Treasuries Risk Shown as Fed Distorts Correlation to Stocks (2)

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(Updates projected loss in 11th paragraph, yield in 14th.)

By Cordell Eddings

Oct. 28 (Bloomberg) -- U.S. government bonds are acting more like equities than any time since before the credit crisis, making Treasuries a hidden risk to investors becalmed by the prospect of the Federal Reserve prolonging stimulus into 2014.

Ten-year Treasuries are moving 0.024 percent for every one- percent change in the Standard & Poor's 500 Index in the same direction, the first time that's happened since July 2007, based on a risk measure known as beta. Prior to this month, the gauge averaged minus 0.12 over the past decade, meaning that bonds have historically moved in the opposite direction.

Treasuries are rising along with stocks as economists say the Fed will keep suppressing borrowing costs to support the world's largest economy after a 16-day government shutdown slowed growth. While government debt was a haven as the U.S.

endured the worst recession in seven decades, primary dealers such as Barclays Plc and Goldman Sachs Group Inc. say the gains this month show the Fed's $85 billion of monthly bond purchases are masking the risk of owning fixed-income securities as the recovery in America takes hold.

"Treasuries are just not worth the risk," Thomas Higgins, the Boston-based global macro strategist at Standish Mellon Asset Management Co., which oversees $167 billion of fixed- income investments, said in a telephone interview on Oct. 23.

"The economy is certainly not going gangbusters, but the Fed will step away at some point, and that will remove one of the forces of lower yields."

Reducing Stake

Higgins said Standish Mellon has been reducing its stake in Treasuries this month and plans to keep selling as long as yields on 10-year notes, which fell to a three-month low of 2.46 percent last week, remain below 3 percent.

The gains in Treasuries in the past month, which pushed down yields on 10-year securities from the highest in two years of 3 percent on Sept. 6, upended the traditional relationship with stocks. On Oct. 16, the day U.S. lawmakers reached an agreement to end the shutdown, the beta for government debt on a total-return basis relative to the S&P 500 turned positive, based on the 26-week moving average compiled by Bloomberg.

While the shutdown restored confidence among debt investors and prompted economists in a Bloomberg survey on Oct. 17-18 to predict the Fed will keep buying $45 billion of Treasuries and

$40 billion of mortgage-backed securities each month for at least five more months to buffer the economy, the perils of lending to the U.S. have also increased in the bond market.

Unprecedented Borrowing

Since mid-2008, the amount of outstanding U.S. debt has more than doubled to an unprecedented $11.6 trillion as the government increased borrowing to finance deficits and mitigate the fallout from the financial crisis.

Potential losses due to rising yields on the longest- maturity Treasuries are now approaching the highest level since at least 1996, Bank of America Merrill Lynch indexes show.

The gauge known as duration, which calculates how much prices change when yields rise or fall, for Treasuries due in 10 years or more has climbed to 16.03, within 3.6 percent of the all-time high of 16.6 in May. The reading is about 50 percent higher than the average during the decade before the Fed began quantitative easing in 2008.

Investors buying 10-year Treasuries today face a loss of about 2 percent if yields for the notes increase to 2.8 percent by year-end, the median yield estimate from 65 forecasters in a Bloomberg survey. That would deepen this year’s losses of about

4.5 percent, based on index data compiled by Bank of America.

Annual Losses

In the past quarter-century, the debt securities have posted annual losses on just three occasions -- in 2009, 1999 and 1994 -- and returned 57 percent in the past five years.

That’s more than six times the 8.6 percent gain for the S&P 500 over the same span, data compiled by Bloomberg show.

“It’s not as easy as it was to own Treasuries,”

Christopher Sullivan, who oversees $2.2 billion as chief investment officer at United Nations Federal Credit Union in New York, said in a telephone interview. “Over the longer term there is less upside and a lot of risk to go along with that.”

Treasuries rose last week, with 10-year yields falling seven basis points, or 0.07 percentage point, to 2.51 percent, according to Bloomberg Bond Trader prices. The 10-year yield was at 2.52 percent at 6:40 a.m. in New York.

It's premature to assume that yields are bound to increase after reports last week signaled the U.S. economy still needs the Fed's support to ensure its recovery, said Jack McIntyre, a Philadelphia-based money manager at Brandywine Global Investment Management LLC, which oversees $44.5 billion.

Uncertain Landscape

Payrolls rose by 148,000 in September, versus the median forecast for an 180,000 gain by 93 economists in a Bloomberg News survey. The data indicated the economy lost momentum leading up to the government shutdown, which S&P estimates shaved at least 0.6 percent off fourth-quarter growth.

U.S. consumer confidence sank to an eight-month low in the week ended Oct. 20, while more households were pessimistic about the economy than at any time in the past year, according to the Bloomberg Consumer Comfort Index.

"The economic landscape is uncertain at best," McIntyre said in a telephone interview on Oct. 24. "There is still room for Treasury yields to move lower."

Bill Gross, the co-chief investment officer at Pacific Investment Management Co., the world's largest bond fund manager, predicts that 10-year Treasury yields will remain close to 2.5 percent. Policy makers are scheduled to meet Oct. 29-30 to consider whether to slow its bond buying.

No Tapering

The Fed "probably won't be tapering anytime soon," Gross said on Oct. 22 in a Bloomberg Radio interview from Newport Beach, California, where Pimco is based.

Price swings of Treasuries indicate most bondholders aren't anticipating a sudden jump in borrowing costs. The implied volatility for U.S. government bonds as measured by the Bank of America Merrill Lynch MOVE index has fallen 45 percent in the past month to the lowest since May, when fluctuations were the least since data began 25 years ago.

The diminished volatility is a warning to Michael Gavin, a New York-based market strategist at Barclays, because it underscores the complacency that's pervaded the debt markets as the Fed flooded the economy with cheap money.

Ten-year Treasuries are at their most expensive in four months based its so-called term premium, a valuation model used by the Fed that is calculated by using interest-rate expectations, economic growth and inflation. The gauge, which indicates a security is overvalued when its reading is below 0.4 percent, was 0.14 percent for 10-year notes.

Not Safe

"Bonds are increasingly shifting from risk relievers to securities that add more risk for investors," Gavin, whose firm is one of the 21 primary dealers of U.S. government securities that are obligated to bid at Treasury auctions, said on Oct. 21.

"The bond market isn't as safe as it was."

Yields on 10-year Treasuries will increase to 2.75 percent by year-end as the economy regains the momentum it lost because of the government shutdown, Jan Hatzius, the chief economist at New York-based Goldman Sachs, wrote in a report dated Oct. 22.

U.S. gross domestic product will increase by 2.6 percent next year, a full percentage point more than in 2013, based on a Bloomberg survey of 75 economists. By 2015, growth is projected accelerate 3 percent, which would be the fastest in a decade, the polls show.

Corporate profits for S&P 500 companies have almost doubled since 2008, and earnings in each of the next two years will increase by more than 10 percent, data compiled by Bloomberg show. That's more than twice as much as the 4.8 percent increase that analysts project for 2013.

'Better Opportunities'

Of the 244 companies in the index that have reported third- quarter results, 76 percent posted higher-than-estimated earnings, the data show. While earnings have helped fuel a 23 percent advance in the S&P 500 to a record this year, its price- earnings ratio of 16.7 is still less than the average multiple of 19.3 for the past 15 years.

"Because of the growth outlook there are opportunities that provide compensation plus a margin of safety that Treasuries do not," Jeffrey Schoenfeld, the chief investment officer at Brown Brothers Harriman & Co., which oversees $33 billion, said on Oct. 23. "There are better opportunities than Treasuries right now if you do your homework."

Schoenfeld said the New York-based company sold of all its holdings of Treasuries and is investing in financial company bonds and inflation-protected securities.

Lost Appeal

U.S. government debt has already lost some of its appeal among foreign investors. They were net sellers of Treasuries for five-straight months ended August, disposing of $133 billion in that span, last week's Treasury data showed.

The streak is the longest since 2001 as China, the largest overseas U.S. creditor, reduced its holdings to $1.268 trillion, the least since February.

The last time Treasuries moved as closely with equities was in 2007, the year before the collapse of the housing market sparked the deepest U.S. contraction since the Great Depression.

Treasuries soared and stocks plummeted the following year as the risk relationship between the two assets was restored.

With the economy recovering from the depths of that recession, Treasuries may be more vulnerable to a selloff this time.

When Fed Chairman Ben S. Bernanke signaled in May that the central bank could taper its stimulus in "the next few meetings" if the U.S. posts sustained growth, Treasuries swooned and caused yields on the 10-year notes to surge by more than a percentage point in 3 1/2 months.

"The interest-rate risk is significant for Treasuries at these low yield levels," Zach Pandl, a Minneapolis-based senior interest-rate strategist at Columbia Management Investment Advisers, which oversees $340 billion, said in a telephone interview. "It doesn't take much. We've already had a reminder of how violent things can get this year."

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