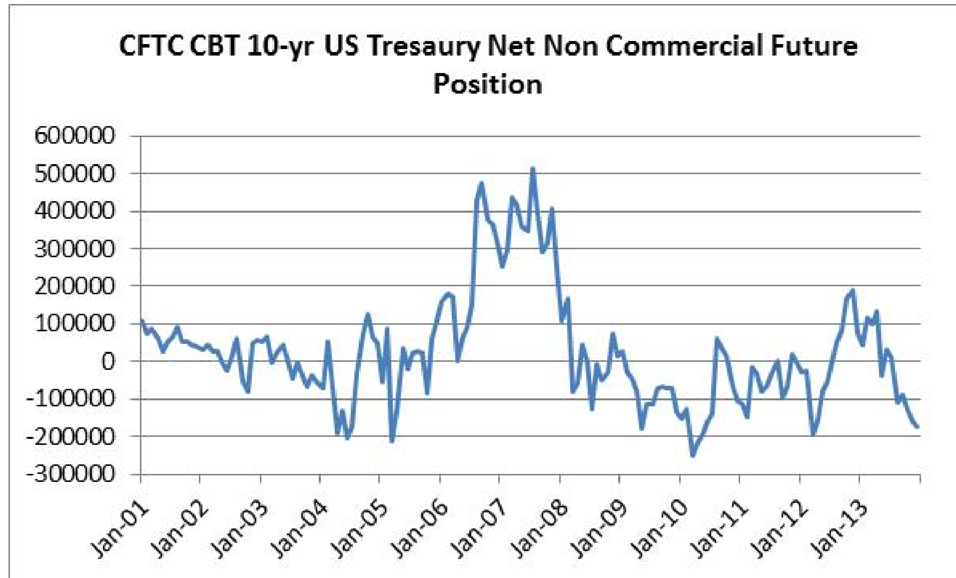
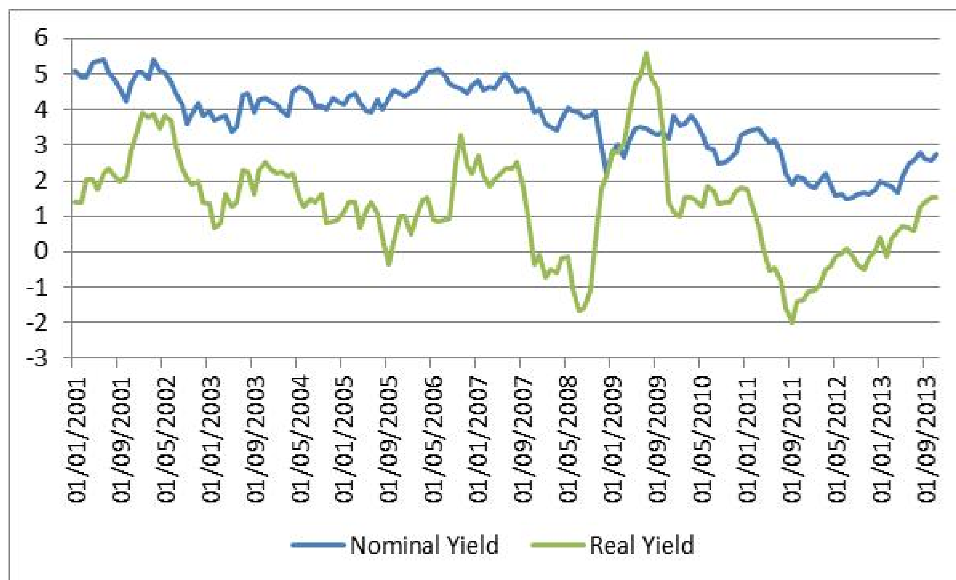
US treasuries were one of the worst performing assets last year as money moved out of bonds and into equities. With the Federal Reserve tapering its QE program, and money markets beginning to think about rate rises, the market has become very bearish on US Treasuries.



The chart above is a proxy for speculators' positions in Treasuries, showing that short positions are close to past maximum levels. This is confirmed by record short interest in the long bond ETF, TLT US.

The strange thing about the negativity on bonds is that falling inflation in the US and higher bond yields mean that investors are currently being offered the highest real yield in years.



Furthermore, US yields are trading at their widest level to both German bonds and Japanese bonds in years.

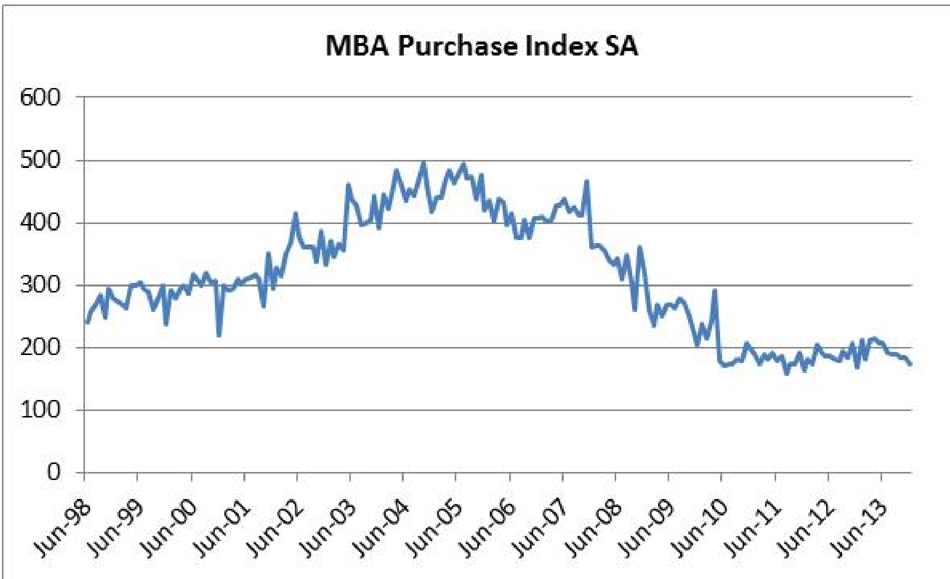
While US investors may feel that treasuries offer a poor return relative to stocks, for international fixed income investors the premium on US treasuries is very attractive – especially for Japanese investors who have a government committed to devaluing the currency but are offered negligible yields.

I also find US bonds are attractive as historically US bond yields have tended to fall, particularly when the US dollar is rising versus Asian currencies.

Given the large devaluation of the Japanese Yen over the last year, the risk of other Asian currencies devaluing is rising in my view. This would be bond bullish.

Finally, in the last two US recessions the Federal Reserve has been keen to reignite domestic demand by forcing down borrowing rates for mortgages.

While the US economy and stock market have improved, some measures of housing activity are still extremely weak, namely new mortgages for purchasing are still at recession lows.



To me this implies that the Federal Reserve would work to stop a significant rise in long bonds as this could further depress housing activity. Conversely if US growth was to slow, perhaps due to a shock elsewhere and if the Federal Reserve wanted US housing to stimulate growth it would need to push long bond rates back to at least levels seen in early 2013, roughly 2.5%. With 30 year treasuries currently yielding 4%, this would imply capital gains of around 25% from a long position.

The risk reward of being long US treasuries looks attractive to me.

Information

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- Source: Bloomberg
- Investor Relations: Alain Zakeossian, Carol Brown
- Email: info@horsemancapital.com
- Telephone: +44 (0)20 7838 7580
- Website: www.horsemancapital.com
- Business and registered address: Horseman Capital Management Limited, 9 Chester Close, London SW1X 7BE, United Kingdom. Registered in England and Wales - Company number: 04034280

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