Yellen Inherits Greenspan’s Conundrum as Long Rates Sink

By Matthew Boesler - Nov 19, 2014

Alan Greenspan couldn’t control long-term interest rates a decade ago, and bond investors are betting Janet Yellen’s luck will be no better.

When then-Federal Reserve Chairman Greenspan raised the benchmark overnight rate from 2004 to 2006, long-term borrowing costs failed to increase, thwarting his attempts to tighten credit and curb excesses that contributed to the worst financial crisis in 80 years.

“We wanted to control the federal funds rate, but ran into trouble because long-term rates did not, as they always had previously, respond to the rise in short-term rates,” Greenspan said in an interview last week. He called this a “conundrum” during congressional testimony in 2005.

The bond market is signaling that past may be prologue as Yellen’s Fed prepares to raise rates next year. The yield on the 10-year U.S. Treasury note has fallen 0.71 percentage point in 2014 even as the Fed wound down its bond-buying program and mapped out a strategy to raise the benchmark federal funds rate from near zero, where it has been since 2008.

Most Fed policy makers expect the central bank will raise the federal funds rate, which represents the cost of overnight loans among banks, some time next year, according to projections released in September.

The stakes are higher this time because rates are lower and the yield curve is flatter. Raising short-term rates in the face of stable or falling long-term rates could lead to a situation where the Fed “quickly inverts the yield curve and turns credit creation on its head,” said Tim Duy, an economics professor at the University of Oregon in Eugene and a former U.S. Treasury Department economist.

An inverted yield curve occurs when short-term securities yield more than longer-dated bonds. That discourages banks from extending credit because they finance long-term loans with short-term debt. Inverted yield curves typically precede recessions.

Duy said the Fed has few options if long rates don’t rise after increases in the federal funds rate: the Fed would have little scope to raise the benchmark further, and not much room to cut if the economy were to slump.
“I’m sort of wondering, what’s the game plan here,” Duy said.

The Fed does have one tool that Greenspan didn’t: a $4.49 trillion portfolio accumulated in three rounds of asset purchases. Selling some of those assets might provide a way to lift long-term rates if necessary, said Michael Gapen, senior U.S. economist at Barclays Plc in New York.

**Excess Savings**

The challenges Fed policy makers face today are similar to those of a decade ago.

The “global savings glut” then-Fed Governor Ben S. Bernanke highlighted as a key source of downward pressure on long-term rates in 2005 has grown even larger over the last 10 years, said George Saravelos, head of Europe FX and cross-markets strategy at Deutsche Bank AG in London.

Saravelos said Europe’s surplus in its current account, the broadest measure of trade that includes investment income, is “bigger than China’s in the 2000s” at around $400 billion per year.

“The next few years will mark the beginning of very large European purchases of foreign assets,” he wrote in an Oct. 6 report.

Economic stagnation has reduced yields in places like Germany and Japan, which will help funnel excess savings into the U.S. and prevent Treasury yields from rising, according to Roberto Perli, a partner at Cornerstone Macro LP in Washington.

The 2.32 percent yield on 10-year Treasuries compares with 0.80 percent on 10-year German Bunds and 0.50 percent on 10-year Japanese government bonds.

**Dollar Gains**

Unlike the 2004-2006 period, when the dollar was depreciating, a rising greenback in this tightening cycle will increase foreigners’ incentive to hold U.S. assets, “which just makes things worse,” Perli said.

“Investors should be mindful of global factors,” Priya Misra, rates strategist with Bank of America Merrill Lynch in New York, wrote in a note yesterday. Weakness in global growth and inflation “can prevent a significant move higher in U.S. 10-year rates,” she wrote.

Foreign investors have replaced the Fed’s purchases, which ended in October, as a major source of demand for U.S. government debt, according to Dallas Fed President Richard Fisher.

“I definitely think that has helped suppress the yield curve,” he told reporters Nov. 3.

Fisher said lack of concern about the potential for a surge in inflation is having a similar effect.

**Inflation Outlook**
A measure of the outlook for annual inflation over the five-year period that begins five years from now, derived from yields on Treasury Inflation-Protected Securities, has fallen to 2.15 percent from 2.69 percent on Dec. 31.

The decline reflects a drop in the price investors are willing to pay for protection against an unexpected jump in inflation, New York Fed President William C. Dudley said in a Nov. 13 speech.

“Many investors have a hard time seeing significant upside inflation risk, even over a 10-year period, and they’re not willing to pay up for that type of protection in portfolios,” said Zach Pandl, a Minneapolis-based interest-rate strategist at Columbia Management Investment Advisers, which oversees $340 billion.

A lack of inflationary pressure, excess savings and global stagnation have combined to reduce the compensation investors demand for unexpected changes in long-term interest rates, measured by a component of yields known as the term premium, according to a New York Fed model.

**Term Premium**

“If you want to know what moves long rates, in general it’s more term premiums than it is the path of policy,” Jeremy Stein, a Harvard economics professor and former Fed governor, said in an interview.

Forecasters are paying attention. Barclays Plc strategists said in a Nov. 13 note they cut their prediction for the 10-year Treasury yield at the end of 2015 to 2.85 percent, citing a negative term premium.

For now, policy makers are probably more worried about unintentionally causing a destabilizing surge in long-term rates, said Jonathan Wright, an economist who developed term structure models at the Fed’s Division of Monetary Affairs in 2004-2008.

**Taper Tantrum**

That’s what happened in mid-2013, when then-Chairman Bernanke triggered the so-called taper tantrum by suggesting the Fed could begin reducing asset purchases within months.

As a result, the 10-year U.S. Treasury term premium derived from the New York Fed’s model rose 1.63 percentage point over the next seven months, driving long-term rates higher.

From policy makers’ current point of view, “a rising term premium is a problem. A falling one is not,” said Wright, now a professor at Johns Hopkins University in Baltimore. That’s why “the Fed is trying to be very, very careful in laying out as much as they can an expected path of tightening.”

What’s more, the conundrum could actually work to the Fed’s advantage as it focuses on raising the federal funds rate above zero and restoring its role as the primary policy tool.
To the extent that long-term rates stay low and therefore don’t add to monetary tightening, “that allows you to put emphasis on that short-term rate and getting it off zero,” Donald Kohn, vice chairman of the Fed from 2006 to 2010, said in an interview.

**Further Action**

Still, the Fed may eventually need to take further action if the economy starts to overheat.

That’s where the central bank’s expanded balance sheet may be useful, according to Gapen, a former Fed economist.

Just as the Fed’s purchases are thought to have depressed term premiums, sales of Treasuries could reverse the downward pressure, Gapen said.

The potential to sell Treasuries “gives people confidence that if there is a serious problem, you have an additional policy tool,” he said.

To contact the reporter on this story: Matthew Boesler in New York at mboesler1@bloomberg.net

To contact the editors responsible for this story: Chris Wellisz at ewellisz@bloomberg.net Mark Rohner

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