"Bond Market Bubble"

Market Commentary – February 2015

By Frank C. Fontana, CFA
President, Banyan Asset Management, Inc.
Written January 31, 2015 – www.banyan-asset.com

The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 2.6% in the fourth quarter of 2014. While the overall reading is down from the rock-solid third quarter rate of 5.0%, the components of the fourth quarter are decent. Consumer spending contributed a robust +2.87 percentage points to GDP. Investment added +1.20 percentage points to GDP, although the notoriously volatile building of inventories generated +0.82 percentage point of this growth. The strong U.S. dollar muted exports and caused imports to soar, resulting in net exports subtracting -1.02 percentage points from GDP. Government spending weighed on GDP by -0.40 percentage point. Overall, we like to see consumers and businesses driving economic growth, rather than net exports and government spending.

In its statement released on January 28, the Federal Open Market Committee (FOMC) agrees that the economy is expanding at a "solid pace". This is an upgrade from the December statement, which called the pace of economic growth "moderate". For now, the FOMC maintained its policies of the federal funds interest rate at 0% to 0.25% and the reinvestment of principal from its quantitative easing bond purchases. Moreover, the FOMC stated that it "can be patient in beginning to normalize the stance of monetary policy." In December, Federal Reserve Chairwoman Janet Yellen indicated that "patient" can be interpreted as the FOMC not raising interest rates at its next two policy meetings. If this is the case, the earliest rate hike could be announced on June 17. While the FOMC is looking to firm its policy, central banks worldwide are simultaneously loosening their monetary policies. The result has been a freefall in interest rates around the globe and a massive strengthening in the U.S. dollar.

As a result of global central banks' simultaneous easing of monetary policy, a massive bubble has formed in the sovereign debt (bond) market. A common saying is that you cannot identify a bubble until after it has burst. We challenge this convention by pointing out the massive bubble in sovereign debt. The yield on a 10-year U.S. Treasury note is a mere 1.68%. In comparison, here are rates on 10-year government bonds in the following countries: Italy 1.66%, U.K. 1.33%, France 0.55%, Germany 0.30%, and Japan 0.29%. Remember that bond yields move inversely to bond prices. Therefore, extremely low bond yields correspond to extremely high bond prices. When an investor in German bonds is willing to accept only 0.30% per year for 10 years (a total of only 3%, less inflation each year), you need to call it what it is – a bubble. What we do not know, however, is when the bubble will burst. When it eventually does, there will be ripple effects throughout financial markets. Many asset classes are priced off of sovereign debt yields. The bursting of the bond bubble will likely result in collapses in the prices of long-term bonds, the stock market, and real estate; gold could skyrocket.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are bearish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) over the next 12 months is $121.31, which implies a price-to-earnings (P/E) ratio of 16.4 with the S&P 500 at 1995. The earnings yield (E/P) of 6.08% represents attractive value relative to the 10-year U.S. Treasury note yield of 1.68%. Earnings estimates have been slashed over the past month. The strong U.S. dollar and the low price of oil are taking their toll.

With two high-volume sell-offs last week, the S&P 500 is at risk for breaking below its 200-day moving average (1975). Should support fail, the next logical test is 1860. A rally higher from that point could set up a bearish "head-and-shoulders" pattern. Our market breadth indicator slipped into negative territory on January 14. The bearish technical patterns seem to correspond to investors anticipating an increase in interest rates from the Federal Reserve. We plan to buy incrementally into any weakness, emphasizing value stocks (attractive valuations, low betas, strong balance sheets, and high dividend yields). This is the type of scenario when cash earns its true return.