the advisor

Summer 2024

# Inevitable

*"History never repeats itself; man always does."* Voltaire

*"You're gonna need a bigger bra…"*
(with apologies to the scriptwriters of Jaws)

If following the typical financial bubble we get the usual bust, what might follow an epic bubble?

Generally, three asset classes account for most wealth - bonds, property and equities (leaving aside more esoteric assets) - and for most bubbles. What funds bubbles is credit expansion. Nothing in the markets is ever certain, especially analysing "bubbles". Nevertheless, we shall attempt a brief assessment of the current situation.

Let's start with bonds and debt servicing. These days, investors are focussed on monetary policy, specifically when and how much the US Federal Reserve will cut interest rates. In January, the market was pricing in six 25 basis-point rate cuts this year, and so far the Fed has disappointed with zero cuts.

The implication is critical for government spending. The US Treasury is the American economy's largest borrower. Higher for longer interest rates contribute to greater budget deficits, now running at 6% of GDP. The cost of servicing the debt - the interest expense - is taking up a growing portion of the budget, leaving less room for other expenses. That means the government has to borrow increasingly larger amounts to maintain basic programmes. The more the American government borrows, the larger the interest expense, which causes it to borrow even more. A classic debt spiral.

Thus, fiscal spending is dominating the Fed's attempt to tackle inflation. The Fed must print ever-increasing quantities of money to fund the government or the system could collapse. For the foreseeable future, low interest rate era Treasury bonds will be maturing and have to be refinanced at today's higher rates. Financing costs are growing faster than the economy and approaching US$1 trillion. The interest expense is already greater than defence spending and everything else in the budget except for Social Security.

This fiscal predicament will worsen the longer real (after-inflation) interest rates remain elevated. When the economy deteriorates, the likelihood of extreme monetary accommodation (i.e. yield curve control, debt monetisation, interest rate cuts, etc.) increases accordingly. This could be why both real interest rates and gold prices are rising simultaneously. The recent price action of gold suggests investors believe the current debt servicing trajectory is unsustainable.

It's not just the government that has an interest rate problem. Let's move onto regional banks.

Regional banks are crucial to the localised economies they serve. During the pandemic, banks, flush with cash from depositors, loaded up on long-term Treasury bonds because they had a yield above the zero rates found in Treasury bills. Treasury bonds have always been considered riskless investments. If you owned a Treasury, there was a certainty that the price of it would gravitate to par upon maturity, and you would get the coupons along the way, plus your maturity payment at the end. With the Fed keeping interest rates artificially suppressed for ten years after the 2007-09 financial crisis, and then crushing rates back to zero again during the pandemic, many bankers assumed that the era of easy money would never end.

Then inflation happened. The Fed raised interest rates from 0.25% to 5.5% and Treasuries collapsed by 30%. Last year, four regional banks, caught in the sovereign bond bloodbath, had to be shuttered. The Fed temporarily papered over the problem with the Bank Term Funding Program (BTFP) which allowed other troubled banks to borrow money against their devalued Treasuries at face value. This gave banks the ability to raise capital against their bond portfolios without realising losses from an outright sale. It also kicked the can down the road for another year. That year was duly up in March but banks haven't paid back much of the money they borrowed. As of April 30, the BTFP still had an unpaid balance of $148 billion.[1]

The bond bubble is deflating - but we're probably only part way through. The high level of unrealised Treasury losses still sloshing around in the banking system means a lot of regional banks are in the same precarious position as the four failed

1401 - 675 West Hastings Street, Vancouver, BC V6B 1N2, Canada Phone: (604) 687-5884 Fax: (604) 681-9694 Email: admin@investwell.ca

**Inevitable (cont'd)**

banks were last year. How much of a slip in the economy would it take to push other banks over the edge?

Banks' balance sheets are also under pressure from their loans to the commercial real estate (CRE) market. That sector faces falling demand, falling prices, and rising interest rates. The pandemic model of remote work has cratered demand for office space and vacancy rates have soared. This has put significant stress on commercial property prices. Citigroup estimates regional banks hold 70 pc of all CRE loans. According to the Mortgage Bankers Association, around US$1.2 trillion of CRE debt will mature over the next two years. CRE borrowers are now having to pay up - or risk default. The commercial property market bubble has been punctured.[2]

Investors have a new headache: it is the obscuring of the information and pricing signals emanating from the debt market. As Lyn Alden, a money manager, has pointed out: "The structure and size of the market is such that intelligent bond traders are not the primary movers of the market anymore. As a result, the informational value that we can get from the bond market is now greatly diminished."[3]

Next, onto equities. The stock market takes its "diminished" pricing cues from the bond market. A relatively quiescent bond market gives assurance to investors to take on risk. As a sign of euphoric sentiment, many punters have been pouring leveraged money into increasingly expensive stocks.

The American stock market is, once again, flirting with giddy valuations (see chart this page). This doesn't mean the market will crash next week. It does suggest buying at these levels could take years to pay off. But if the market were to normalise around past levels, it could easily fall by 50%. The equity market bubble has yet to burst, and probably won't as long as the government keeps pumping borrowed money into the economy.

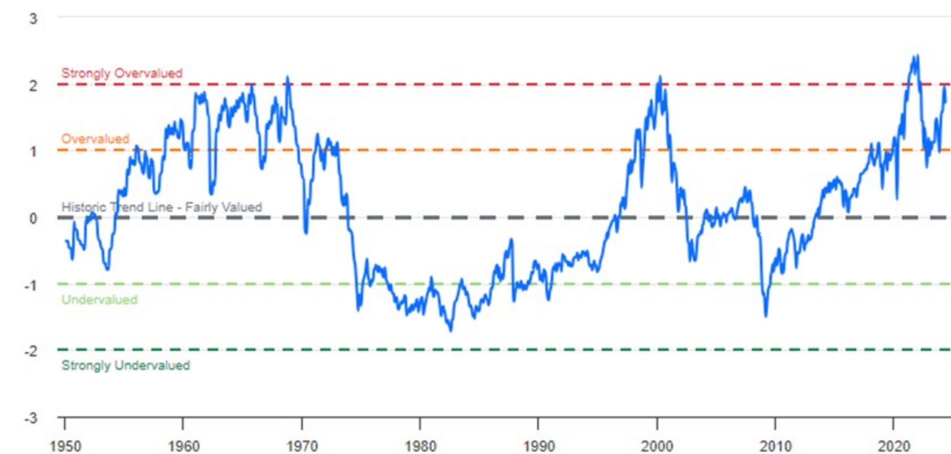
All of this is important because these asset class debts and their various market risks have now been kicked up to the government level. When the next crisis occurs, it will have to be the sovereign level (i.e. the taxpayer) that must bear the brunt of it.

Already burdened by US$35 trillion of federal debt and a debt-to-GDP ratio of 120%, America is staggering towards a debt abyss. The gravitational pull of the debt will be a drag on economic growth for years to come. What is the option for the U.S. government if they continue to borrow and spend? The only answer - apart from default - is inflation. So bond investors will have to suffer negative real rates. That means the coupons on Treasuries will need to be lower than the inflation rate, and they will have to remain so in perpetuity.

The 20th century economist, Ludwig von Mises, neatly sums up the Fed's predicament: "There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as the result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."[4]

Bottom line - confidence in the system is what matters. But confidence is hard to quantify, harder to model, and hardest to predict. When investors lose confidence in the US Treasury market, it will feed into the US dollar. That's when the Fed will face its thorniest quandary yet: fight inflation or debase the currency.

The US dollar is tied to the Treasury market which is hostage to government spending. An epic bubble appears present in the credit markets. Baring a miraculous improvement in economic growth, we are heading for the inevitable bust. Best be prepared for a bra sizing.




**Sources:**


1. Mike Maherrey, "Is There A Financial Crisis Bubbling Under The Surface?", Money Metals, 10 June 2024
2. Ibid
3. Lyn Alden, "The Bond Market is the 'Dumb Money' Now", Newsletter, 29 May 2024
4. Ludwig von Mises, "Human Action: A Treatise on Economics", Yale University Press, 1949
5. Chart this page, Buffet Indicator, https://www.currentmarketvaluation.com/


*The information contained herein has been prepared from sources believed reliable but is not guaranteed by us as to its timeliness or accuracy. The views expressed in this commentary reflect those of TFP Investment Counsel Corp (TFP IC) as of the date of this commentary. These views are subject to change at any time and TFP IC disclaims any responsibility to update such views. These views may not be relied upon for investment decisions and should not be considered a recommendation by TFP IC to purchase or sell any security. This data is intended solely for our clients, is for information purposes only, and may not be publicly disclosed or distributed without our prior written consent.*