What’s Next for U.S. Treasuries

Transcript

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ZIDLE: Priya, thanks for joining me. One of the surprises this year has been the strength of the Treasury markets, even after the downgrade. What’s been driving that flight to quality in Treasuries?

MISRA: Primarily through the entire year, the biggest driver for sort of the strength of the Treasury market has been the weakening growth environment. Both global growth, but I would say much larger is the U.S. growth picture. So as growth expectations have declined, Treasuries are the safest asset, and that’s where investors have flocked to. Even after the downgrade, we’ve had a very tumultuous stock market reaction. And I think that’s again helped in the improvement in the Treasury market.

ZIDLE: So could Treasury prices go higher, in other words, yields go lower from here, and if that’s the case, what does that mean for investors looking for income?

MISRA: I certainly agree that Treasury rates can go down here. I think it will all depend on the extent of risk aversion. If risk aversion in the system increases, of the concerns about recession in the U.S., or about the European banking system, Treasury rates can certainly head lower. Our fair value model for Treasury rates given growth is 2.5 percent for the 10 year. They’re already trading below that. If those concerns increase, certainly Treasury rates can decline, but I would say watch the risk-aversion index out there for the view on how low Treasury rates can get.

ZIDLE: And what do you mean by risk-aversion index? What is that?

MISRA: You know, that’s a combination of everything that creates flight to quality. If there’re concerns in the stock market, if there’re concerns about global growth, there’re concerns about European banking system, all of that creates fear. So I call it almost a fear factor. Fear factor increases, I will say Treasury rates go lower or prices increase.

ZIDLE: And recently, the Federal Reserve discussed in its minutes that they intend to keep rates on hold for a longer period, at least until 2013. So how does that play into the outlook for the medium- to long-term for treasuries, and does the Fed have any remaining tools left to influence Treasury yields from here?
MISRA: They do, certainly. In terms of the Fed, if you think about it, there are two ways that the Fed can affect longer-term Treasury rates. There's a direct effect, which we saw through QE1 and QE2. If the Fed goes out and buys longer-term Treasury securities, that has a direct effect on sort of lowering longer-term Treasury rates.

The second or the indirect effect would be that, with the Fed committing sort of to holding rates on hold for an extremely long period of time, investors search for yield and move up the yield curve. So that has a dampening effect on yields even further out the yield curve. The other aspect is, as sort of that indirect effect, would be inflation expectations. If the view is that the Fed is being sort of accommodative for too long, that can actually increase inflation expectations. And that can put an upward pressure on longer-term yields.

ZIDLE: And what about some signals that investors should be looking for? Signals that Treasury markets might be coming to an inflection point or that there might be more reason for caution?

MISRA: I would say the most important signal is growth indicators. Over the next few weeks or months, if growth continues to weaken and we look like we’re heading into a recession, Fed policy at this point will be extremely important. The Treasury market will care about whether the Fed is going to embark on QE3, which is actual asset buying. Or is the Fed going to put a cap on yields, for example? So I think the growth outlook is extremely important. Risk aversion will be extremely important, which is what’s happening in Europe, what’s happening with the U.S. stock market, because that increases the safe quality of Treasuries, or the attractiveness of Treasuries. And finally, does, and this is over the next six months, does Congress actually put a plan in place to address our longer-term budget situation?

ZIDLE: Priya, thank you very much for your insights. Be sure to speak directly with your Advisor about the ideas we discussed here and how they can best meet your own financial goals and objectives.

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