Bond Bubble

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July 30, 2005

Predicting markets is often fools folly, yet many professionals continue to make their prognostications. Maybe it's at their clients request…. maybe their employer's, maybe out of pure human nature to divine the future. I find myself falling into the same traps knowing full well that the best strategies for mere mortals are those that diversify and model portfolios according to well define objectives. Given that, it is still often worthwhile to observe markets for trends, which tend to be long lasting or can go on for longer than most pundits predict. It is in that vein that I write here today.

I cannot help but highlight the arguments that are being made today for fixed income investing. Pointedly, I am not making a recommendation or forecast for bonds, only an examination of current sentiment. Similar attitudes were advanced in the case for equities prior to the tech bubble bursting. Namely, that baby boomers needed to save aggressively for their retirement and would do so in the stock market where returns were perennially above that of bonds. We know where that led. Overinvestment in technology was an outgrowth of the enormous resources that these boomers could harness and stocks (particularly IPOs) were the vehicle of choice. Today fixed investment, especially in real estate, is the field of investor's affection. The vehicle of choice to advance the cause is of course mortgages. Additionally, pensions (now less enamored with stocks) are buying serious amounts of bonds to better match their assets with their liabilities (baby boomer retirement redux). I guess the idea of long-term stock out performance has lost its cache.

Importantly, it is helpful to remind ourselves that markets are often the expression of supply and demand dynamics as much as efficiency and those may not always be the same. Prior to the tech bubble bursting very large quantities of stock were issued, but often only a limited number of them became available to the public. A good example might be the IPO of Yahoo in 1996 where 25.7 million shares were issued, 2.6 million in their public offering, the rest in the hands of employees and principals who often had a lock-up period of 18 months to two years. Multiply this example over and over and you can see a lot of equity was issued prior to the bubble bursting, but much of it was in restricted shares initially allowing only a minority share to float. Over time, as that issuance found its way in to the market, the supply of stock eventually swamped demand leading to the fallout we now categorize as the tech bubble. Its affect was much broader, of course, than just the technology market.

With the endless fascination of bond yields and an even greater appetite for the bonds themselves, we may find it constructive to ask if similar supply/demand dynamics are at work in the fixed income markets. Certainly, with total credit market debt at all-time highs relative to GDP, bond issuance is even more colossal than stock issuance prior to the tech bubble bursting. Like stock issuance, much of this debt is taken off of the market quickly (or never makes it to market) leaving investors hungry for more. The culprits are none other than the most talked about and celebrated members of the modern press: China, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. China has $750 billion in reserves. Fannie, Freddie and the Federal Home loan Banks have as much as $2 trillion in mortgages on their books. Combined, these enterprises share the equivalent of 25% of US GDP in debt that effectively could come to market in a supply shock similar to the unlocking of billions of tech stock shares just prior to the market meltdown from 2000-2002. Interesting signposts have now begun to emerge. Legislation to regulate the GSEs and limit their portfolios is now being seriously debated in congress. Although not likely to pass this year, much needed reform appears to be something the Bush administration and others are gunning for. China's recent revaluation most likely is not the beginning of a quick rebalancing of trade posture and may only be political. Nevertheless, we appear to be closer than only a month ago to a rationalization of China's massive foreign currency reserves. It may prove wise to follow these two developments very closely as the delicate supply and demand balance gives way to market efficiency in the only way it knows how… sensational adjustments.