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The Case for Treasuries

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In this time of puny rates, corporate bonds may seem like the better bet. But economic forecaster David Levy thinks otherwise.

In these times of microscopic short-term interest rates and puny bond yields, it may seem like a no-brainer: if you are going to buy bonds, they should be corporates, and perhaps corporates with as much risk (and therefore yield) as you can tolerate.

But don't be so sure. Bond spreads are likely to work in favor of Treasuries in 2014—no matter what happens to the economy. And in these unsettled times, one should be better compensated for taking risk than the corporate market is offering.

It is obvious that under some of the darker economic scenarios, financial stress will increase and bond spreads with it, but even if the expansion remains reasonably solid, spreads are likely to widen. That's because spreads tend to bottom during each business cycle roughly when the corporate debt-to-value-added ratio turns up, and the re-expansion of spreads is overdue.

Contrary to popular belief, nonfinancial corporate sector leverage in the aggregate is higher than it was on the eve of the last recession and close to the record high reached in 2008. Adjusting for the liquid assets on corporate balance sheets does not alter the picture.

Will firms continue to increase their leverage? Using a financially oriented macroeconomic framework (the profits perspective), the Jerome Levy Forecasting Center concludes that in 2014 the prospects for continued economic expansion, increasing business investment, and increased corporate borrowing are all closely intertwined. Indeed, as long as the expansion is intact, most firms will tend to increase their capital expenditures somewhat while maintaining trend growth in dividends. Additionally, share buybacks will probably remain robust, given that equity earnings yields are still well above corporate bond yields.

The stock market rally to date may further encourage buybacks and possibly even induce some executives to increase capital spending and reach for growth as they seek to justify higher valuations. Because of all these phenomena, corporate leverage is likely to keep rising as long as the current economic expansion continues, and a sustained rise in leverage has consistently led to an increase in spreads before long.

Thus, Treasuries prices will tend to outperform corporate bond prices if economic conditions remain benign. But what if they are much better than benign? We have serious doubts about the economy managing more than a moderate pace of expansion, but if we are surprised and the economy does show considerable vigor, it will require more business spending and a more rapid increase in leverage—which will tend to accelerate the widening of spreads.

Still, will spreads widen enough to offset the differences in yields? Maybe, maybe not. But spread expansion will at least make the contest close, and the other possibilities—weakening or failing expansion—clearly favor the government's paper.

The past five years have illustrated the unsettled financial nature of this era in national and global economic history, and oversized private sector balance sheets here and around the world continue to pose risks and limit economic potential. In times of stress—whether a major crisis or time of moderate market nervousness over potential trouble—investors flock to safety, and repeatedly that has meant U.S. Treasuries. Yen holders buy JGBs, euro holders buy German bunds, and everybody seems to buy our Treasuries.

Just look at Treasuries' performance at every moment of market worry, from the financial disasters of 2008 and the free-falling 2009 economy to the various scares of the serial euro-zone crisis to the domestic showdowns over the debt ceiling. There is a relative shortage of safe assets in this financially challenged world economy, and try as we might in Washington to scare foreign investors away, when it comes to safety, those investors want dollars and want their dollars in Treasuries.

Trouble in the global economy would mean both swelling spreads and a plunge in yields, meaning sizable capital gains on Treasuries. Bloated private U.S. balance sheets (it is a common misimpression that our economy has "deleveraged" and is ready to leverage up again) limit the potential of yields to rise without sparking financial instability, which would tend to bring yields back down abruptly. Even more bloated private and public balance sheets in Europe and many emerging markets make the world precarious and vulnerable. Another global recession, probably beginning abroad, is likely in the next few years and cannot be ruled out for middle or late 2014. A significant weakening of the expansion that carries even the threat of recession will rally bonds.

Holding any bonds in the short-term requires a strong stomach and, depending on timing, may work out poorly, but if you can commit and hold for a year or longer, give Treasuries some thought.

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