

US-TREASURIES: INCREASING INTEREST RATE FLUCTUATIONS CALL FOR CAUTION

2013 has been a poor year for bonds

After years of positive annual returns, this year bonds have not produced very gratifying results for investors in most cases. For the first time since the end of the 1990s the performance of Swiss Confederation bonds, US government bonds and German federal government bonds has been negative year-to-date: the longer the maturity, the higher the losses. Compared to their historical results, the performance of medium- to long-term Swiss Confederation bonds and US Treasuries is poor as in the years 1994, 1999 and 2009. Emerging market bonds also followed this trend and suffered badly. The main reason for being a poor year for bonds is the uncertainty about the direction of the US monetary policy and the impact it will have for the appropriate level of US interest rates.

Conventional central bank policy

Until 2008 it was sufficient for the US central bank to influence the US economy by controlling short-term interest rates (Federal Funds Rate FFR). During the economic upturn, the interest rate target for the Federal Funds Rate (the interest rate at which US banks can procure liquidity on the inter-bank market to cover their reserve requirements with the Fed) was continually raised until the economic growth rates slowed down and the inflationary risks subsided. Conversely, in recessions the FFR was lowered until economic activity had recovered sufficiently.

Unconventional central bank policy

During the financial crisis, money market interest rates were cut to virtually zero. The conventional potential of monetary policy for stimulating the economy was thus exhausted. In order to stimulate the highly indebted US economy struggling with the headwind of debt reduction and to prevent deflation, some further-reaching, “unconventional” measures became necessary. From 2008 onwards the Fed therefore intervened directly in the US bond market and purchased large quantities of mortgage-backed securities and government bonds in order to lower long-term interest rates. Initially these bond purchasing programmes, which were called Quantitative Easing (QE), were limited in time. The disappointing impact on economic activity of the first two QE rounds prompted the monetary policymakers to conduct the still-ongoing QE3 without any time limit and only to scale it down when there was a sustained improvement in the situation on the labour market. In spring 2013 Fed

chairman Ben Bernanke remarked that the Fed was considering a first, cautious reduction of its bond purchases. The consequence was an abrupt increase in the interest rate on 10-year Treasuries from 1.6% at the beginning of May to almost 3.0% at the beginning of September. This led to heavy price losses on the global bond markets. However, at the end of September Ben Bernanke announced that the Fed wanted to wait a while before scaling down QE3. The market distortions that were experienced show clearly the difficulties the market operators are having in correctly interpreting the changes in the unconventional elements of US monetary policy that have been introduced since the financial crisis. It is clear that this situation is giving rise to turbulence.

Determining the plausible interest rate level

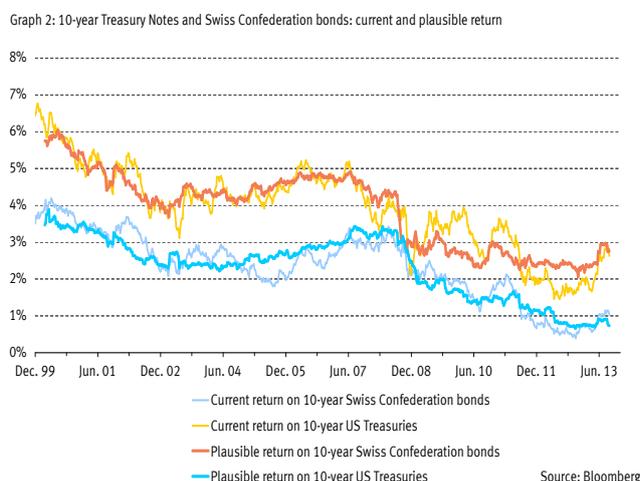
Based on a quantitative analysis, Dreyfus Banquiers have attempted to identify the main monetary policy factors that influence US long-term interest rates and to estimate their influence quantitatively. In doing so, a distinction was drawn between traditional and new unconventional factors. In our research, we subsumed the latter factors with the balance sheet total of the US central bank. We examined the extent to which US interest rates can be explained by the change in the Fed's balance sheet.

Graph 1: Balance sheet total of the Fed and the SNB (December 2006=100%)



Graph 1 shows a comparison of the balance sheet expansions of the US central bank and the SNB. They have both allowed their balance sheets to increase by more than 300% since autumn 2008. This enormous creation of money is likely to be jointly responsible for the decrease in interest rates in the

USA and Switzerland. In concrete terms, we come to the conclusion that without the impact of the balance sheet expansion the level of interest rates on 10-year Treasuries would be nearly 1.3% higher than it is now. For Switzerland, we arrive at a magnitude of approximately 1.0%. Our estimates for the USA are in line with empirical investigations conducted by the Bank for International Settlements (BIS) and the Federal Reserve Bank of Kansas City.



Graph 2 compares the current interest rates on 10-year Treasuries and Swiss Confederation bonds with the interest rates that we can derive by means of a plausibility calculation, taking into account monetary policy factors and other variables. Apparently the decrease in interest rates after 2007 in both the USA and Switzerland can be explained very well with Dreyfus Banquiers' approach. The present long-term interest rates are currently close to their plausible values.

What conclusions can be drawn from our analysis for the future trend in long-term interest rates?

1. As soon as central banks announce that they want to reduce their balance sheets, the level of interest rates is likely to rise durably.
2. But at present the emphasis is not on a reduction of the balance sheet but on a slower expansion of the balance sheet. One would only have to expect a reduction of the balance sheet from the end of 2015 onwards and only subsequently an increase in money market interest rates.
3. The bond markets' reaction shows how difficult it is for investors to interpret the current monetary policy and how great an effort the Fed has to make in communicating its intentions if it does not want to run the risk of considerable interest rate fluctuations.
4. An increase in interest rate volatility appears to be in the cards, especially for long-term bonds. When combined with the low yield on bonds, the return-risk ratio is falling compared to cash. Bonds with shorter and medium-term maturities as well as equities are likely to look more attractive when considered in relative terms. However, a reservation must be expressed here too: an increase in long-term interest rates can also have a negative effect on equities. In addition to bonds with shorter and medium-term maturities, we therefore recommend focusing attention on low-risk equities of companies with sound balance sheets and stable profitability. (See "Company quality as the key to lasting success with investments in equities", BaZ special supplement on investing, March 2013 and "More return with a lower risk: it is possible through defensive shares", BaZ special supplement on investing, November 2012).

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

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