GRANT'S
INTEREST RATE OBSERVER®
Vol. 29, No. 23a Two Wall Street, New York, New York 10005 • www.grantspub.com DECEMBER 2, 2011

How the bond vigilantes got fat

Failure of a German government debt auction on the Wednesday before Thanksgiving launched a thousand tweets. Ah, said the bold ones who presume to speak for Mr. Market: The vigilantes will work their will on the Germans as they have already done on the Italians, Spaniards and Greeks. Avenging creditors will restore good order to public finances of Europe.

We write to correct that interpretation as well as to offer an alternative. In fact, the record persuades us, what the "vigilantes" want isn't old-time religion but low, low funding costs. Balanced government budgets are what they are heard to demand, but quantitative easing and Operation Twist are what they actually desire. Very heaven, for the 21st-century vigilante, is a central bank-pegged bond yield overlaid on a purely nominal money market rate. Perfection itself is a central bank chief who drops broad, periodic hints (in private, of course) about the future direction of interest-rate policy, as, indeed, *The Wall Street Journal* last week revealed that Chairman Bernanke is wont to do.

This publication's expectation remains the same: the bondholders will come to rue the very things for which they now agitate. Leverage will bury the speculators. That will happen all of a sudden on a date nobody knows. Inflation will—at a more deliberate pace—lay low the investors.

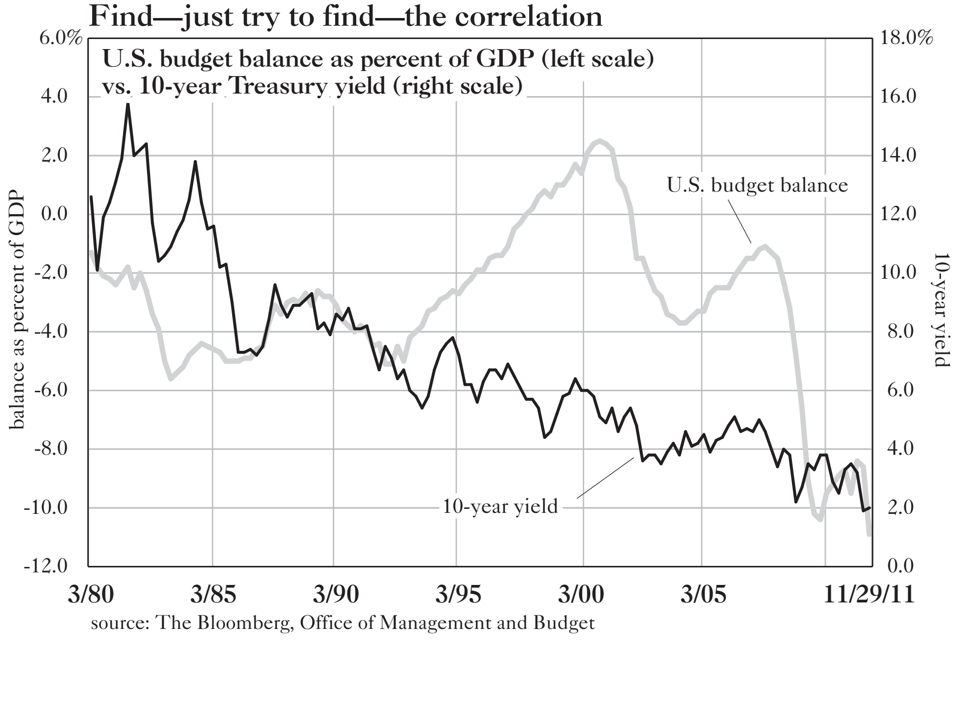
If memory serves (which it does about once every three weeks), the economist Ed Yardeni coined the phrase "bond vigilantes" in the mid-1980s. Recall, please, that the bond-holding constituency had been through the mill. Between 1946 and 1981, long-dated Treasury yields had climbed to 15% from 2.1%. To not a few investors, 6% had seemed a well-nigh irresistible rate of return; this was in the year 1969. When, 12 years later, the market reached the snow-capped summit of 15%, even the remnant of surviving bulls was gasping for breath.

Looking backwards, one can see that the bear market ended in 1981; it's an historical fact. In 1981, however, squinting forward with about 35 unhelpful years of bearish memories to try to put aside, one couldn't be sure, and the bond bulls walked on tiptoe. Who could positively warrant that a new inflation might not come along to push yields to even higher record elevations? Not even Paul Volcker himself could satisfy the doubters. It was at this juncture—call it 1985, with the long bond still yielding 11%—that the vigilantes bared their teeth.

Never again would they submit to being robbed through the agency of a great inflation, they vowed. Never again would they allow the Treasury to borrow at inflation-adjusted interest rates of less than zero. At the first sign of fiscal or monetary backsliding, they would lift real yields to heights that would stop the economy cold. The politicians, begging for mercy, would make the appropriate policy adjustments. Such was the vigilantes' creed.

Occupy Wall Street should have

Find—just try to find—the correlation



source: The Bloomberg, Office of Management and Budget been alive to see it, because the vigilantes did—briefly—have the establishment paying obeisance. James Carville, adviser to President Bill Clinton, famously quipped that, if reincarnation were possible, he would come back as the bond market, because he would then hold the whip. But time passed, yields plunged and the vigilantes forgot—or they retired on their bond bull market earnings and played golf. By early 1993, the 30-year Treasury fetched a mere 6.82%, even as the federal deficit swelled to 3.9% of GDP. Compare and contrast the year 1981, when yields were twice as high even as the deficit was just two-thirds as large. The cartoon on this page, reprinted from the issue of *Grant's* dated Jan. 29, 1993, depicts the beginning of the transformation of the one-time guardians of sound money and fiscal integrity into today's easygoing yield slurpers.

Remarkably, in the United States—impossibly from the vantage point of the original bond vigilantes—the federal budget deficit is coming in at upwards of 10% of GDP while real yields are negative. As against a 3.5% year-over-year rise in the October CPI, the 30-year U.S. Treasury bond fetches less than 3%. In the U.K., a 5% inflation rate compares to a 3.04% 30-year rate. In the wake of last week's failed German auction, 10-year gilts traded through bunds. Astoundingly, debasement-prone Britain has become a port in a monetary storm.

Of course, you will hear, there are extenuating circumstances. An historically weak currency may prove a better short-term bet than a possibly doomed currency. The risk of a debt-induced deflation is more immediate than the threat of a persistent, significant inflation, no matter what the CPI may currently read, the bond bulls say. At the kind of inflation prevailing in Switzerland, for instance—that would be minus 10 basis points—inflation-phobes would grasp at Treasurys the way Black Friday shoppers lunged for $2 Wal-Mart waffle irons.

Those who wait for the storied vigilantes of yesteryear have so far waited in vain. The fixed-income hooligans who disrupted the German auction weren't proper vigilantes, Seattle money manager Bill Fleckenstein observes. They, or their cross-channel brethren, bought gilts even as they sold bunds. "No more inflation!" cried the vigilantes of yore. "Anything but deflation!" cry the vigilantes of 2011.

Muscular monetary ease is the way to the heart of today's creditors. Thus, the Swiss National Bank's campaign to cheapen the franc against the euro has coincided not with a sell-off in Swiss government securities but with a stiff little rally.

The central bankers of Zurich made a clean breast of their intentions in September. They would, they said, permit no export-killing strength in the Swiss franc but would enforce a rate of 1.2 francs to the euro (vs. the 1.03 quoted before the intervention). In a Sept. 6 press release, the SNB said it was "aiming for a substantial and sustained weakening of the Swiss franc. . . ." It would enforce this rate, the SNB went on, "with the utmost determination and is prepared to buy foreign currency in unlimited quantities. . . . If the economic outlook and deflationary risks so require, the SNB will take further measures." In July, before the central bank promised to print enough francs to suppress the franc against the euro, the Swiss 10-year note fetched 1.36%. Today it's quoted at 0.88%.

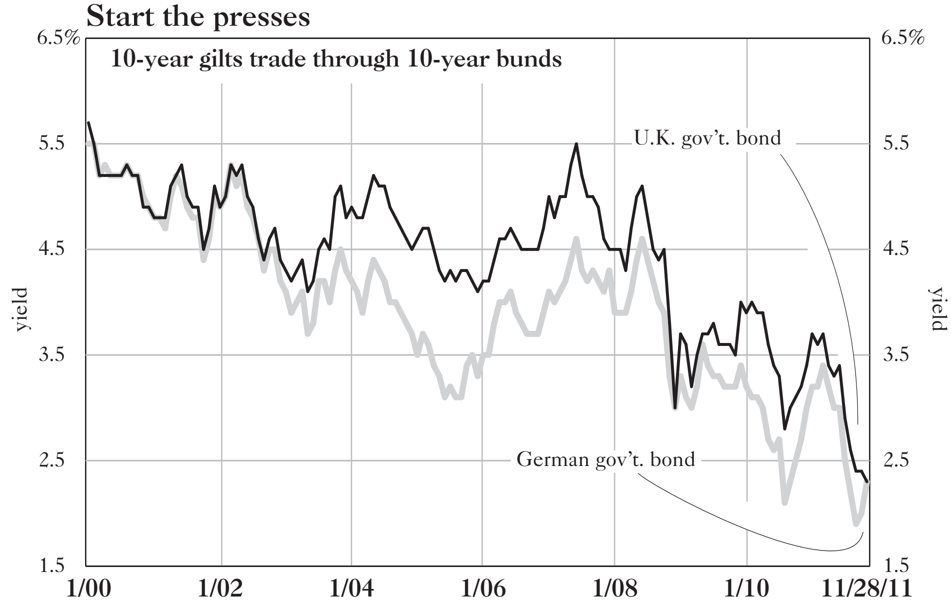
Debasement has been the one-word story line of the sterling-denominated debt markets since Britain left the gold standard in 1931. However, with the raging crisis on the Continent, the past is either forgiven or forgotten. Today's narrative is that of a central bank determined to keep deflation at bay—even in an environment of 5% inflation.

"Make no mistake," said Adam Posen, a member of the Monetary Policy Committee of the Bank of England in a Sept. 13 speech, "the right thing to do now is for the Bank of England and the other G-7 central banks to engage in further monetary stimulus. If anything, it is past time for us to do so. The economic outlook has turned out to be as grim as forecasts based on historical evidence predicted it would be, given the nature of the recession, the fiscal consolidations underway, and the simultaneity of similar problems across the western world. Sustained high inflation is not a threat in such an environment, and in fact the inflation that we have suffered due to temporary factors in the U.K. is about to peak. If we do not undertake the stimulative policy that the outlook calls for, then our economies and our people will suffer avoidable and potentially lasting damage."

So far, the gilt market is putty in the central bank's press-cranking hands. When, on March 3, 2009, the Bank of England undertook its first adventure in quantitative easing, 10-year gilts fetched 3.36% as against a year-over-year inflation rate of 2.9%. Today, four QE installments later, the 10-year is quoted at 2.23%.

Our central bankers are neither arrogant nor unaware (well, most of them). They've heard about the 1970s, even if they weren't of mon-

Start the presses



source: The Bloomberg

ey-printing age in that inflationary decade. "We have to accept," the SNB acknowledged as it vowed to print francs, "the fact that the costs associated with [the radical new policy] might be very high." And in remarks the other day, Martin Weale, another member of the Bank of England's Monetary Policy Committee, observed that gilt yields have fallen to levels not seen since the close of World War II, i.e., at the start of what proved to be a 35-year bond bear market. "Indeed," said Weale, referring to the long-dated British sovereign bonds, locally known as "stock," that impoverished a generation of British savers, "with the price of 4% Consols above par and the price of 3½% War Stock . . . only just below par, it is hard not to wonder whether these venerable stocks themselves will be casualties of our current circumstances."

What Weale is describing is what the investor Paul J. Isaac has called "return-free risk." Ground-hugging yields afford no margin of safety, yet still they tumble, rising public deficits and swelling central bank balance sheets notwithstanding. There is, of course, a notable exception to the trend to lower sovereign debt yields, and that exception is the euro zone.

To listen to the market and the politicians (all except the German ones), the simple solution is interest-rate fixing, the socialization of banking risk and QE. The old vigilantes would strain to believe it, but yesterday's sin has become today's virtue. What nearly everyone seems to think is what Tuesday's *Wall Street Journal* asserted, namely, "The European Central Bank has showed no signs of abandoning its conservative approach to buying government bonds in recent days." The truth is that the ECB appears "conservative" only in comparison to the policies implemented by the Federal Reserve, the Swiss National Bank and the Bank of England. It has, since year-end 2010, expanded its footings by 21%, to €2.4 trillion. Over the past three months, its balance sheet has grown at an annual rate of 77%. "We are aware," the new ECB president, Mario Draghi, told an audience in Frankfurt on Nov. 18, "of the current difficulties for banks due to the stress on sovereign bonds, the tightness of the funding markets and the scarcity of eligible collateral."

As of May, the ECB's list of eligible collateral comprised 28,708 securities with a value at year-end 2010 some 50% greater than the 2010 GDP of the 17-nation euro zone. Since May, the eligible list has expanded to 29,350 names. Question: Would it not be simpler to publish an ineligible list? Then, again, as noted in these pages one issue ago, each of the 17 national euro-zone banks is free to lend against any collateral it wishes. No system-wide disclosure of such so-called Emergency Liquidity Assistance operations is available, though two of the more opaque line items on the ECB balance sheet—"other claims on euro area credit institutions denominated in euros" and "other assets"—have risen by €106.3 billion to €430.6 billion since the end of last year.

Once upon a time, the Bank of Italy might have engineered a decline in Italian government yields by tightening policy. Now, to listen to the hubbub of the new vigilantes, the ECB must save the Italian bond market by creating still greater volumes of euros. Heeding its critics, President Draghi will materialize this money from the very same thin air from which Chairman Bernanke plucks dollars and Governor King conjures pounds sterling. For ourselves, we hew to the doctrine that the place in which you find real money is a mine.

•