

WHAT HAS HAPPENED TO THE THIRTY-YEAR GOVERNMENT BOND? 08.27.2007

We have had several calls from clients who closely watch the markets, wondering why recently the 30-year government bond has not acted in conformity with the 10-year government note. The spread between the two has normally (if anything is normal these days) been around 10 basis points, but is now 30 basis points. It is now 4.70% and 5.00% rather than 4.70% and 4.80%.

One is never sure why short-term markets behave as they do; however, it is obvious the pressure to sell the 30-year bond has been stronger than the desire to buy. The following are our best guesses as to the reason:

- 1. The change in market conditions occurred during a Treasury refunding. The primary dealers were loaded with inventory, which included the 30-year, just as they were having a run on the bank. Many times you have to sell what you can rather than what you want.**
- 2. There remains a large body of investors that continues to fear inflation. The recent move by the Federal Reserve board is an indication of re-inflation in their minds, no matter that they are wrong. The consensus believes that they will not want to own long-dated paper.**
- 3. Another body of investors just wants liquidity at any cost. Short-term treasuries have the greatest liquidity of any market in the world. The second best, of course, are longer government bonds. When in doubt, go with the greatest liquidity instrument.**
- 4. The carry trade is being unwound. Traders have been borrowing yen at almost zero rates, converting them to dollars, and then buying long-term government bonds. This has been a moneymaking affair for years. Recently the yen is going**

up versus the dollar, and is taking away the profitability of this formerly effective trading program.

- 5. We are sure there are others; however, the above reasons seem to be the major ones in our mind.**

What should one do under the circumstances? Just the opposite of what intuition would say. Buy more long-term government bonds! We have beaten the drum on this for 16 years. Unfortunately, when markets go against one all of a sudden, somebody else knows more than you and us; therefore, the head for the hills mentality usually prevails. Almost without question, those who have left our management have done so during periods of market weakness. Human nature never seems to change.

Please keep this in mind. The long held belief of ours concerning deflation is just around the corner. The Federal Reserve can't stop the debt liquidation that is underway; they can only stretch it out.