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Fixed-income powder keg

A strange thing happened exactly 12 months ago. Running scared from the pandemic, people sold U.S. Treasurys rather than buying them. Foreign central banks led the stampede out of the world's putatively safest, most stable asset class.

Now in progress is a speculation on a new, overdue (say we) bear bond market. The risks attending suppressed interest rates, stifled interest-rate volatility, fiscal impecunity, untimely financial regulation and decades-long abuse of the reserve-currency privilege have long lain dormant. It took the bug to crystallize them.

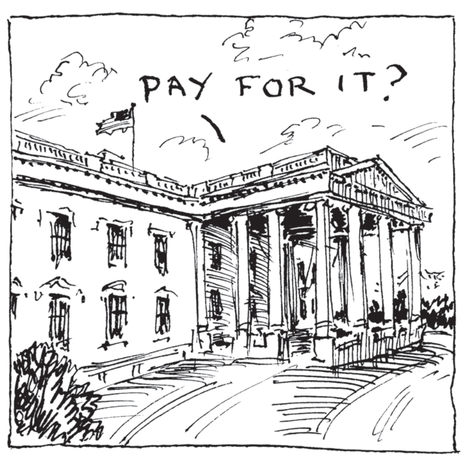
Miniature bond yields are on the road to extinction, we are about to contend. Leverage and overregulation may deliver a propulsive charge to that negative price action. Complexities abound, but the root of the problem is simplicity itself: The supply of bonds is greater than the demand for bonds at prevailing artificial interest rates.

Never before has peacetime government borrowing approached today's volumes, and not since the Treasury-Federal Reserve Accord of 1951 have the nation's monetary and fiscal functions been so intimately intertwined. Resurgent money growth, the bond market's own structural flaws, the prospect of an unscripted new inflation and investor expectations, conditioned by two generations of shrinking interest rates, complete the fixed-income tableau.

Properly, the burden of proof falls to the bond bears, and the longer-credentialed the bear, the higher his intellectual hurdle. The arguments that have served so many so well for so long start with inflation. It's the crux of the long-term interest-rate equation.

For now, as measured, it's also a no-show. In this time of technological progress and overbearing debts, how could it be otherwise, the bulls demand. The Fed's furious creation of new dollar bills sparks no inflation when those green pieces of paper go unspent.

Besides, the bond boosters say, dollar interest rates tower over most rates in most developed countries. Sooner or later, the income-starved foreigners will see what they're missing. Even without renewed overseas buying interest, dollar-denominated yields would hardly grow to the sky, because high domestic leverage effectively caps them. America's encumbered corporate balance sheets are the bond market's own "circuit breaker," says George Goncalves, founder of The Bond Strategist.



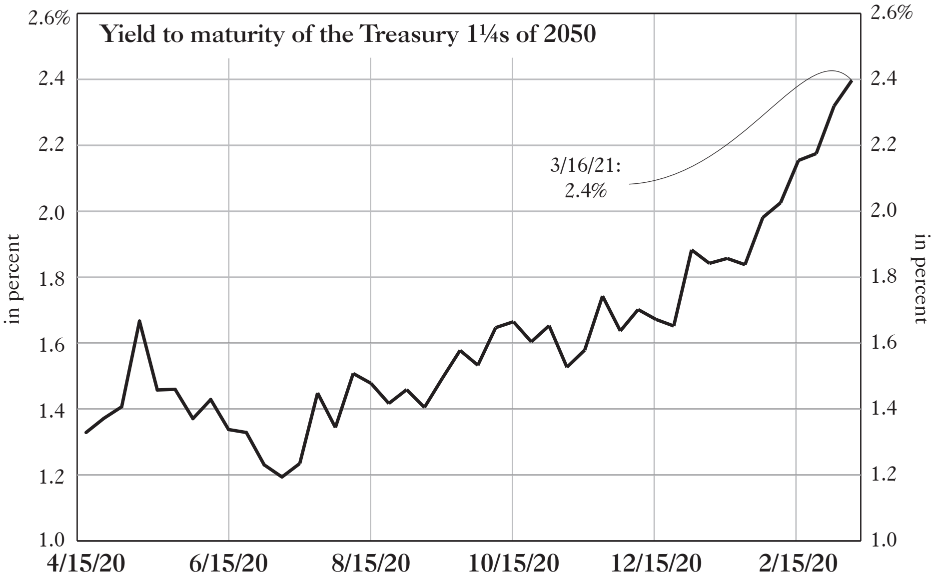
However, every bull market contains the embryo of the next bear market. Treetop bond prices (ground-scraping borrowing costs) induce people to lay on debt, chase yield and misallocate capital. Ultimately, markets crash and the Fed intervenes with still-lower interest rates. These new rates restart the same speculative processes. Observant people eventually lose confidence in the money that the Fed materializes so effortlessly.

The mighty post-1981 bond bull market derived its force and longevity from the high yields at which it began. Likewise, the new bear bond market will draw its power from the depths of the yields at which it started. Bond prices were much too low in 1981. They are much too high in 2021. They almost want to go down.

Monica Erickson, DoubleLine Capital's head of investment-grade corporate bonds, reports that the IG market this year has gotten off to its worst start since 1980. Speaking at the Fall 2020 Grant's Conference, Erickson observed that the then-current yield of 1.89% (now 2.2%) and duration of 8.4 years (now 8.2 years) promised some "very muted returns." And so it has come to pass: To date this year, LQD, the exchange-traded fund stocked with long-duration, investment-grade corporate debt, is down a fast 6.62%. It's fully half the loss inflicted in the early going of 1980, when the CPI was raging at 14%.

It's been rough going, too, in the long-duration end of the government bond market (thank you, Gary Bialis). Thus, the U.S. Treasury 1¼s of 2050 came to market on May 15, 2020 at

The high cost of low rates



source: The Bloomberg

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97.73, a price to yield 1.279%. On Tuesday, the same bonds, before completing even one full trip around the sun, changed hands at 75.88, a price to yield 2.4%—and a 22% mark-to-market loss to every original investor. Rock-bottom, central-bank-suppressed interest rates can persist—indeed, have persisted. But give them a reason to rise, and they oblige in a jiffy. No bond bear market can be sustained for long without inflation. But mispricing and oversupply can drive a powerful selling squall.

The Fed has its reasons for buying $120 billion's worth of Treasurys and mortgages every month, but not one such motive concerns valuation. Of that vital investment attribute, the central bank has stripped the market bare. In the days of hat-size interest rates, the rule of thumb was that bond yields and nominal GDP growth should align. Today's 1.6% yield on the 10-year Treasury, however, is 6 percentage points lower than the 7% real GDP growth rate that many economists envision for the fourth quarter. Bloomberg News calls it the widest such gap since 1966.

There's another valuation rule of thumb that the government securities market also flunks. It says that the 10-year note should deliver an inflation-adjusted yield of 2%. And, in fact, since 1962, that benchmark issue has returned an average real yield of about 2¼%. At today's measured rate of inflation, however, the 1.6%-yielding Treasury earns its holder a real rate of interest of just about nothing. Nor, as others have observed before us, does the official measurement of inflation always comport with the prices that consumers actually pay.

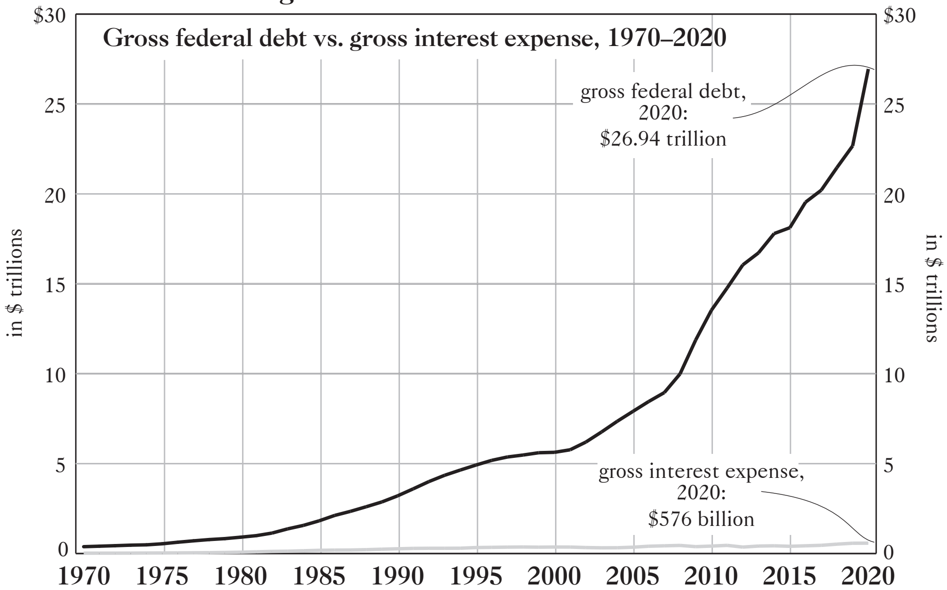
"In February," blogs the former director of global economics research at Alliance Bernstein, Joseph Carson, "BLS-reported owners' rent increased 2% over the last 12 months. House price inflation, as reported by the Federal Housing Finance Agency, increased 11.4%. That gap of over 900 basis points exceeds the 800 basis point gap recorded during the housing bubble peak."

"Imputing prices for the cost of housing services makes the CPI a hybrid index, or a cross between a price index and a cost of living index," Carson adds. "A hybrid index is not appropriate as a gauge to ascertain price stability, especially when the hypothetical measure of owners' rent accounts for 30% of the core CPI."

In America, the Fed's lawn-level borrowing costs have facilitated the runup of the gross public debt to today's $28 trillion, from the $1 trillion in the fourth quarter of 1981. During the big-borrowing Reagan years, yields halved and the public debt tripled. But the halving began, on the 30-year portion of the yield curve, at 15%, not 1¼%. In recent years, it's the Fed's vast hospitable balance sheet that's made fiscal ruination affordable.

Even so, the bonds have to go somewhere. Post-crisis regulation took the too-big-to-fail banks out of the business of trading and warehousing the public debt. The balance-sheet capacity of the primary government dealers, the bank subsidiaries that face the Fed and bid for bonds and bills in Treasury auctions, is stretched. Nonregulated

Overborrowing made affordable



sources: Office of Budget and Management, Treasury

entities—hedge funds, for instance—have stepped into the breech.

"Treasury debt held by the public (including the Federal Reserve) relative to GDP rose from 40% in 2008 to more than 110% in the second quarter of 2020," write Nellie Liang and Pat Parkinson in their excellent essay, "Enhancing Liquidity of the U.S. Treasury Market Under Stress" (available for free online).

At the same time, agency debt and corporate bonds have been increasing in line with GDP. The sum of Treasury, agency and corporate debt now equals 2 times GDP, up from about 1.4 times in 2008. In addition, corporate bonds have grown much more rapidly than bank loans to businesses. Bonds issued by nonfinancial businesses rose, in nominal terms, from $355 billion in 1980 to $6.38 trillion in 2020, while business loans from depository institutions grew more slowly, from $206 billion to $1.34 trillion, over that same period.

Last October, Randal Quarles, the Fed's vice chairman of supervision, made news by musing out loud about the incapacity of the Treasury market to absorb flyaway Treasury issuance, but Darrell Duffie, a financial economist at the Stanford University Graduate School of Business, had scooped him in June with an essay entitled "Still the World's Safe Haven?" (Also yours for the asking online.)

"The Treasury market," Duffie concludes, "appears to have outgrown the capacity of dealers to safely intermediate the market on their own balance sheets, raising questions about the future safe-haven status of U.S. Treasurys and concerns over the cost to taxpayers of financing growing federal deficits."

The pinch of normal borrowing costs provided a kind of check on government extravagance in the days of normal interest rates (say, between 4% and 5%). A dollar convertible into gold on demand by foreign public creditors represented an earlier impediment to overdoing it. Perhaps more important than even those financial guardrails (the latter now 50 years in the rear-view mirror) was an old-fashioned sense that the integrity of the public credit was deserving, at least, of lip service. What has succeeded this broadly diffused rhetorical conservatism is today's bipartisan embrace of a crude form of Modern Monetary Theory.

And while it can't be said that Paul Volcker's three immediate predecessors at the Federal Reserve succeeded in containing, let alone preventing, the Great Inflation of the 1970s, William McChesney Martin, Arthur Burns and G. William Miller at least didn't root it on. Perhaps Jerome Powell or his successors will rise to the occasion if the CPI escapes from the statistical cage that modern economics have built to contain it, but that critical work will be no easier for the many years the Fed has spent trying to talk inflation higher.

"I don't think it's a significant risk," said the Treasury Secretary, and former Fed chair, Janet Yellen, referring to inflation, in an appearance on ABC's "This Week" on Sunday. "And if it materializes, we will certainly monitor for it, but we have tools to address it." Will the Fed prove as aggressive a seller of Treasurys, should that prove necessary, as it has been a buyer? The answer perhaps has less to do with "the tools" than with the will.

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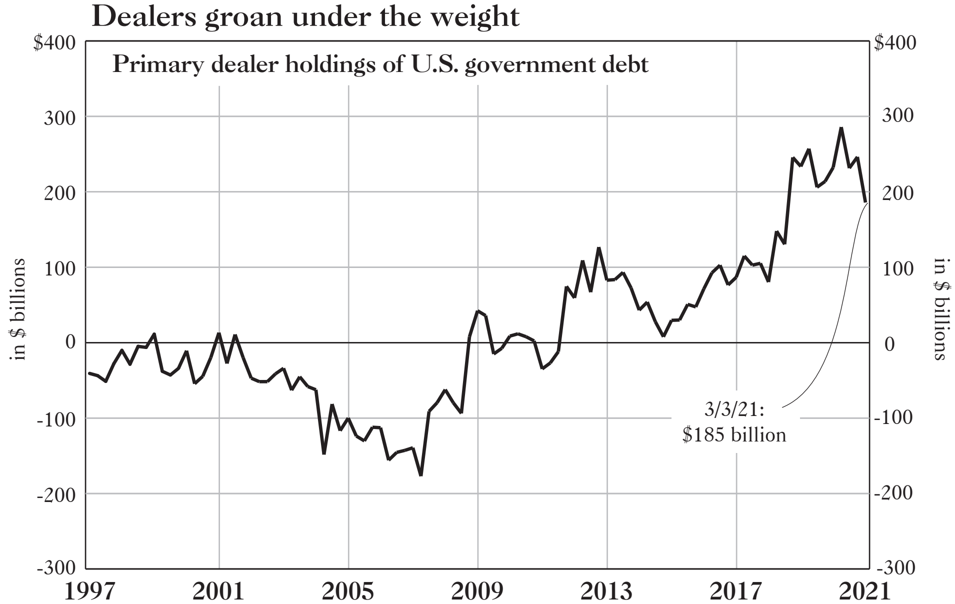
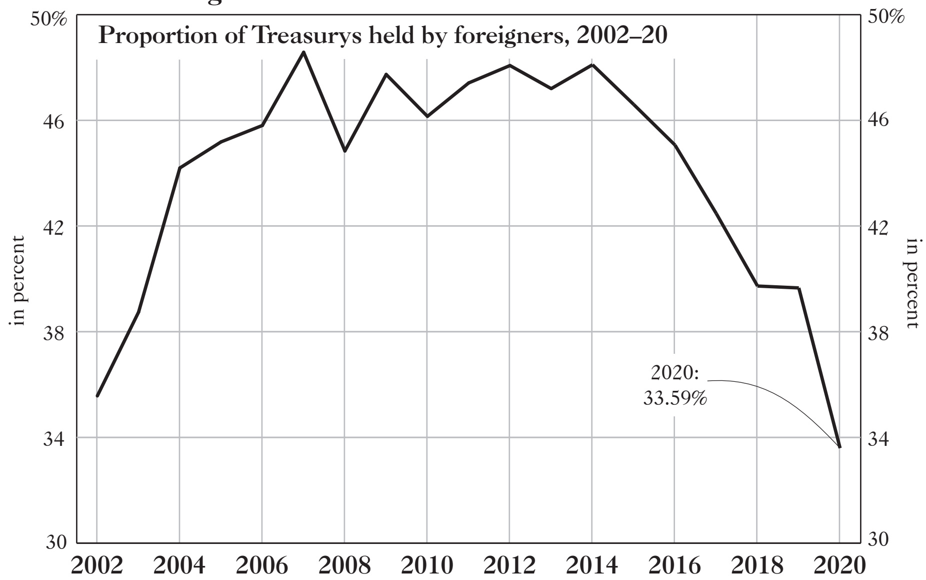
Dealers groan under the weight



source: The Bloomberg

The foreign bid fades



source: SIFMA, Treasury International Capital

We all have our opinions about inflation and the politics of public borrowing. The investor is on firmer ground in observing that today's bond market is uniquely vulnerable to rising yields. Relentless supply, inadequate private warehousing capacity and a highly leveraged investor base are among the top risks. There are others.

In March 2020, according to Federal Reserve Governor Lael Brainard, foreign institutions dumped some $400 billion's worth of U.S. government securities on a market that truly didn't want them. Perhaps rising dollar interest rates will send the income-starved foreigners running back to America, but overseas holdings of Treasurys, as a share of total Treasurys outstanding, have been dwindling since 2015. In the first quarter of 2019, the Treasury's Office of Debt Management pointed out, the dollar's share of worldwide foreign-exchange reserves, then 62%, had peaked at 72% in 2000. This publication can think of better things to do with $60,000 than to buy a bitcoin, but the crypto bulls can read the money-supply statistics, too (that is, such statistics as the Fed chooses to continue to publish—see pages 6 and 7).

Intrusive post-2009 financial regulation presents another potential source of fixed-income turmoil. Slamming shut the barn door of the Great Financial Crisis, regulators and legislators commanded the guilty bankers of 2008 to lay in hundreds of billions of dollars of idle balances to satisfy a new "supplementary leverage ratio."

Suffice it to say that, pre-crisis, regulations treated Treasurys and deposits at the local Federal Reserve Bank as if they were risk-free, but post-crisis reforms reversed course. The new rule required that reserves be posted against even these formerly unimpeachable assets. Then came the Covid panic and still another rethink, this one concluding with the exemption of Treasurys and Fed deposits from SLR reserve requirements. If you are still with us, the regulators must decide by April 1 whether to extend this exemption or to revert to the more stringent and contractionary pre-Covid rules. Betting is that the regulatory authorities will order the extension—the bond market needs the balance-sheet capacity.

The convergence of big deficits with taut regulation has made for recurrent bouts of disorderly price action. "The seven-year [Treasury] auction size is 220% from where it was in 2018," Ryan Hall, a rates trader at Capital Group, tells *Grant's*. "We went from $28 billion a month to $62 billion a month." In effect, adds Hall, "We've doubled the flood and halved the size of the bucket to bail it with."

No small part of Hall's bucket are the aforementioned primary government-bond dealers. The graph plots dealers' surging inventories. They look big, and they are big, except in relation to the booming growth of the marketable public debt. "At the same time," again to borrow from the paper by Liang and Parkinson,

> the share of Treasury securities held by funds that are reliant on the ability to quickly sell Treasurys for liquidity has risen. In 2019, open-end mutual funds held 12% of Treasury securities outstanding, and hedge funds held 9%, indicating a greater risk of a surge in liquidity demand in stress periods. In addition, the increase in trading by proprietary trading funds (PTFs) may make the Treasury markets more vulnerable to a sharp pullback in market liquidity in times of stress, even though market liquidity is ample in normal periods. PTFs now account for nearly half of the daily volume in the inter-dealer market on typical days.

The atypical days are the problem, Liang and Parkinson add. Hedge funds provide liquidity when the sun shines but withdraw in heavy weather. More and more, the Fed is the indispensable fiscal presence. Its bond bid is large and unconditional.

There are lots of ideas for improving the structure of the Treasury market. Reform-minded scholars—they include Duffie, Parkinson and Liang (the last-named being President Joe Biden's nominee to serve as Under Secretary of the Treasury for Domestic Finance)—suggest a standing Fed repo facility to assure market liquidity and a centralized clearing system to economize on the capital now absorbed by warehousing homeless Treasury securities.

But such proposals are in the early discussion phase, so the market in place is the market we have. And not a true market at that, but an administered one, repressed with respect to price and volatility alike.

A like-minded friend describes the troublesome consequences of this arrangement:

> When you suppress one market artificially, as they have the rate market, the volatility that is normally expressed there—wants to be expressed there—goes somewhere else. It can go into currencies and go into equities and go into commodities. But it's unnatural to have that kind of suppression in a market that wants to move naturally, fundamentally, in one direction. And so, something's going to happen. Even if they put yield-curve control in place and they keep the 10-year well below 2% or 2.5%, which are long-term, normal levels, it's un-

natural. And given the size of the [Treasury] issuance now and the disproportionate size of the Fed balance sheet relative to the private market, something is going to break. It may not be the Treasury market, but one of these markets is going to have a problem because the volatility needs to be released.

On the agenda, then, is a bear market in something or other. Bonds are the likely target, we say, with repercussions, both bearish and bullish, to ripple far and wide.

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