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# Predictions of a bond market bubble are wrong

By David Rosenberg
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I find it truly amazing to see how many pundits refer to the bond market as if it is in some sort of a bubble. How can a security whose price is constantly projected to decline by the economics community be in a bubble? How can any asset class be in a bubble where the capital is guaranteed and which pays out a coupon twice a year? It makes no sense.

Of course, the retort is that retail investors have been ploughing money into bonds and bond-equivalents en masse, choosing fixed-income securities even in the face of a pronounced bear market rally in equities. What is rarely mentioned is that the median age of the 78m baby boomers is 54 and even after two bubbles bursting in less than a decade, about 30 per cent of the US household asset mix is represented by equities and real estate apiece and only six per cent is in bonds. The demographic drive towards capital preservation and income orientation and away from capital appreciation strategies looks to be a secular theme. As such that small share of the asset pie that is in bonds and equivalents is likely going to continue to expand over time.

Looking at the outlook for Treasuries, the point must be emphasised that supply alone has been an inadequate focus for predicting future prices/yields. The 30-year Treasury bond yield went from 4.7 per cent to 6.7 per cent in 1999 even though the federal budget was in surplus and new issuance non-existent, and the dramatic decline in JGB yields over the past two decades even in the face of a spectacular deficit financing binge that has left the country with a 200 per cent gross debt-to-GDP ratio. Last I saw, the 10-year JGB yield was hovering near 1.2 per cent.

The problem in trying to assess either supply or demand is that everything seems so confusing in the early stages of this new secular paradigm of a global credit collapse. There is no way to get it completely right - the contraction in household and business credit bumping the rapid expansion of public sector deficits as losses are socialised and debts from the private sector get transferred to the public sector balance sheet. The bottom line is that in all levels of society, and across most countries in the industrialised world, there is still far too much debt and debt-servicing relative to income-generating capacity. Extinguishing this debt will be deflationary even as central banks are forced into further dramatic actions to cushion the blow.

History shows that deleveraging cycles typically last as long as seven years, and we have just completed year number two - at a time when most measures of underlying inflation are less than 1 per cent.

Indeed, it makes perfect sense to assess the outlook for inflation as the primary effort in predicting Treasury rates, especially since the correlation is twice as large as for fiscal policy alone. Or perhaps instead of inflation, we should really be discussing deflation, which has emerged as the primary trend and governments have few bullets left to deal with it.

It still seems that inflation is what is on the minds of the bond-bubble enthusiasts, perhaps because practically everyone has spent his or her professional lives living with it. The double-digit inflation days of the 1970s and 1980s are still not that far removed from everyone's psyche.

Outside of wars, deflation is the norm, not the exception. The exception has been the experience of the post-second world war era. It is remarkable how so few people in the financial industry get it.

The US inflation rate peaked in 1980 at nearly 15 per cent. By the summer of 2007 it was down to 3 per cent. It fell dramatically even though the number of baby boomers exploded. The aggregate non-financial debt to GDP ratio surged from 135 per cent to 220 per cent over this period and yet the inflation rate collapsed by 12 percentage points. The reason were all classic supply-related shocks - globalisation, capital deepening, massive gains in technology, productivity, freer trade, lower marginal tax rates - which spurred the trend towards secular disinflation.

But in mid-2007, the secular credit expansion came to a thundering halt. Deleveraging is the new secular trend. Inflation is down to 2 per cent and the core rate of inflation is 90 basis points below zero. Imagine that when the oil price was at $10 a barrel back in 1998, the core inflation rate was 2.5 per cent and today at $75 a barrel the rate is below 1 per cent. The situation now is one of debt destruction, not debt expansion, and it is only a matter of time before we see prices in aggregate start to deflate.

We are not talking about 10 or 20 per cent price declines - more like 2 to 3 per cent. But enough to jeopardise the lofty earnings estimates embedded in equity market valuations, enough to thwart the progress needed to resolve our intractable deficit and debt problems, and enough to take bond yields back to their 2008 microscopic lows.

*The writer is chief economist and strategist at Gluskin Sheff & Associates*

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