hree-Decade Treasuries Rally Is Far From Over: A. Gary Shilling
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(This is the last in a two-part series.)

By A. Gary Shilling

Dec. 13 (Bloomberg) -- The Federal Reserve usually starts to raise its federal funds rate before economic expansions are very old. This time, however, any move toward higher rates will probably have to wait until the wave of deleveraging, and the related slow growth, have ended.

Continuing annual growth in real gross domestic product of about 2 percent compares with a rate of 3.4 percent in the post-World War II years through 2007, when the recession began. Under normal circumstances, deleveraging after major financial crises takes a decade to complete; this round started in 2008, and it has four or five years to go.

Meanwhile, I believe Treasury yields are more likely to go down than up. First, persistent slow growth, gridlock in Washington, business uncertainty, and ample supplies of capacity and labor on a global scale mean the U.S. employment situation will probably remain weak.

The Fed has said it wouldn't raise its federal funds rate until the unemployment rate -- now 7 percent -- comes down to 6.5 percent. That target is becoming less meaningful, however, because the decline in joblessness has been primarily the result of a falling labor participation rate, not rising employment. If the participation rate hadn't dropped from its February 2000 peak because of the retirement of members of the baby-boom generation, discouraged job-seekers and youths who have stayed in school during the recession, the unemployment rate now would be 13 percent. As investors increasingly grasp the Fed's falling unemployment rate target, Treasury yields -- which have anticipated a rise in interest rates -- will probably continue to decline.

Inflation is close to zero and deflation is probably only being forestalled by huge fiscal and monetary stimulus efforts. But that stimulus has been replaced by fiscal drag, resulting in the shrinking federal deficit. In addition, the impending Fed tapering of its bond purchases won't tighten credit by reducing excess bank reserves, but it will reduce the monthly additions to that $2.4 trillion trove.

With inflation this close to zero, it won't take much of a hiccup to rattle the economy. And deflation is distinctly beneficial to Treasuries.

I've believed for some time that there is an unsustainable gap between investors' focus on Fed largesse and their lack of interest in limping economic performance -- a state of mind I call the "Grand Disconnect." There's been a close correlation between the rising Standard & Poor's 500 Index and the expanding balance sheet of the Fed since the central bank started flooding the economy with money in August 2008.

I've also been expecting a shock to end the Grand Disconnect and perhaps push the sluggish economy into a recession. Will the negative effects of the October government shutdown and debt-ceiling standoff, coupled with the confusion caused by the rollout of the Patient Protection and Affordable Care Act, provide that jolt? The initial Christmas retail selling season may be telling, and the risks are on the down side. I'm also focused on corporate profit, which may not hold up in the face of persistently slow sales growth, the lack of pricing power and increasing difficulty in raising profit margins.

A substantial drop in stock prices will benefit Treasuries -- not because of the economic weakness and deflation that are likely to be generated by a bear-market-generating shock, but because investors will be drawn to the securities as the ultimate haven.

Furthermore, stocks are vulnerable. The S&P 500 recently reached an all-time high, though corrected for inflation, it remains in a secular bear market that started in 2000. This reflects the slow growth since then and the falling price-earnings ratio, and it fits in with the long-term pattern.

From a long-term perspective, the price-earnings ratio on the S&P 500 is 34 percent above its long-run average of 16.5. I'm a strong believer in reversion to well-established trends, and this one goes back to 1881. Also, the ratio has been consistently above trend in the last two decades, and it probably will be below 16.5 for years to come.

Finally, stocks are vulnerable because of the elevated

level of profit margins. As a share of national income, profit recently reached a record high as U.S. business in recent years reacted to the lack of pricing power and meager sales-volume growth by cutting labor and other costs.

But productivity growth engendered by cost-cutting and other means is no longer easy to achieve. It is important to remember that neither capital nor labor has the upper hand indefinitely in a democracy, and compensation's share of national income has been compressed while profit's share has leaped. In addition, corporate earnings are vulnerable to the probable strengthening of the dollar, which would reduce the value of exports and foreign earnings by U.S. multinationals.

In my Jan. 30 column, I forecast a decline in the 30-year Treasury bond yield to 2 percent from its 3.2 percent level and said that the 10-year Treasury note yield would drop to 1 percent from 2 percent. Rates did fall until April but then rose sharply after the Fed began its tapering talk in the spring. The 30-year yield has remained at, or close to, its 3.9 percent high for the year, and the 10-year-note yield is now at 2.88 percent after reaching 2.99 percent.

My targets for this year were too optimistic, obviously. But I expect further declines in Treasury yields, and my forecasts may yet be realized. The "bond rally of a lifetime" will end someday, but it probably isn't over yet.

(Gary Shilling is a Bloomberg View columnist and president of A. Gary Shilling & Co. He is the author of "The Age of Deleveraging: Investment Strategies for a Decade of Slow Growth and Deflation." This is the last in a two-part series. Read Part 1.)

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