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Bond Revulsion?

Nominal Prices and Yields

The greatest bubble ever in bond prices has been accomplished. Credit markets are inevitably cyclical. While the peak is in and prices have declined, we are not now looking for ending action. That comes later. However, bond markets appear vulnerable to another critical loss of liquidity.

The 1970s taught that bond prices went seriously down with soaring commodities. More recently, long-dated Treasuries went up – no matter what was happening to commodities. In previous post-bubble contractions bond prices were trashed during weak or quiet action in commodities.

We have called these Bond Revulsions.

The party has been in all classes of bonds and so will be the bear market.

Junk (JNK) was the first to peak, which was on June 24th, 2014. Our June 12th Pivot noted that we were "Pounding the table on technical excesses recorded in Junk." The Weekly RSI soared to 80. The price-high for JNK was 41.81 and the advice was to get out of lower-grade stuff.

The low with the August panic was 35.83 and with the pressures into late September it was 35.10. The rebound clocked an impressive swing in momentum and made it to 36.65. The 50-Day moving average stopped the rally and the price has remained below the line. Not constructive.

However, long Treasuries enjoyed an outstanding rally as crude oil collapsed into January. This along with the rush to bizarre yields in Europe prompted a special study "Ending Action". Dated January 20th, it concluded that the greatest bubble in financial history was completing. The ChartWorks of February 3rd noted that the plunge in US yields had registered a rare Downside Exhaustion reading.

We expected that the reversal in the US market would eventually hit the European market, which started on April 11th.

The low yield for Treasuries was set on January 30th and the rising trend since is now attempting to extend the move. Also technically, the action in Junk is deteriorating.

Real Interest Rates

The central bank drive to negative interest rates is without precedent and overly discussed. Perhaps it is symptomatic of an impractical theory. The theory that central bank easing always forces business expansion has not been working. But the central bankers won't quit easing.

Actually, the public, not central bankers, decide which will be the next speculative item to be leveraged up. Often to its own surprise, it also decides when speculation will fail.

So let's consider that negative nominal rates indicate radical application of policy and failure. Rather than unique brilliance.

Historically, what really counts during great bubbles and their inevitable collapses has been the course of real interest rates (nominal rate net of inflation). The path has been methodical, with real rates plunging to a significant low during the mania. This can be to negative levels as in the 1873 and 1825 Bubbles. The lows were minus 8% and minus 5%, respectively. In 2007 it was minus 1 percent.

On some examples such as in 1929 the decline was distinctive but did not get down to negative levels.

But, and it is a very big point. In each of the five post-bubble contractions from 1720 to 1929, real rates increased by some 12 percentage points. It seems that a massive increase in the real cost of money is needed to end the massive abuse of credit, otherwise known as a New Financial Era.

As the 2007 Bubble completed, the real rate declined to minus 1 percent. On the bust it increased to 6 percent for an overall increase of 7 percentage points. Clearly it wasn't enough to end the endless speculation.

On the latest zoom in speculation, the real rate declined from 3 percent to 1 percent in 2014. It has since increased to the 3 percent level and it is worth reviewing the mechanism behind the rise.

Nominal interest rates increase as the rate of CPI inflation declines and commodity prices decline.

During the Greenspan chairmanship, there were times when bond prices went up with commodities. This was considered unusual and called the "Conundrum". We described the bond rally as yet another asset class being inflated in yet another New Financial Era.

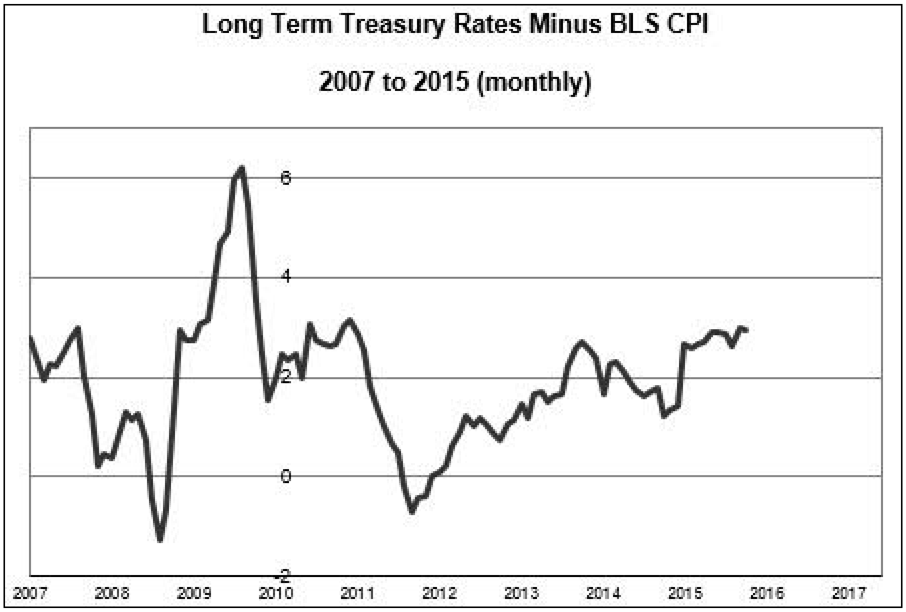
Deflation in bond prices began when Junk peaked in 2014 and Treasuries earlier in the year. This will likely continue along with generally weak commodities. The other part of the recipe is the basic feature of the post-bubble world.

The senior currency is chronically firm against most other currencies and most commodities for most of the time.

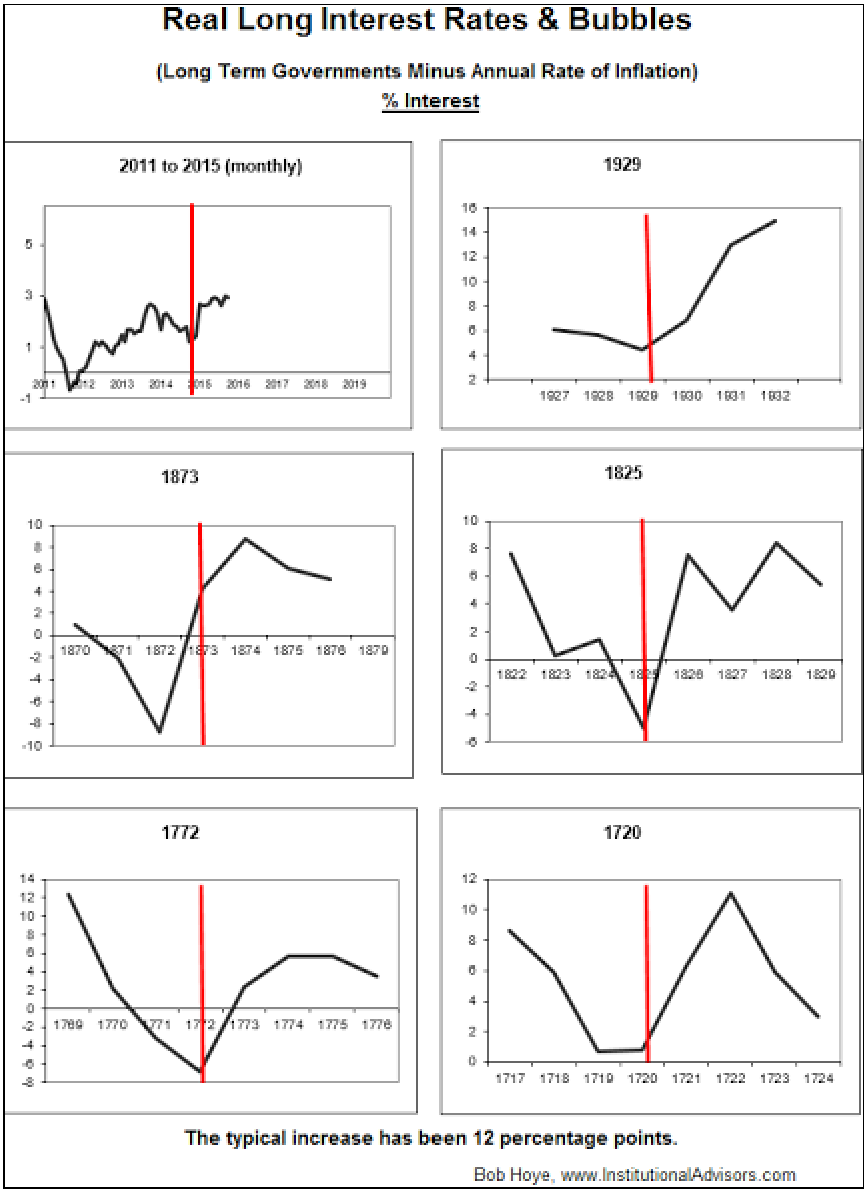
By way of summary, the latest hit to both JNK and commodities started in June 2014. Both are close to breaking down. Since January, Treasuries have set a series of lower highs in price and are also close to breaking down.

This is the basic recipe for rising real interest rates and some charts follow. Above 3 percent would be a significant event.

Real Interest Rates



- One of the characteristics of a great bubble has been a significant decline in real interest rates.
- With the 2007 example, the rate declined to –1.5%.
- In the consequent contraction real rates soar, with the typical rise amounting to some 12 percentage points.
- In 2009, the rate rose to 6%, making the increase some 7 percentage points. Bad as it was it was not the full hit.
- There has been a remarkable effort to lower nominal interest rates, but real rates have been going up.


Real Long Interest Rates & Bubbles
(Long Term Governments Minus Annual Rate of Inflation)
% Interest
2011 to 2015 (monthly)
1929
1873
1825
1772
1720
The typical increase has been 12 percentage points.
Bob Hoye, www.InstitutionalAdvisors.com