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Featured G

Treasury Bond Bubble?

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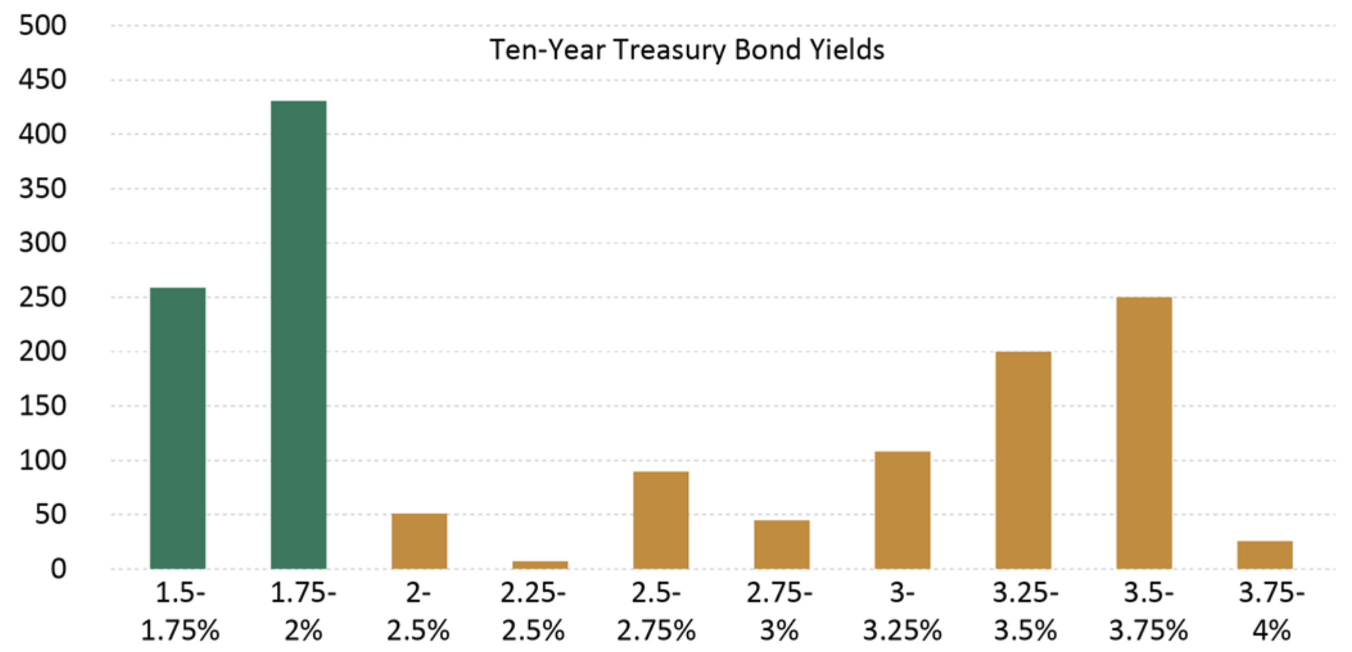
Are long-term U.S. Treasury bond prices in a bubble? Probably not. However, there are a few things to worry about.

There have been several attempts during the last nine years to breach the 2.5% level on the 30-year Treasury yield beginning with the crisis in December 2008. None have succeeded on a sustainable basis. The most recent attempt was June 2016 when the yield almost touched 2%, arguably triggered by the Brexit surprise, before rebounding strongly to 3.2% by December. In spite of this trend, there has been a well-documented, large, and sustained shift into bond funds and out of equity funds ever since the Global Financial Crisis (GFC).

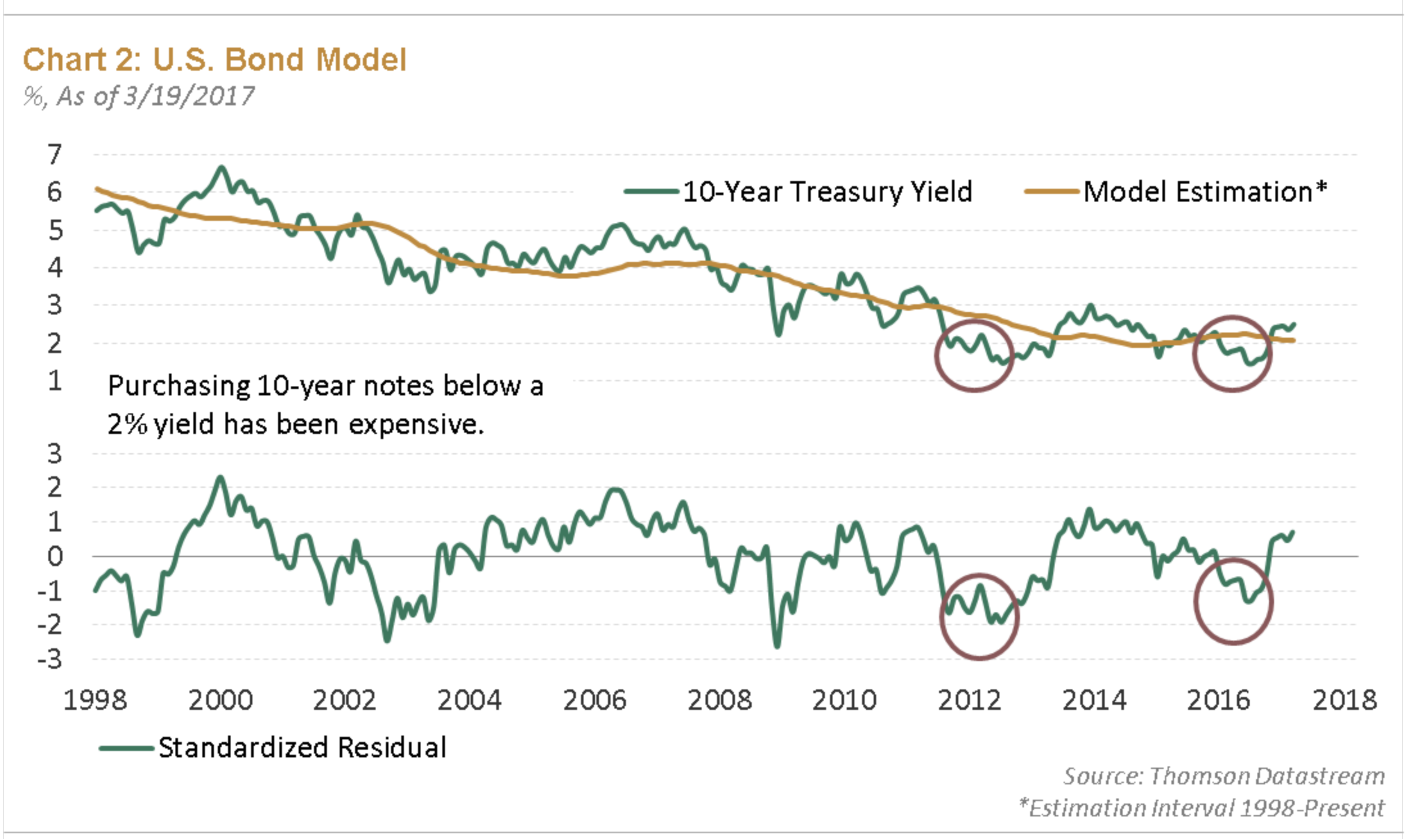
Recent research from Mike Goldstein at Empirical Research Partners suggests that almost half the inflows into U.S. bond funds, including taxable bond mutual funds and ETFs, since the GFC have taken place when the yield on 10-year Treasury notes was 2% or less (see Chart 1).[1]

Chart 1: Bond Mutual Funds and ETFs Net Flows By Ten-Year Treasury Bond Yields
(In USD Billions), 1/1/2009 - 1/31/2017



Source: Investment Company Institute, Federal Reserve Board, Empirical Research Partners Analysis

Our own valuation work suggests that any bond purchases that occurred when the 10-year Treasury yield was below 2% were at a substantial premium to intrinsic value (see Chart 2). More generally, Treasury yields across the curve remain depressed relative to nominal gross domestic product (GDP) growth, itself depressed relative to levels that existed before the crisis.



So are bond prices in a "bubble?" It is a term that gets tossed around a lot. One of the more serious original works on asset bubbles, in my opinion, was produced by Charles Kindleberger in his famous book, Manias, Panics and Crashes.[2]

Kindleberger deconstructed the anatomy of a financial crisis, concluding that financial crises were almost always tied to the implosion of an asset bubble or a non-sustainable pattern of price change in an asset. The reason is the tendency for financial institutions to collateralize the creation of credit fueling the asset bubble against the object of speculation itself. When the asset boom turns to a bust, the fallout in the financial system wreaks havoc on Wall Street and Main Street alike. Think real estate in 2008, tech stocks in 2000, the Nikkei in 1989, gold and inflation assets in the late 1970s, and the "go-go" stocks of the 1960s.

He believed that there were two other factors behind every asset bubble, in addition to an excess creation of credit. The first is some kind of displacement or positive event which captures the imagination of the investing public and creates a kind of new-era thinking. The second factor is that the public needs to be able to participate in the opportunity on a massive scale. Truly manic investment trends were created by this potent brew of euphoria, upbeat sense of investment opportunity, new-era thinking, easy public participation, and excess credit. Market tops take time to form partly because most investors get in at the top. When the bust comes, often due to stringent monetary policy, asset prices can fall by 90%.

Based on Kindleberger's research, the Treasury market is NOT a classic investment bubble.

- **First, investors buy bonds out of fear, not euphoria, and see them as a shelter from risk. They are viewed as a hedge against uncertainty of which there has been plenty over the last nine years. Calling this trend of bond buying a euphoric mania is an oxymoron. Instead, it has been a bull market in fear. Even the boom in corporate debt issuance has been a reflection of pessimism. Most of the debt has been issued to retire corporate equity. Firms that cannot find investment opportunities or do not have confidence see retiring equity as a better return on assets. The latter has been the main source of equity demand throughout the post-crisis period.**
- **Second, there has been no credit tailwind. The defining development contributing to the "sub-normal new normal" of the last nine years has been household deleveraging. U.S. commercial banks have found it difficult to create credit.**
- **Lastly, the valuation anomalies in the bond market over the last several years are not out of the norm**

relative to previous deviations from intrinsic value—the latter driven primarily by the long-term trend in inflation. This pattern contrasts with classic asset bubbles where the price distortions are massive.

Unlike most investment bubbles, stringent monetary policy in this instance would probably strengthen the bond market more than hurt it, at least in the medium term.

Hence, Treasury bonds are NOT a classic asset bubble. Nonetheless, there are still plenty of danger signs of the sort that Kindleberger warned about.

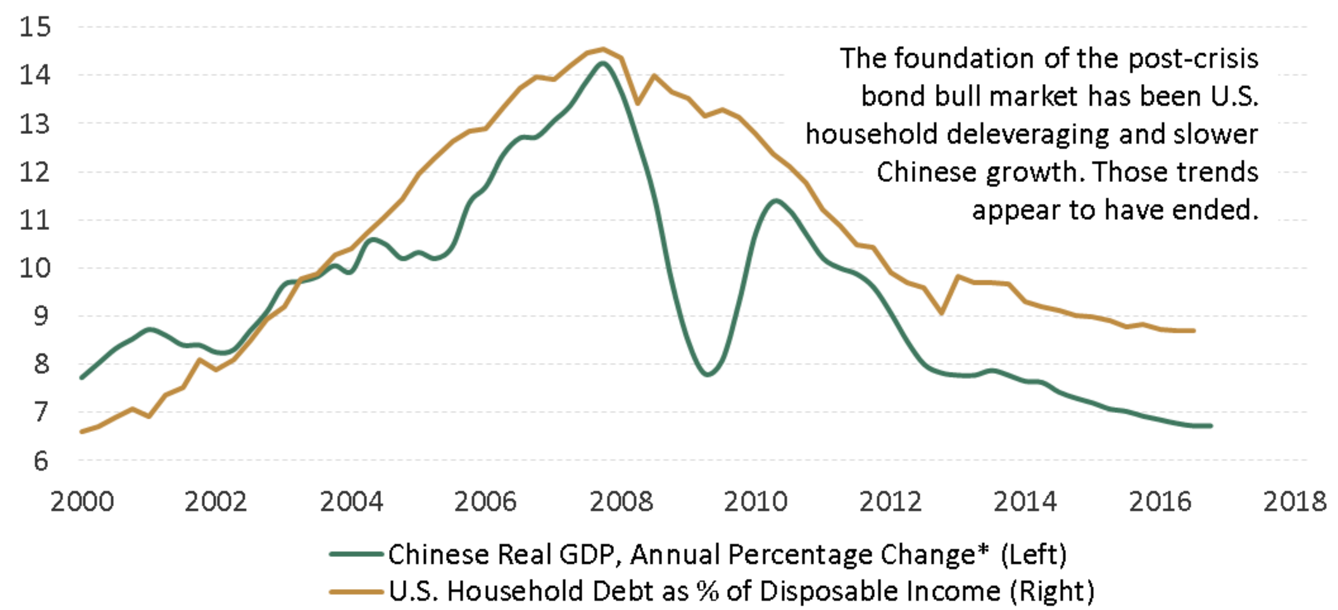
- The rally in Treasuries has accommodated mass participation from the public via bond funds and ETFs, direct holdings, as well as holdings of bond-like equity surrogates. This allocation has been encouraged by the authorities. Monetary unorthodoxy and the emergence of zero and negative policy rates, for example, have forced investors looking for return to move out along the curve of duration risk.
- There has been lots of new-era thinking; it has just been the depressing kind. The so-called "secular stagnation" thesis promoted by Larry Summers has emerged as a popular explanation for the sub-normal new normal of the past nine years. According to this theory, low yields will remain hostage to the gloom of poor demographics, lousy productivity, and a structural decline in aggregate demand around the world, and the policy elites of the world appear to have embraced this thinking.
- Lastly, regulators have imposed more stringent risk limits and restrictions on banks, resulting in a feedback loop into Treasuries. Commercial banks' purchases of bonds are clearly part of the bond bull market, even though they have not provided a self-reinforcing tailwind of credit-financed bond purchases.

The warning signs are important because many of the elements which we think have supported the market over the last nine years are ending or beginning to turn.

Household deleveraging in the U.S. has come to a halt. Similarly, Chinese economic growth has stopped falling (see Chart 3). Just as "secular stagnation" goes mainstream, the factors responsible for some of its symptoms have ended at least for the time being. Correspondingly, the world economy is stabilizing. In the U.S., wage inflation is slowly on the rise as the labor market tightens. The last time average hourly earnings reached current levels was 2009, prior to which wages were significantly higher.

Chart 3: Behind the Bond Bull Market

As of 12/31/2016



Source: Thomson Datastream

**Shown as a 4-quarter moving average*

In addition, macroeconomic policy around the world remains very expansionary—despite signs of stabilization—because the concept of secular stagnation has become mainstream. The Federal Reserve (Fed) is tip-toeing toward normalization, its confidence undermined by nine years of overly optimistic economic projections, while its beliefs are anchored in the faith that inflation will not rise sustainably past 2%. In Europe and Japan, the focus of policy is to create inflation.

And finally, Trump won the presidency partly on a mandate to end the economic "malaise" that has supported the bond market for the past nine years. He campaigned on a platform of aggressive tax cuts/reform and deregulation aimed at beefing up U.S. economic growth and productivity. The administration also wants to recalibrate America's approach to trade, a process which will make consumption more expensive.

Conclusion

The Treasury market is not in a bubble, but a 2.5% yield on 10-Year notes does not offer much in the way of a hedge against medium-term macro risks.

The bull market is well advanced, participation by the public has been substantial and widespread, financial and regulatory factors have helped depress bond yields relative to nominal GDP growth—which is beginning to stabilize globally—U.S. wage inflation is picking up, and the current U.S. administration has its sights set on reducing regulation and revving up GDP growth. Trump wants to fire up the animal spirits and end the bull market in fear that has supported bond prices. So far, U.S. monetary policy has shown little inclination to get ahead of this new policy direction, while investors seem to be waiting for details before putting any pressure on the Fed to act.

The irony of the bond market outlook is that one factor limiting the potential upside in yields over the medium term is the current low level of yields themselves. Treasuries are the global fixed income risk-free benchmark, and asset prices are collateralized around this central rate. Yields have been so low for so long that the multiple on any asset with an intrinsic return is high by historic standards. It may not take much of a sell-off in Treasuries to trigger the kind of growth-smothering multiple contraction that would limit bond yields upside. But, that is a story that is yet to come.

1. Michael Goldstein, Empirical Research Partners, Portfolio Strategy, "Understanding the Market’s Post-Election Move, Bond Investors, Undeterred, Offshore Cash Hoards: Less Than Meets the Eye," March 3, 2017.
2. Charles P. Kindleberger and Robert Aliber, Manias, Panics and Crashes: A History of Financial Crises (John Wiley & Sons, Inc., 2005).