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Everyone feels that a
correction is necessary

But some markets might need
more correcting than others

Where Will The Correction Strike?

After one of the longest and strongest uninterrupted rallies on record, the market is over-extended and there is the risk of a sharp correction—or maybe something much worse. On that much almost everyone can agree. Nor will the correction be delayed by Friday's publication of yet another above-expectation US job report, bolstered by big upward revisions to earlier figures plus a sizeable improvement in the labour participation statistics? On the contrary, the inevitable correction will now come even sooner and prove even more painful. **But the real risk is a correction in bonds, not equities.**

Last September, when US and German bond yields plunged through 2% for the first time since 1951, financial pundits were unanimous that the next bubble to burst would be in bonds. We had some sympathy with this view, but believed it was too early to expect an attack from the bond vigilantes at a time when evidence of global economic recovery was still so patchy. Today investors seem to have forgotten their earlier fears about bonds, focusing instead on the risks of an equity correction. Yet conditions are much more conducive than ever before to a bursting of the bond bubble (see our latest [Quarterly: The Global Bond Yield Conundrum](#)). On top of all the structural arguments we have advanced about negative real rates and market manipulation by the Fed and ECB, the risks of a cyclical bond meltdown like 1994 and 2003 are now much greater than last year for three reasons.

First and foremost, economic conditions are now much more dangerous for bonds than they were six months ago, when worries about a bond bubble were near-universal. Back then, the risk of a double-dip US recession offered some possible justification for negative real bond yields. Today, there is no conceivable reason for real interest rates to remain negative – as they have been recently (for the first time in financial history) on ten-year US inflation-protected bonds.

Secondly, Ben Bernanke's "promise" to keep short-term rates near zero until 2014 is not nearly as reassuring as many bond investors believe. Even if the Fed sticks to its word (which it probably will not) and even if zero rates create no inflation (which they probably will), there is an unconditional reason why Bernanke's "promise" should offer no reassurance to bond investors: At this point in the economic cycle, the yield curve could easily steepen by 100 or even 150 basis points, even if Bernanke kept his promise and pegged Fed funds at zero until 2014.

Finally there is the dangerously overbought condition of the bond market itself. While everyone worries that equities have advanced by 20% in just five months, without a meaningful correction, the 20% jump in bond prices in the past 12 months is actually much more unusual. As the charts below reveal, equities have had gains of this size eight times in the past 20 years and these have generally been followed by nothing more painful than a

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But which market is dangerously overextended?

Equities up 20% in five months....

Or bonds up 20% in 12 months?

slowdown. Bond markets, by contrast, have only once been as overbought as they are today (in 1995) – and the four other occasions when the 12-month rate of change was in the 15% plus range were all followed by memorable bond meltdowns – in 1994, 1999, 2003/4 and 2009. You have been warned.

