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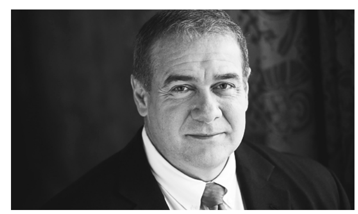
‘The Urban Legend of the Bond Bubble’



BY SCOTT MINERD

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Throughout my career in the bond markets I’ve witnessed several periods where people grew fascinated with theories that the secular decline in fixed income yields was on the verge of a dramatic reversal. The markets were especially convinced of this in years like 1987, 1994, and 1997, to name a few. Each time new theories cropped up, I would listen to the arguments, look at the data, and then eventually conclude that the secular bull market in bonds would continue and yields would eventually push lower, rather than skyrocket upward.

But after three decades of declining yields the benchmark 10-year Treasury bond is now hovering around 2.5 percent, and there are a trillion and a half newly printed dollars accumulating like thunder clouds in the financial troposphere. The optics alone are enough to make one wonder whether the bewitching hour for bonds has finally arrived.

Then I remember an old adage that has stuck with me ever since my days as a bond trader in London. Malcolm Muggeridge, an English newsman (who, in an interesting and unrelated story, is credited for making Mother Teresa a household name), used to say that there’s no such thing as new news, only old news happening to new people.

I don’t believe in the urban legend of the bond bubble. On the contrary, I believe the yield on the 10-year note will continue its decline, to 2.0 percent, and possibly lower. The “old news” happening to a new economy will most likely be a prolonged period of low long-term interest rates and low yields.

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While the idea of a sustained low-yield environment may be unfamiliar to the current generation, it's not unfamiliar to the former one – just ask anyone who remembers the 1940s, a time when the average yield on 10-year U.S. Treasuries was 1.99 percent, *for the entire decade.*

'Real Rates suggest it's Definitely Not a Bubble'

To address why yields should continuing their decline, I'll begin by debunking the myth that they are going to skyrocket upward. Economist Charles Kindleberger studied the history of asset price bubbles from the Dutch tulip mania of 1636 to the dot-com era of the late 1990s. In his book *Manias, Panics, and Crashes: A History of Financial Crises*, Kindleberger writes that two of the main characteristics of asset price bubbles are that they start with a "displacement" that presents investors with a new financial opportunity (often due to a major financial or technical innovation), and they witness asset prices that are inflated well above their intrinsic value.

Building on Kindelberger's definition, in 2002, the Federal Reserve Bank of Chicago added that "in a bubble, the price of the asset deviates from its 'fundamental value,' and a reversal of expectations and a sharp decline in prices (a crash) usually occurs."

Based on these definitions, I see very little in the bond market that exhibits the characteristics of a bubble. Looking at the first part of the bubble definition, a 29-year secular decline in Treasury yields is not attributable to any particular market-moving "displacement," and that trend certainly has had ample opportunity to reverse course. In fact, in 11 of the past 29 years, bond yields rose year-over-year. Still, the secular trend has been for yields to continue their downward migration. Generational asset price movements like this do not turn on a dime; they change over very long periods of time, which is inconsistent with the definition of a bubble.

Next, there is the all-important concept that in a bubble, asset prices deviate substantially from their fundamental value. The best measurement of a bond's fundamental value is its real rate of return. In 2010, the average monthly real rate of return on the 10-year Treasury is 2.22 percent, which is actually 4 basis points higher than the historic average of 2.18 percent dating back to 1920. One might argue that the real return on Treasuries is somewhat lower today than its 2010 monthly average. As of October 20, the real yield for 10-year Treasuries was 1.45 percent (2.55 percent adjusted for 1.1 percent inflation based on September's year-over-year CPI reading). Still, 1.45 percent is a relatively healthy real return by historic standards, especially considering there have been 17 years since 1920 where real

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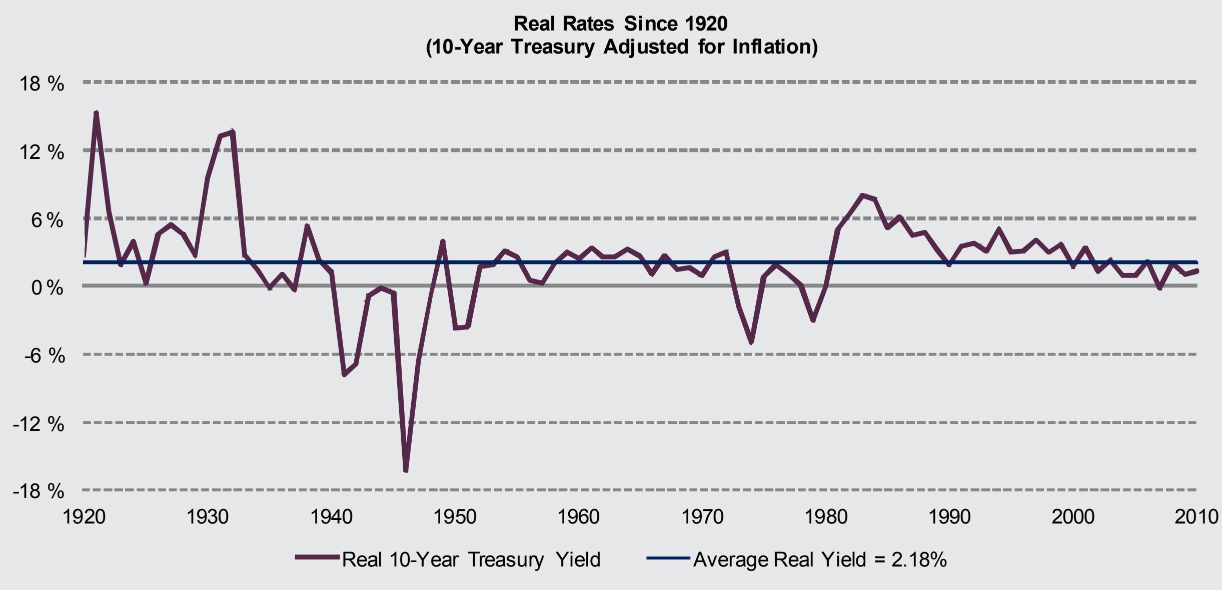
yields were negative, and in 30 of the last 90 years real returns were lower than they are today. Additionally, real rates tend to rise during times of high credit demand (or strong economic growth). There is certainly no pressure on real yields given the broken state of the financial system. In essence, investors should expect the real yield to be low today.

Still, one might argue that the difference between the current real rate of 1.45 percent and the historic average of 2.18 percent is actually quite large at 77 basis points. Once again, the data would disagree. The standard deviation of the difference between any one year's average real yields and the historic average is 413 basis points, meaning the current real yield is actually in a band quite close to its fundamental value. So even though the nominal yield appears alarmingly low, that is really just optics, rather than proof that yields are far from their intrinsic value. If you are looking for something that is historically out of whack, the culprit is not nominal Treasury yields, it's inflation, which is at its lowest level in 50 years.

'STILL PRETTY NORMAL' – REAL RATES TODAY VS. HISTORIC AVERAGE

A key characteristic of a bubble is that an asset's price deviates substantially from its fundamental value. Looking at real rates of return on the benchmark 10-year U.S. Treasury bond shows that real prices today are actually close to the historic average since 1920, which is uncharacteristic of a bubble.



Source: Bloomberg; Guggenheim Partners

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'Fooled by the Optics of Experience'

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I've read that the average age of an investment professional is around 46 years. The perspective of any investor in his or her forties or fifties is most likely influenced by the events of the market during his or her lifetime, i.e., the 1970s onward. The decades with the highest average nominal 10-year Treasury yields on record happen to be the 1970s, 1980s, and 1990s, which is why I believe many investors think the only thing for rates to do is climb back up again. They tend to dismiss the other two options of rates going lower or even going sideways because those outcomes fit less with the paradigm of their life experience.

What's missing is historical perspective. Since the 1950s, a graph of the 10-year note yield looks a line drawing of a mountain peak. Rates went up, and then rates went down. For example, from 1950 to 1980, long-term rates rose from 2.1 percent to as high as 15.8 percent. In the subsequent 30-year period from 1981 to present, yields cascaded all the way back down to 2.5 percent in what is now known as the "Great Bull Market in Bonds."

Now that rates have seemingly reached a basin on the other side of this 60-year spike, the question for investors is "What happens next?" Many investment professionals assume that it's time to climb back up the mountain again. A better answer may come from looking at the world of rates prior to the 60-year rise and fall. What came before the mountainous ascent of 1950s, 1960s, and 1970s was what I call a "base camp" of low long-term interest rates that steadily spanned a historically tumultuous period. During this time, the average yield of the 10-year note was less than 3 percent – for thirty years.

The low long-term interest rates experienced during the 1920s, 1930s, and 1940s, obviously didn't take place against a consistent backdrop. Treasury yields maintained at 2 to 3 percent through periods of the worst bouts of both deflation and inflation in the modern era, severe recessions and robust economic recoveries, World War II, as well as deficit spending that would make the recent administrations look frugal. What I often find surprising from these years of boom and bust is that long-term interest rates have managed to be much less attached to inflation than one might think. Such an extended period of low rates is what I believe awaits the U.S. economy in the next decade as it approaches the end of the Great Bull Market in bonds. This may sound contrarian, and for good reason: for the majority of investment professionals, an extended period of low rates is outside of their life experience. It is not, however, outside of historical context.

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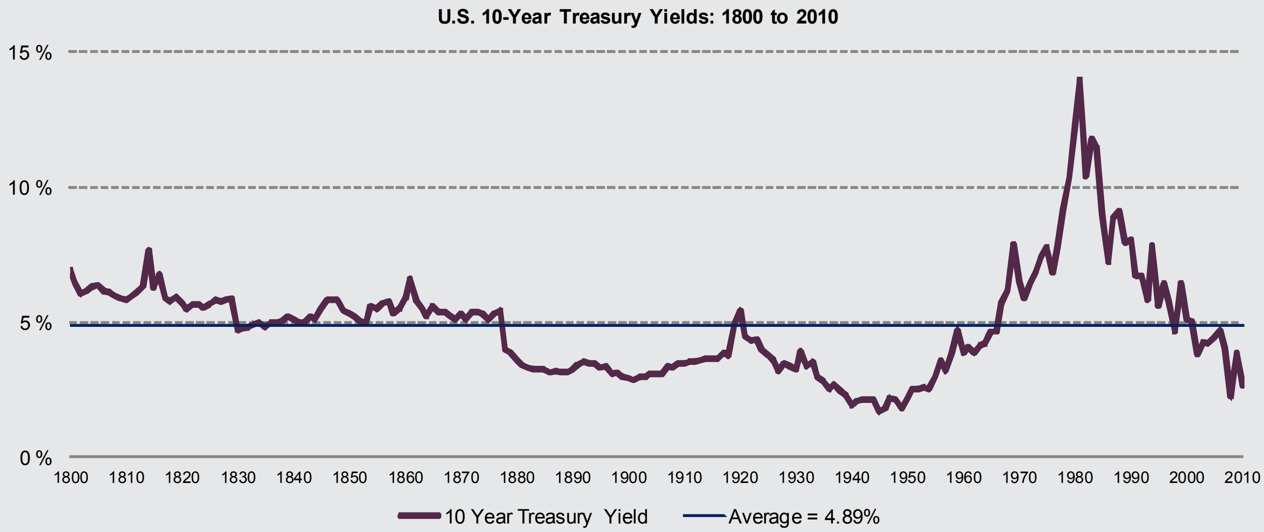
'THE FULL PERSPECTIVE ON RATES' – NOMINAL 10-YEAR TREASURY YIELDS SINCE 1800

From 1960 to 2009 the average nominal yield on the 10-year government bond was 6.8 percent; however, the average of the 40-year period before that was just 3.0 percent, well below the 210-year average of 4.9 percent. The 1940s, in particular, show that rates can remain low for an extended period of time.



Source: U.S. Federal Reserve, Bloomberg, Guggenheim Partners

'A Page out of the 1940s'

Given that the U.S. economy is recovering from the worst financial collapse since the 1930s, the decade after the Great Depression should be of extreme interest to investors today. Looking back to the period immediately following the United States' entrance into World War II, the Fed and the U.S. Treasury held a series of meetings wherein the Fed essentially agreed to acquire all 10-year U.S. Treasury securities at a rate of 2.25 percent or more. The Fed took such an unconventional step at the request of the Treasury in order to keep the borrowing costs of the federal government low to finance the War efforts. This understanding was announced to the public. As a result, the Fed actually purchased a surprisingly small amount of Treasuries because investors believed that there was a "put" option on Treasuries and naturally stepped in and bid down yields any time they approached 2.25 percent.

Things grew more interesting at the end of the War, however, when War-time price controls were repealed and inflation set in. In 1945, the yield on the 10-year

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Treasury was 1.67 percent and inflation was just 2.2 percent. By 1946, inflation had jumped to over 18 percent, but still the Fed stood by its commitment to keep rates low – the yield on the 10-year note in 1946 was just 1.82 percent, resulting in real yields of negative 16 percent. The Fed then grew anxious to raise interest rates, which obviously conflicted with its entangled agreement with the Treasury under the Truman administration.

The administration, in effect, said that the Fed had blown it in the 1930s when it tightened its policy and unemployment skyrocketed from 14 percent in 1936 to 19 percent in 1937. (See my September 1 commentary on the Great Depression.) In the latter part of the 1940s, the U.S. was in the midst of a baton-pass from a War-time economy fueled by government spending to a peace-time economy where consumers and businesses needed to take the reins (a similar situation to the current baton-pass that Chairman Ben Bernanke has referenced from government spending and inventory rebuilding to the U.S. consumer). In the estimation of the Truman administration, if the Fed raised rates during this transition period, it would cause the same problem it did in the 1930s, and that was not worth risking.

Despite inflation of 18 percent in 1946 and 9 percent in 1947, and deficit-to-GDP ratios double that of today, the Fed acquiesced and continued to uphold its policy of purchasing Treasuries in order to keep long-term interest rates low. Even though the real returns were negative, the Fed continued its practice of keeping rates artificially low until the Treasury Accord of 1951. The result of the Fed's posturing during the 1940s was an average 10-year note yield of 1.99 percent for the entire decade. It is worth noting that the Fed pulled this off in the face of rampant inflation, negative real rates, and massive government deficits.

The moral of the 1940s allusion is that history has proven the Fed can keep long-term interest rates low for an entire decade if it believes it is warranted in order to ensure the viability of long-term economic recovery. Today, with the recent commitment to another round of quantitative easing ("QE2"), I sense the Fed preparing to use monetary policy as a blunt instrument once again. If the Fed is indeed committed to keeping rates low as long as necessary for the economy to recover, which I believe they are, it would once again mean higher yields are not on the horizon anytime soon.

10-Year Treasury Yields during the 1940s

Year	Nominal Yield	Real Yield
1949	1.80%	3.90%
1948	2.12%	- 0.88%
1947	2.18%	- 6.62%
1946	1.82%	-16.28%
1945	1.67%	- 0.53%
1944	2.10%	- 0.20%
1943	2.12%	- 0.88%
1942	2.11%	- 6.89%
1941	2.07%	- 7.83%
1940	1.88%	- 1.18%

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'The Best Argument: Supply and Demand'

Even if you don't buy the historic data, or the case for the Fed wanting to encourage a low rate environment for an extended period of time, the best argument for whether there is a bubble in the bond market will always come back to fundamental supply and demand. In the very near term, the Fed's upcoming quantitative easing program will boost demand for long-duration Treasuries. On November 3, the day after the elections, I believe the Fed will announce an incremental program and commence buying securities at a measured monthly pace. While estimates vary for the pace and total size of QE2, I predict the initial program will purchase in the neighborhood of $100 billion worth of Treasuries per month. This may sound surprising, but the best estimates I've heard are that it will take somewhere between $1 and $2 trillion total on the part of the Fed to achieve their overarching goals with QE2.

> "It's not difficult to estimate that demand from the Fed and other central banks around the world for long-duration U.S. Treasury bonds will be three to six times the amount of near-term supply."

In addition to QE2, demand for long-duration U.S. Treasuries will come from other central banks around the world, particularly those committed to currency manipulation in the foreign exchange markets. The continued policy of competitive devaluation requires foreign central banks to buy U.S. dollars and sell their own currency (be it yen or yuan, etc.). In order for such interventions to work, the accumulated U.S. dollars must be held in dollar-denominated assets, which generally mean long-duration Treasuries. Aggregating the global demand for Treasuries from central banks building dollar reserves would result in potentially another $500 billion to $1 trillion.

When you add in the potential amounts for QE2 and currency manipulations versus the dollar, you arrive at demand for Treasuries in the range of $1.5 to $3 trillion dollars over the next 12 months. The long end of the yield curve is the investment area of preference for all of this global liquidity. Total new issuance of Treasuries with maturities of 10 years or longer is estimated to be approximately $500 billion in the next 12 months. Therefore, it's not difficult to estimate that demand from the Fed and other central banks around the world for long-duration U.S. Treasury bonds will be three to six times the amount of near-term supply.

There simply is not enough new issuance to meet the demand for Treasuries at the long end of the curve. Therefore, holders of existing long-duration Treasuries will have to be convinced to sell some of their holdings to satisfy global demand. In Econ 101, this is what is known as a shift in the demand curve, which leads to a higher price. In Fixed Income 101, we know that a higher price means a lower

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yield, which is why yields on long-term U.S. Treasuries will not go up anytime soon. In fact, I believe they will go to 2 percent, and possibly lower, in relatively short measure – the fundamental demand is that strong.

'The Boomers Enter the Fray'

The backdrop of rising global demand for long-duration Treasuries is occurring at the same time that there is a big demographic shift occurring among U.S. investors. The Baby Boomer generation is now in their late 40s to early 60s. They've experienced a lost decade in the equity market, with the average annual return for the S&P 500 at just 0.89 percent over the past 10 years. A recent CNBC poll showed that 67 percent of investors have lost faith in equities. Baby Boomers, in particular, are increasingly concerned with the need to preserve monthly income. The shift is moving from capital gains and capital appreciation toward securities that pay stable monthly coupons – in other words, from equities toward fixed income (which, just for the record, I do not believe is an appropriate rebalancing of asset allocation).

So how do all these seemingly competing forces play out? Central banks around the world are accumulating long-duration Treasuries and pulling duration out of the fixed income market. Investors who sell their holdings of long-duration Treasuries to central banks will have to turn around and buy some other long-duration asset, competing with the Baby Boomer demand for stable fixed income returns. What will inevitably happen is credit spreads will start to collapse, which means any credit product that is money good will see its rate of interest fall faster than the rate of interest on Treasuries. This will make finding strong yields more and more difficult in the future, but it also represents a capital appreciation opportunity to be captured in long-duration assets today. Once again, however, I find that evidence for increasing rates is conspicuously absent.

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'The Story in Housing Revisited'

Of course, the Federal Reserve is aware of all of the trends I outlined above. What the Fed is planning with QE2 is completely intentional, especially since one of the biggest long-duration assets that the Fed would like to see appreciate is residential real estate. To do so, it needs to keep interest rates low for an extended period of time in order to keep the price down on mortgages. If you look at the current situation in housing, there is about a year's worth of inventory on the market (11.6 months to be exact). When you add to that the shadow inventory sitting on the balance sheets of financial institutions, it could take another three to five years to clean up the inventory in housing. (See my August 2 commentary on "The Story in Housing".)

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The Fed would like to accelerate the cleanup in housing, and it certainly doesn't like that progress is currently slowing down. Why does the Fed care so much about residential real estate? Because if housing sales slow, inventory would build, and prices would fall. If housing prices deteriorate further it would increase the losses at Fannie Mae and Freddie Mac, which would in turn force the U.S. government to write another massive bail-out check. For example, it is estimated that a 10 percent decline in home prices from current levels would cause around $300 billion in capital impairments at Fannie and Freddie. At the same time, such a decline in home prices would also increase the number of problem mortgages on the balance sheets of financial institutions, which means banks would feel even more capital constrained (especially heading into Basel III) and would be even less likely to extend new loans. This would perpetuate the liquidity trap and accentuate deflationary pressures, which is an outcome the Fed would do almost anything to avoid.

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Therefore, I believe the Fed is embarking on a program to keep long-term interest rates suppressed in order to keep the affordability of housing attractive without allowing prices to decline. It knows that until the economy deals with cleaning up the burst bubble in housing the entire financial system cannot properly fire on all cylinders again. One might say, "Well, if there is three to five years of housing inventory to work through how long can the Fed realistically keep rates low? Eventually, won't they face the inevitable specter of inflation?" The answer is the reason why I spent so much time describing the 1940s. That decade is living proof that the Federal Reserve – acting in conjunction with the markets through clear communication – can keep interest rates low for an extended period of time, especially if it believes that is what is needed to successfully bridge a period of economic duress.

So whether it's due to global aggregate demand, demographic shift, or the story in housing, the moral is that there are not enough long-duration, U.S. denominated, fixed income assets in the market to satisfy demand over the next three to five years. From any of these standpoints, the idea of a rising yields just doesn't make sense, and the theory that there is a bubble in the bond market appears to be just another urban legend along the lines of chanting "Bloody Mary" or running into New York's famed "Sewer Gator." The rumors and stories are rampant, but the evidence is lacking.

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'What This Means for Investments'

Now, let's bring this all home and look at what this could mean for investments over the next three to five years. First, let me clarify that this whole discussion isn't intended to be about comparative value between stocks and bonds. My purpose in writing this piece was to debunk the urban legend of a bond bubble. I believe stocks are cheap in the current environment and should provide annualized returns in the neighborhood of 7 to 10 percent over the next decade. When Treasuries were at 4.0 percent in April, I advocated adding to positions. Today, at 2.5 percent, I don't recommend loading up on Treasuries, even though I believe rates will continue to fall to 2.0 percent or possibly lower.

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In general, the main opportunity for investors today is to take advantage of the rising tide of liquidity that will lift asset prices in stocks, bonds, and commodities and will not be immediately inflationary. In fixed income, both Treasuries and corporate debt have already seen price appreciation. Eventually, I believe it will spill over into municipal bonds and other sectors of fixed income. It has already spilled over into the equity market, and although there will be setbacks, equities should generally rise over the next six to twelve months. In the commodities market, gold and silver will generally continue to appreciate. The only assets that aren't rising are the boats that have holes in them. Residential real estate, for example, is so badly damaged that it just sits there even as liquidity rises all around it. Real estate is cheap, but until the market clears the glut of housing supply it will stay cheap. There will be an opportunity to purchase residential real estate, but not for at least another five years. The places to invest today are those areas where liquidity is flowing: bonds, commodities, and equities.

With the broad theme painted, I will attempt to speak more specifically to opportunities in fixed income (especially since this is a commentary focused on the bond market). Given the demographic shift of the Baby Boomer generation toward fixed income, as well as all the demand for long-duration fixed income securities to come from the Fed and other central banks, there is an opportunity for investors to purchase fixed income assets today at spreads that are still attractive that also afford the opportunity for price appreciation.

In particular, the opportunities I'm most enthusiastic about in this new world of low rates are in fixed income asset classes that have fallen out of favor, such as asset backed securities (ABS) and select high yield and municipal bonds. The spreads relative to Treasuries are historically wide in these sectors, especially in investment grade municipal bonds, because the markets have effectively thrown

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the baby out with the bath water. In fact, I have to remind people all the time that "ABS" is *not* a four-letter word and all municipalities are *not* the next Vallejo, CA or Harrisburg, PA. In the high yield market, spreads have contracted the most for the "brand name" issuers that appear in the popular indices, but there is a lot of value if you can do the credit research on lesser-known, illiquid names that have attractive risk-adjusted returns. So, I still believe there is a lot of opportunity out there in fixed income, but investors need to do more credit work and be savvier than in years past, which is exactly the way it should be.

'What this Means for the Long Run'

A lot of the policy decisions today will have long run consequences that may not be very palatable. But one of the things I remind people about the long run is what John Maynard Keynes said, "The long run is a misleading guide to current affairs. In the long run we are all dead."

To give you my view beyond the next three to five years, I would reference back to the story of what the Fed pulled off between 1942 and 1951. When you come to the end of the story in 1951, interest rates rise for 30 years. Today's economy is not analogous to 1951 – it's a lot closer to 1941, or perhaps even earlier, like 1935. So, for the next few years I see the inevitability of low interest rates and view the so-called bond bubble as little more than an urban legend. Nonetheless, just as a broken clock is right twice a day, the economy will inevitably reach a point where interest rates will rise. When they do, I believe they will rise for a long, long time. What happens after that? The ultimate end game, I believe will be a paradigm shift for money. But don't worry, that's not for a while and it's also not something new. In fact, the United States has witnessed no fewer than five monetary paradigm shifts in its brief history, which is something I hope to write about in a future commentary. □