What Is The Next Bubble?

US Government Securities

Ralina Georgieva

American University in Bulgaria
Major: Business Administration
Minors: Economics, European Studies
US Government Securities – the next bubble

By Ralina Georgieva

The currency crisis

The stock market bubble of 2000 became the housing bubble of 2006 and now the credit crisis. With the government trying to paper over each successive crisis, federal deficits have spun out of control. Doing its part, the Federal Reserve has ballooned and in the process debased its balance sheet with all manner of toxic waste, seriously undermining the long-term strength of the currency. 2010 has every prospect of being an interesting year, to say the least. The big picture incorporates enormous US government debt, real estate loans that are still defaulting, aggravating commercial real estate issues, considerable unemployment, and a massive government spending regime. The US is now firmly on the path to the next logical stop in the progression: a currency crisis. However, the majority of economists throughout the world have quite favorable projections for the state of the economy forecasting 3% growth and only nominal increase in interest rates.

But let us question the status quo.

The meltdown in the global financial markets created an extensive wave of distress. As a result, many resorted to what has always been considered safe – short-term U.S. treasury securities. In order to pay for its expenditures, the U.S. government levies taxes. When expenditures exceed tax revenues, the government borrows money. It does so by ordering the Treasury Department to sell government IOUs to investors in the form of Treasury bills, notes and bonds, known as “Treasuries.” Despite the fact the U.S. public debts is on the increase, amounting $12,311,350 million (12,311 trillion), as of December 31, 2009¹, the investors are willing to lend money to the government since the U.S. has never failed to meet a debt payment. The rush into government securities has put pressure on the yields and in 2008 has driven them down the lowest, even negative, levels since the Great Depression.

Given that investors have been quite averse to asset classes operating in commercial real estate markets, equity markets and such that are incorporated in the work of insolvent banks, we have observed a considerable appetite for fixed-income government securities. The case with those instruments, however, is that when their price rises, the yields fall. The idea

here is that when foreigners buy more US debt, the interest rate on the Treasuries drop. In October, 2008, foreign central banks bought more Treasuries than they had ever done before; at an annualized rate for the quarter, they would have added up $750 billion. That drove the rate on the 10-year Treasuries down to close 2% in December, 2008. This was also triggered by the widespread panic when the Fed handed out $500 billion in currency swaps to foreign central banks. The dollar rose as that time as well.

Since then, foreign purchases have decreased and the interest rate has risen. While there are many other factors at work, the indication of having foreign purchases decrease to $200 billion annualized for the last quarter means that the Treasury should find other buyers at perhaps higher rates.

“The Inflation Holocaust”

Even though many economists believe that 2010 will be marked by growth, decline in unemployment, and stabilization of the dollar in regard to other currencies, we should question the mainstream projection. The dollar will continue to erode in 2010 and we will experience a major decrease in its purchasing power contrary to what many expect. Higher inflation and higher interest rates will result from the Fed’s irresponsible monetary expansion and subsequent government deficit. Nobody could escape the laws of money. If we turn on the printing press, we will eventually end up possessing dollars that worth less. The real source of inflation does not come from wages or bank lending but rather from unsupported government spending. Once people take inflation as what it really, interest rates would go up in order to compensate the lenders for the expected decline in the purchasing power of the dollar.

Figure 1. presents the considerable increase in U.S. monetary base.

---

2 “We are facing an “inflation holocaust”, Jim Rogers  http://www.cnbc.com/id/27097823/
Big government spending has proved to be inefficient, so the positive effects are frequently less that the costs. For instance, approximately $3 trillion has already been spent at large banks and a couple of Detroit giants with little effect. Banks are not making loans but instead holding excess reserves deposited at the Fed. It is important for our forecast to mention that the government is showing no real intention to slow its aggressive spending. At the end of last year, Treasury Secretary Geithner announced a lifting of the caps on the government’s financial support for Freddie and Fannie. Until that, the caps were set at $200 billion each, or $400 billion total. In 2010, the government’s involvement in and dedication to these two failed and ineffective institutions is to be come unlimited. That implies two things: that the government policy is to continue to spend to bail them out at all costs and that the problems that Fannie and Freddie face are worse than $400 billion.

There are other factors that contribute to the worsening of the US government deficit such as the new unqualified borrowers supported by the almost bankrupt Federal Housing Authority (FHA), the worsening conditions in the Federal Deposit Insurance Corporation (FDIC) and its depleted insurance fund, the actively borrowing from the federal government State Jobless Funds responsible for paying unemployment claims, and the newest batch of 30,000 soldiers to be sent to Afghanistan adding $30 billion per year to the deficit. Lastly yet
importantly, the $75 trillion of baby boomer bubble retirement obligations that will increasingly become due and payable.

To sum it up, the US is already bankrupt. Considering the new Healthcare Program, the government deficit will exceed farther than can be managed. Running a $1.5 trillion deficit to fund $3.5 trillion in government expenditures means the federal government is now borrowing 40+% of the money it spends. It should be highly cautionary that when that same ratio reached 60% in Weimar Germany, the government completely lost control and a hyperinflation ensued. The result of these deficits will be a dollar debasement that will surprise most traditional economists and market analysts. In 2010, we will most probably have mild but increasing inflation that will push interest rates higher, putting downward pressure on the price of bonds and making the government's deficits even worse.

**Downward pressure on the price of bonds**

In order to keep its own financing cost low, the Treasury has dramatically shortened the duration of its debt offerings. As a result, when higher rates return, the interest cost on federal deficits will adjust upwards much more quickly than would otherwise be the case. Consequently, if the Fed tries to support the dollar by raising rates to keep foreigners buying our debt, it will immediately translate into higher interest costs to the government. It is an interconnected web with no easy way out.

With the eight-year-long slide of the dollar, there is the obvious expectation that, in time, rates will have to rise to offset these losses and anticipated future losses in the dollar. If foreigners decide to divest their dollar holdings, they’ll do so by selling Treasuries, and that will drive rates higher and prices – lower.

**The toxic asset is US Treasury Bonds – Buffet and Roger’s view**

The US and the world as a whole are about to experience the biggest ticking financial time bomb due to the fact that the US government have followed one of the most irresponsible financial policies in history. Treasury bonds would most probably be the new toxic assets. 10-year Treasury bonds have a record of being the most popular investment and now they would turn into the most risky ones. Interest rates have one direction to go, so does
US Treasury bonds. As Jim Rogers pointed out in December, 2009: “The only bubble I see developing in the world right now is in long-term government bonds in the United States. The idea that somebody would lend money to the United States for 30 years in U.S. dollars at 4 or 5 or 6 percent interest is incomprehensible to me.”

Warren Buffets also shared his concern regarding US Treasury bonds by warning investors that “The U.S. Federal Reserve and Treasury Department going all in to jump-start an economy shrinking at the fastest pace since 1982, "once-unthinkable dosages" of stimulus will likely spur an onslaught of inflation, an enemy of fixed-income investors.”

If interest rates rise, for instance, bond prices will fall dramatically. The prices of even seemingly risk-free Treasury and municipal bonds could fall 30% or more if interest rates increase over the next few years. Some corporate bonds could fall even more. The 4.7% annual interest that a current 20-year Treasury bond is paying would most probably seem attractive now compared with a bank certificate of deposit but it will seem mediocre in five years when interest rates rise and banks start offering 7% CDs. In such a case, for example, an investor would be stuck it bonds maturing in 2030.

Still, individual investors continue buying up bonds. In October, 2009, when there were barely any attractive bond deals, investors bought nearly $88 billion in bond funds, or about $118 million an hour. If the US experience severe inflation as it most probably will, bond return would worsen significantly. As we already pointed out, in order to tackle the financial crisis, the US government injected huge amounts of liquidity into the system. This would inevitably lead to rampant inflation which in turn would diminish the purchasing power of bonds’ interest payouts. Many investors do not take into consideration the risk associated with fixed-income investments that they are not adjust for inflation.

To sum it up, the U.S. government will resort to paying increasingly higher interest on U.S. Treasuries in order to attract investors which will push prices down, and the yields demanded by investors up. The safe heaven of buying US treasuries is no longer the case.

4 http://uk.reuters.com/article/idUKTRE51R1Q720090228
**Currency, Interest and Default Risk**

The early ‘80s, when long U.S. Treasuries were yielding 12% and better, was the best time to buy bonds in living memory. Now, however, is probably the best time in living memory to sell bonds. In fact, let’s go further. Selling U.S. government bonds now is probably the safest and highest return speculation one can make. There are three reasons why that is true:

1. **Currency Risk** - The bonds are payable in dollars. Those dollars are certain to be worth much less in purchasing power. And soon. The situation is not likely better for other currencies.
2. **Interest Rate Risk** – Interest rates are at historic lows, which means bonds are at historic highs. Rates are headed back toward historic highs, which means bonds are going into a huge bear market.
3. **Default risk** – We have all seen what happened to GM, Chrysler, Fannie, Freddie, Lehman, Bear, and others. There are plenty more to come.

**Short-term Interest Rates**

The U.S. budget deficit for FY 2009 rang in at just under $1.4 trillion, nearly three times the previous record, and expectations for FY 2010 are no better with a projected deficit between $1.5 and $2 trillion. There is no end in sight for the reckless spending either: the White House is now projecting that the federal deficit will grow by $9 trillion over the next decade.

In order to fill its widening budget gaps, the Treasury is reaching into its bag of tricks, including purchasing $300 billion of its own debt in order to keep interest rates down. As we can see in the following chart, the new supply of Treasuries has been focused on the short end of the yield curve.
This skewing towards the short term, while helpful in attracting buyers, leaves the Treasury with the daunting task of having to roll over its short-term debt in the near term, while simultaneously trying to add another trillion dollars a year to the deficit.

So far, the Treasury has had little trouble attracting investors for its massive debt auctions. Foreign dollar holders continue to do their best to support their own currencies by supporting the dollar – purchasing 45% of the $1.917 trillion in U.S. notes and bonds sold in 2009, compared to only 29% a year ago.

That continued foreign support, along with purchases of its own debt, has allowed the Treasury to keep a lid on its borrowing costs. That will become increasingly difficult as trillions of dollars worth of additional debt is forced into the market at the same time the bubble now forming in short-term debt starts maturing and needs to be refinanced. Interest rates on Treasury debt will have to rise in order to attract new buyers.
Given the monumental government deficits and Federal Reserve monetary expansion, we also have to allow for the possibility of a dollar crisis. While that may be an extreme scenario, at the least I expect to see inflation on the rise for many years. With the government’s debasement of the currency, an inflationary result should not come as a surprise to anyone – but will.

The Greater Depression is Here

It’s been 63 years since the Great Depression ended in 1946. From then until the early ‘60s, the U.S. enjoyed a genuine boom. The conditions for prosperity were right. Among the major countries, the U.S. economy was the freest, which was by far the most important factor. The U.S. also possessed the largest accumulation of physical and human capital, both absolutely and per capita. And its savings rate was high; Americans produced much more than they consumed.

The boom ended in the mid-‘60s, when the U.S. government undertook a policy of “guns and butter” - Cold War plus Vietnam War plus Great Society – which it paid for with taxes, debt, and money printing. What ensued was an era of stagflation – a tumultuous series of increasingly severe recessions and worsening bouts of price inflation, with higher...
unemployment, higher government deficits, higher interest rates, lower real stock prices, and international monetary turmoil. The most notable victim was the dollar itself, which lost its last link to gold in 1971.

The process driving stagflation seemed to end in the early 1980s, with the Reagan policies of lower tax rates and slower money printing. Those policies achieved what has been called the Long Boom, but it wasn’t quite a return to conditions pre-Great Society. The dollar remained unattached to gold or anything else, and few of the costly projects invented in the preceding decade were abandoned.

By the time the Long Boom ended in 2000, the U.S. had long since shifted from being the world’s biggest creditor to, by far, its biggest debtor. The savings rate collapsed, so the country financed its rising standard of living through debt, which meant exporting trillions of dollars in IOUs in exchange for consumer goods – cars, clothing, electronics, recreational drugs, and miscellaneous chotska – much of which has, or will, wind up in landfills.

With enough government twisting of the economy – taxes, subsidies, prohibitions, regulations, and money printing – a depression becomes both unavoidable and useful. It becomes unavoidable because it can only be postponed by ever more ambitious exercises in government tinkering. Again raising taxes. Again borrowing money. Printing up still more new dollars. Imposing regulations that reach even further. A depression becomes useful because it’s needed to wash out the wasteful patterns of production and consumption that the government policies have encouraged.

But that sort of thinking is far out of the mainstream. It would be fair to call it taboo. Since the days of Roosevelt’s New Deal, most people have believed that government not only should but can “fine tune” and control the economy. It’s thought “politically impossible” for a president to allow a depression to occur on his watch.

But it is happening anyway. There will not be a serious recovery from this “recession” for a long time. The reason is that the government – which is far more powerful than ever before – is not just doing the wrong things.

So is it going to be significantly different this time? Is the crisis that started in 2007 “it”? My answer is that what is underway now is going to be a lot different from any recession since World War II. And very probably, yes, this is the Greater Depression.
REFERENCES:

Frank Fabozzi, The Handbook of Fixed Income Securities
Murray N. Rothbard, The Case Against The Fed
Peter Schiff, Crash Proof: How to Profit From the Coming Economic Collapse
Ron Paul, The Revolution