THE OMNIVEST MARKET VIEW

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Don't Be Lured Into the JGB Trap

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Bond bulls have come up with yet another reason why US Treasury yields will remain low for years to come, if not decades, citing the example of interest rates on Japanese government bonds have remained at ultra low yields for 20 years. Even though this correlation is interesting, it is also very misleading. The reason why investors should not be lured into thinking that there will not be a bond market bubble relates to the structure of Japanese Government Bonds (JGBs) versus US Treasuries.

According to the Ministry of Finance (MOF) in Japan, foreigners hold only 6.8% of outstanding JGB debt. By way of contrast, foreigners in the US hold about 56.7% of outstanding marketable Treasury debt or about $2.6 trillion. Moreover, the two largest foreign holders of US Treasuries, China and Japan, hold $1.65 trillion or nearly 63% of the aggregate foreign interest in US Treasury bonds.

As a result, bond holders have to rely on the steady hand of foreign demand in order to keep interest rates from moving back to fair value. The additional source of demand for US Fixed Income assets (which should be considered temporary) is the massive increase in the Federal Reserve's balance sheet. It has increased from $869 billion in August of 2007 to over $2.4 trillion today.

The Federal Reserve indicated at the August 10th FOMC meeting that they would continue to maintain the size of their balance sheet by reinvesting interest income and principal payments back into the Treasury markets. This action has only acted to deepen the bullish fervor of fixed income investors.

Retail investors have also been increasing their appetite for Treasury notes and bonds by moving out of near zero yielding money market funds and equity mutual funds. The "safety" of owning Treasury debt has almost become cult-like.

Investor demand for fixed income assets has created an accelerated issuance of long-term corporate debt which has allowed corporations to lock in ultra low borrowing costs. Norfolk Southern took advantage of low interest rates by issuing a 100 year bond yesterday at a yield of 5.95% and was able to increase the debt offering from an original offering of $100 million to $250 million just prior to issuance. The issuance of long-term debt has increased by nearly 50% this month, as corporate yields have fallen to their lowest levels on record.

If interest rates are so low as to entice an increase in long-term corporate borrowing, investors should ask the question; "If borrowing costs are at record lows, shouldn't they expect returns from the fixed income markets to also be relatively low?" In other words, is it more prudent to borrow for 100 years at record low interest rates, or is it more prudent to lend for 100 years at record low interest rates?

The fact that JGBs were able to stay at ultra low levels for two decades is not the result of an open market where demand increased or decreased freely. To be more than frank, the JGB market is a closed market with demand controlled by the Japanese government. On the other hand, US interest rates are determined by the stability of investor demand. From my perch, I would be very nervous holding long-term Treasury debt knowing that China is in the process of diversifying their portfolio. In the most recent month, data shows that China has reduced its US Treasury holdings by $24 billion.

Imagine what happens when the largest foreign holders of Treasury bonds (China & Japan) stop adding to their positions and the Federal Reserve also begins to reduce its balance sheet. What would be the likely outcome for the bond market? It is my opinion that the Treasury market is indeed in a bubble state and it is being promoted by an unusual suspect, the Federal Reserve.

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