

Return of the Bond Vigilantes:

The Great Dilemma

The bond vigilantes are back in town as indicated by the blowout earlier in the month in sovereign credit spreads of the PIGS (Portugal, Ireland, Greece and Spain), and widening of corporate spreads over Treasuries (Chart 1). It was precipitated by Greece's catastrophically high fiscal deficit (13% of GDP), debt (120% of GDP) and current account deficit (10% of GDP), numbers that imply default is likely. Bond investors have reassessed risk in a number of countries whose fiscal position is tracking Greece's.

Saddled with rising costs from the financial bailout and the prospect of below trend growth, many developed nations will need to take drastic action to reign in their ballooning deficits in the next couple of years. Japan is in the worst shape, with government debt to GDP at 200%, fiscal deficits of 13% of GDP, interest payments of 1.9% of GDP, and little hope of growing its way out of the problem. Suspicion of sovereign debt has spread to these countries, as indicated by rising credit default swaps (the cost of insuring bonds). In the case of Japan, CDS insurance absorbs almost the entire yield. CDS spreads in the U.S are such that some high-grade corporate bonds are rated above Treasuries.

There was some easing in credit market tensions late in the month, although civil unrest in

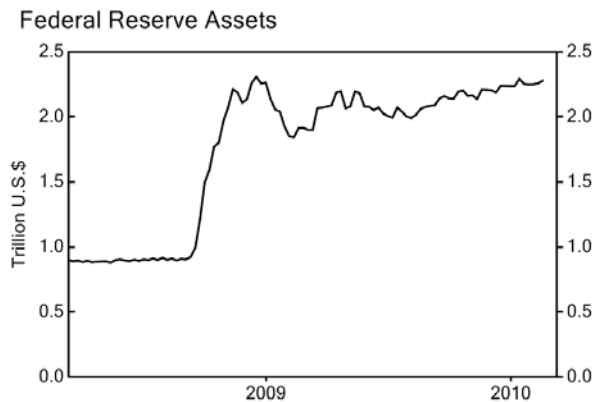
Greece, Portugal and Spain call into serious question whether deficits can be reduced in some countries. Treasury yields have eased a bit as did U.S. corporate spreads against Treasuries (Chart 1). However, it is clear that credit risk fears for both sovereign and sub-investment grade corporate debt are not going away any time soon as more and more people are focusing on the limits to government borrowing and what happens to the economy and private debt once government stimulus is unwound.

Chart 1



Source: *Moody's

Chart 2



Pressure from the bond vigilantes is already forcing the authorities to talk tough, and in the case of the U.S., the Fed raised the ceremonial Discount Rate by ¼ %. The Fed has also been talking about backing away from debt monetization at some point and reducing its swollen balance sheet to pre-crisis levels (Chart 2). Other countries are also showing concern. Germany, for example, seems unwilling to participate in a Greek bailout. CNN and other major media voices¹ have sharply raised the volume on the global debt saga.

¹ See, for example, Martin Wolfe, "The world Economy Has No Easy Way out Of the Mire"; Financial Times February 23, 2010.

The media, of course, love nothing better than a good crisis and are providing plenty of coverage. Rogoff and Carmen², the prolific chroniclers of banking crises and government fiscal disasters, are now among the most widely quoted economists in the media and in investment research reports.

Massive exposure of the debt problem is very positive in the long run. The risk is in the short run. The authorities of the more solid countries may be forced into premature tightening while the U.S. and global economies are still in the convalescent ward. It is still less than a year since the near-death experience in the financial markets and banking system and we are far from returning to anything like full economic health.

The dilemma for the authorities is clear. The specter of deflation will not go away in spite of massive stimulus. This had to be on an unprecedentedly large scale because of the magnitude of the banking collapse, the total freezing-up of the credit mechanism, and the risk of a complete toppling of the private debt structure.³ The crisis and the government response was a phenomenon not seen since the 1930s. It is truly an experiment with an unpredictable outcome and we should not use postwar cyclical experience to gauge how this one will unfold. Two big uncertainties have to do with: a) the sustainability of the recovery after the stimulus has run its course by mid-year, and b) the consequence of exploding government debt ratios in virtually every OECD country. In effect, we may soon test the limits of government ability to support the economy with fiscal deficits at a time when the economic recovery may already be running out of steam.

² See their recently released, *This Time Its Different: Eight Centuries of Financial Folly* September 11, 2009.

³ See Boeckh Investment Letter, *The Great Reflation Experiment* July 23, 2009.

The authorities are perfectly aware of precedents in the U.S. (1937) and in Japan (post-1989 on three occasions) when tightening of economic policy to improve public finances was premature and caused fragile recoveries to abort. In all cases, unemployment rose sharply and in the end, the governments' fiscal position deteriorated even more so than had they stayed the course. However, the bond vigilantes, each in trying to protect their own assets, may collectively have the opposite effect of undermining the value of those assets. This is a classic example of fallacy of composition and puts the authorities in a difficult situation.

The dilemma for the bond market is also clear. Out of control deficits and debt: GDP ratios tend to push yields up. The prescription to reverse these trends is first to generate a sustainable growth rate in nominal terms for the economy that is more than the average rate of interest the government pays on its debt. The second is for the government to reduce its deficit below the interest payments on its debt. For countries with some flexibility, the former is by far the more important. However, when the credit generating mechanism is broken, as is still the case in the U.S., the economy can't sustain growth without government intervention. Deflation will resume once the government pulls back on stimulus. This tends to push interest rates down in the short run, but by reducing growth, government deficits and debt will remain on their long-term rising trend. This in turn feeds the fears of the bond vigilantes. For countries like Greece which have hit the wall and growth prospects are non-existent, there is no choice but to slash the deficit if they do not have their own central bank to print money.

On the U.S. credit scene, U.S. bank lending is still contracting at a rapid rate. U.S. money supply on the M2 definition is falling at an 8% rate (charts 3 & 4). The monetary base has

continued to grow but that simply reflects financial constipation—banks are holding increased reserves but not lending. Hence, the money multiplier, the ratio of money supply to bank reserves, has continued to shrink. The well worn analogy is that “you can take a horse to water, but you can’t make it drink.”

Chart 3

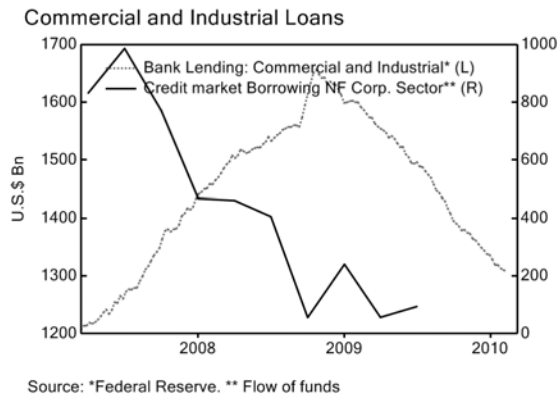
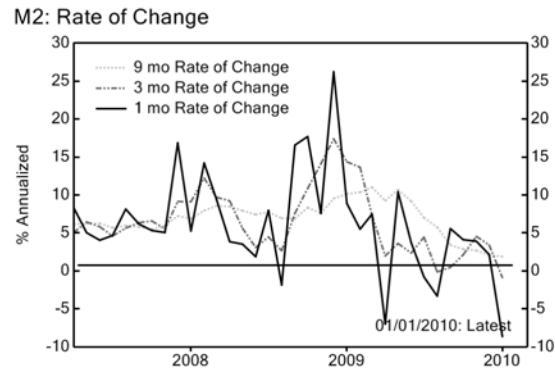


Chart 4



Bond investors face the difficult decision of whether to focus on the short run which would suggest that any significant rise in U.S. Treasury yields ought to reverse, or to focus on the longer run when pressure to push yields up will become stronger. The issue is further complicated by the fact that U.S. Treasury yields are probably about a hundred basis points (1%) too low compared to what would be fair value based on government debt, deficits and long-run inflation expectations. Therefore, from a risk/reward point of view, owning long-term government bonds will probably be a poor investment and investors will be lucky to break even on a total return basis, barring another debt-deflation scare like the one in 2008-2009.

In our last issue, we focused on potential problems in financing the huge U.S. government borrowing requirement should bond prices fall and traditional demand falter, as seems almost

certain at some point not too far away. Recently the Chinese have announced a reduction in their holdings of U.S. Treasuries, although it is still not certain whether they have shifted some holdings to non-transparent accounts. Should conventional demand weaken further, the Fed will be faced with a huge decision regarding its balance sheet. Should it scrap the idea of liquidating the securities it bought after the crash and step up quantitative easing again or should it just let rates find their own level? In a world of contagion, fragile confidence, credit deflation, falling money supply and deflating prices, letting rates move up significantly could be suicidal.

One of the key benchmarks we have emphasized as critical for investors is the trade weighted dollar (Chart 5). It has rallied in recent weeks, particularly against the euro as the E.U. is on the front line in the Greek debt fiasco. As long as the dollar remains firm or at least relatively stable, the U.S. bond market is also likely to remain relatively stable, or erode slowly. However, having said that, we must repeat our long standing concern that the business and financial world is based on Alice in Wonderland economics. No one knows what is real and what is not. Fragility will remain with us for a long time. Markets and institutions are brittle and subject to confidence shocks, as can clearly be seen in the Greek debt saga. The return of the bond vigilantes is an assault on complacency and confidence and it would not take much to push sovereign yields up significantly from their artificially low levels in some major countries like the U.S., UK and Japan. And it may not take much to derail the U.S and global recovery. Therefore, a healthy degree of risk aversion and focus on wealth preservation must remain paramount.

Chart 5

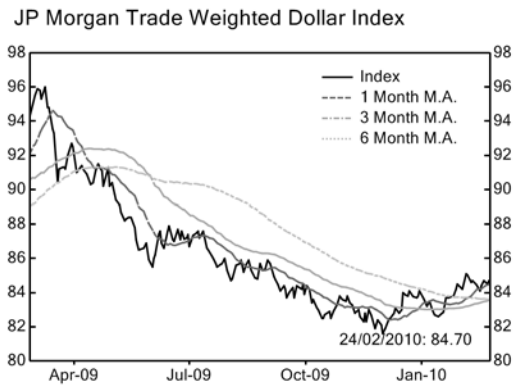
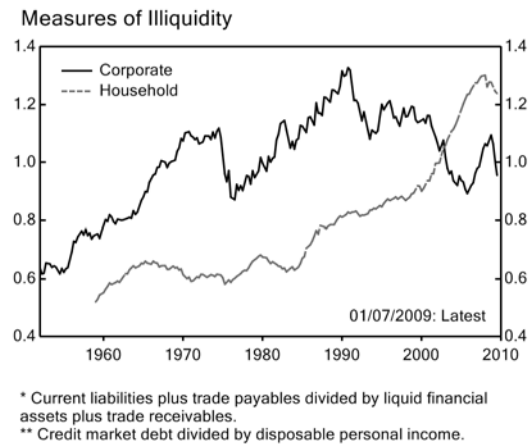


Chart 6



The U.S Non-Financial Corporate Sector

The one relatively bright spot in an otherwise gloomy long term picture is the U.S. non-financial corporate sector. Bankruptcies and debt defaults have been uncommonly restrained given the circumstances. The sector had been reducing debt ratios and rebuilding liquidity for some years before the crash. Chart 6 (above) shows a comparison of liquidity in the non-financial corporate sector, defined as the ratio of liquid assets to short-term liabilities, and comparable measure for the household sector. The strong financial position of the corporate sector has allowed it to weather the storm surprisingly well given the downward jolt to GDP and the credit markets in 2008-2009. This is in stark contrast to the household sector, whose debt levels rose sharply relative to income since the late-90's, obviously closely associated with real estate speculation and general overconsumption.

Chart 7 shows U.S. non-financial corporate profits, while still down from the extraordinary high of 2007, have increased by a factor of four from the low in 2002. Business productivity, the other side of the 10% unemployment rate, has risen dramatically with the

economic recovery (Chart 9). Firms have delayed hiring, as they always do at the beginning of an economic recovery and this has held the unemployment rate at very high levels. Chart 8 shows another measure of corporate sector liquidity: the ratio of corporate debt to equity. The ratio doubled in 2009. However, adjusting for stock market volatility, the ratio is at 0.4, not much changed from 10 years earlier.

Chart 1

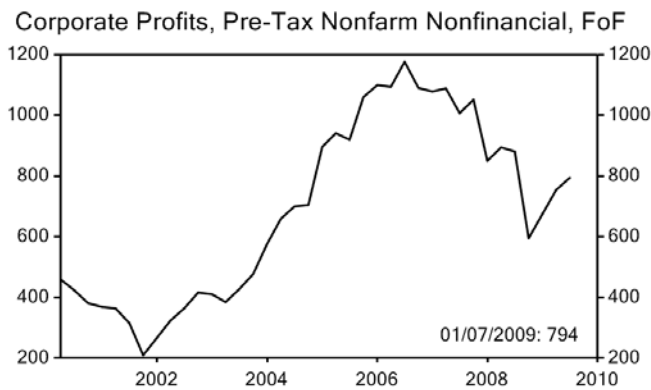
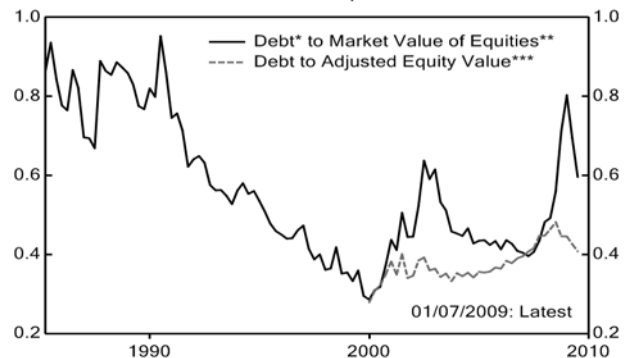


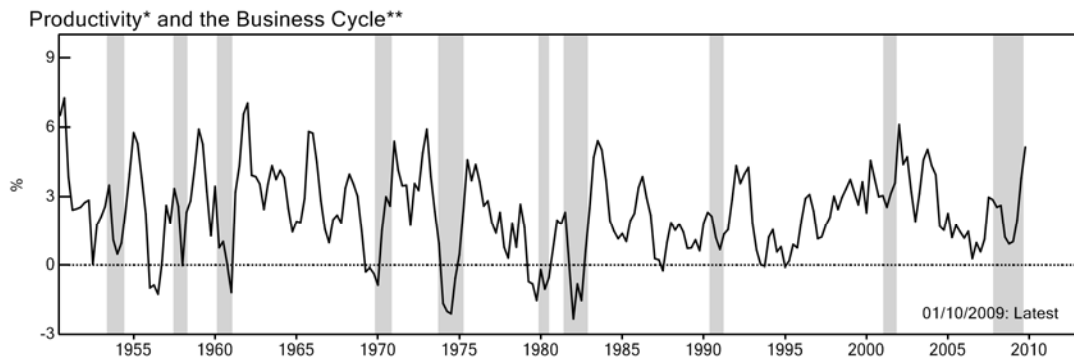
Chart 8

Another Measure of Corporate Liquidity:
Credit Market Debt / Total Equities



* Non-financial corporate sector total credit market debt outstanding.
** Non financial corporate sector market value of equities., FoF
***Market value of equities adjusted by dividing by S&P 500 index rebased to 1 in Jan 2000.

Chart 9



* Non-farm business sector index output per hour of all persons. Change from previous quarter, 4Q moving average. Source: BLS.
**NBER Business Cycle. Shaded areas denote recessions.

It is important to note that a key difference between the Japanese experience post-1989

(the year their bubble burst) and the U.S. post-2007 is the location of excess debt. In Japan, it was primarily in the corporate sector, while in the U.S. it was primarily in the household sector. Japan's leverage and bad loan problem was also much greater, which is why the loss in wealth from its burst bubble was three times GDP; triple the U.S loss at its worst point.

The relatively sound position of the U.S. non-financial corporate sector has an important implication. It could well be a relative oasis of stability in the overall unstable world we see unfolding in the quarters and years ahead. When some very high-quality corporate bonds are rated above Treasuries, it tells you a lot. Equities in high-quality companies with bullet proof balance sheets, stable cash flow and reasonable valuations should, over the long run, withstand the inevitable shocks that lie ahead better than sovereign bonds, at least until serious fiscal restraint is undertaken.

Investment Conclusions

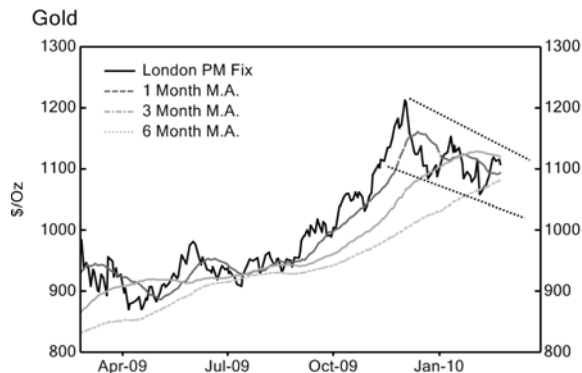
Stocks have bounced back from their third significant correction since the lows almost a year ago. The tailwind from monetary policy will likely continue for several more quarters as flagging consumer confidence and extremely weak housing data in January highlight that consumer deleveraging will persist and employment will remain weak. Past history of Fed behavior makes it clear that it does not tighten (particularly in an election year) until unemployment starts falling significantly. Therefore while, we should expect more tough talk from the Fed, significant tightening action for some months is not on the horizon. The bull

market is intact, but it does depend on continuing government intervention to compensate for weak consumption and deleveraging. However, gains in 2010 will be much harder to come by than last year.

Government bond yields have nowhere to go but up, and a sharp rise later in 2010 is possible if the Fed is determined to shrink its balance sheet. At present that is not in the cards but conditions could change in the 2nd half of the year. The compression of corporate yield spreads has been played out (Chart 1). The juicy returns seen in this sector in 2009 won't be repeated until the next cycle.

Gold has lost momentum. The one & three month moving averages have turned negative (Chart 10). From a technical perspective, gold is currently trading in a downward-sloping channel and we expect this trend to continue. We believe that gold has reached its peak in this cycle, even considering the sovereign debt drama now playing out. Inflation remains tame and U.S. monetary authorities still seem to have enough room to maneuver in the short term to avoid the type of dollar collapse gold bugs have been fantasizing about. The risks in the longer term, however, are still present.

Chart 10



Industrial commodities have been extremely volatile over the last two months. Copper sold off by 15% in a matter of weeks and has since bounced back. Aluminum and zinc have shown a similar pattern although the rebound has been weak (see commodity charts p. 13). We expect oil and natural gas to remain in a narrow trading range over the next few quarters and this should be a positive backdrop for profits of energy companies.

In summary, our basic view remains unchanged; we look for stock prices to move higher but on a much flatter trajectory than last year and Treasury bond yields to remain range bound at best with the risk clearly to the upside (down in price). The U.S. dollar has been firm over the last two months, in good part reflecting the unfolding sovereign credit problem brought to the fore by Greece and the other PIGS. Our view has long been that the U.S. dollar will not collapse but rather erode slowly over time with counter trend rallies. As long as this remains the case, inflation is nonexistent, and unemployment is at 10% or so, the Fed can keep monetary policy very loose, providing a solid liquidity base for stock prices. Near zero short-term interest rates will keep pushing investors into riskier assets to increase expected returns. However, we must continue to urge investors to focus on wealth preservation. There are plenty of things that could go wrong on a very short notice.

Tony & Rob Boeckh

February 25, 2010

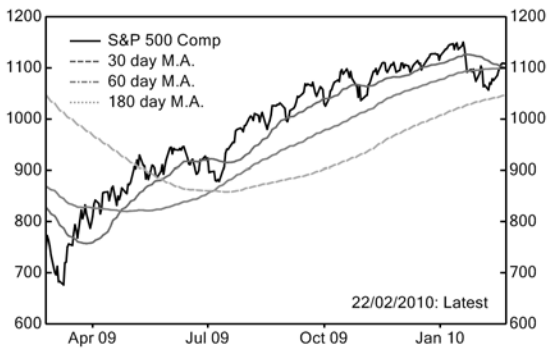
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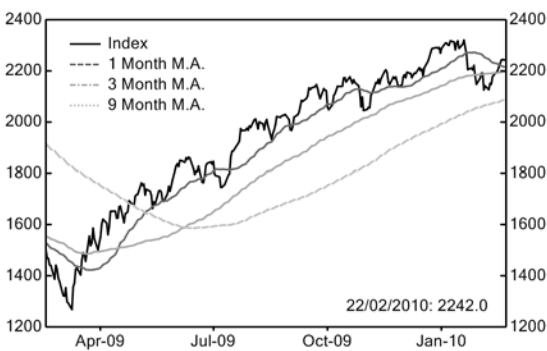
Charts

Stock Market Indices

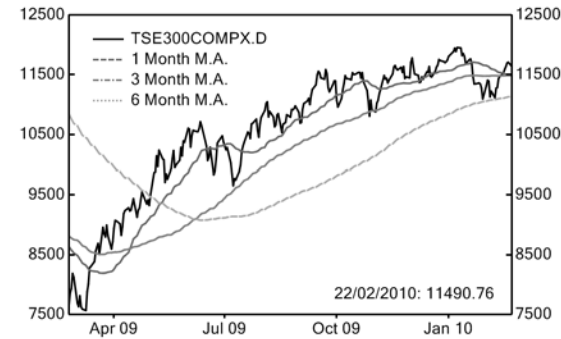
U.S. S&P 500 Comp



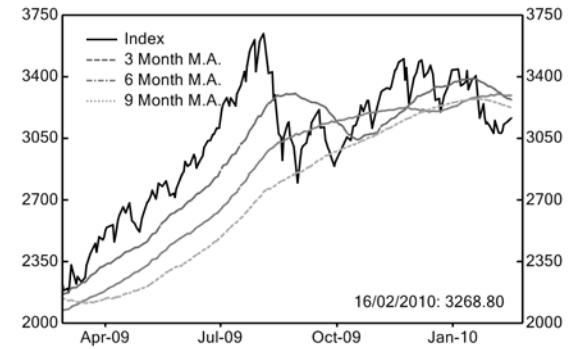
NASDAQ



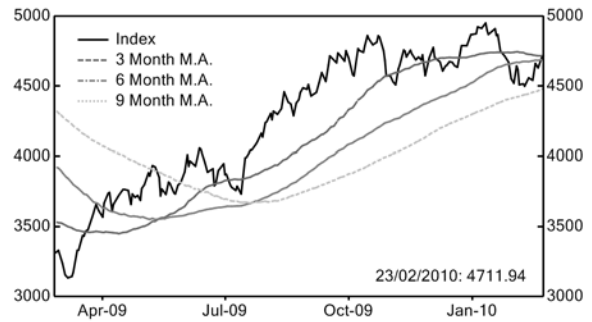
Canada S&P TSX Composite



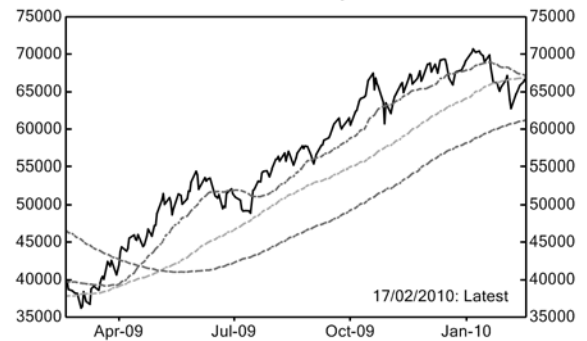
China Shanghai A Shares



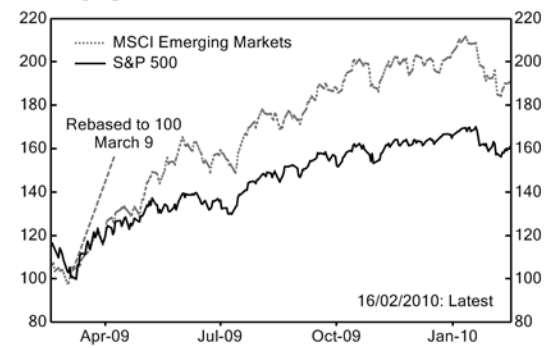
Australia S&P/ASX 300



Brazil: Sao Paulo Stock Exchange

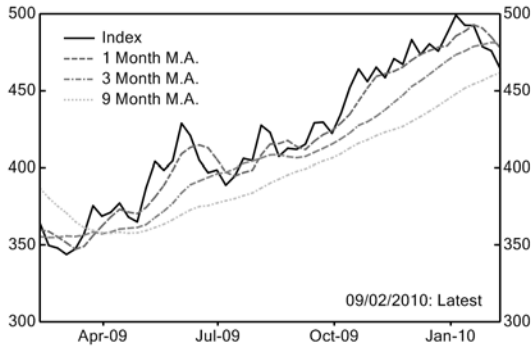


Emerging vs. U.S. Markets

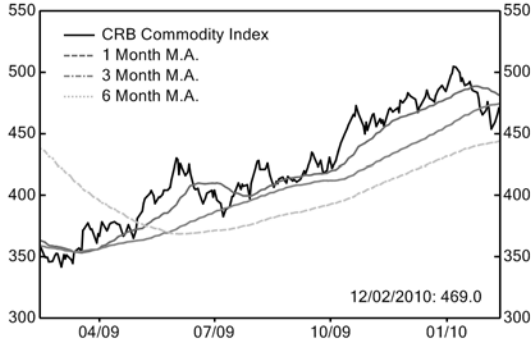


Commodities

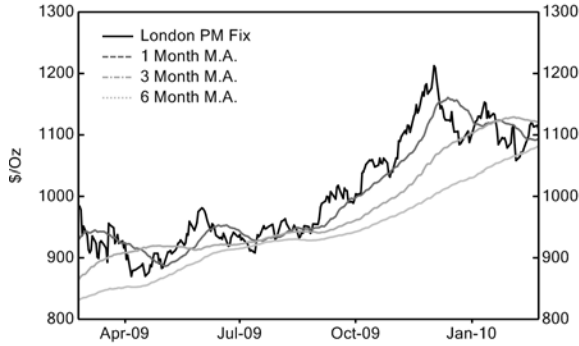
CRB Continuous Commodity Index



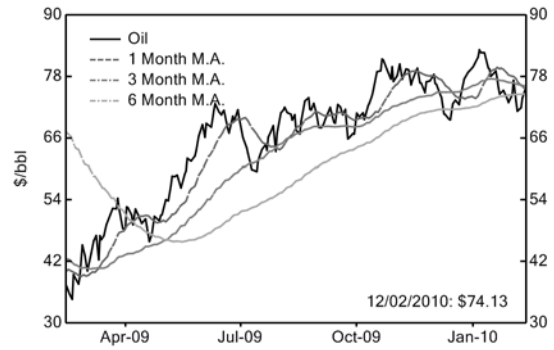
CRB Futures Commodity Index



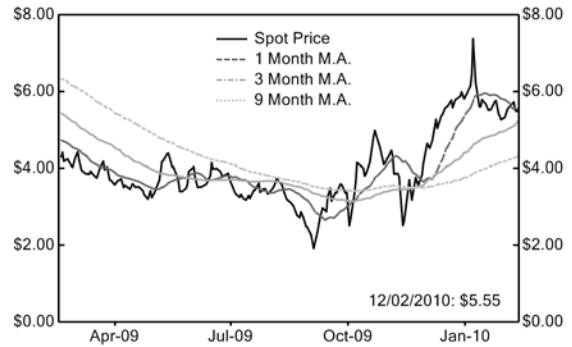
Gold



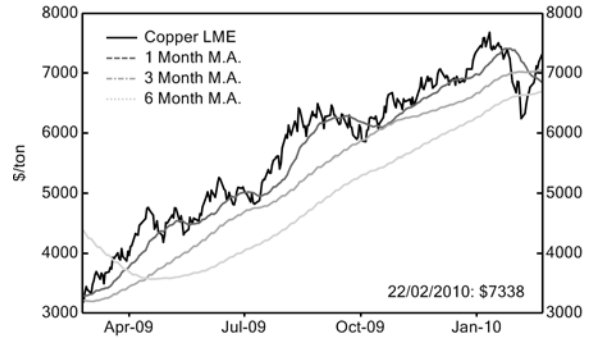
Oil: WTI



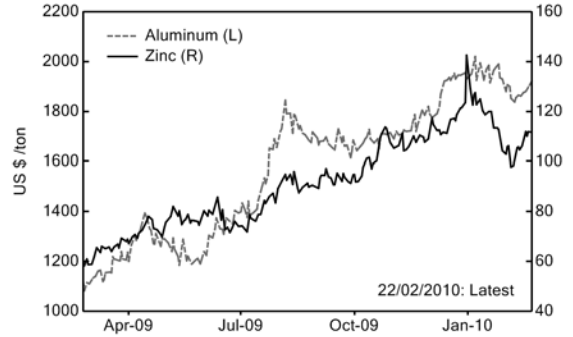
Natural Gas, Henry Hub



Copper



Metals

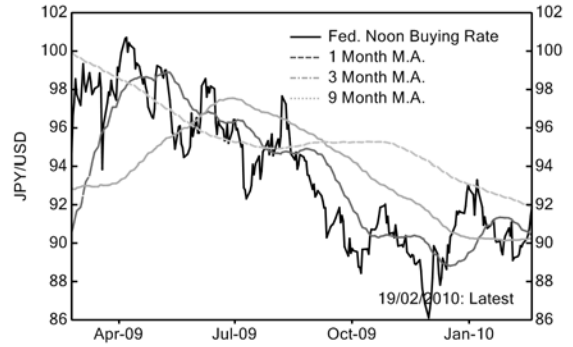


Exchange Rates

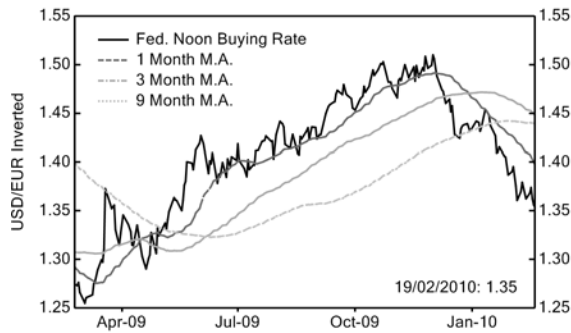
JP Morgan Trade Weighted Dollar Index



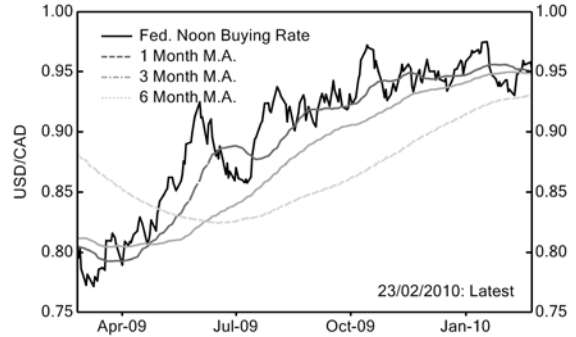
Japanese Yen per U.S. Dollar



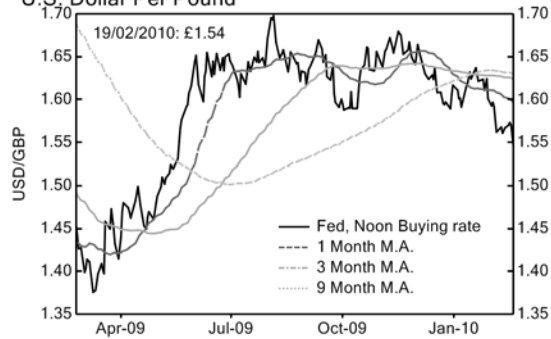
U.S. Dollar Per Euro



U.S. Dollar Per Canadian



U.S. Dollar Per Pound

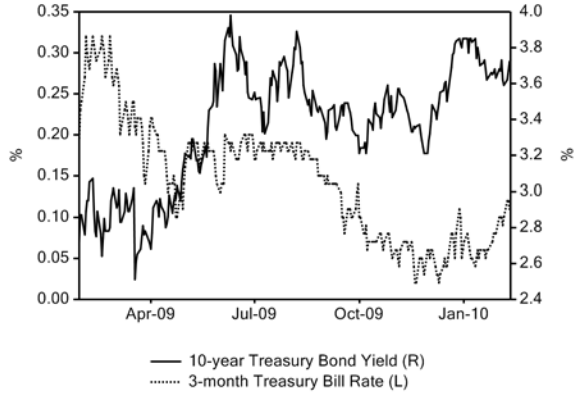


China; RMB per U.S. Dollar

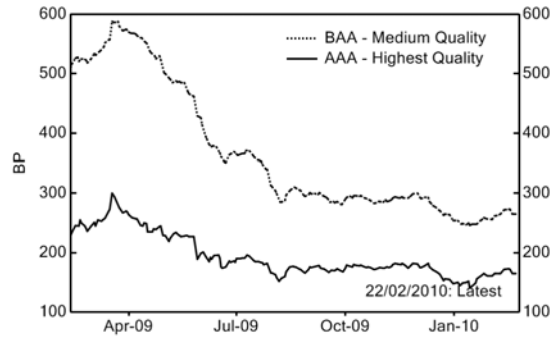


Interest Rates

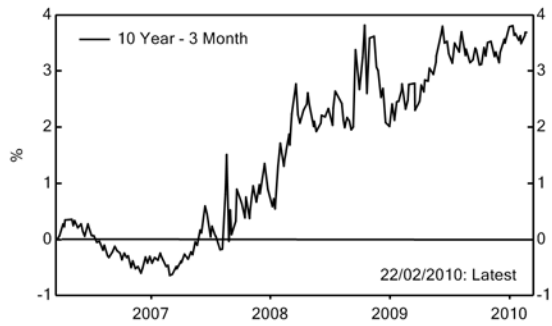
Yield: U.S. Government Paper



Corporate Spread over 10 Year Treasuries (Moody's)



Yield Curve



VIX: CBOE : Options Volatility Index

