PIMCO

Viewpoints
September 2008

Thanks for the Duration, But is it Time to Say Goodbye?

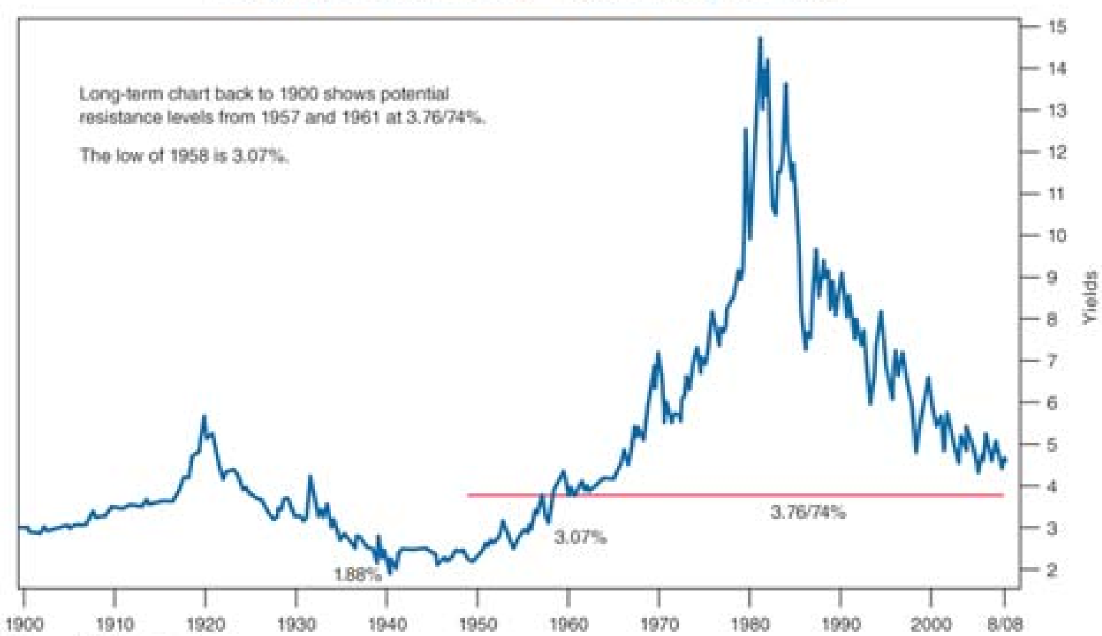
By Vineer Bhansali

Timing financial market debacles is virtually impossible, but knowing a debacle is impending is reason enough to take out "insurance" against it, particularly if the "protection" is sufficiently cheap. Taking a long-term secular view as well as a shorter-term cyclical view – the core of PIMCO's investment process – can give active managers the tools to simultaneously position for potential future crises at the same time they are dealing with an immediate crisis. Using this logic in the middle of the current credit crisis, it's plain to see that a major issue on the horizon for money managers – and one that we should be preparing for – is rising interest rates.

U.S. Treasuries: Too Expensive?

Greed and fear can drive security prices to extremes. In 2007, greed drove U.S. house prices to all-time highs and tightened credit spreads to historic levels. Now, fear has driven U.S. long-term yields to around 4%, making the cost of hedging against a bond bear market (by not buying Treasuries in the first place) inexpensive. When inflation is reading around 4%, a 4% yield on a long bond only makes sense if a depression-like abyss is looming for the U.S. economy.

Long Term U.S. Yields – 1900 to August 2008



Source: Updata, Credit Suisse

While sustained yield levels below 4% are possible, they are not probable given the risk premium that Treasuries will require in light of 1) an expanding U.S. government balance sheet, 2) an increase in the supply of government debt, and 3) historically low bond yields in the face of "in"-credible monetary policy. Long-end Treasury yields are currently very low because they've gone from pricing in credit risk to pricing in liquidity risk and now to pricing in insolvency risk, all of which are likely to be cyclical, rather than secular, phenomena. And assuming the debate over inflation risks versus deflation will end in a draw, yields can rise by an unbounded amount but can only fall to 0%. The asymmetry of the situation is stunning.

The lowest long bond yields seen in modern times were when the 10-year Japanese Government Bond hit 1% in April 2003. If U.S. long yields made a bee-line to that level they would give a whopping total return of 50%, a dream scenario for investors who bought Treasuries as a hedge against Armageddon. And even if we generously assign a 10% probability that this collapse in rates will happen, the expected value of such a hedge is a piddling 5%.

The Cost of Printing Money

With the risk tilted toward higher yields, Treasuries are unlikely to remain the ultimate hedge asset they have been, particularly in light of the limitless number of "insurance policies" the U.S. government may be willing to write. Taking a lesson from the Japanese banking crisis in the 1990s, the Federal Reserve and the Treasury will attempt to avoid a liquidity trap at all costs. Despite the "line in the sand" the government and policymakers attempted to draw by letting Lehman Brothers fail, the takeover of AIG, protections granted to money market funds, and program to buy troubled mortgage assets all suggest that the U.S. will continue to shovel money at failing financial institutions – or perhaps even drop it from a helicopter. But unlike Japan, the Treasury's bankroll does not come from net savings. It relies on the goodwill of foreign investors, taxpayers and the government's printing press, and will have consequences for holding Treasuries in a portfolio.

And the list of risks to Treasuries continues. First, the U.S. Federal Reserve is now accepting all sorts of collateral in exchange for hard cash, effectively creating a moral hazard call option for risk takers that is financed with taxpayers' and foreign investors' dollars. Second, as a net borrower, the U.S. will depend on foreigners who will increasingly become aware that their investments are being diluted. And third, the U.S. has a strong incentive to inflate its way out of its debt problems, and that is the primary reason fixed income assets could depreciate. We know that we cannot pay our debtors back in current dollars, so we will likely attempt to pay them back in cheaper, or deeply discounted, dollars.

Whose Default is it Anyway?

Corporations default by refusing to pay interest and/or principal, but sovereign nations default by inflating away their obligations. Facing a meltdown in the U.S. financial industry, the government has responded by converting private sector risk into public sector risk, simultaneously converting the credit crunch's risks into inflation risk. While the government cannot lose because it can simply print more money to meet its obligations, the holders of the government's debt can and will likely lose.

Greed/Fear Drivers For Credit Default Swaps vs. Treasuries

	Credit Spread Compression	Yield Compression
Driver	*Greed*: packaging of credit products and levering for yield	*Fear*: hedge against risk assets
Impact	Spread levels got compressed	Yield levels got compressed
Buyers	Conduits, SIVs*, money managers, hedge funds	SWFs*, central banks, retail, duration matchers
Sellers	Wall Street, hedge funds	Treasury, Fed, U.S.A.
How to Hedge Against Tail Risk	Super-senior tranches	Sell duration, bet on steepening yield curves, sell the dollar

*Structured Investment Vehicles (SIVs), Sovereign Wealth Funds (SWFs)
Source: PIMCO

In the middle of a crisis, it can be difficult to really get a handle on how expensive hedging has become. Indeed, the current market panic is being used to justify the high price of the relative safety of U.S. Treasuries. However, the ultimate value of this hedge may turn out to be no different than the failed promise of credit insurance offered by monoline insurers, albeit in a more corrosive way. At the same time, the cost of hedging against a future crisis is typically inexpensive for investors who prudently look ahead. In a world where the cost of hedging against a bear bond market is as low as it is today – and as easy as it is to achieve by simply not owning Treasuries – it may well be time to say goodbye to the duration factor.