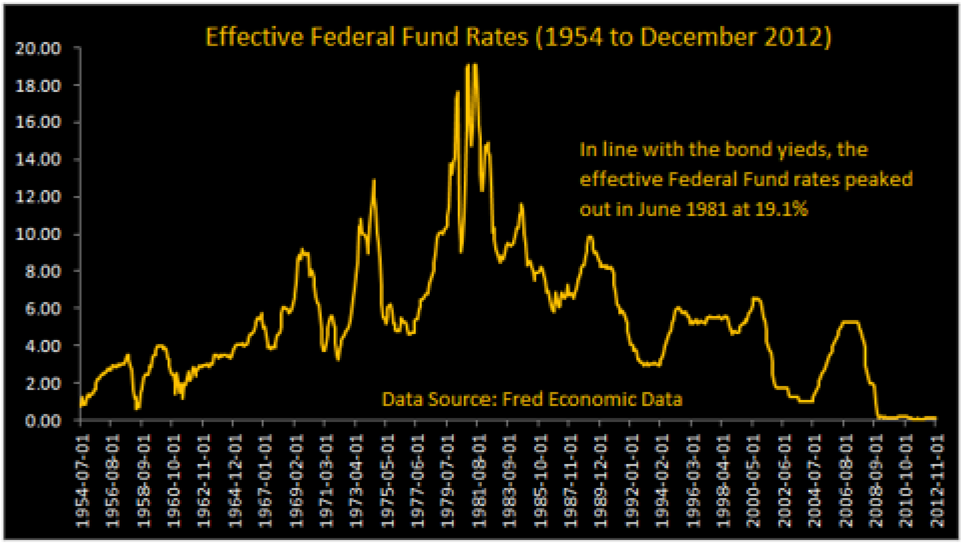
| includes: GLD, SLV, SPY, VDE

Disclosure: I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. **(More...)**

It was way back in 1981 that the 10-year Treasury bond yields peaked out at 15.8% and the effective Fed fund rates peaked out at 19.1%. Since then, the US Treasury bonds have witnessed nearly three decades of the bull market, with bond yields and Fed fund rates trending down during this period. This article discusses the reasons for believing that the long-term bull market for Treasury bonds was over in 2012. In line with this assumption, I believe that bond yields will trend higher for long term and so will interest rates in the United States.

The charts below give the 10-year Treasury bond yield from 1962 to January 2013 and the effective Fed fund rate from 1954 to December 2012.

(click to enlarge)



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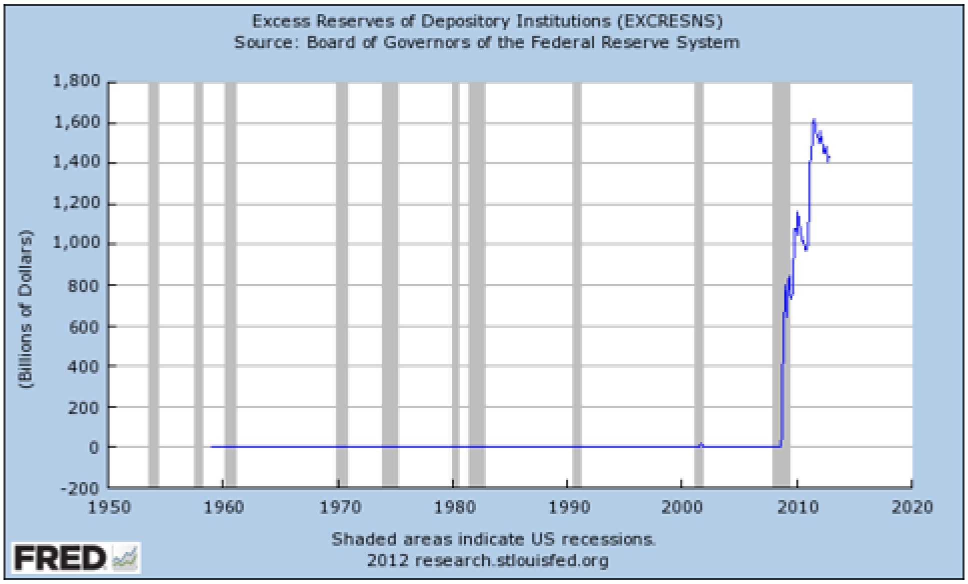
Given the current scenario, it is easy to conclude that effective Fed fund rates will trend higher along with bond yields. I would like to mention here that effective Fed fund rates just follow the short-term bond yields, and low interest rates might be more a decision of market participants than policymakers. Coming back to the point on interest rates trending higher, the timing of the reversal in bond yields is more important to determine than just concluding that bond yields will trend higher.

I am of the opinion that 10-year Treasury bond yields touched a long-term low of 1.4% in July 2012. Therefore, that point marked the end of the bull market for Treasuries and the beginning of a long-term bear market. There are several reasons for this critical conclusion, which might help investors in rebalancing their portfolios.

Investors should note the reasons for bond yields touching record lows in the last few years. On analysis, risk aversion and liquidity freeze comes in as the most important factors. Bond yields slumped during the Lehman collapse and the subsequent credit freeze leading to an economic free-fall. Bond yields also slumped in 2012 on renewed fears of global recession and a deepening crisis in the Euro zone. However, after the announcement of the sterilized unlimited bond purchase program by the ECB and the unlimited bond purchase program by the Fed, the bond yields stabilized and started to trend higher.

Currently, the global financial system and the US financial system are flooded with liquidity, and banks are in a relatively safer position than they were in 2008 or 2009. My point is proved by the fact that excess reserves of depository institutions with the Federal Reserve currently stand at $1.4 trillion. Therefore, it is difficult to make a case for another liquidity freeze in the foreseeable future.



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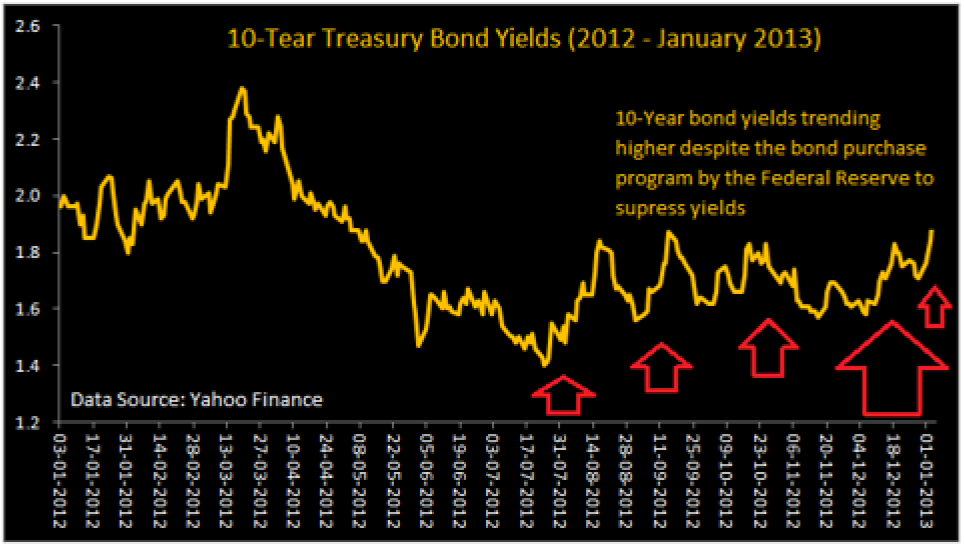
Investors might argue that the global economy is not in the best of shape and bond yields might touch 2012 lows. However, I am of the opinion that growth has bottomed out in several economies globally and might stabilize at these levels or trend higher. With the S&P 500 touching a five-year high, market participants are certainly moving more towards a "risk on" trade than "risk off" trade. My point of global economic recovery is clearly evident from the chart below, which shows an improving global manufacturing and services PMI.

NOTE: This index measures purchasing managers' perspectives of current business conditions. An index value greater than 50 indicates economic expansion from the previous month, while a value below 50 indicates contraction.

(click to enlarge)

My point related to the end of the Treasury bull market is further strengthened by the fact that bond yields have been trending higher meaningfully despite the unlimited bond purchase program by the Federal Reserve. One of the primary objectives of the purchase program is to keep yields artificially lower. However, market participants are demanding higher yields as global economic recovery does bring in relatively higher inflation. Yields on the 10-year Treasury bond have surged from a low of 1.4% in July 2012 to over 1.9% currently.



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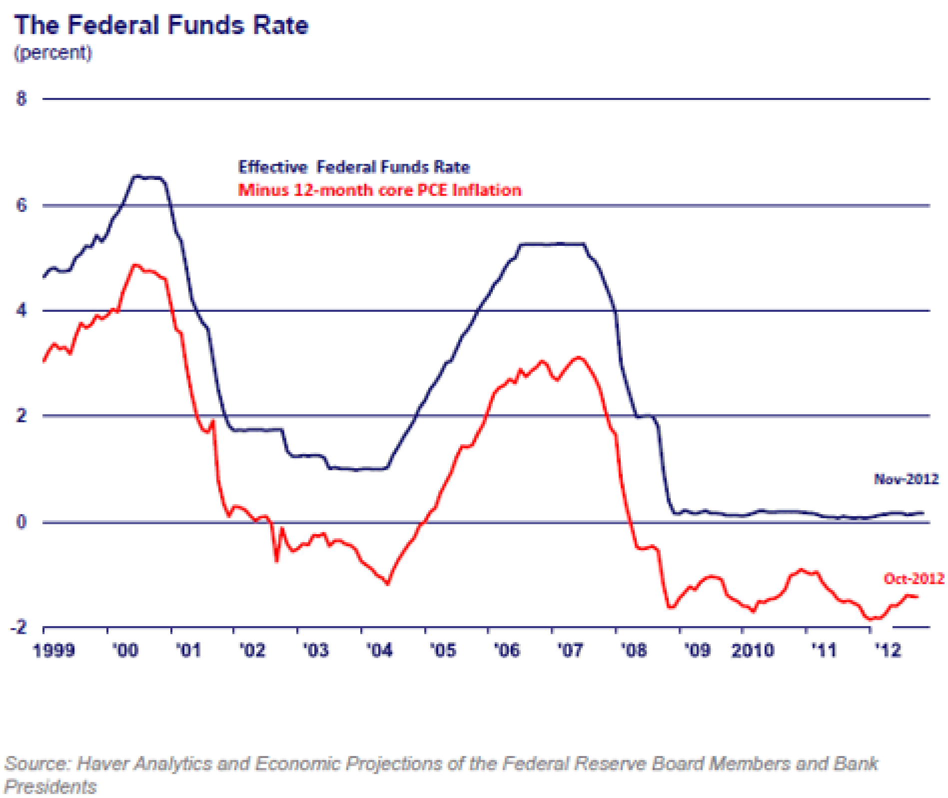
To add further to the point on inflation and returns for investors, the effective federal fund rate (adjusted for inflation) has been negative since the beginning of the recession in 2008. I do believe that real interest rates will remain negative even if interest rates trend higher over the long term. In other words, inflation might be much more rampant. As such, I would avoid longer-term Treasury bonds and prefer the short-term bonds for trading. The fear of rampant inflation might be in the mind of Fed officials when they suggested a possible end to the asset purchase program in 2013.



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Considering these factors, the Treasury bond yields have bottomed out in all probability in 2012. I don't expect yields to surge in 2013. Yields will however continue to trend higher, leading to much higher debt servicing cost to the government in the future. From the government's perspective, higher interest outgo might be offset by payment through a depreciated currency. In other words, financial repression will be a possibility in the future. In any case, inflation will be meaningfully higher, and investors will need to generate much higher returns from their investments in order to preserve their purchasing power.

With the probability of high inflation, my portfolio would include:

SPDR Gold Shares ETF (GLD) - I had discussed the reasons for being bullish on gold for 2013 and beyond in one of my earlier articles. The ETF seeks to replicate the performance, net of expenses, of the price of gold bullion. The ETF has an expense ratio of 0.4%, with net asset holdings for the fund at $74.9 billion.

iShares Silver Trust ETF (SLV) - I had discussed the long-term outlook for silver in one of my earlier articles. The ETF seeks to reflect the price of silver owned by the trust, less the trust's expenses and liabilities. The ETF has an expense ratio of 0.5%, with net asset holdings for the fund at $10.75 billion.

SPDR S&P 500 ETF (SPY): It has been proven that beating the index is not an easy task. Therefore, the strategy should be simple -- beat the index or invest in the index. From this perspective, SPY looks interesting on any meaningful correction. Further, the markets should trend higher if inflation does get rampant. The ETF provides investment results that, before expenses, generally correspond to the price and yield performance of the S&P 500 Index.

Vanguard Energy ETF (VDE): In times of inflation, investors seek refuge in hard assets. Energy as a sector will do well in times of inflation. The ETF seeks to track the performance of a benchmark index that measures the investment return of stocks in the energy sector. With a low expense ratio of 0.19%, the ETF is a good investment option in a sector, which has good upside potential in the long term.

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