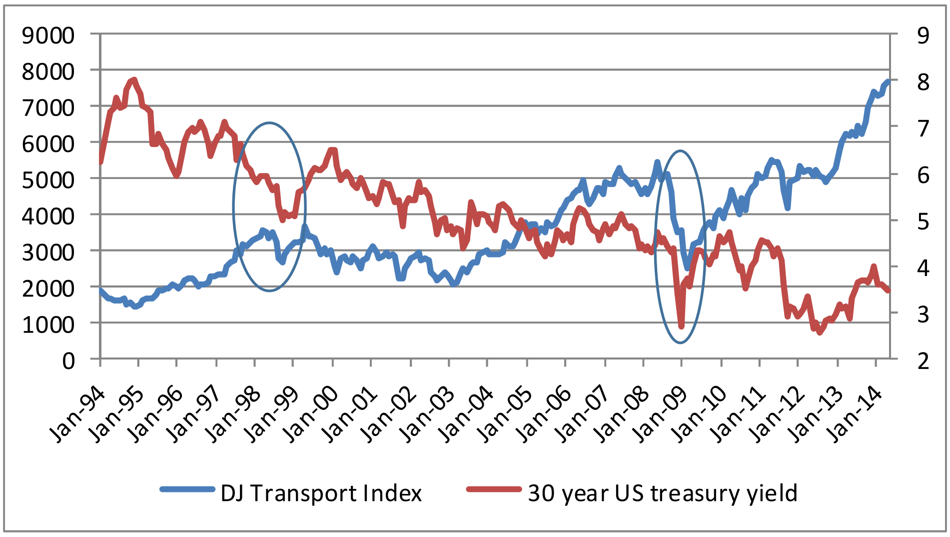
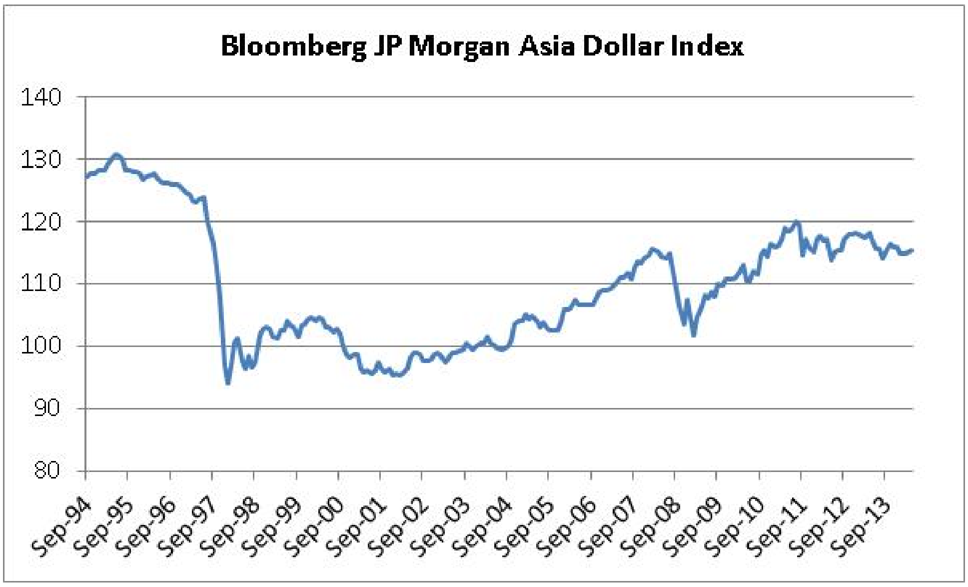
To my mind there are three possible reasons for the move in treasuries. Firstly, they are telegraphing problems in Asia. Secondly, they are signaling efforts by both Europe and Japan to weaken their currencies. Finally, they are moving due to a short squeeze caused by Fed ownership of treasuries and MBSs.

Asian Currency Weakness



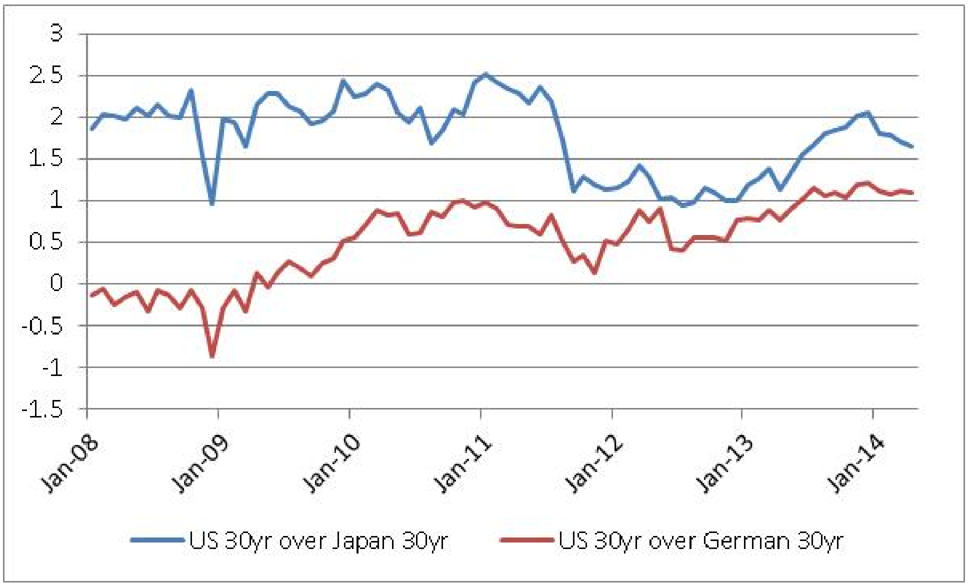
Looking at the Dow Jones Transport Index and US 30 year yields, we can see yields tend to move lower before equity markets. The period from 1996 to 1997 seems to match up most closely to current period. Both had a strong Transport Index as the US left recession, but suddenly yields began to fall even as the Transport Index hit new highs. In this case, the move in bond yields was reacting to trouble in Asia, and the deflationary consequences of the Asian Financial crisis.



The Bloomberg JP Morgan Asia Dollar Index is shown above and shows that lower Asian currencies, tend to coincide with sharp drops in US yields. In both 1997 and 2008, a fall of 2% in yields occurred. With a recent peak in US 30 years at 4%, this would imply a fall of yields to 2%. Should the recent devaluation of the Chinese Yuan continue, then such a fall seems very likely to me.

Potential Treasury Buying by the ECB and BOJ

As the Federal Reserve has moved to taper its QE program, both the Bank of Japan and the ECB have signalled their willingness to ease policy further. As yields in the US are significantly higher than in either Europe or Japan, this could cause traders to seek a carry trade where they buy US Treasuries while selling Japanese and German bonds.

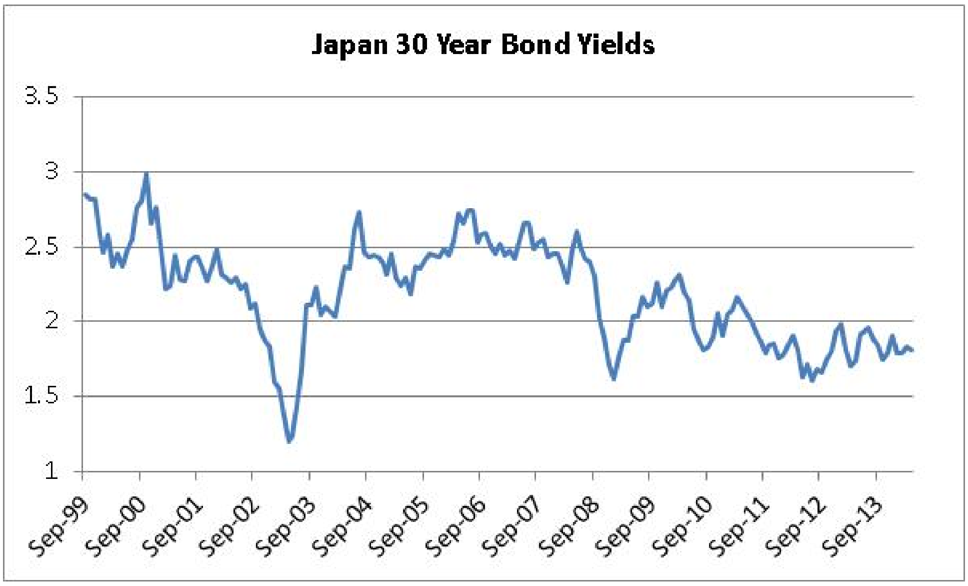


During 2008 and 2009 US treasuries traded in line with German 30 years. If they were to move to a similar level that would imply the US 30 year moving to 2.2%. From 2012 the spread of US treasuries to Japanese 30 years was 1%. That would imply a move to 2.6% at current yields.

Traders pre-empting any move by the ECB could be driving the huge increase in Belgium (home to Euroclear) holdings of treasuries.

Short Squeeze

As noted in my last note, the Federal Reserve owns 50% of all long dated bonds. This creates the potential for a short squeeze. The Japanese bond market offers the best example for this as this is a market that has consistently attracted short interest which has then squeezed higher on market shocks.



In 2002, the Japanese banking system came under severe threat of going bust, which caused bond yields to move from 2.5% to 1% before selling off. The 2008 financial crisis caused a move from 2.5% to near 1.5%. Both moves pushed yields well beyond where they had traded in the recent past. This makes me think a similar thing could happen with US bonds, and then a move below the 2012 low of 2.5% is clearly possible.

Conclusion

All three of the above situations are possible in my view. I also find it interesting that all three could occur at the same time. I think there is a good chance that we will see 30 year US treasuries yields move to below 2%.

Information

- Issue date: 30th May 2014
- Source: Bloomberg, unless otherwise stated
- Investor Relations: Alain Zakeossian, Carol Brown
- Email: info@horsemancapital.com
- Telephone: +44 (0)20 7838 7580
- Website: www.horsemancapital.com
- Business and registered address: Horseman Capital Management Limited, 9 Chester Close, London SW1X 7BE, United Kingdom. Registered in England and Wales - Company number: 04034280