

Credit Markets Don't Lie: But They Do Confuse

*A version of the below essay, on the current state of the bond market and the U.S. economy, was published by **The New York Times** earlier today, as part of its Dealbook blog, edited by Andrew Ross Sorkin. Please do not hesitate to offer comment at the Times' link below.¹*

Much has been made lately of a possible bubble in bonds. The rapid decline in yields could certainly be taken for evidence of over-exuberance. The fact that we are seeing bonds rally up and down the credit spectrum adds to concerns about the existence of a fear driven rally in fixed income.

Market analysts are also fretting about (a) the level of investment capital inflows (much of it from domestic sources) to credit markets, relative to net withdrawals from equities and (b) the impact of the Fed's announcement that it will be re-deploying run off from its existing positions to support the market and ensure low yields.

Nevertheless, for all the support the bond market is receiving from the prevailing mix of panic and policy, the fact remains that there is no perceptible increased demand for capital, sufficient to offset the rather small flow of new issuance in the government and corporate fixed income markets.

The lack of demand for money has been signaled by the bond market all year – even back when the "V-shaped" recovery crowd was misinterpreting short term surges in economic activity.

Many corporations have yet to find productive use for their prodigious capital reserves (other than to reduce debt); real assets are for the most part over-leveraged already and not available as collateral for fresh lending; inflation is an all but distant memory lifting "real" (inflation adjusted) returns on bonds; and the consumer is de-leveraging rather than spending.

The only meaningful debt issuance today, as a practical matter, has been undertaken to push maturities farther out on the yield curve to take advantage of longer term rates that are cheaper than any since the 1960's (but for a brief moment during the panic of Q1 2009). Total outstanding debt in the U.S. (in all business, consumer and governmental sectors) – after more than doubling to \$52.6 trillion from 2000 through 2008 - is slowly, but inexorably, declining (down about 1% through Q1 2010) despite large government deficits.

Those seeking a rosier scenario point to a historically steep yield curve measured in basis point spread – which some believe signals expectations of greater demand for capital, and inflation, in the future. But since the U.S. Treasury began to reissue the 30-year bond (after a hiatus of four years) in 2006, as now a period of negligible CPI inflation,

¹ <http://dealbook.blogs.nytimes.com/2010/08/24/another-view-gleaning-the-bond-markets-message/?ref=business>

the prevailing yield on that security has fallen by over 18% to about 3.7% at this writing from the 4.5% average in that year.

Long term yields, while preserving some modicum of inflation expectations relative to the short end of the curve, are not signaling future growth as much as they are slowly accommodating themselves to the Japan-style, easy money policies of the Federal Reserve (the treasury curve has steepened because short term rates are near-zero, not because long term rates have gone higher).

The lack of demand for capital is, not surprisingly, underpinned by the performance of the economy itself. As is generally the case after any material economic recession, we have seen deferred demand for goods and services deliver spikes in consumer activity, inventory restocking and, therefore, demand for manufactured goods (mostly, unfortunately, from abroad). Similarly, businesses with sufficient resources have engaged in a modest amount of capital spending.

But post-Q1 2009 consumer activity – some 70% of our economy – has come in the form of "echoes" of the original crisis, dating to November of 2008, when spending fell off a cliff and the savings rate ballooned (mostly via consumer debt repayment). Since then we have seen three detectable waves of revolving debt repayment correlated with spending declines, and re-borrowing correlated with slight improvements in retail sales. Burdened by a mountain of consumer debt and persistent unemployment, the economy has proven unable to achieve "escape velocity" and generate steady demand.

Beginning in 2007, the U.S. economy experienced a degree of non-commodity asset deflation (in the prices of housing, commercial real estate and corporate equities) unseen since the Great Depression. With the economy apparently unable to navigate through or around the prevailing headwinds, recent activity in the bond market is legitimately signaling concerns about the potential for deflation in ordinary goods and services and, ultimately, wages – some of which concerns are already being realized.

The existence of a global oversupply of labor and physical productive capacity, neither of which is being meaningfully absorbed according to recent statistics, means the bond market can hardly be accused of behaving irrationally.

While there has been a miniscule amount of wage growth on a unit basis, the percentage of the employable population with jobs continues to decline – such that aggregate wages earned per capita in this country are continuing to decline. If that phenomenon continues unabated – as recent weeks' jobless claims data implies – renewed downward pressure on unit labor costs is more likely than not.

Wage deflation is particularly insidious, as it would ignite not only price declines at the consumer level, but could also set off renewed pressure on the price of assets – as demand falters for that which can no longer be afforded.

The decline in fixed income yields also feeds on itself to a meaningful extent in terms of its impact on savers. For each 1% decline in interest rates on government debt in the U.S. (all forms) nearly \$150 billion of income is not received by investors, resulting in additional pressure on consumption.

Certainly, prices in the bond market are exposed to the "risk of recovery," as odd as that sounds. But what the market, and the fundamentals of the economy, is signaling is that recovery that produces any meaningful demand for capital, and extinguishes deflationary pressures, will be painfully slow to materialize.

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Daniel Alpert is a Managing Partner and Founder of the New York-based investment bank Westwood Capital, LLC, and its affiliates. He is a frequent commentator on the housing and credit crises on the CNBC, Bloomberg and FoxBusiness networks, as well as in leading newspapers, periodicals and websites.