The New York Times
nytimes.com

August 3, 2003

Treasuries as Predictor and, Maybe, Shocker

By KENNETH N. GILPIN

THERE has been a huge shift in the bond market over the last six weeks.

In mid-June, yields on 10-year Treasury notes hovered just above 3 percent. By the time trading wound down on Friday, the yield was 4.4 percent.

Edward Yardeni, chief investment strategist at the Prudential Equity Group, took some time last week to chat about the implications of the rise in interest rates for the economy and the stock market. Following are excerpts from the conversation.

Q. Was there a bubble in the bond market? Have we been watching the bursting of the bubble?

A. Bonds did get dramatically overbought. But much of what has happened in the last few months probably had more to do with derivative transactions related to mortgage-backed securities.

As mortgage rates declined, prepayments increased, reducing the duration of mortgage backs. Mortgage portfolio managers with certain duration requirements then had to go out and buy Treasury bonds, which pushed rates lower. They were the most aggressive buyers in May and June.

In many ways what happened is similar to what happened in the fall of 1987, when the purchase of portfolio insurance exacerbated the slide in stock prices.

Q. What set off the sell-off in bonds that has taken place over the last six weeks?

A. The announcement from the Treasury that they would need to raise $450 billion over the course of the next year started to reverse the process.

With that announcement, the bond market realized they were going to get stuffed with a lot more bonds for the sake of reviving the economy, and more parochially, for the sake of re-electing the president.

That started to push interest rates up, and all that derivatives-related activity suddenly went into reverse.

The Federal Reserve also played a role. Alan Greenspan testified in Congress last month that some research showed that alternative methods of conducting monetary policy, like buying 10-year Treasuries to bring rates down, wasn't a good idea. That didn't help.

Q. The economy is looking a bit better and inflation is still very low. Are bonds now oversold?

A. There is a very simple way to think about the relationship between 10-year bond yields and the economy.

There is a very close correlation between the year-over-year change in nominal G.D.P. growth and 10-year bond yields.

In the 1960's and 1970's, bond yields tended to trail growth of nominal G.D.P., because inflation fears were not there. From 1980 to now, the yield has exceeded growth in nominal G.D.P. by 1.90 percentage points. But more recently there has been a tendency for the two to be nearly identical.

When I look at the 10-year now, I don't have a problem with a yield of 4 or 4.5 percent, because that is what I think the nominal growth rate in the economy is.

Q. Is the rise in interest rates likely to dampen the economic recovery?

A. Rather than seeing it as an imminent threat, I think it is a reflection that the economy is doing better. The risk is that bond yields keep going up, and push rates to levels that do threaten economic growth.

At that point we are looking at a real conundrum: the stimulative effects of deficit-financed tax cuts will be offset by higher long-term interest costs. This fiscal stimulus better work very quickly. If it doesn't, the bond market won't wait for another round of tax cuts financed by another round of deficits.

Q. Have bond yields risen to the point where bonds are more attractive than stocks?

A. With bond yields at between 4 percent and 4.5 percent, stocks still look relatively cheap.

We are not used to looking at the bond market as having a price-to-earnings ratio, but it really does.

At 4.5 percent, 1 divided by 4.5 is 22. Using forward earnings, the P/E ratio on the S.& P. 500 right now is about 18. So stocks still look like a relatively better bet.

It is possible the P-E's of both might converge around 20, which implies that the 10-year yield would get up to around 5 percent.

Q. So far, the stock market hasn't paid much attention to what is happening to interest rates. If rates went up another half a point in the next six weeks, would that create a problem?

A. Equity investors really don't pay enough attention to either the government or the corporate bond market.

At this point, the backup in bond yields confirms that we should expect a better economy. But if rates went up another half a point in the next six weeks, that would be a cause for worry, and might be too much of a shock for the economy and the stock market.