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MARKET FACTS

A Historical Look At The Markets
September 18, 1998

The "Current" Bond to the "Old" Bond Spread

An interesting measure of bond market sentiment is the spread between the "current" or "on-the-run" long-bond (5.500% of 8/15/2028) versus the "old" bond (6.125% of 11/15/2027). This spread is currently 11 ½ basis points – the widest level since October 1995. When this spread becomes unusually wide, we believe it tells us much about the bond market.

As the attached chart shows, this spread rarely gets as wide as it is now. When it does, it is usually a period when "non-traditional" buyers have entered the bond market. These "non-traditional" buyers are usually not picky about which long-term U.S. Treasury securities they own, so they prefer the additional liquidity the "current" bond offers. This causes unusual demand for the "current" bond and its yield falls in relation to the rest of the long-bond sector. Thus the spread to the "old" bond widens.

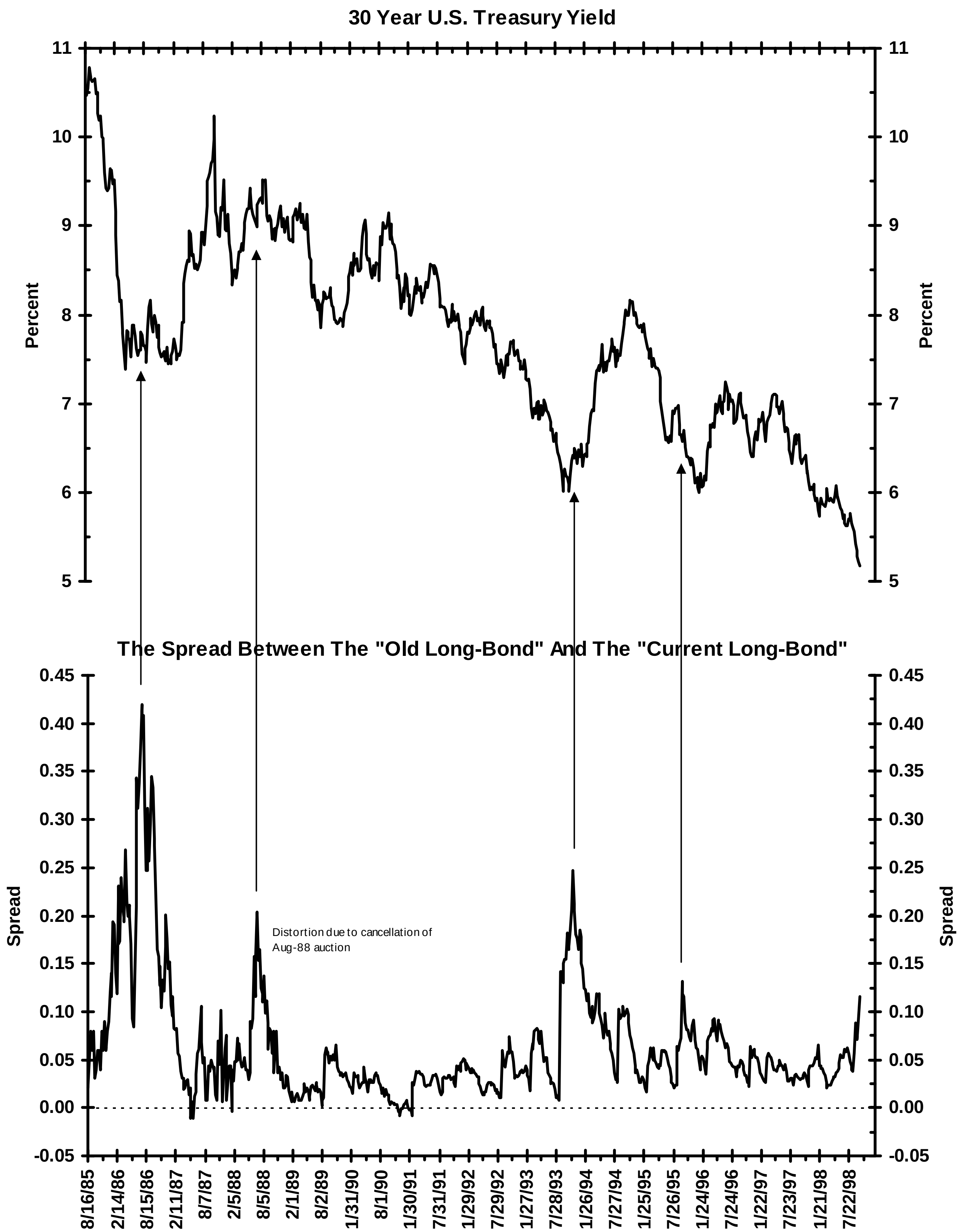
Listed below are the periods when this has happened along with the subsequent market action.

- In mid-1986 this spread widened to over 40 basis points (and nearly 100 to the "old, old" long-bond). The "non-traditional" buyers back then were the Japanese. In fact, they bought so many "current" bonds that it inverted to the 10-year note. **Yields were near cyclical lows.**
- In July/August 1988 this spread widened to over 20 basis points. Yields were not, however, near cyclical lows. The reason for this widening was more technical as the Treasury had to cancel its August 1988 long-bond auction. The Treasury had exceeded its "long-term" borrowing authority (this is different from the debt ceiling) and Congress did not renew its authority in time for the auction. A "scarcity premium" was placed on the "current" bond, which drove this spread out to such wide levels.
- In November 1993 this spread widened to 27 basis points. Back then the "non-traditional" buyers were primarily equity players betting that the recently signed deficit reduction act was bullish for bonds. **One month earlier bond yields had hit their cyclical low.**
- In October 1995 this spread reached 14 basis points. The "non-traditional" buyers were a leveraged player "pressing" their positions in an attempt to re-coup their losses from 1994. **Two months later, bond yields reached cyclical lows.**
- In the current environment the "non-traditional" buyers are seeking a "safe haven" from the world's turmoil.

Except for the cancelled auction in 1988, when this spread widened to extreme levels, bond yields were nearing cyclical lows. Too many "non-traditional" buyers push prices to extremes. This can make the market vulnerable to a sharp reversal.

This is not to suggest that the widening, or the fall in yields is done. Rather the dramatic widening of this spread typically occurs when yields are approaching cyclical lows. This low may still be many months in the future. More importantly, this spread widening suggests the nature of the current bond buyer and their motivations. ("non-traditional": prefers the additional liquidity of the "on-the-run" bond to the extra yield of the "old" bond.) The recognition that the "non-traditional" buyer is becoming a dominant force in the bond market will be important in the weeks to come.

Chart 1


30 Year U.S. Treasury Yield
Percent
11
10
9
8
7
6
5
The Spread Between The "Old Long-Bond" And The "Current Long-Bond"
Spread
0.45
0.40
0.35
0.30
0.25
0.20
0.15
0.10
0.05
0.00
-0.05
Distortion due to cancellation of
Aug-88 auction
8/16/85
2/14/86
8/15/86
2/11/87
8/7/87
2/5/88
8/5/88
2/1/89
8/2/89
1/31/90
8/1/90
1/30/91
7/31/91
1/29/92
7/29/92
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7/28/93
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