## Can the Fed Keep The Bond Market Bubble Levitated?

NO.  Bonds are the largest investment class in the world, yet are probably the most misunderstood.  The media keeps us appraised every minute of the day on how the ***Dow Jones Industrial*** stock average is doing, but how often do we hear about any major bond fund or U.S. Treasury rates or prices?

The bond market is similar to all other markets in that many forces are constantly pushing and pulling at their trading prices.  For example, the price an investor is willing to pay for a 10-Yr. Treasury is a function of the traditional forces of supply and demand.  These major forces include:

1. **Massive & Growing Treasury Debt-Security Supply…** If the supply is abundant due to massive government budget deficits that require a new Treasury issuance of approx. $100-125 billion monthly in addition to funding the existing $14.0 trillion of Treasury debt that is constantly maturing and redeemed, then it represents a huge force attempting to attract investors.  If investors (potential buyers) are sparse, then interest rates (yields) must increase (& bond prices must drop) to attract buyers.  Assuming for a moment that global buying interest was neutral, then an increase in the supply of Treasury securities for sale would force government to reduce the price to raise cash that it desperately needs to fund its spending in excess of tax revenues.
2. **FED Monetary Policy to Keep Interest Rates Suppressed…** If there is a political interest in keeping interest rates low and a FED mandate to implement policies that will pursue full employment which means keep interest rates low, then the FED must counter the abundant supply force noted above with a greater force of contrived demand.  Today this major demand force is currently coming from the FED's Q.E. II longer-term Treasury buying program of $600+ billion over the next 6 months.
3. **Bond Market Momentum…** Another huge force is the market trend to invest ever greater amounts into bonds if the momentum is continuing in the direction of lower rates ahead.  One can easily see that a bond fund manager that is enjoying the momentum of a downward trend in interest rates (increase in bond prices) loves the added reinforcement of the FED also purchasing bonds.  Just count the millions falling right into their laps courtesy of the FED.  The more the FED supports the suppression of rates, the further they fall, which encourages an ever stronger private investment force plowing more liquidity into bonds, which pushes bond prices higher and higher.  It is an endless self-reinforcing fairy tale of wealth creation… or is it?
4. **An Improving Economy…** There is a natural cyclical force that ebbs and flows in the general economy which is driven by sociological as well as speculative forces.  The natural reaction by consumers in an economic downturn is to restrain spending and save more.  This force tends to suppress interest rates due to the higher demand for investing in debt securities.  Conversely, as the economy improves, spending increases; hence, interest rates tend to increase.  This force is very natural and healthy.  It is important to allow this force in either direction to remain effective without FED or government intervention.

What happens when the FED suppression **(#2)** and market momentum **(#3)** schemes reach a point of no return?  What happens when rates are so low that a new larger force appears in the market which anticipates a future of increasing inflation?  Enter major force **#5**:

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5. **Markets Anticipating Inflation Ahead…** At some point the reinforcing Ponzi scheme of the FED **(force #2)** will flood the banking system with an ocean of liquidity through the increasing exchanges of debt assets onto its balance sheet for "printed" money. Investors reach a point where they **expect** the excess money "printed" by the FED will finally come out from under the mattresses of banks and consumers, and begin pushing consumer goods and service prices up. This Increased inflation **expectation** is a gigantic downward force on bond prices. Who on earth would want to lend money at 1-2% interest, if they expect to be repaid in severely devalued dollars?

**The Enginomic Perspective on Bond Valuations:**

Enginomics recognizes all debt securities are NOT Real Wealth (1); they are simply contracts to acquire Real Wealth (1). Assuming the economic engine that includes all capital stock, skilled labor, and natural resources, and its associated market valuation is constant, then an artificially increased aggregate price in debt securities is an illusion of wealth. One cannot Will Real Wealth (1) into existence by artificially suppressing interest rates and raising the price of debt securities. This leads bond investors to believe they have more buying power than they really do. A compounding consequence involves real estate. If interest rates are low, the pressure exists to blow real estate valuations up which works in concert with the debt security markets, thus becoming a self-reinforcing spiral of bubbles in both.

**Can Ben Bernanke be More Public without Risking the FED's Credibility?**

The FED has long enjoyed a relatively benign role in the public light having been relegated to a history of convoluted communications (e.g. Greenspeak) that interested very few people. There has always been, however, a small dedicated band of FED watchers trying to interpret every word from those in the FED to guess their next move. That quiet life of the non-public, small band of FED watchers for Ben and his clan is over. Because the U.S. dollar has become increasingly under attack, the organization most responsible for its international standing, the FED, is coincidentally under attack. This attach has prompted more public communications. As a result the credibility of the FED is at stake more than any time since its inception. This is bad. I don't recall any FED chairman in history who has become as regularly visible on major network programs as Mr. Ben Bernanke. There is more public and political pressure for the FED to disclose the rational for its actions. We've all witnessed the brief video clips reminding us of the countless missed forecasts and judgments by the FED, which are forcing yet more disclosure of actions by these powerful elites.

On the popular network new magazine **60 Minutes** broadcast on Sunday, Dec. 5, 2010, Mr Bernanke stated:

> "Fear of inflation, I think, is way overstated" and said he had 100% confidence he could act quickly enough to keep prices in check. "We've been very, very clear that we will not allow inflation to rise above 2% or less," he said. "We could raise interest rates in 15 minutes if we have to. So, there really is no problem with raising rates, tightening monetary policy, slowing the economy, reducing inflation, at the appropriate time."

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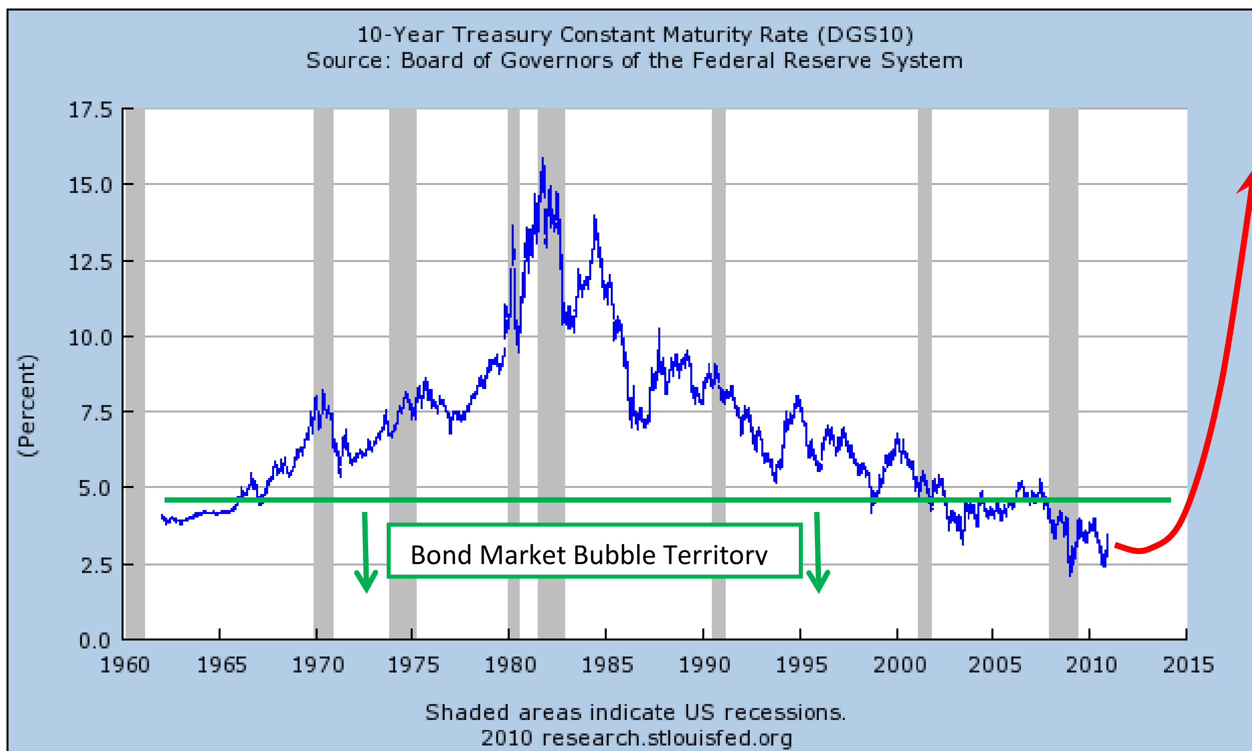
> Mr. Bernanke said the Fed decided to embark on its bond-buying plan because of high unemployment and "very, very low" inflation that put the economy at risk of deflation.

Nobody asked Ben whether he could prevent a deflationary collapse. If he attempted to prevent one by buying up all debt security assets on earth and flooding the world with printed dollars in exchange, would he then be able to prevent a crack-up inflationary boom in 15 minutes? You can rest assured, if the wheels start coming of the economy where the bond markets collapse and force a deflationary plunge in nearly all asset and goods prices, the threatening "D" card (depression) will be played again. At that point Mr. Bernanke will promote higher inflation as their new policy like GEICO promotes insurance. Unfortunately, it will be a belated attempt to create yet another financial paper illusion.

**Where Are We in the Debt Bubble Cycle?**

The graph below is a 50-year picture of an historical cyclical move in interest rates for U.S. Treasuries.




One can see we're near the end of the "lower interest rate trend" cycle. The 10-Year Treasury Note yield reached a low point on Oct. 6, 2010 @ 2.41%. The yield has since climbed to 3.50% (12-28-2010). The value of a treasury purchased on Oct. 6 declined by 9.1% as of Dec. 28th, 2010 (less than 3 months!). Could the yield drop back down below the 2.41% rate or even lower? Of course, but we would be in the middle of a deflationary collapse where investors would be fleeing other asset categories (stocks, commodities, housing, etc.) and creating a short-to-medium term panic demand for the save haven of Treasuries. I anticipate this will actually occur, but will not last longer than 2-3 years. Ultimately, the ocean of liquidity that all central banks have created will portend hyperinflation, which will empower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the force **#5** (Anticipating Inflation Ahead) to overwhelm all others. i.e. bonds crash and continue dropping in price, interest rates rise, and inflation rises.

**Conclusion:**

We are experiencing the greatest bond market bubble in the history of the Republic due to both a 30-year momentum joy ride to the top (beginning in 1982) and a FED relentlessly creating artificial demand for bonds with the intent of keeping interest rates low and preventing their prices from collapsing. All bubbles must end when natural market forces finally overwhelm them. At that point the forces of the extraordinary Treasury debt security over-supply and the inevitable inflation anticipation will overwhelm the opposing forces.

I expect the bond bubble illusion will be discovered within the next year or two. The so called bond vigilantes will rise up from the dead and demand higher yields. The municipal bond markets have already begun their collapse. Year 2008 was only the warm-up round for a sad descent into the next Great Depression.

by Russell M. Randall 1-6-2011

References:

1. Real Wealth is defined on page #2 in the following article: http://austrianenginomics.com/DebtRelativetoGDPTheAustrianEnginomicDebtAxioms.pdf

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