



Letter to the Editor – The Interest Rate Debate

April 20, 2010

The following is in response to a [commentary](#) by David Rosenberg of Gluskin Sheff, published on April 12, 2010:

To the editor,

As a Treasury bond bear of modest conviction, I read with interest David Rosenberg's piece in your April 12 issue. Though providing little data to support his thesis, Rosenberg makes a solid argument for why it is inflation, not supply and demand, that drives Treasury prices and yields. In taking this position, he pits himself against, among others, Jim Grant, with whom he has been carrying on a running debate.

I wonder if, were the two arguing real yields instead of nominal, their views might not be so starkly opposite. After all, a 4% nominal yield with, for argument's sake, 1.5% deflation is a 5.5% real yield. The differences in the numbers they are arguing over can disappear quickly under an assumption of even modest deflation. That their argument would be couched in nominal rates at all seems a fairly basic error for economists of their stature. Perhaps they are in fact just having the inflation vs. deflation debate.

But, returning to Rosenberg's critique of the supply and demand argument, he seems to be assuming a closed system, specifically a US economy standing by itself. Of course, this is far from the reality. Critically, foreigners make up a sizable portion of the demand for US Treasuries. Our situation is not comparable to that of Japan's collapse, in that Japan was running a sizable trade surplus then, as it still does. That influx of funds and a high domestic savings rate permit Japan to run extraordinary government deficits, financed with debt issued at rates of interest barely above zero. With our massive trade deficit, not to mention our preference for consumption, I do not believe we will be afforded that same luxury.

In spite of Mr. Rosenberg's thesis, the question remains – who is going to absorb the expected avalanche of Treasury supply that the US government's obligations (Medicare principally) will necessitate in the coming decade(s)? And, more importantly, at what price will the marginal buyer be induced to absorb this supply? In the context of what many expect to be a rising rate environment around the globe, irrespective of what happens domestically in the US, will we not be compelled to offer higher rates to attract buyers?



Under only one specific scenario can I see us financing our mounting debt load without interest rates rising. That scenario will require domestic entities – institutional and individual – to assume the lion's share of the issuance. Current Treasury yields that Rosenberg posits will persist can stay this way if, and only if, there are no more-attractive opportunities to deploy longer-term capital. The one scenario under which I can imagine this would be the case is in a near, or outright, global depression. Maybe a closer read between the lines would reveal that this outcome is what Rosenberg is implying.

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