Strippers Declare Inflation Dead in Zero-Coupon Bonds

By Susanne Walker, Bloomberg

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The 18-month slump in Treasury zero- coupon bonds is giving way to rising demand as the rate of inflation falls to a 40-year low, turning so-called Strips into the best performers in the U.S. government debt market.

Investment banks increased the securities -- created by separating the interest and principal payments of a bond and selling them at a discount -- by 4.4 percent to $179.4 billion from December through April, according to Treasury Department data. It's the first time that the market expanded for five straight months since 2006.

The call for Strips, which started in 1985 after former Federal Reserve Chairman Paul Volcker broke the back of inflation, suggests growing bullishness toward the bond market after the Bank of America Merrill Lynch U.S. Treasury Master Index fell 3.7 percent in 2009. Yields on Treasury Inflation- Protected Securities show money managers expect the consumer price index to increase an average 1.96 percent annually over the next decade, down from 2.43 percent as recently as April 29.

"We are in some sort of a new normal environment and inflation is not going to be a problem anytime soon," said Jeffrey Caughron, an associate partner in Oklahoma City at Baker Group Ltd., which advises community banks investing $20 billion of assets and is recommending that some clients buy zero-coupon Treasuries. "Strips would be beneficial if we go to anything close to deflation."

Falling Prices

The consumer price index dropped 0.1 percent in April, the first decrease since March 2009, figures from the Labor Department in Washington showed May 19. Excluding food and fuel, the so-called core rate was unchanged, capping the smallest 12- month gain in four decades.

Slower inflation preserves the value of fixed-interest payments, especially for longer-maturity bonds. Treasury 30-year zero-coupon bonds have returned 16.7 percent this year, including 15.2 percent in May, according to Bank of America Merrill Lynch indexes.

Strips are outperforming the rest of the $7.9 trillion market for Treasuries, the benchmark for everything from corporate bonds to mortgage rates. Government securities have returned 4.4 percent since December, including reinvested interest, the most at this point in a year since gaining 8.6 percent in 1995, according to Bank of America Merrill Lynch indexes.

Beating Stocks

They're beating the Standard & Poor's 500 Index, down 2.46 percent in 2010, and the Reuters/Jefferies CRB Index of 19 commodities, which has fallen 11.3 percent. Treasury Inflation- Protected Securities, or TIPS, developed in 1997, have also lagged behind, gaining 3.32 percent on average.

"Inflation is not a near-term concern," said Tom Girard, the New York-based head of the portfolio management and strategy in the fixed-income group of New York Life Investment Co. The insurer holds Strips among the more than $127 billion in assets under management.

Strips, short for separate trading of registered interest and principal of securities, are created by Wall Street firms that split bonds into their face amount and individual coupon payments.

The amount of Strips outstanding climbed to an eight-year high of $206.9 billion in April 2008, before falling to $171.7 billion in November 2009, according to Treasury Department figures. The decline came as credit markets recovered and concern rose that the unprecedented cash pumped into the economy by the Fed and record borrowing by the Obama administration would spark inflation.

Rebounding From Loss

The securities lost 47 percent on average last year, according to Bank of America Merrill Lynch indexes.

Demand is picking up on speculation the expanding sovereign debt crisis in Europe will slow the global economy and keep the Fed from boosting its target rate for overnight loans between banks from a range of zero to 0.25 percent. Rising rates hurt the value of Strips more than bonds because investors don't get any payments from the securities to reinvest until they mature.

The gain in Strips "tells me other fixed-income securities usually bought by pension funds probably aren't also attractive because of credit risk," said George Goncalves, the New York- based head of interest-rate strategy at primary dealer Nomura Holdings Inc. The firm pushed back its forecast last week for a Fed rate increase to June 2011.

Corporate bonds have lost 0.66 percent this month, the most since they fell 1.88 percent in February 2009, based on Bank of America Merrill Lynch indexes.

Pushing Back

Last week, Citigroup Inc. joined the growing list of bond dealers pushing back forecasts for when the central bank will start raising rates until the first half of 2011. Europe's debt crisis has led to "the threat of renewed financial instability and heightened risk aversion," Citigroup, one of the 18 primary dealers that trade directly with the Fed, said in a report.

Demand for Treasuries picked up last week. The yield on the benchmark 3.5 percent note due May 2020 fell 22 basis points to

3.24 percent as investors sought a refuge from losses in higher- risk assets, according to BGCantor Market Data. The yield touched 3.10 percent on May 21, the lowest in a year, as bond prices rose. Ten-year yields declined to 3.21 percent at 9:22 a.m. in New York.

The rally is a surprise to most of the primary dealers. At the start of 2010 they predicted investors in Treasuries would lose money again this year as the economy continued to recover and pushed the Fed closer to tightening monetary policy.

'Economic Slack'

"Even though the recovery appeared to be continuing and was expected to strengthen gradually over time, most members projected that economic slack would continue to be quite elevated for some time," according minutes of the Federal Open Market Committee's April 27-28 meeting released last week.

Officials expected inflation to remain "below rates that would be consistent in the longer run with the Federal Reserve's dual objectives" of maximum employment and stable prices, the minutes said.

Some policy makers said they were concerned about potential spillover to the U.S. from the Greek debt crisis. European officials announced an almost $1 trillion aid package and the Fed decided to open emergency currency swaps a week later.

"With the austerity measures slowing growth and taking pressure off inflation, we're seeing a drifting back into Treasuries and into Strips," said Mark Fovinci, who manages $2.8 billion for Ferguson Wellman in Portland, Oregon. "We are coming out of a recession and into recovery, which has been led by exports. The declining euro will take the edge off growth and pressure off inflation."

Dollar Strength

The dollar has strengthened 9.4 percent this year while the euro has weakened 6.6 percent, according to Bloomberg Correlation-Weighted Indexes. The euro dropped to $1.2144 on May 19, the lowest level since April 2006.

Global purchases of U.S. equities, notes and bonds totaled $140.5 billion in March, more than double economists' estimates, after net buying of $47.1 billion in February, the Treasury said May 17. Purchases of Treasuries rose by the most since June as China, the largest lender to the U.S., added to its holdings for the first time since September.

Demand for Treasuries and dollar-based assets is helping cap borrowing costs as President Barack Obama finances the economic recovery by selling record amounts of bonds to finance a budget deficit that exceeds $1 trillion. More Americans filed applications for unemployment benefits in the week ended May 15 than economists forecast, showing firings remain elevated even as employment rises.

Strips History

Strips were created after the Fed risked losing credibility as inflation reached a 14.8 percent annual rate in March 1980.

Volcker, now chairman of Obama's Economic Recovery Advisory Board, responded by raising rates as high as 20 percent even as the economy slipped into the longest post-World War II recession to win back confidence among investors. By the time Volcker stepped down from the Fed in 1987, inflation slowed to 4.3 percent and benchmark borrowing costs were 6.75 percent.

Zero-coupon securities have traditionally been most popular for investments on which taxes can be deferred, such as individual retirement accounts and pension plans, since any increase in value is accrued annually. At the same time, the known cash value at specific future dates enables savers and investors to tailor their use.

"In this post-crisis environment, it's back to basics for these pension funds," said Richard Bryant, senior vice president in fixed income at MF Global Inc. in New York, a broker of exchange-traded futures. "The increase in the amount of long Treasuries held in strip form is because of demand at these yield levels." auction on May 11.